Money, Markets and the State.
Some Notes on Social Democratic Economic Policies Since 1918.

by

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ABSTRACT
The essay examines macroeconomic policy strategies of Social Democratic parties since 1918 in five West-European countries (Germany, the Netherlands, Norway, Sweden and the United Kingdom). Three regimes can be distinguished: a gold standard regime, from the early 1920s to the mid 1930s; a growth regime from the mid 1930s to the early 1970s; and a disinflationary regime subsequently. Maintaining a fixed exchange rate by means of restrictive macroeconomic policies enjoyed priority under the gold standard regime. Since macroeconomic policies were assigned to the defense of the exchange rate, unemployment was interpreted as a micro level problem of excessive costs. Accordingly wage cuts and downsizing of welfare spending appeared as the best way to improve economic performance. This created a dilemma for Social Democracy as the interests of its constituency seemed to be inimical to economic prosperity. This dilemma was overcome during the 1930s when expansionary macroeconomic policies and a densely organised civil society came to be considered essential for fostering growth. This policy constellation confirmed the core Social Democratic tenets that interventionist policies are needed to promote prosperity and that a strong labour movement benefits the economy as a whole. The emergence of this regime lay the foundation for the dominance of social democratic concepts in economic policy making during this period. Since the 1970s macroeconomic policies have been assigned to disinflation. Accordingly unemployment is interpreted again as a micro level problem. Therefore a dilemma emerged for Social Democracy which in a number of ways resembled the problems of the 1920s. The changes in regimes themselves were the result of the emergence of cumulative changes in the price level. The Gold Standard regime was established in response to runaway inflation after 1918. The rapid deflation during the Great Depression, led to the establishment of a regime which, amongst other things, relied on a strong civil society in order to prevent rapid downward movements of nominal prices. The erosion of the ability to maintain inflation low under tight labour markets by means of some form of incomes policies has provoked a renewed regime shift since the early seventies.
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An Overview of the Argument

Since the First World War, European societies have jointly gone through three major redefinitions of the proper role of the state in the economy. In each case the boundaries between government and civil society were significantly redrawn with far-reaching implications for the conduct of economic policies as well as the character of political accommodation in general. The change in responsibilities assigned to economic management in each instance coincided with a paradigmatic change of view concerning the role of economic policy in advanced industrial societies.

In reaction to the high inflation from the mid teens to the early twenties, West-European governments, within a span of five years, embarked on a policy regime which elevated maintaining a fixed gold parity to the position of sole macroeconomic policy concern. The postwar inflationary mayhem was generally perceived to be the result of ill-guided attempts to mitigate domestic distributional conflicts by means of fiscal expansion and the printing press. Accordingly the resurrection of the Gold Standard was to provide a "knave-proof" protection against politically caused economic instability, limiting as much as possible the access of domestic political actors to monetary policy decisions. Since the experience of high inflation had allegedly shown that macroeconomic policies could not durably alter output, responsibility for growth and employment apparently could not be placed with the state but instead had to rest with civil society. If the growth rate of an economy indeed depended on individual’s saving decision and unemployment on the real wage workers desired, it would be rather difficult for the state to alter the performance of the economy, at least as long as it was willing to respect the individual economic choices made by its citizens. Especially with respect to demands for employment policies, governments stressed that the unobstructed operation of the labour market was the most promising road to full-employment while expansionary fiscal and monetary policies were argued to either reduce the room available for private investment or merely result in inflation.

In the turmoil of the Great Depression, however, the Liberal belief in the self-regulating market came to be widely considered fundamentally erroneous. Apparently the price governments had to pay for their abstention from discretionary policies was the worst economic recession in recorded history and a threat to the legitimacy of liberal democracy. Rather than being a threat to the functioning of the free market, activist macroeconomic policies now came to be seen as a means to ensure full employment and economic stability in the face of a market economy which could not

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1 Clarke 1988, p. 27.
provide either. In a full U-turn, independent central banks, who in the preceding decade were heralded as the strong institutions which would restore monetary discipline to society, came to be seen during the Great Depression as one of the major villains in the piece, who had sacrificed the interests of society in general in favour of the particularistic interests of haute finance. Accordingly monetary policy lost its position as providing an exogenous framework for macroeconomic policy decisions and instead became an integral part of overall policy goals. Moreover, Keynes’ contention that countercyclical fiscal policies could maintain full-employment became a generally accepted dogma for most governments after World War II.

While the recognition that market economies could not be left to their own devices, but needed to be stabilized, was politically more amenable to long held convictions amongst the political left, the centre and right of the political spectrum seemed equally ready to recognize the bankruptcy of Laissez-faire. Indeed, in several countries the most vocal opposition against the Gold Standard and deflationary policies was voiced by farmers for whom falling prices and credit restriction threatened immediate ruin. Rather than giving rise to further political polarization over the proper responsibilities for and conduct of economic policies, the Great Depression stood at the cradle of a new policy consensus based on the belief in the desirability and feasibility of activist economic policies. While the transition to a new orthodoxy proceeded at a different pace and to a different degree in the specific European countries, by the end of the 1940s governments had generally accepted responsibility for domestic growth and employment, which a free market allegedly could not provide to a satisfactory degree. In most European economies this new policy orientation came to be expressed in a legal framework, which defined the goals of macroeconomic management in terms of a so-called magic quadrangle. The four sides of the quadrangle being growth, price stability, external payments equilibrium and full employment.

It was not until the early seventies that this policy consensus was fundamentally challenged. Confronted with escalating inflation, unstable exchange rates, burgeoning social welfare systems and rising budget deficits, governments throughout western Europe found it necessary to reconsider the policy convictions inherited from the Great Depression. In a complete reversal of the post Great Depression regulatory optimism, government intervention now frequently came to be seen as the

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2 Perhaps the most ambitious interpretation of the epochal nature of this change was provided by Karl Polanyi (1957), for whom the Great Depression signified the final failure of the market economy and the transformation to a more regulated economy.

3 As similar interpretation of economic policies can be found in Article 104 of the Rome treaty. And also in the USA this policy view entered legislation in the form of the Employment Act (1946) and the Humphrey-Hawkins act ".. which gave the government responsibility for employment and prices.” (Meltzer 1998, p. 2).
main source of, rather than the cure for, economic instability. While Britain may have been confronted with more deep rooted economic problems than most of its European neighbours, James Callaghan's famous recantation of macroeconomic interventionism would gradually come to be shared by most parties on the continent. "We used to think that you could spend your way out of a recession, and increase unemployment by cutting taxes and boosting government expenditure. I tell you in all candour that that option no longer exists, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as a next step."4

The changing economic policy orientation in each of these periods has been of decisive importance for the overall pattern of political interest intermediation. The state’s acceptance of the postulate that expansionary monetary policies only lead to inflation and the priority given to a fixed exchange rate target, implied the need to exclude organized interest from the decision making process on monetary and exchange rate policies. Corporatist bargaining rests on the willingness to coordinate policies between fiscal and monetary authorities and trade unions and to offer quid pro quos, for example lower interest rates and fiscal expansion in exchange for moderate wage policies. In a regime where expansionary macroeconomic policies are considered inflationary and the central bank has been tied to the mast of a fixed exchange rate, both the willingness and the institutional ability of the state to pursue corporatist strategies is absent. Given the priority of a fixed exchange rate, the central bank is structurally unable to offer quid pro quos as it has to vary its policies with respect to the requirements of the balance of payments and not in accordance with the outcomes of a domestic process of policy concertation. Moreover, the presence of organized economic interests and welfare arrangements, which protect wage earners from the market pressures of unemployment, under this macroeconomic policy constellation must be considered an obstruction to the states policy goals as they tend to obstruct the flexible adjustment of domestic prices, on which a policy which excludes exchange rate changes must rely to a large extent. With monetary policies considered unable to affect growth and employment, the low growth and mass unemployment which tends to be characteristic of such periods is inevitably attributed to microeconomic causes. Extensive social welfare systems, the trade unions’ resistance against real wage cuts and more labour market flexibility, cartel agreements and insufficient adoption of new production techniques and product innovation now come to be seen as the main impediments to renewed prosperity.

Historically it has been the changing character of economic policy regimes which has been decisive for the political fate of Social Democracy and the organised labour movement in general. Politically Social Democracy finds it quite difficult to thrive under a policy regime in which strong trade unions and extensive welfare systems are considered antithetical to overall prosperity. Pursuing a macroeconomic policy which requires weakening wage earners' bargaining power places Social Democracy in conflict with trade unions and hence undermines one of its most crucial power resources. And while a policy which attempts to improve micro-level performance by improving productivity rather than reducing costs may seem to mitigate the need for wage cuts, the selective character of such policies stand in conflict with the requirements of an encompassing organisation. Rather such policies will tend to promote organisational fragmentation in the form of firm or regional level, instead of national level, interest articulation. In addition, the perceived conflict between overall prosperity and the interest of Social Democracy's main constituency reduces its appeal amongst the broader electorate.

Since the early twenties the high unemployment and the need to depress the overall price level through lower wages, which resulted from the decision to return to the Gold Standard, drove a wedge between liberal and labour political groups and aborted an accommodation between labour and capital. As the inflation of the immediate postwar years was considered to be the result of excessive access of civil society to the levers of monetary policy, the return to gold instituted a 'strong state', which potentially had to consider organized economic interest groups as an impediment to domestic price adjustment. While social democrats generally supported it, the decision to return to gold necessarily put them on the defensive. As a fundamental reorganisation of the ownership of production was economically and politically far beyond the horizon of the feasible, and the adherence to gold excluded domestic macroeconomic growth policies, Social Democrats frequently found it difficult to disagree that the major impulse to growth and employment had to come from domestic cost reduction, while at the same time being unable to politically accept the consequences in terms of social security and wages.

The political outcomes of the Great Depression are best characterized in terms of a 'Social-Democratization of the political economy' which led most political parties to accept that growth and full-employment were a responsibility of macroeconomic policies. While many Social Democratic parties initially may not have been well placed to politically exploit the policy changes during the Great Depression, the general acceptance of the view that free markets lead to unacceptable economic outcomes in the longer term could not fail to ideologically benefit a political movement which had traditionally stressed the shortcomings of market economies. Moreover, the
acceptance of the primacy of macroeconomic stimulation removed the perceived conflict between overall prosperity and the interest of labour. At the moment when stimulation of growth by macroeconomic means rather than the reduction of costs came to be considered the best strategy for economic prosperity, Social Democracy could present itself as a true people's party rather than just the representative of blue collar workers.

Politically the advent of disinflation regimes in the seventies and eighties marked the decline of Social Democracy hegemony. In the period following the first oil-price shock, West European Social Democratic governments either changed from the government bench to the opposition, or when remaining in office abandoned their commitment to full employment and pursued overall economic policies which in many ways implicitly admitted the correctness of much of the conservative critique. The renewed emphasis on markets and supply side policy, however, is both ideologically and institutionally difficult to square with traditional Social Democratic tenets. Whereas during the thirties, economically correct or not, the Social Democrats could emphasize the importance of high wages for consumption, under the inflationary pressures of the seventies such a defense was not available.

But why have the political consequences of major economic crises differed so radically over time? Why did the crises of the early twenties and the last two decades give rise to a (neo) Liberal policy regime while the Great Depression established the ideological hegemony of Social Democratic concepts? Why was the solution to persistent mass unemployment during the twenties and seventies and eighties sought in removing obstacles to the operation of the free market, while mass-unemployment during the Great Depression came to be interpreted as the failure of free markets? Are regime changes historical instances during which political leadership can play a crucial role in changing the course of society for years to come? Or are these periods just reflections of phases in the development of capitalist societies which are determined by an ineluctable economic logic?

In the common understanding of the history of economic policy these successive developments are interpreted as a movement from Laissez-faire to Keynesian interventionism and back to a more liberal reliance on market forces. However, the characterization of the 1920s and the post OPEC I period as (neo)liberal is seriously misleading as it suggest substantially less government intervention as compared to the intermediate years. Rather than to distinguish them with respect to the interventionist character of economic policies, it is more accurate to distinguish regimes according to policy priorities and the specific assignment of instruments to goals.
To consider the interwar Gold Standard as well as the present regime Liberal as the mirror image of an interventionist Keynesian regime is inaccurate for four reasons: (1) To accord highest priority to maintaining the exchange rate at an arbitrary level can hardly be termed liberal or laissez-faire, rather this label should be reserved for a regime which allows the exchange rate to be determined by the market (pure float).\(^5\) (2) Attaching the currency to gold by no means implied the advent of automatic, 'non-discretionary' monetary policies. And despite the popularity of monetarism, the last two decades have probably been characterised by more, rather than less, monetary discretion. Even the Bundesbank more often let its monetary target be undershot or overshot than it adhered to them, while changing the target figure from year to year as well as changing the aggregate targeted. (3) The unemployment and low growth which characterises both regimes gives rise to extensive supply side policies. The need for supply-side policies per definition signals a distrust in the automatic healing forces of the market. (4) The alleged radical shift in fiscal policy from the balanced budget dogma to Keynesian countercyclical policies did not take place. Budgets were frequently unbalanced during the interwar Gold Standard as restrictive policies automatically created deficits, and the alleged Keynesian response to the Great Depression was virtually absent. And also after World War II Keynesian policies were largely irrelevant as governments were rather confronted with the need to cool down a potentially overheating economy rather than reduce unemployment by means of budget deficits.

Historically it is more accurate to distinguish, on the one hand, interventionist regimes which maintain high unemployment and a fixed exchange rate in order to combat inflation while relegating the concern for growth to microeconomic policies and, on the other hand, an interventionist regime in which cheap money policies were pursued and, if so required, the exchange rate was adjusted in order to maintain growth and full employment, while the concern for combating inflationary pressures was delegated to microeconomic policies. To distinguish policy regimes in terms of goals, however, violates a fundamental assumption of political analysis. namely that economic policies are always pursued with the aim of improving the performance of the economy. Especially in a democratic polity policies which induce low growth and mass-unemployment would seem hardly viable electorally. Indeed, distinguishing policy regimes in terms of goals might seems rather inappropriate as political parties, whatever their differences, generally agree that growth and full-employment should enjoy high policy priority. And also the respective sides in the long standing

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\(^5\) To tolerate a government-sanctioned monopoly in the supply of money (central bank), whether politically independent or not, is a quite fundamentally a-liberal concept. Rather a consistently liberal regime should give all commercial banks the privilege of note issue.
debate about the proper role of the state in the economy - presently known under the labels Monetarists and Keynesians - understand their disagreements to concern methods and not goals. For neoclassics, freeing the market from its social and political shackles is considered the most promising road to growth and full-employment, while in the Keynesians perspective interventionist policies will be required in order to reach the same goal.

But neither the neoclassical nor the Keynesian interpretation of policy-making seem theoretically and historically very convincing. While satisfying the demands of a polity which requires that political intervention be justified in terms of promoting growth and employment, the neoclassical assumption that a free market economy will produce a Pareto-optimal outcome is not a conclusion which can be drawn from its own theory. Instead, even neoclassical theory ultimately arrives at the conclusion that free markets will most probably not arrive at Pareto-optimal outcomes. While showing theoretically that individual markets will tend towards an optimal partial equilibrium, to obtain a general equilibrium neoclassical theory needs to introduce the so-called auctioneer which exogenously imposes a Pareto-optimal equilibrium. A system of interconnected (partial) markets instead would arrive at such an outcome only by pure coincidence. To the extent that Keynesians base their views on a real-world deviation from the neoclassical model, they cannot avoid to confront the same problem. It may or may not be true that the presence of real-world nominal rigidities impedes the adjustment process of wages from which neoclassics expect a return to full employment. And accordingly it may be true that government manipulation of the price level instead may bring about such real wage adjustment. But if it remains unclear what outcomes flexible markets would produce, it is also unclear how relevant an analysis which deduces a need for government-assisted market adjustment is. In addition the habit of both Keynesians and monetarists to conduct their analysis in term of comparative statics defines away a problem which must be crucial for policy-makers, namely whether adjustment processes are in fact dynamically stable.

Starting from the assumption that governments in general will prefer growth and full-employment to stagnation and mass-unemployment, the conduct of economic policies during the three major crises of this century must seem rather paradoxical. In most western European countries the policy response to the inflation of the early 1920s consisted of massive monetary

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6 Keynes 1973, p. 33-4, for example suggested so himself: "..there would obviously be a natural tendency towards the optimum employment of resources in a society which was functioning after the manner of the classical postulates. It may well be that the classical theory represents the way in which we should like our economy to behave. But to assume that it actually does so is to assume our difficulties away."
contraction and fiscal retrenchment. Restrictive policies were maintained even when the massive unemployment, which appeared in the wake of the stabilisation crisis, proved to be rather durable. Similarly the onset of the Great Depression was marked by restrictive monetary policies and intensified efforts to balance the budget in order to defend the gold parity. During the last two decades inflationary problems again have given rise to restrictive macroeconomic policies. And, as in the twenties, the emergence of lower growth and durable mass-unemployment did not prompt a regime change. In addition both the crisis of the early twenties and the 70s and 80s have led to government efforts to reduce their own ability to pursue a more expansionary policy by awarding a larger degree of independence to the Central Bank and tying the currency to a fixed exchange rate in a restrictive international environment.

From a Keynesian perspective such restrictive policies in times of high unemployment obviously would seem perverse. And while Keynesians may, incorrectly, seek refuge in the argument that Keynesian recipes were not known during the twenties, such a view would not hold for the present. Also blaming restrictive policies in times of high unemployment on the existence of external constraints arising from internationally mobile capital remains unconvincing, as international capital mobility during the interwar period was certainly on a level comparable to the situation nowadays. Since neoclassics argue on the basis of a theory which maintains that nominal price changes have no durable effect on the real economy, policies to combat inflation must seem irrational to them. If inflation is stimulating in the short run but has no effects whatsoever in the long run, why should governments ever want to provoke a stabilisation crisis in order to get rid of a non-problem? More surprisingly perhaps, why should governments, in the 1980s embark on restrictive monetary policies to stamp out inflation when the experience of the twenties and seventies showed that the alleged short run negative effects proved to be very long lasting indeed?

Both the timing and the character of political intervention during the three major crises of this century rather suggest that economic policies primarily respond to rapid movements in the price level instead of depression and low growth. While most economists would generally agree that full price flexibility is optimal, the history of economic policy intervention rather suggest that excessive nominal price flexibility has been the crucial problem confronting governments. Major disturbances of price level stability have been a such a crucial problem because they tend to become cumulative. Expectations of a falling price level increase the attractiveness of hoarding money relative to investing in industry. As a result investment and growth decline while unemployment increases. Debt defaults due to the emerging recession further reduce the willingness to finance investment. Prolonged periods of unemployment moreover tend to fragment the trade union’s power in wage
setting as workers on the local level are willing to accept lower wages in exchange for some employment security. The resulting drop in the price level leads to further hoarding and a further increase in unemployment which leads to a additional decrease in nominal wages in a downward spiral. Inflation is very much a mirror image of this. Expectations of inflation make it unattractive to hold money. The increase in investment leads to a reduction in unemployment. Prolonged scarcity of labour fragments the trade unions as local employers start bidding up wages in order to attract workers. The final stages of such a cycle are usually characterized by a so-called flight out of money, i.e. heavy speculation in real estate and other real assets.

But if the interaction of financial and labour markets tends to cumulatively reinforce instabilities in the price level, then the state will eventually be left with no other option than to intervene. Rather than operating in a neoclassical or Keynesian economy in which government intervention, either by freeing or constraining markets can be aimed at realising politically determined goals, governments in practice are first of all confronted with the need to maintain the macro level coherence of a decentralised system of decision-making. Before governments can attempt to steer a monetary economy in desired directions it will have to ensure the conditions under which such an economy can function. Historically it is the loss of control over economic developments as marked by rapid deflations and inflations which prompts fundamental changes in government policies. While economic recessions are generally conceived as exogenous events, which only leaves room for discussing divergent views on the best means for overcoming the difficulties, the potentially cumulative character of inflation explains why states may have to provoke a crisis in the real economy in order to restore price level stability.

The failure of Social Democratic policies in both the twenties and the eighties is the direct outcome of a failure to contain domestic inflation without recourse to restrictive monetary policies. The rise of Social Democratic policies during the Great Depression was prompted by the disastrous deflationary effects of the policy regime set up in the twenties in order to prevent inflation.

Consequently the core assumption of political analyses according to which the conduct of economic policies reflects the relative strength of interest groups fails to capture a crucial aspect of political intervention. Before the struggle about 'who gets what' can be conducted it is necessary to establish a framework of rules and institutions in terms of which such a political struggle can be conducted. In economic policy, regimes provide this framework as they impose a specific assignment of instruments to goals and institutionalise a specific theoretical understanding of the

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economic effects of specific (political) behaviour. Put differently, during regime changes state policies reshape the nature of political interests and their channels of articulation rather than being driven by them. Accordingly regime changes cannot be understood as the outcome of a change in relative power relations by which a specific interest groups is enabled to impose its understanding of society as the dominant one. Rather regime changes are marked by a reinterpretation of the rule of the economic policy game which permeates the whole political spectrum.

The periodic changes in economic orthodoxies - from the quantity theory in the twenties to Keynesianism and back to neoclassics in the seventies- must in fact, be understood as the mechanism by which a democratic polity adjusts to the inherent policy priorities of a monetary economy. The democratic constitution of the polity requires, as a rule, that economic policies which wish to enlist a political majority must be presented in terms of benefiting the overall performance of the economy. As no political movement can hope to derive support from a strategy based on the concept of a policy-induced crisis, the theoretical justification of government policies which aim to break an escalation of the price level takes the form of a paradigmatic shift to a theoretical position which points to the impotence of macroeconomic policies in affecting the real side of the economy as well as a shift from emphasizing the short run to emphasizing the long run. The deflationary constellation of the Great Depression, however, meant that policies required to ensure the stability of the monetary framework were identical with policies promoting growth and employment. It is this constellation which accounts for the emergence of an interpretation of economic policies which inverted the previously accepted relation between markets, civil society and the state, that it came to be accepted that (1) the state could and should intervene in the face of the market’s inability to produce politically acceptable economic outcomes, and (2) the presence of organised interests was an economically stabilising rather than destabilising factor.

While the observed regime changes must be attributed to pervasive problems of in- or deflation, policy-making does not revert to the old pattern once the formative problem of de- or inflation has been conquered. The crisis which stands at the cradle of a new regime constitutes a trauma which continues to inform policy-making. The desperation with which many nations clung to restrictive policies for fear of renewed inflation during the Great Depression, when the world economy was actually collapsing under the weight of deflation, is perhaps the most telling example of the inertia of regimes.
It is this politico-economic dynamic of monetary economies which ultimately had determined the political fate of West European Social Democracy during this century. While analysis of the development of Social Democracy are generally based on a notion of a capitalist economy which automatically directs the attention to issues of the ownership of production, the major problems which Social Democracy has been confronted with during this century and which have driven its political as well as its ideological fate are not rooted in questions of ownership but of coordination of a monetary economy. The failures of Social Democracy to realise it programme cannot be attributed to the systemic power of 'capitalists', nor are Social Democracy's successes the outcome of a successful mobilization of power resources which enabled it to overcome the opposition of 'capital'. Being both unable to provide an alternative solution to inflationary pressures and to politically tolerate the unemployment and wage cuts following from the Gold Standard regime, Social Democrats during the twenties were structurally unable to govern or advance their goals. And again during the last two decades, the disintegration of institutional devices designed to contain inflation and the subsequent shift to a disinflationary policy regime has marked the loss of ideological and political initiative on the part of Social Democracy and the acceptance of a substantial part of the conservative or Neo-Liberal policy-interpretation. Conversely, while Social Democrats generally did not initiate the new policies during the Great Depression, they eventually were to reap the electoral and ideological benefits. After the cataclysm of the Great Depression, Liberals now had to pay the price for labelling the interventionist policies of the Gold Standard a free market regime, while at the same time Social Democrats could claim that history had shown their postulate of the need for political regulation of a capitalist economy to be correct.

This is the story to be told in the following pages.

The structure of the paper is as follows. Chapter 1 argues that Social Democracy can only thrive politically in a macroeconomic regime in which the interests of labour in high and stable wages and well-developed social security systems are not considered to be damaging to overall economic performance. Chapter 2 reviews the main economic views commonly underlying political analysis and sketches an alternative view in which the general orientation of economic policies (i.e. the regime) is seen to be informed by the need to combat or prevent cumulative movements in nominal prices. The following three chapters provide a historical overview of the three policy regime changes of this century. Chapter three argues that the combination of expansionary monetary policies plus the absence of appropriate institutional and political instruments for the microeconomic control of inflation aborted a nascent Social Democratic policy regime around the early twenties. Chapter 4 interprets the regime change during the Great Depression as a response to the destructive
effects of price deflation. In contrast to a still widespread view it is argued that the decisive character of the new regime did not consist in a shift to Keynesian countercyclical policies but rather in a proliferation of institutional devices designed to promote downward nominal rigidity, in particular agricultural price stabilisation agreements and cartels backed up by tariffs, and, in some countries, a deliberate effort to strengthen the wage bargaining power of the trade unions; the elimination of the need for further deflation by abandoning the Gold Standard and stabilising the domestic price level instead of the exchange rate; and pursuing a policy of cheap money. Chapter 5 argues that the advent of disinflationary policy regimes during the seventies and eighties is ultimately a story about the slow disintegration of the ability to contain inflationary pressures without having recourse to macroeconomic restriction and unemployment. Chapter six addresses the argument that international financial mobility poses a decisive constraint on domestic economies to pursue expansionary policies. It will be concluded that rather something akin to the opposite holds true. Historically external constraints have mainly been self imposed in reaction to an increasing inability of the domestic polity to contain domestic inflationary pressures. Chapter 7 concludes with an overview of changes in Social Democratic ideology in response to the dynamics of monetary economies.

As a survey of all West-European countries would exceed the space limits of the present paper - as well as the time and knowledge constraints of the author - the historical sections will mainly focus on Germany, Great Britain, the Netherlands, Norway and Sweden. Moreover, more detailed attention will be paid to the economic policies of Social Democratic governments than to those of non-Social Democratic governments. The selection of countries with a traditionally weak (Germany and the Netherlands) and a traditionally strong (Norway and Sweden) Social democracy will allow for a better understanding of the impact of domestic political power relations on the orientation of macroeconomic policies. By selecting two large and three small economies it will also be possible to explore the topic of the differential impact of external constraints according to the position of the respective country in the international hierarchy. Since Social Democratic governments are generally seen to attach prime importance to full-employment, an examination of their policies should more clearly reveal the limits of national autonomy.
A Note on Terminology

In this essay the terms inflation and deflation will be used in their technical meaning of a continuous rise/fall in the price level. This in contrast to the interwar usage of the term inflation when it frequently meant an expansion of the money supply, and a common present usage of the word deflation as denoting restrictive demand management policies. Reflation denotes the recovery of the price level from a preceding deflation. Inflationary and deflationary policies accordingly are policies which lead to a continuous rise or fall of the price level, while reflationary policies are aimed at a once and for all increase in the price level.\(^8\) Disinflationary policies, in contrast to deflationary policies, are measures aimed at reducing the rate of inflation rather than depressing the overall price level. The terms restrictive and expansionary will be used for policies aiming to reduce/increase overall demand, irrespective of their effect on the price level. A currency will be called convertible if it can be freely exchanged against other currencies. Also this is in contrast to the usage of the interwar period when convertibility frequently meant that the currency in question maintained a fixed parity with respect to gold. In accordance with standard usage in economics, policies are said to have nominal effects if they lead to a change in the absolute price level and real effects if they alter relative prices, growth employment, overall demand etc. This is not to suggest that real effects are what matters while nominal effect are merely epiphenomenal. In effect the argument presented here rests on something akin to the contrary. In the case of the two Scandinavian countries, non-social-democratic governments are referred to as bourgeois governments. This is in accordance with the common usage in Norway and Sweden and it is not meant to suggest that these governments somehow are the political wing of the 'bourgeoisie'. The word Liberal is used here in the European sense of a political movement which advocates minimal government interference with free markets rather than in the American sense of right-wing Social Democracy. Finally, one billion equals one thousand millions.

\(^8\) Margaret Thatcher actually is one of the few non-economists who correctly distinguishes a once and for all increase in the price level from inflation. See Thatcher 1993, p. 43.
Acknowledgements

Like most dissertations also this one has known a long gestation period. I first became interested in questions of economic policy in advanced industrial nations while attending Manfred Schmidt’s excellent seminars at the Freie Universität Berlin during the mid eighties. At the same time my regular visits to Hajo Riese’s seminar in the economics department convinced me that any account of economic policy making would have to be centred on money and monetary policy.

One of my early attempts to make sense of economic policy making drew the comment from Lars Mjøset at the Institutt for Samfunnsforskning in Oslo that it did not seem to apply particularly well to the Scandinavian countries. Throughout the years Lars’ continuous help has been invaluable. His vast knowledge of, not only, the Scandinavian countries on numerous occasions has prevented me from entering a dead alley. I must admit that Lars’ initial comment was correct. I hope the present attempt will be more acceptable to him.

The political science department at MIT may not be the most suitable place for someone who believes that money and finance are crucial for the political fate of Social Democracy. During my first term in Cambridge I had the great luck of meeting Andrew Martin of Harvard university. Without Andy’s intellectual and moral support this thesis probably never would have been written. The argument advanced here has been shaped in more ways by Andy’s comments than he probably realizes himself. Douglas Forsyth of the MIT history department was one of the few who shared my interest in money and finance. Especially during 1993-4 have discussed almost on a daily basis. Douglas’ numerous critical comments have been of great benefit to the present essay.

During my frequent trips to Europe affiliations with three institutes in particular have been most helpful. In Oslo the hospitality of the Insitutt for Samfunnsforskning has made my stays both more fruitful and more pleasant. I would like to thank in particular the director of ISF, Frederik Engelstad, Trond Nordby, Geir Høegsnes and the staff of the library for their kind assistance. The Swedish Trade Union Institute for Economic Research most probably is the ideal research environment for someone interested in economic policy and Social Democracy. Without the invaluable assistance of the people at FIEF the Swedish part of this study could not have been written. In particular I would like to express my gratitude to FIEF’s director, Villy Bergström, and to Magnus Henrekson, Anders Vredin and Cesar Fuentes-Godoy. In Germany I greatly benefited from my stay at David Soskice’s Labour Market and Employment Research Group at the Wissenschaftszentrum Berlin.

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The list of people who have provided helpful comments or assistance would probably fill several pages. Instead I will restrict myself to thanking the following persons for their comments: Dan Andersson, Karl Betz, Lars Höngren, Lars Jonung, Simona Piattoni, Charles Sabel and Richard Samuels. Interviews with policy makers have been of crucial importance, but, as is common in this type of study, I will not mention them by name.

While working on the historical parts of this study, access to various archives has been of crucial importance. I would like to thank the board of directors of Norges Bank; the general secretary of the SAP and the Norwegian and Swedish LO for granting me access to their respective archives. Dr. Turid Wammer, head of the Archives of Norges Bank, has most kindly sacrificed a considerable amount of her time to help me locate relevant material. Equally kind and helpful assistance was received from Anneli Alrikson at the LO Archives in Stockholm. In addition I wish to thank the staff at the Archives of the Labour movement in Oslo and Stockholm.

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<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ADGB</td>
<td>Allgemeiner Deutscher Gewerkschaftsbund</td>
</tr>
<tr>
<td>AES</td>
<td>Alternative Economic Strategy</td>
</tr>
<tr>
<td>AfA</td>
<td>Allgemeiner freier Angestelltenbund</td>
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<td>AFL</td>
<td>Arbeidernes Faglige Landsorganisasjon i Norge</td>
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<td>AK</td>
<td>Riksdagens Protokoll, Andra Kammaren</td>
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<tr>
<td>ALMP</td>
<td>Active Labour Market Policy</td>
</tr>
<tr>
<td>ARP</td>
<td>Anti-Revolutionaire Partij</td>
</tr>
<tr>
<td>BbkG</td>
<td>Bundesbankgesetz</td>
</tr>
<tr>
<td>BDI</td>
<td>Bundesverband der deutschen Industrie</td>
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<td>BdL</td>
<td>Bank deutscher Länder</td>
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<td>Bondeförbundet</td>
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<td>BoE</td>
<td>Bank of England</td>
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<tr>
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<td>Bondepartiet</td>
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<tr>
<td>BVP</td>
<td>Bayrische Volkspartei</td>
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<tr>
<td>CDU</td>
<td>Christlich Demokratische Union</td>
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<td>CDU(NL)</td>
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<td>Christelijk Historische Unie</td>
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<td>CPB</td>
<td>Centraal Planbureau</td>
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<td>CSU</td>
<td>Christlich Soziale Union</td>
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<td>DAF</td>
<td>Deutsche Arbeitsfront</td>
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<td>DANAT</td>
<td>Darmstädter und National Bank</td>
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<td>DP</td>
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<td>EAC</td>
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<td>EEA</td>
<td>Exchange Equalization Account</td>
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<td>EMU</td>
<td>Economic and Monetary Union</td>
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<td>ERM</td>
<td>Exhange Rate Mechanism</td>
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<td>FF</td>
<td>Frisinnad Folkpartiet</td>
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<td>FIEF</td>
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<td>Federal Republic of Germany</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>Gestapo</td>
<td>Geheime Staatspolizei</td>
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<tr>
<td>GNP</td>
<td>Gross National Product</td>
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<td>HRA</td>
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<td>HST</td>
<td>Hegemonic Stability Theory</td>
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<td>ICFTU</td>
<td>International Confederation of Free Trade Unions</td>
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<td>IFTO</td>
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<td>ILP</td>
<td>Independent Labour Party</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>ISF</td>
<td>Institutt for Sanfunnsforskning</td>
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<tr>
<td>JMK</td>
<td>The Collected Writings of John Maynard Keynes</td>
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<td>KPD</td>
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<td>KVP</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>LO(N)</td>
<td>Landsorganisasjon i Norge</td>
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<td>LO(S)</td>
<td>Landsorganisasjon i Sverige</td>
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<td>LSP</td>
<td>Liberale Staatspartij</td>
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<td>M</td>
<td>Moderate Samlingsparti</td>
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<td>MAK</td>
<td>Motioner i Andra Kammaren</td>
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<td>MFK</td>
<td>Motioner i Första Kammaren</td>
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<tr>
<td>MIT</td>
<td>Massachusetts Institute of Technology</td>
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<td>MOF</td>
<td>Minister of Finance</td>
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<tr>
<td>MP</td>
<td>Member of Parliament</td>
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<td>NAF</td>
<td>Norges Arbeidsgiver Forbundet</td>
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<td>NB Ark.</td>
<td>Norges Bank’s Arkiv</td>
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<td>NBPI</td>
<td>National Board for Prices and Incomes</td>
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<td>NHO</td>
<td>Næringslivets Hovedorganisasjon</td>
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<td>NIF</td>
<td>Norges Industriforbund</td>
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<td>Neoclassical-Keynesian Synthesis</td>
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<td>NL</td>
<td>The Netherlands</td>
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<tr>
<td>NNP</td>
<td>Net National Product</td>
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<tr>
<td>NOK</td>
<td>Norwegian Krone</td>
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<td>Norges Offentlige Utdrønner</td>
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<td>NP</td>
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<td>NSA</td>
<td>Norges Socialdemokratiske Arbeiderparti</td>
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<td>NSBO</td>
<td>National-Socialistische Betriebszellenorganisation</td>
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<td>NSDAP</td>
<td>National Sozialistische Deutsche Arbeiterpartei</td>
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<td>NUPE</td>
<td>National Union of Public Employees</td>
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<td>NVV</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>ÖTV</td>
<td>Gewerkschaft Öffentliche Dienste, Transport und Verkehr</td>
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<td>OPEC</td>
<td>Organization of Petroleum Exporting Countries</td>
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<td>PBO</td>
<td>Publiekrechtelijke Bedrijfsorganisatie</td>
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<td>PM</td>
<td>Prime Minister</td>
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<td>PPR</td>
<td>Politieke Partij Radicaaln</td>
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<td>SV</td>
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<td>SWP</td>
<td>Solidaristic Wage Policy</td>
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<td>TCO</td>
<td>Tjänstemännens Centralorganisation</td>
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<td>TFAH</td>
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<td>TUC</td>
<td>Trade Union Congress</td>
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<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>USPD</td>
<td>Unabhängige Sozialdemokratische Partei Deutschlands</td>
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<td>VDB</td>
<td>Vrijzinnig Democratische Bond</td>
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<td>VF</td>
<td>Verkstädfoerungen</td>
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<td>Vertriebenenpartei</td>
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<td>Z</td>
<td>Zentrumspartei</td>
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<td>ZAG</td>
<td>Zentralarbeitsgemeinschaft der industriellen und gewerblichen Arbeitgeber und Arbeitnehmer Deutschlands</td>
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<tr>
<td>ZBR</td>
<td>Zentralbankrat</td>
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List of symbols

B  Public sector budget balance
C  Consumption
E  Expected exchange rate changes
i  domestic interest rate
I  Investment
i' foreign interest rate
i'' domestic real interest rate
M  Volume of money
P  Price level
T  Real National Product
U  Unemployment
V  Velocity of Money
W  Nominal wage
W' Real Wage
Y  National Income
Dramatis Personae

Attlee, Clement Richard  
Labour MP, 1922-55; Leader of the Opposition, 1935-40; British Deputy Prime Minister, 1942-45; British Prime Minister, 1945-51.

Baldwin, Stanley  
Conservative MP, 1908-37; Chancellor of the Exchequer, 1922-3; British Prime Minister, 1923-4, 1925-9, 1935-7.

Berge, Gunnar  
Norwegian Finance Minister (DNA) 1986-89

Bevin, Ernest  
General Secretary of the Transport and General Workers Union, 1921-40;  
Minister of Labour and National Service, 1940-5; Labour MP, 1940-51.

Bildt, Carl  
Swedish Prime Minister (M), 1991-1994

Bjerve, Petter Jacob  
Norwegian Finance Minister (DNA) 1960-63

Blessing, Karl  
Member of the Reichsbank directorate 1937-39, President of the Deutsche Bundesbank, 1958-1969

Bomhoff, Karl Gether  
Governor of Norges Bank, until 1920

Branting Hjalmar  
Swedish Prime Minister (SAP), 1920, 1921-23, 1924-25.

Brink, J.R.M. van den  
Dutch Minister of Economic Affairs (KVP), 1948-52

Brofoss, Erik  
Governor of Norges Bank, 1954-70.

Brüning, Heinrich  
(Z) Member of the Reichstag, 1924-33; German Chancellor, 1930-2;

Callaghan, James Leonard  
Labour MP, 1945-87; Chancellor of the Exchequer, 1964-7; British Prime Minister, 1976-9.

Cassel, Gustav  
Professor of Economics, University of Stockholm.

Catto, Thomas Sivewright  

Chamberlain, Austen  
Conservative MP, 1892-1937; Chancellor of the Exchequer, 1919-21; Leader of the Conservative Party, 1921-22.

Chamberlain, Neville  
Conservative MP, 1918-1940; Chancellor of the Exchequer 1923, 1931-37, Prime Minister 1937-40.

Churchill, Winston Leonard Spencer  
Conservative MP, 1900-4; Liberal MP, 1904-22; Conservative MP, 1924-64;  
Chancellor of the Exchequer, 1924-9; British Prime Minister, 1940-5, 1951-5;  
leader of the Opposition, 1945-51.

Cokayne, Brian  

Colijn, Hendricus  
ARP Dutch Minister of Finance 1923-26, Prime Minister 1925-26, 1933-39.

Cunliffe, Walter  

den Uyl, Joop  
(PvdA) Dutch Prime Minister 1973-77, Minister of Social Affairs and Employment 1981.

Dennis, Bengt  
Governor of Sveriges Riksbank, 1982 - 1993

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9 Biographical notes on British persons have mainly been taken from Moggridge 1992.
Duisenberg, Wim (PvdA) Dutch Minister of Finance 1973-77, Director of De nederlandsche Bank 1981-83, President of De Nederlandsche Bank, 1982-.. 

Emminger, Otmar Vice President of the Deutsche Bundesbank, 1970-77, President of the Deutsche Bundesbank, 1977-79 

Erhard, Ludwig (CDU) 1949-63; Minister of the Economy, 1953-63; Vice Chancellor, 1963-66; Chancellor. 

Erlander, Tage (SAP) Swedish Prime Minister, 1946-1969. 

Erzberger, Mattias (Zentrum) German Minister of Finance 1919-20. 

Feldt, Kjell-Olof Swedish Minister of Finance (SAP), 1982-1989 


Havenstein, Rudolph President of the Reichsbank, 1908-23 

Heckscher, Eli Filip Professor of Economics and Statistics, Stockholm University, 1909-29; research professor, 1929-45. 

Henderson, Arthur Secretary of the Labour Party, 1911-34, Home Secretary 1924 

Hilferding, Rudolf (SPD), German Minister of Finance, 1923, 1928-9. 

Holtrop, M.W. President of De Nederlandsche Bank, 1946-1967. 

Jahn, Gunnar Governor of Norges Bank, 1946-54. 

Johnsen, Sigbjørn Norwegian Finance Minister (DNA), ...1992-3...

Karleby, Nils Member SAP secretariat 1920-26, (co-)editor of Tiden, 1922-26 

Klasen, Karl President of the Deutsche Bundesbank, 1970-1977 

Kleppe, Per Norwegian Finance Minister (DNA) 1971-72, 1973-79 

Law, Andrew Bonar Conservative MP, 1900-6, 1906-10, 1911-23; Chancellor of the Exchequer, 1916-18, Prime Minister, 1922-3. 

Lawson, Nigel Conservative Chancellor of the Exchequer, 1983-89. 

Liefstink, Pieter (PvdA) Dutch Minister of Finance, 1945-52 

Lloyd George, David Liberal Chancellor of the Exchequer, 1908-15, British Prime Minister, 1916-22 

Luther, Hans German Minister of Finance 1923-25, German Chancellor 1925-26, President of the Reichsbank 1930-33. 

MacDonald, James Ramsay Treasurer of the Labour Party, 1912-24, British Prime Minister, 1924, 1929-31, 1931-35 

Macmillan, Harold Conservative MP, 1924-9, 1931-64; Chancellor of the Exchequer, 1955-7; British Prime Minister, 1957-63. 

McKenna, Reginald Liberal MP, 1895-1918; Chancellor of the Exchequer, 1915-16; Chairman Midland Bank, 1919-43. 

Moland, Torstein Governor of Norges Bank, 1993 - ....
Norman, Montagu Collet  

Nygaardsvold, Johan  
Norwegian Prime Minister (DNA) 1935-1945

Pöhl, Kai-Otto  

Rygg, Nicolai  
Governor of Norges Bank, 1920-46.

Schacht, Hjalmar Horace Greely  
President of the Reichsbank, 1923-30, 1933-39.

Schlesinger, Helmut  
Vice President of the Bundesbank 1980-91, President of the Deutsche Bundesbank, August 1, 1991 - September 1993

Schmidt, Helmut  

Schumacher, Kurt  

Skånland, Hermod  
Governor of Norges Bank, 1985 - 1993

Snowden, Philip  
Labour MP, 1906-18, 1922-31; Chancellor of the Exchequer 1922, 1929-31

Tietmeyer, Hans  
President of the Deutsche Bundesbank, September 1993 - ....

Trip, L.J.A  
(RKSP) President of De Nederlandsche Bank, 1931-1946.

Vöcke, Wilhelm  
Member of the Reichsbank Directorate 1919-39, President of the Directorate of the Bank deutscher Länder 1948-57.

Wigforss, Ernst  
(SAP) Swedish Minister of Finance 1932-49

Willoch, Kåre  
Norwegian Prime Minister (Høyre), 1981-86

Zijlstra, Jelle  
I Introduction
1 Social Democracy in the Macroeconomy

In terms of the relationship between state and markets, Social Democracy occupies an independent middle position between Liberalism and Marxism. On the one hand, it rejects the socialist planned economy as being both economically inefficient and undemocratic. On the other hand it also rejects the liberal demand for government abstinence and the acceptance of market outcomes, as it holds that unfettered markets lead to economically sub-optimal and normatively unacceptable outcomes. In sociological terms Social Democracy traditionally considers itself to be the political representation of working class interests. Its historical roots lie in the firm level struggle between workers and owners in an industrial economy. In the Labour movements’ own understanding of its internal division of labour, trade unions are to represent workers’ economic interests in the bargaining process, while Social Democratic parties represent the political interests of workers on the level of the state.

A potential tension exists, however, between the firm level conflict of interests between workers and employers and the macro-level desirability of a market economy. Already the electoral logic of a political movement which derives much of its strength from a close association with trade unions requires that Social Democrats cannot be seen as embracing the interests of the employers, while its advocation of a market economy requires that it must promote conditions under which privately owned business can prosper. This tension at the core of its ideology implies that Social Democracy finds it difficult to thrive in a world where the micro level pursuit of workers’ interests is considered to be antithetical to the prosperity of a market economy. Social Democratic principles can hardly be accommodated within a neoclassical zero-sum game where the reduction of unemployment requires a reduction of wage costs either in the form of lower real wages or by reduced employers’ contributions to social security. And while the view that unemployment is mainly the result of excessive wage costs may also be acceptable to Marxists, who hold that labour cannot satisfy its demand for full-employment at acceptable wages in a capitalist economy anyway, it conflicts with the Social Democratic conviction that market economy is not incompatible with the legitimate demands of labour. In such a constellation Social Democracy faces the unpleasant dilemma of supporting trade unions’ efforts, thereby risking to loose electoral support for being

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10 It is true that widespread unemployment weakens the market position of labour, and thereby weakens the trade unions (Cf Esping-Andersen 1985, p. 191-3). Unemployment by itself however does not necessarily weaken the political and ideologial position of Social Democracy, as the developments in the wake of the Great Depression showed. What is more important for the strength of Social Democracy is the reining understanding of how unemployment and crisis are best combated.
seen to lack a policy which can benefit society as a whole, or concentrating on what are considered sound economic policies thereby risking a conflict with the trade unions. In practice such a situation generally entails that Social Democrats loose the political imitative as they move uneasily between the two sides of the dilemma. Not being convinced that extensive welfare state arrangements and a high degree of income equality benefit economic performance Social Democrats have to justify these policy goals defensively by arguing that the desirable social effects outweigh possible negative economic effects.

Due to its inception as a working class movement, the early 'Social Democratic Image of Society' was based on the conviction that the microeconomic organisation of society determines its overall political and economic dynamics. Generalizing from the experience on the shop floor, early Social Democrats held that the distinction between those who own the (physical) means of production and those who do not is constitutive of modern societies. At present this view is sometimes to be found among the left wing of Social Democracy and, more frequently, amongst academic students of Social Democracy. This socialist interpretation of Social Democracy hence denies that the potential tension between micro- and macro-level aspirations is constitutive of the historical and political development of Social Democracy. In this view Social Democracy and Socialism (or Communism) do not differ with respect to their policy goals but only with respect to the methods they employ in order to achieve this goals. While both movements are seen to strive for a socialist economy in which the private ownership of the means of production is abolished, socialist hold that this end can only be achieved by means of a political revolution, while Social Democrats strive to achieve this goal in a democratic and evolutionary way.

In theoretical terms such a view rests on the argument that the conflicts of interest found at the micro level are constitutive for the macro level dynamics of society also. Yet, such an argument is inadmissible as it rest on a fallacy of composition; probably the most common fallacy in social science. In no social system can the micro level determinants of behaviour be constitutive of macro-level dynamics. Since the constraints under which individual actors make decisions are themselves the result of the decisions taken by the sum of the other actors, a system which is based purely on a micro-level rationale can have no coherence nor structure. Put differently, theories for which the constraints which inform individual-level decision making are the result of individual level decision-making generally have no solution. Accordingly theoretical constructs which purport to analyse social dynamics from a micro level perspective are forced to postulate the existence of a set of exogenous constraints, i.e. a set of institutional or structural elements which are not man
made, or at least are not continually changing in response to the sum of micro level decisions made by the other actors in the system. Put differently, such a theoretical construct requires that much of the constraints which inform social life are treated as matters beyond politics.

In political philosophy the problem of the fallacy of composition has been well known, at least since Hegel’s (1986) critique of Kant. While Kant argued that the categorical imperative is the only principle of law acceptable to free and rational individuals, Hegel argued that society is not possible on such a basis because the categorical imperative only requires conduct to be internally consistent but places no substantive constraints on it. On the basis of a procedural, and not substantive, principle of law, the state is incapable to discriminate between beneficial and destructive conduct. To give an example, a member of the NSDAP who abandons his beliefs upon learning that he actually is of Jewish ancestry does not act in accordance with the Kantian principle. Yet if he does persist in his view there is no basis in Kant any more to condemn Nazism. The intuitive appeal of the Kantian view rests on the assumption that no rational individual would support principles by which he himself may come to harm and hence must also accept to constrain his behaviour in such a way as to cause no harm to others. But since millions of men were willing to sacrifice their lives for the sake of Nazi ideology it seems rather unlikely that consistent fascism would not be possible. Because the principle of law derived from what must be acceptable to free and rational individuals cannot sustain a society, Hegel argues that social coherence is ensured by the state - which comprises the state proper and intermediate associations- as it enforces substantive principles of law.

Hegel then proceeded, quite unsuccessfully, to answer the question what substantive principles the state enforces by reference to a historical teleology in which the different historical forms of polities are interpreted as stages in a dialectical process of the unfolding of the 'Geist'. While Marx, the theoretical father of socialism, equally unsuccessful, aspired to put Hegel’s philosophy from its head onto its feet by rooting his historical teleology in the sphere of production instead in the realm of ideas, it was his failure to incorporate Hegel’s critique of micro-level theory which lies at the root of the logical flaws of his economic system. Already in volume I of *Das Kapital*, Marx stumbled over the impossibility of deriving the macro level dynamics of a society from its micro level structure. In principle the Marxist argument was quite simple. Since the bourgeoisie monopolises the means of production, it is able to extract a rent, i.e. exploit the working class. Moreover, the bourgeoisie performs no productive function as all value ultimately is derived from labour. Expropriating the bourgeoisie hence is unambiguously beneficial for workers as it simply means getting rid of a parasitic class. At the same time Marx cannot possibly derive the
ability to extract surplus value from an imperfection in competition. To attribute the possibility of exploitation to the existence of, for example, monopolies and cartels would, of course, run counter to the main normative tenet of Marxism, namely that the working class can only liberate itself by means of abolishing the private ownership of the means of production. Otherwise policies aimed at eliminating imperfections in competition would be able to end exploitation. However, it is simply not possible to simultaneously assume the existence of perfect competition and rent income (surplus value). Even if the bourgeoisie as a class monopolizes the means of production, this concept of a class cannot become economically operative as individual bourgeois are in constant competition with each other. Especially in a system where the bourgeois must accumulate in order to survive, competition for labour should eliminate the rent. In order to exclude this possibility in Ch. 23 Marx exogenously has to introduce the presence of continuous unemployment. Accordingly at the heart of the Marxian theoretical construction lies the crucial assumption that persistent mass-unemployment is a precondition rather than a consequence of a capitalist system of exploitation.\footnote{See Marx 1977, Ch. 23, esp. p. 661.} Put differently, even in the Marxian system private ownership of the means of production and a market economy were insufficient assumptions to arrive at a system in which exploitation was endemic, and accordingly what should have been the outcome of an economic analysis - the presence of persistent unemployment - is introduced as a deus ex machina who is to save the normative principles, derived at the micro-level, from evaporating on the macro level.\footnote{See also Scherf (1986, p. 140) who notes that because Marx failed to solve the transformation problem, i.e. failed to show the link between his theory of values and the price system, the workings of the economy remain unexplained.}

Since the macro dynamics of the economy are not determined by the micro organisation of society, labour movements generally found that the emphasis placed on the question of the ownership of the means of production proved to be a poor guide for policy. While expropriating the bourgeois might seem an attractive prospect for workers engaged in wage bargaining with more powerful employers, it rather seemed to create more problems than it solved once the focus went beyond the mere distributional struggle. By itself socialisation would, of course, not create more demand nor improve competitiveness, but instead would place more burdens on the budget by having to support ailing firms. Especially in the depressed conditions of the interwar period labour itself was not
convinced at all that it had a better recipe for managing firms than the employers so as to avoid unemployment and wage cuts. Socialisation of industries in a crisis might easily mean socialisation of losses.\textsuperscript{13}

At the end of World War I labour movements were generally quite unprepared to answer the question how the economy would benefit if control over the means of production was placed in the hands of labour.\textsuperscript{14} The German, Dutch, Swedish and Norwegian Social Democrats all set up commissions which were to study this question but they generally failed to produce an answer. In Germany, Hilferding's theory of 'Organised Capitalism' in fact implied that socialisation was not an urgent requirement. Instead the organic development of capitalism itself, by means of increasing cartellisation and monopolisation, would create the necessary preconditions for control of the economy.\textsuperscript{15} The report of the Norwegian public commission was published in 1924 but was largely ignored, also by the DNA. The DNA's own commission produced its report already in 1920. The Norwegian commission went into some detail concerning the order in which different sectors were to be nationalised but it did not treat the question of how nationalised firms were to be managed and in what way nationalisation would solve the firms' and the economy's problems.\textsuperscript{16} Similarly the Dutch report, published in 1920, focussed mainly on the administrative structure by which a socialized economy was to be managed rather than providing concrete guide-lines for how socialized firms were to be managed so as to produce superior economic results. The Swedish commission, however, did attempt to do so\textsuperscript{17} and its fate is rather symptomatic of the inherent problems of a strategy of socialisation. The commission was established in 1920 by a minority SAP government in order to develop concrete plans for the socialisation of industry and natural resources. In the end the commission would devote 15 years to this task without being able to come up with substantive answers.\textsuperscript{18} And more than sixty years later the Swedish labour Movement still was not able to

\textsuperscript{13} Within the SAP executive strong doubts about the wisdom of socializing industry existed after the war. See Tingsten 1941, Vol. I, p. 330. The SAP executive member Möller reiterated similar views during the Great Depression. See also DNA's crisis programme of 1933 (Colbjørnsen & Sømme 1933), p. 19: "We have to guard against a socialisation of loss and debts. It will often be better for society to build a new modern firm rather than to take over an old and weak one." (My translation).

\textsuperscript{14} For the SPD see, for example, Könke 1987, p. 45.

\textsuperscript{15} As Könke (1987, p. 46) notes, rather than practical policy being determined by theoretical findings the concepts of organised capitalism rather served to legitimise an already pursued reformist policy.

\textsuperscript{16} For a summary of the commission's findings see Mauerseth 1987, p. 101-07.

\textsuperscript{17} See Tilton 1991, p. 92: "rather than write still another ineffectual theoretical treatise on socialism's superiority to capitalism, the committee would produce a concrete empirical report on methods of socialization that would provide sound practical guidance for Swedish measures."

\textsuperscript{18} For a useful discussion of the Swedish socialisation commission see Tilton 1991, p. 86-102.
produce an answer. With respect to the debate about wage earner funds, which were to give the LO trade union a say in investment decision, Jonas Pontusson (1992, p. 235) remarks: "... the labour movement never developed anything like an 'alternative model of development' that could have provided criteria for allocating public or collective capital and for identifying the type of private investment that the state should promote."

Not only could labour give no content to Marx contention that the liberalisation of labour was the precondition for the liberalisation of society, i.e. that labour’s control over the means of production would benefit everyone, but socialisation appeared to be a threat to the coherence of the labour movement itself. Since in a market economy firms are in competition with each other, placing labour in charge of investment decisions implied placing labour in one firm in competition with labour in other firms. Such a situation hence would necessarily undermine labour’s organisational coherence and hence its main source of influence. During the Great Depression, for example, the SAP toyed with the idea of starting state owned companies which would supposedly be run more efficiently than private companies. But even if the SAP had found a way to run a profitable firms in the middle of the Great Depression the result would have been job losses for workers in competing private sector firms. A labour government which were to take control over firm level investment decisions likewise would be confronted with such problems. To socialize firms would imply that decisions concerning wages and employment would become internal political problems for the labour movement. But as the active participation of Social Democratic Parties in the regulation of the wartime economy had shown, administration of scarcity increased internal tensions both in and between the party and the unions. To a political movement dependent on an appeal to workers in general, political viability and unity required that such divisive issues remained external. Given the economic and internal political problems of socialisation it is not surprising that trade unions generally were skeptical. Even during the turbulent years of 1918/19 the German trade unions were opposed to far reaching socialisation because they feared it would destabilise the economy and hence lower worker’s living standard even more, and because they considered it a threat to their own position. LO(s) had similar views.

Hence it is not possible to understand Social Democracy as a political movement which only differs from socialism with respect to its methods and not its goals. Socialist revolutions have only been a historically relevant option in less developed economies with a radical peasantry and have

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generally had quite disastrous consequences for economic performance and political democracy. The arrangement reached after the Great Depression in which extensive welfare benefits and full-employment were combined with private ownership of the means of production was not a temporary compromise which was to be discarded as soon as Social democracy had accumulated enough power resources to expropriate the bourgeoisie.\(^{21}\) Nor can the 'failure' of Social Democracy to establish a socialist economy be attributed to the electoral logic which requires Social Democrats to water down their programme in a situation where the working class comprises less than half of the electorate, or to the electoral infeasibility of a programme which would lead to superior economic outcomes in the long run but cause economic dislocations in the short run.\(^{22}\) Rather it was its economic and organisational inappropriateness which led Social Democrats to use the socialist programme as a -a times very useful- rhetorical device with negligible importance for practical policies. Historically only the western communist parties chose to ignore the inherent problems of their programme and remain true to the dogma, but at the inevitable price of robbing themselves of an effective policy with which to address the concerns of their alleged constituency and remaining rather inconsequential and dogmatic splinter parties.\(^{23}\)

Yet the error of holding micro level conditions to be decisive for the overall dynamics of the economy is by no means one to which only Marxist fall prey. In effect, supply side views which consider micro-economic competitiveness to be the key for full-employment and overall growth suffer from a similar problem.\(^{24}\) Historically supply-side policies have occupied centre stage in the policy debate at times when macroeconomic policies were dominated by a concern for combating, or preventing the reemergence of, inflation, i.e. during the 1920s and the last two decades. While both the political Left and Right during these periods agreed on the centrality of supply-side policies, each groups advocated different versions. The neoclassically inspired version mainly sees high real wages, high taxes and extensive welfare benefits as the main obstruction to growth and full-employment. The supply side version preferred by the political left, not surprisingly, turns around the neoclassical contention that a weak labour movement is beneficial for economic

\(^{21}\) See, for example, Korpi 1978, Stephens 1986.

\(^{22}\) See Przeworski 1985, Przeworski 1991, Przeworski & Sprague 1986. Given the history of economic policies it would seem a rather odd argument that policy programmes which cause a short term economic crisis with the promise of superior economic performance in the long run are electorally unfeasible. All disinflationary policies rest on this type of argument. Margaret Thatcher, for example, fared fairly well electorally with such a programme.

\(^{23}\) Starting with Lenin, Marxists would commonly attribute the lack of enthusiasm amongst workers for the socialist programme to the latter’s false consciousness rather than to faults in Marxist theory. For a summary see Esping-Andersen 1985, p. 11-14.

\(^{24}\) See also Albo 1994.
performance. In this view, increasing productivity and improving the attractiveness of the product mix, rather than cost cutting, is seen to be the key to prosperity. Strong trade unions and high real wages promote overall prosperity because they prevent employers from choosing the low cost road to competitiveness but instead force them to continuously innovate and compete on the basis of quality instead of price.\textsuperscript{25} Hence in a complete reversal of Marxist assumptions labour's microeconomic strength now is seen to have positive effects for overall economic performance. Whereas the neoclassical demand for lower costs remains rather unchanged throughout the decades, the strategy of regaining prosperity through higher productivity during the twenties was known under the label rationalization. Despite the sometimes heated debates between the advocates of the respective views, in practice both types of policies are pursued in times of crisis as the argument that in the long run only productivity increases can ensure survival may not be useful for firms in acute difficulties.\textsuperscript{26}

One possible reason for their repeated popularity is that supply side views do conform to the micro level experience of labour. For workers who lose their job as their firm failed to attract sufficient demand for its products the conclusion that improved competitiveness equals more jobs would seem rather obvious. And while wage-earners generally do realize that lower wages would improve the competitiveness of the individual firms, they quite naturally display a preference for avoiding wage cuts and improving productivity.

However, such strategies cannot be generalised to the macro level. As will be discussed in more detail in chapter 2, it is not clear at all that wage earners can reduce their real wage by accepting nominal wage cuts. Since wages are variable costs, general nominal wage reductions may rather lead to deflation rather than real wage cuts. Moreover, competitiveness is a relative term. Even if a firm manages to improve competitiveness, either by cost reduction, improved productivity and/or a more attractive product mix, there is no reason to assume that this will lead to an increase of aggregate employment. Aggregate employment increases only if production is increased by more than productivity gains. By itself, increased competitiveness for one firm just means loss of market

\textsuperscript{25} For a recent versions see Matzner & Streeck 1991, and Streeck 1991. For Sweden Erixon (1989) has argued that insufficient cost pressure has caused Swedish industry to lag with respect to innovation and modernization. Already in 1923, the SAP's leading figure on economic policies, Ernst Wigforss, could point out that the argument that high wages would stimulate employers to 'rationalise' production was an old argument within the labour movement. See Unga 1976, p. 60.

\textsuperscript{26} The Samuel Commission on the reorganisation of British Coal Mining -whose report precipitated the general strike of 1926- clearly saw that in the longer run the solution had to be improved productivity but in the short run could think of no other solution to the losses accumulating in the industry than to lower costs (i.e. wages). See, for example, Mowat 1963, p. 297-8.
shares for another firm, while increased productivity of the economy simply means that the same level of production can be will require less labour. In sum, whatever the merits of the respective supply side positions, since there is no reason to assume that improved supply side performance will lead to higher aggregate production, there is no reason to assume either that such strategies, by themselves, can lead to renewed prosperity. Rather a policy which relies on a microeconomic strategy for employment under a restrictive macroeconomic regime is likely to contribute to increased inequality between a highly paid, highly educated sector of the economy and an increasingly marginalised, underemployed and undereducated sector.

Practically it would prove impossible to base a successful Social Democratic strategy on such a concept of supply side policies. Most importantly because, such strategies too have the effect of undermining the cohesion of organised Labour.\(^{27}\) Indirectly they do so because their failure to remedy unemployment implies a weakening of the Unions labour market position. But in a situation of continued unemployment workers in individual firms will be increasingly tempted to accept wage cuts in order to save their jobs. As will be shown in chapter 3 since the late twenties the unions started to exert massive pressure on Social Democratic parties to seek macroeconomic solutions to high unemployment exactly because the existing economic constellation had become an acute threat to their internal cohesion. And while in the present conditions unemployment may be less of a threat to the unions it is no coincidence that the strategy of employment through high wages and strong unions cites the IG Metall as its crown witness. Organizing mainly the highly skilled highly paid blue collar metal workers, the IG Metall can be fairly indifferent with respect to permanent mass unemployment in Germany. Seen from the policy side, Kennworthy (1990) has correctly argued selective industrial intervention is incompatible with the logic of encompassing organisations. A Social Democratic party which engages in selective industrial policy will almost inevitably be confronted with local coalitions of workers and employers competing for state assistance.\(^ {28}\) Moreover, because supply side policies historically have been unable to solve the

\(^{27}\) Sabel 1993, p. 155, confirms the point when he argues that in order to effectively contribute to improving firm level competitiveness the traditional model of a centralised trade union may not be suitable. Rather trade unions should “push responsibility for decision-making down to the local operative level...”.

\(^{28}\) See also Pontusson 1992, p. 224 for a Swedish example. "Selective state intervention did indeed open a new arena of political contest in the 1970s, but the way issues of industrial policy came to be framed did not elicit class-based mobilization of wage earners. Instead, it elicited their community based mobilization in defense of jobs, frequently involving an implicit alliance with the managers and owners of firms in competitive troubles. Such mobilization weakened the cohesion of the labour movement, and it was partly for this reason, along with budgetary considerations, that the Social Democrats abandoned selective industrial policies in the 1980s"
problems of mass-unemployment and economic stagnation, they also implied the stagnation of another project of crucial importance to Social Democracy, namely the development of the welfare state.

In short, somewhat similar to the problems inherent in a Marxist programme, also supply side policies generally could not provide a foundation on which a successful Social Democracy could be build because neglecting the macro-policy dimension makes the goal of full employment unattainable. To avoid confusion, the point being made here is not that supply side policies are unnecessary or ineffective, but that it is inadmissible to treat microeconomic policies as a functional equivalent for macroeconomic policies.29 It is indeed hard to see how a healthy economy can be based on high wages and low productivity. And especially in an international system in which other countries pursue such policies, neglect of the supply side will have high costs. The level of productivity traditionally had to be an important concern for Social Democracy because it determines firm level competitiveness and the feasible real wage.30 But there is no reason why a high productivity, high wage economy cannot be at the same time a low growth high unemployment economy and vice versa. Nor is it to be argued that supply side policies are undesirable because they tend to lead to fragmentation of the labour movement. Trade unions are no holy cows and if the traditional Social Democratic union indeed is an impediment to economic performance, there seems to be no good reason for maintaining them.

Social Democrats hence could not afford to concentrate on micro level policies alone but had to become involved in macroeconomic policies. The Marxist rhetoric of many early Social Democrats has led some to argue that Social Democrats neglected economic policies because they believed socialist society would inevitably fall into their lap anyway without much effort on their part.31 Yet, Social Democrats could at no time afford to ignore that the state’s economic policies could strongly affect the circumstances of their constituency, either for the good or the bad.32 SPD, DNA and SAP already before the war saw themselves as reformist parties. Despite the official acceptance of Kautsky’s historical fatalism, in its practical policies the SPD saw the transition to socialism rather as the end result of a gradual strategy of reforms.33 And with the fall of the

29 For example, Streeck 1991, p. 23, 31.
30 On the concept of the feasible real wage see Layard 1986, Chapter3.
31 See Lewin 1967, Chapter 1.
32 In 1922, for example, the DNA, which in theory had shed its former reformism by joining the Comintern in 1919, published an 8 point programme with measures to combat unemployment. See Esping-Andersen 1985, p. 10.
33 See also Könke 1987, Chapter 2.
Kaiserreich and the emergence of the Weimar Republic, the political preconditions for such a strategy now seemed to be given. Especially after the war, references to the historical inevitability of socialism, within the SPD rather served to defend reformist practices against internal criticism of a lack of revolutionary policies. In Britain, Marxism traditionally had failed to gain a strong hold of the Labour Party. British socialism viewed the transition to socialism as a gradual process, and accordingly the party recognized the need to develop policies which could be applied already within a capitalist economy.\textsuperscript{34}

The weakness of the early labour movement relative to employers and the inability to make much headway on the issue of socialisation rather led Social Democrats traditionally to look towards the state as a third party which might improve their circumstances. Given their ideological and sociological structure Social Democrats had a natural affinity for macroeconomic theories which postulated that measures benefiting the working class also benefited the economy. Traditionally this meant adherence to underconsumptionist theories.\textsuperscript{35} In these views it is assumed that the uncoordinated process of investment in market economies periodically leads to an expansion of the production capacity which exceeds societies ability to consume. An effective policy to combat the crisis hence should increase the purchasing power of workers in particular since they generally tend to consume a higher share of their income than most other groups. In the longer run avoidance of crisis would require social control over the macroeconomy.\textsuperscript{36} While Keynesianism did not have much in common with underconsumptionist theories, Keynes advocation of countercyclical fiscal spending, his contention that greater equality of wealth benefited the growth of the economy,\textsuperscript{37} and his belief that "a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full-employment"\textsuperscript{38} did echo economic policy proposals which had already been formulated in older views. It is hence not surprising that Social Democrats would embrace Keynesianism during and after the Great Depression, because here seemed to be a policy which could solve their political and ideological dilemmas.

\textsuperscript{34} See, for example, Skidelsky 1967, p. 28-30.
\textsuperscript{35} See Lewin 1967, p. 66.
\textsuperscript{36} On the SAP's shift from stressing nationalisation of industry to emphasising control of the macro economy see Tilton 1988, p. 374-9. Keynes, of course, held similar views, "It is not the ownership of the instruments of production which it is important for the State to assume. If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary." Keynes 1973, p. 378.
\textsuperscript{37} Keynes 1973, p. 373.
\textsuperscript{38} Keynes 1973, p. 378.
To argue that employment can be increased with stable or even increasing real incomes by stimulating effective demand removed the contradiction between the pursuit of firm-level interest and overall prosperity. Wages, and social security benefits did not have to be reduced any more in order to attain economic prosperity, rather they were seen to play a fundamental role in maintaining effective demand and hence stabilising the economy. Hence Social Democrats could abandon the defensive view that high wages and social security benefits perhaps had some negative economic consequences but were desirable from a social and moral viewpoint and embrace the politically rather more effective argument that such arrangements were beneficial to growth and economic stability.\(^{39}\) Moreover, the view that markets are crisis prone and that only by means of interventionist policies full-employment and adequate prosperity can be assured allowed Social Democrats to interpret such policies within their traditional ideological framework that a capitalist system needs to be subjected to social control, while it avoided politically and economically disastrous experiments with socialisation of the means of production. By arguing that social control over the economy could be attained without necessarily having to abolish private ownership, macroeconomic interventionism could be accommodated within traditional ideological concepts.\(^{40}\) While nationalization generally proved unpopular with the electorate\(^{41}\), macro stimulation would allow to extend their appeal beyond the narrow base of manual workers. In short with placing the emphasis on maintaining growth and full employment by means of macroeconomic stimulation, Social Democrats seemed to have a programme which not only could satisfy the economic and ideological needs of its constituency but also would seem appealing to middle class sections of the proletariat and even employers.\(^{42}\)

Yet, despite the inherent political and economic attractiveness of a view in which the state would overcome the zero sum game into which capital and labour seemed locked, Social Democrats almost immediately had to find out that such a position was not an appropriate foundation for policy making. Entering the macroeconomic level inevitably meant that Social Democrats also would


\(^{40}\) See, for example, Colbjørnsen & Sømme 1933, Chapter II.

\(^{41}\) In Sweden for example, The strong emphasis on socialisation in the elections of 1920 and 1928 lead to disappointing result for the SAP. In the twenties the DNA had its greatest electoral success when it stressed concrete remedies to the economic crisis in the election of 1927, whereas the greater emphasis on revolutionary socialism in the 1930 elections caused an electoral defeat.

\(^{42}\) See also Scharpf (1987, p. 43) who points out that it was on the basis of Keynesian economics that "Social Democratic concepts gained the 'hegemonic' plausibility which, in the post war period shaped the political programmes even of bourgeois parties and established a 'social democratic consensus' even in those countries where Social Democratic parties only governed rarely." (My translation).
have to come to terms with problems of inflation and deflation and the management of the monetary system. But not only were problems of absolute, rather than relative prices quite beyond their traditional thinking in terms of distributive problems between classes, the issues of inflation and deflation also could hardly be fitted within their understanding of the state.

Due to its focus on a distributive micro level conflict between capital and labour macro level problems of inflation and deflation and the management of the monetary and financial system did not occupy a prominent place in Social Democracy's theoretical image of the economy. It could be observed, of course that rapid change in the price level did affect the economy. A rapid inflation would mean that real wages would tend to be reduced and profits and employment increased while a rapid deflation had the opposite effect. But while monetary management apparently did influence the pattern of booms and crisis, these were considered short term effects. To conceive of a system in which monetary causes would have real effects in the long run went beyond the normative framework of Social Democracy, for which the labour-capital conflict and the development of the productive system were considered of core importance. For Marx, of course, the dynamics of the economy were determined by the productive system while monetary phenomena ultimately were considered epiphenomenal. As in neoclassical quantity theory, for Marx, changes in the quantity of money would ultimately only lead to changes in the price level while not interfering with the productive forces of the economy. This view, however, had two unpleasant implications.

First, the policy reaction of conservative and liberal governments in response to inflation could hardly be accommodated within the Social Democrats' traditional understanding of the constellation of interest informing macro level politics. What were early Social Democrats, with their emphasis on the struggle between capital and labour, to think of the spectacle of Liberal or Conservative governments - who were allegedly the political representatives of the employers-returning to the Gold Standard against the wishes of some prominent 'capitalists' and at the cost of provoking a major crisis? If governments could disregard the wishes of industry to such an extent, it would obviously be difficult to consider them the political representatives of capital. But at the same time governments were decidedly not sympathetic to Labour. So what were the motives behind these policies?

Of course, Social Democrats might try to attribute these restrictive policies to the wishes of financial capitalists. But even the use of the term financial capitalist would not be sufficient to conceal that these issues could hardly be subsumed under the great antagonism between capital and

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43 See Marx 1977, ch 3.
labour. If restrictive monetary policies would cause major unemployment crisis, even though only in the short run, did not industrial capital and labour have similar interests against financial capital? And if so, would a political alliance between capital and labour against the interests of financial capital not be in the interest of both groups? Moreover, what interests could financial capitalists have in a policy which would even bring many banks in trouble due to debt defaults?

Representative of this confusion is a passage from a manifesto of the 1923 Norwegian Blue Collar Trade Union (AFL) congress published in reaction to Norges Bank’s deflationary policies which had caused massive unemployment plus a banking crisis. "The many bank scandals which have shaken the society and have caused the people immeasurable losses, show clearly what a disaster it is that the capitalist class is the ruling class, and how necessary it is that its power is broken. Instead of regulating and stimulating productive work, banks have supported capitalist speculation. They have created more insecurity, and with the abnormally high interest rates, banks have become a burden for the people." 44 But who are 'the people' here? Certainly not only the working class who suffered from unemployment, but certainly also the 'productive capitalists' who suffered bankruptcies. Certainly also bankers who confronted an economy wide banking crisis. And certainly also financial investor who lost due to the failure of firms and banks. Similar question could be asked about more recent episodes like, for example, Margaret Thatcher’s extremely restrictive policies of the late seventies and the early eighties, or about the policies of the Bundesbank since 1974.

Secondly, the view that problems of money were rather ephiphenomenal in the longer run reintroduced the zero sum game on the macroeconomic level and hence implied that the state could not perform the function of mediating the micro level zero sum game. If changes in the volume of money could not affect the real economy, than fiscal policy could not do so either. Certainly the state could attempt to alleviate a crisis by increased spending but if it were to balance the budget it would have to raise taxes thereby drawing in again the purchasing power it created. Alternatively it could finance a deficit by means of loans but that meant drawing in means of credit which the private sector could have used for expansion. And financing a deficit by money creation would not help because that would merely create inflation. Hence Social Democracy would be back at the micro level strategy of trying to reduce unemployment by means of supply-side policies.

While in order to thrive politically Social Democrats hence needed to avoid a constellation in which the goal of strengthening the position of labour was considered antithetical to the overall performance of the economy, historically there have been only two periods since 1918 in which they have been able to do so. At the end of the first world war reducing the claims of labour on the national product generally was not considered the most promising avenue to economic recovery and prosperity. Rather governments placed their hopes primarily on accommodating monetary policies in order to promote growth and investment. This policy orientation however, did generally not survive the year 1921. The view that macroeconomic policies hold the key to growth and employment again surfaced in the wake of the Great Depression. Stimulating growth and employment now became the main concern of macroeconomic policy authorities. And instead of being considered a threat to economic prosperity strong trade unions and developed welfare systems rather came to be seen as valuable stabilising elements. As a result monetary policy, rather than setting the parameters for economic policies, now became integrated within the overall policy strategy and Central banks accordingly enjoyed a much less autonomous position. With macroeconomic policies assigned to growth, the responsibility for price stability came to rest on micro-level measures like incomes and price policies. The first world war gave rise to extensive price regulations and close cooperation between business governments and labour concerning wages. Yet these microeconomic policies did not survive for long after the armistice. After 1945, however, price and quantity regulations remained in force much longer, and incomes policies became a constant feature of European political economies. Ideologically and politically this regime was the Golden Age for Social Democrats. As the developments of the interwar period had convinced also centre-right political parties that interventionist macroeconomic policies were required to achieve acceptable economic outcomes and that cutting wages, taxes and welfare benefits was not a promising avenue to economic prosperity, Social Democrats would see much of their policy programme realised even in those countries where they did not manage to obtain a dominant position in government.

During the interwar Gold Standard and in the disinflationary regime of the seventies and eighties, in contrast, Social Democrats, even when in government generally found themselves on the defensive. In both regimes the assignment of responsibilities between micro and macro policies was opposite to what it had been in the preceding regime. As the Conservative Chancellor of the Exchequer, Nigel Lawson (1993, p. 414-5) explained: "The conclusion on which the present Government's economic policy is based is that there is indeed a proper distinction between the objectives of macroeconomic and microeconomic policy, and a need to be concerned with both of
them. But the proper role of each is precisely the opposite of that assigned to it by the conventional post-War wisdom. It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macroeconomic policy. And it is the creation of conditions conducive to growth and employment, and not the suppression of price rises which is or should be the objective of microeconomic policy."

Combating inflation now became seen as the main concern of macroeconomic policies. Restrictive monetary (and fiscal) policies, were argued to have only short term negative consequences for growth and employment while in the longer term they lead to continuously lower inflation. As a result of this policy orientation, Central Banks were given the authority to divest themselves from the domestic policy concertation process and to set the parameters to which the remaining policy actors have to adjust. In contrast to the other two regimes, the interwar Gold Standard and the present day disinflationary regimes were continuously plagued by low growth and mass unemployment. But also in contrast to the previous regimes these problems now were attributed mainly to micro level deficiencies. High wages, high social security benefits, the inflexibility of labour and insufficient innovation on the side of employers, now became the main focus of attention. And while Social Democrats, quite naturally placed the emphasis on the last cause, in a world economy marked by low growth and high unemployment they could not but fight a defensive battle on the other three issues.

But why did the economic policy orientation change so radically over time? Was Social Democracy simply politically too weak to prevent a change to an unfavourable regime in the early twenties and during the last two decades. Or was it rather Social Democratic policy mismanagement which made a change in regimes inevitable? Can the history of the early twenties and the last two decades be read as proof of the "liberal" contention that a macroeconomic policy which attempts to stimulate growth and employment must necessarily result in inflationary mayhem? Or are we to conclude that changing policy orientations were merely the passive reflex of structural economic developments like, for example, the transition from a "fordist" to a "post fordist" type of technology, the emergence of international capital flows, the emergence of a supply side crisis in the last two decades as opposed to demand efficiency in the Great Depression? Was the possibility of a accommodation between capital and labour dependent upon the coincidental emergence of a long period of economic growth after the end of the Second World War? Or was the social and political accommodation achieved the result of the change in policies during the Great Depression?
2 Politics, Economics and Political Economy

"Economics is well known for the supposed inability of economists to agree amongst themselves on almost anything." (Derek Robinson 1986, p. 2)

"We [political scientists] swallowed economics before subjecting it to a political analysis." (Theodore J. Lowi, 1992, p. 5)

"the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economists. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." (Keynes 1973a, p. 383)

2.1 Politics, Policy Preferences and Economic Theory

Commonly politics can be understood as a process in which competing groups, within a stable framework of rules and institutions, try to affect the distribution of political goods in their favour by means of, for example, coalition building and resource mobilization. But while societal institutions usually interlock tightly and hence are prone to exhibit considerable inertia, the cohesion of the institutional network seems to be radically weakened during certain periods, which opens the possibility of a radical rearrangement of the entire institutional infrastructure. A those critical junctures in history, politics is mainly concerned with the reshaping of the framework of rules and institutions within which political competition is to take place. These periods of regime changes are primarily marked by a reinterpretation of the relation between policy instruments and outcomes and a redefinition of the responsibilities of political actors. In the field of economic policy a period of regime change can be understood as a period in which a different theoretical interpretation of the economy becomes dominant within the political process.

Although the body of economic theory is continuously expanded and refined, the theoretical interpretations of the economic process which have gained dominance in the policy sphere during the last century or so can be characterised in terms of two competing sets of propositions. In terms of policy-making the core difference between what may be called the neoclassical and the Keynesian position is that the former holds that macroeconomic policies can only affect the price level and not real values like national income and employment, whereas the latter argues that the state can and should influence growth and employment. At the core of the neoclassical perspective stands
the so-called quantity theory of money which basically involves the proposition that the price level is a function of the volume of money. In the standard notation of equation 2.1 the quantity theory can be characterised as the triple proposition that; the volume of money (M) is determined by the political authorities (the Central Bank); the level of real income (T) is determined by the market and the velocity of money (V) is stable.\textsuperscript{45} In that case the price level (P) is a function of the money supply. An in(de)crease of the volume of money will simply lead to a higher (lower) price level while not affecting real income.

\[ M \times V = P \times T \quad (2.1) \]

From the view that monetary policies cannot affect the level of income also follows the proposition that fiscal policies cannot do so either. Having become famous in the 1920s under the name Treasury View, the neoclassical position holds that a loan-financed fiscal deficit will rather have the effect of replacing private with public investment, as it absorbs funds which otherwise would have been put to use in the private sector.

Historically the periods in which the neoclassical interpretation was dominant in economic policy-making have also been periods of high unemployment and relative stagnation. In practice, therefore, those views have required an explanation of how the view of a market determined level of real income is compatible with persistent unemployment. The answer is provided by what may be called neoclassical supply side views. In terms of the labour market the neoclassical position holds that the level of employment is independent of the level of national income and a function purely of the real wage. Figure 2.1 shows the standard neoclassical labour market analysis in terms of demand and supply. The labour supply curve (S) is upward sloping as wage earners will consume less leisure time and offer more labour as the real wage (W_r) increases. The demand curve for labour (D) is downward sloping as the decreasing marginal utility of factors of production requires the real wage to be lowered for an additional unit of labour to be profitably employed. Existing unemployment is hence either voluntary, to the extent that wage earners preferences lead them to reject the lower real wage which would clear the labour market, or involuntary, to the extent that institutional factors like trade unions or minimum wage legislation prevent wage earners from supplying labour at a lower price level.

\textsuperscript{45} In more recent versions of the Quantity Theory, like, for example, Milton Friedman's, inflation is understood as a tax on money holdings and the velocity of money is hence seen to increase in response to higher inflation. Four our purposes this point is not crucial.
Because in the neoclassical theoretical framework inflation is a purely political phenomenon actual historical inflations are explained with reference to misguided political interventionism. Or, put differently, the state comes to be seen as a destabilising element in an otherwise stable market economy. Inflations are the outcome either of a weak state, which by means of printing money attempts to satisfy the incompatible distributional demands of social groups, or of a calculating government which tries to maximise its own electoral popularity by engineering a short term boom at election time at the cost of long term inflation. In their "Monetary History of the United States" Friedman and Schwartz (1963) argued that the Federal Reserve's policies had to bear the main responsibility for the Great Depression in the U.S. As a consequence the quantity view generally gives rise to the demand to isolate the conduct of monetary policy from the demands of civil society and governments by awarding central banks political independence and/or removing the possibility for policy discretion by tying the currency to an external anchor.

In sum, in the neoclassical view inflation and deflation are political phenomena while the level of employment and income are market phenomena. Macroeconomic policy makers cannot accept responsibility for national income and employment while the central bank, and only the central bank determines the nominal price level. In a Keynesian perspective, in contrast, the state can have a decisive influence on the level of income and employment while inflation and deflation are primarily seen to originate in the labour market. Equations 2.2 to 2.4 present a rudimentary Keynesian model. Equation 2.2 represents total effective demand (Y) as the sum of consumption (C), investment (I) and the public sector budget balance (B). Assuming that consumption is a function of income (2.3), equation 2.2 can be rewritten as 2.4.
\[ Y = C + I + B \]  \hspace{1cm} (2.2)
\[ C = cY \]  \hspace{1cm} (2.3)
\[ Y = \frac{1}{1-c} \times (1 + B) \]  \hspace{1cm} (2.4)

Whereas neoclassical views tend to hold that a free market produces a stable and optimal level of income, Keynesians hold that investment demand, and hence also income, tends to fluctuate over time. Yet, by means of discretionary changes in the budget balance the government can neutralise the effects of investment on income. Because employment is seen to be primarily a function of income rather than the real wage, this also implies that by means of demand management the state can maintain full-employment despite the inherent instability of a market economy. Although it is recognized that it cannot continue indefinitely without monetary accommodation by the central bank, inflation is primarily interpreted as a phenomenon which originates in the labour market under conditions of full-employment. Confronted with high demand and no possibility to expand production employers will increase prices (profit inflation) while full-employment conditions will lead to higher nominal wage agreements (wage inflation). Restrictive fiscal management in order to reduce excessive demand will be required in such a constellation.

Since governments are seen to be able to reduce employment by means of expansionary policies. Historically Keynesian views have required an explanation of why governments, at times do not do so during recessions. In practice this meant that Keynesian have displayed an affinity for arguments which stress the crucial influence of economic ideas on policy-making or the external constraints on demand management policies in open economies. In times when expansionary policies are seen to be unavailable due to external constraints also Keynesians may come to emphasise supply side policies, understood as attempts to expand total demand by promoting investment. Yet, in line with their more skeptical attitudes towards free markets, Keynesians historically have rather shown an affinity for active stimulation of innovation; new technologies; rationalization and productivity instead of the neoclassical preference for policies which aim to remove what are perceived to be institutional obstacles to free markets.

In a positivist understanding of social science it should be possible to decide the debate between these two competing schools of thought in an empirical manner. Indeed the advocates of the respective views regularly claim that historical developments have confirmed their view and refuted the competing position. For neoclassics the inflation of the late teens and early twenties and the inflation of the seventies provided conclusive evidence that a policy of stimulating the economy by macroeconomic means will only lead to inflationary disorder. For Keynesians the
Great Depression showed that a policy which attempts to stabilize the economy by tying monetary policies to an external anchor and to by striving for balanced budgets will produce crisis and instability instead.

Yet the historical shift in economic orthodoxies speaks powerfully against the positivist interpretation of the process of economic theory building. As Charles Kindleberger (1987, p. 6) has pointed out that the debate between neoclassics - or monetarists as he labels them - and Keynesians "did not have its origin in the 1920s or 1930s, as many students of the subject think. but can be traced back to the seventeenth century and beyond." Instead of observing a process whereby the interplay between theoretical reflection and historical reality leads to the crystallization of a commonly accepted theory of the working of the economy, the historical shifts in politically dominant economic theories rather seems to describe some sort of sinus curve in which some core positions - always in different historical forms - replace each other as the dominant interpretation. As will be argued in the next chapter the view that expansionary fiscal policies could be used to alleviate unemployment had been around for a long time and governments certainly did not have to await the publication of the General Theory. Similarly the view that expansionary monetary policies will merely create inflation dates back at least two centuries before Milton Friedman. As, for example, Frank Hahn (1984, p. 325) argued in the context of a review of modern monetarist theory: "...macroeconomics today is in the state in which astronomy would be if Ptolemaic theory once again came to dominate the field. There can in fact be few instances in other disciplines of such a determined turning back of the clock. A great deal of what is written today as well as the policy recommendations which have been made would be thoroughly at home in the 1920s."46

To avoid misunderstandings, the argument here is not that economic science has achieved no progress. The development from Adam Smith's (1981) notion of the 'invisible hand' to the Arrow/Debreu/Hahn formulation of general equilibrium theory does indeed constitute major scientific progress. The same holds true for Friedman's version of the quantity theory as compared to Hume's early formulation. Sraffa's (1960) modelling of the classical view is clearly a significant step ahead from Marx' inconsistent solution of the transformation problem.47 Similarly the step

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46 Clarke (1988, p. 324), in the context of the British debate, interprets the emergence of monetarism in the seventies as a return to some of the core position advocated in the pre-Keynesian Treasury view of the 1920s. Similarly Tobin (1980, p. XIII) understands the modern debate in macroeconomic theory as "a resumption of an older theoretical battle forty years ago, provoked by Keynes' challenge to the old classical macroeconomics." (See also p. 20).

47 See also Steedman 1977.
from mercantilist notions of the stimulative effects of cheap money to, for example, Keynes' views on monetary policy is a major scientific advance. Yet, as the above enumeration implies, theoretical progress in economic theory apparently does not lead towards the replacement of competing theories with one generally accepted view, but rather takes the form of developing and refining separate economic paradigms. Despite the recent debate between monetarists and Keynesians for example, the core issue which sets these two schools apart, namely whether money is neutral in the long run or not, remains as undecided as ever.

The repeated changes in economic orthodoxies, the continuous disagreement between economists, and the observable real world affinity between on the one hand neoclassical views and the centre-right of the political spectrum and, on the other hand Keynesian views and the centre-left has led some scholars to suggest an analysis of the process of economic policy-making primarily in terms of political power relations. In this perspective competing economic models are seen as rationalizations of particular interests. From the point of view of the policy maker, economic theory provides the valuable function of enhancing the political acceptability of arguments based on political preferences by presenting them as the outcome of neutral scientific reasoning. Especially in democracies, where the political viability of many proposals requires fairly broad-based political support, it would seem advisable to couch particularistic interests in generalised and scientific terms. And because the debate between economic theories is seen to be rooted in conflicting political interests, it should indeed not come as a surprise that, despite a long-standing attempt by many of its practitioners to give the science of economics a more objective grounding, economic arguments can commonly be found on both sides of an issue. According to Susan Strange (1986, p. 79), for example, ".. there is also ample evidence that economic theories are like detergents on a supermarket shelf. Politicians decide on other grounds what ends they wish to achieve and will pick on the appropriate legitimating economic theory as a shopper picks off the shelf the detergent that suits the kind of washing or cleaning he or she wants to do." Alan Budd recently argued. "Even if it is their [the government's] preferences that have changed they are likely to justify their actions (or inaction) by reference to unavoidable technical constraints - 'There is No Alternative'" And in the view of Theodore Lowi (1992, p.3) "economics has replaced law as the language of the state" in modern democracies.

48 Under a pure Gold Standard and with no domestic gold mines expansionary monetary policies require a trade surplus. Hence the mercantilist policy of placing restrictions on imports. See also Keynes 1973, Ch. 23.

Yet, the attempt to reduce economic theories to political preferences is unconvincing for both historical and theoretical reasons. If economic theories indeed merely serve to camouflage political preferences, the observed changes in the theory informing the process of economic policy-making should be related to broad societal changes in political power relations. But historically policy regime changes have been characterised by a reinterpretation of the proper role of economic policy across most of the political spectrum rather than simply by shifts in the political support pre-existing positions could muster. During the twenties, for example, most Social Democrats embraced the dogma of the Gold Standard and sound finance just like their conservative counterparts. And while they frequently preferred not to express it too openly, many Social Democrats, as a result believed cost reduction to be the most promising road to more employment. During the Great Depression, the new policies of abandoning gold, stabilising prices and cheap money, were frequently initiated by parties to the right of Social Democracy. Similarly during the 'Golden Age', conservative parties generally accepted expansionary macro policies and the welfare state. As is well known, during the sixties 'we were all Keynesians'. PM Thatcher's economic policies, for example, were not only a significant break with the policies of her Labour predecessors but also differed radically from previous Conservative policies.50 At present most Social Democratic parties, although frequently for different theoretical reasons, have come to accept the neoclassical postulate of the impotence of macroeconomic policies.

And while there is no reason to deny that in the daily policy process economic theory indeed is frequently used to give political preferences an aura of scientific objectivity, it is ultimately theoretically impossible to reduce economic theories to political interests. Even if it is assumed that the structure of industrialized societies necessarily creates groups with a priori preferences concerning goals - high profits and high demand for employers and high real wages and full-employment for employees- it is the economic theory employed which will determine how these preferences are to be translated into demands for policy. But, if economic theories are prior to policy preference formation, explanations of regime changes in terms of the changing balance of power in civil society must necessarily be inadequate.51 In that case the standard political science

51 Inevitably even those who attempt to reduce economic models to political interests must do so on the basis of some form or other of economic theory. Sometimes one is tempted to pervert Keynes famous dictum, quoted at the beginning of this chapter: social scientists who believe themselves to be quite exempt from any influence from economics, are usually the slaves of some defunct economists.
model which is concerned with the analysis of the process, by which a given societal distribution of interests translates into actual policies, will have relevance only for the analysis of politics within a given policy regime but not for regime changes.

To give an example, assume that trade unions and Social Democratic parties do have an inherent interest in full-employment and high wages. How this interest translates into policy (demands) necessarily depends on what economic theory they consider to be correct. It would, therefore, be erroneous to assume that organised Labour generally considers expansionary demand management to be in its interest. This is only the case in periods where the organised Labour movement has come to believe in some form of Keynesianism, but it is just as well possible, as was the case in, for example, the twenties and the present period, that organised Labour advocates a rather conservative stand on macroeconomic policies and places its hopes on microeconomic policies promoting high productivity and competitiveness. If it is accepted that macro-policies do not affect the real economy, the political battles over employment will focus on microeconomic policies. (Some) employers might prefer to emphasize the need for cost cutting while (some) unions might be tempted to stress ‘rationalization’ as a way of improving competitiveness without cutting real wages. A decisive shift in the balance of power between these groups hence, at best would lead to a different type of microeconomic policies, rather than to the paradigmatic shift in assignment of instruments to goals which can be observed during regime changes.

Put differently, the theoretical project of a political theory of economic policy which tries to interpret policies pursued and the political dominance of specific economic theories as a function of the interests of political groups is unfeasible because in order to determine which policies are in whose interests a prior economic theory is required which specifies how economic policies affect outcomes. Even those economic theories which become accepted in the policy-making process accordingly cannot be understood as apologies of political interests. On the contrary, because economic theories specify which goals economic policies can affect and what the links between policies and outcomes are, they structure the boundaries between state and civil society and mould the policy preferences of the electorate.

52 See, for example, Gourevitch 1989.

53 Within the trade unions these different views on the relevance of micro versus macro policies also tends to promote an intra-organisational shift between local and central levels. Only the state pursues macroeconomic policies and effort to influence them hence will tend to be channelled through the national leadership. It unions believe to be best served by microeconomic policies, the firm level would seem a more important policy arena.
But this simply implies that political science or political economy cannot attempt to analyse the process of economic policy-making without explicit or implicit reference to a theory of how the economy and economic policies function. Hence the dilemma that also confronts political analysis of economic policies is that they have to employ a theory of the economy but that there seem to be no generally accepted criterion for selecting amongst the several available candidates, because "each of today's major economic doctrines also presupposes a model of society and politics" and because it is not possible to attempt an analysis of economic policy-making without reference to an economic doctrine, also for political scientist the choice of a model of politics and society comes to be strongly influences by the economic views they implicitly or explicitly adhere to.\(^{54}

Is one to embrace a neoclassical type of view and direct the attention in periods of inflation to the weakness of the state and the conflicts between social groups, or a Keynesian view and focus on the organisation of the labour market? Or does the emergence of inflation require political scientist to explain why it is that the state tries to fool the electorate by engineering short lived booms? Is one to understand the political accommodation between capital and labour in the wake of the Great Depression in a neoclassical fashion as the result of an exogenous process of growth or as the outcome of a reorientation of policy? Does the persistence of mass unemployment require us to analyze the sociological process of micro level interaction between employers and employees, or is the political process of macro policy formation the more appropriate focus for analysis? Is the emergence of mass unemployment an exogenous economic event or does it require an analysis of the political failure of macro policies? Is one to understand the changes in economic policies during the last two decades in terms of adjustment to structural and external forces like international capital mobility or technological change, or in terms of the destabilising effects of previous policies?

2.2 The (non) neutrality of money as the core paradigmatic concept in political economy

Because the economic theory implicitly or explicitly employed has a crucial influence on the focus of analysis as well as the conclusions drawn, also political scientists and historians ultimately cannot reject to justify their economic views. Fortunately this justification can be a bit less defensive than a reference to the existence of several and ultimately unfalsifiable economic paradigms. In

\(^{54}\) Maier & Lindberg 1985, p. 570.

\(^{55}\) Those with a more cynical bent might want to argue that the choice of theoretical approach to the analysis of economic policy is a function of the prior political convictions of the respective authors.
this section it will be argued that both neoclassical and Keynesian approaches have to be rejected as a starting point for the analysis of the process of economic policy-making. The argument rests on four main points:

(1) The quantity theory cannot be an accurate specification of the policy constraints and possibilities facing governments during times of inflation. Because it argues that inflation has positive effects in the short run and no effects in the long run, the priority governments have given to combating inflation in the twenties and during the last two decades remains inexplicable.

(2) The neoclassical assumption of a stable market economy, and the subsequent attribution of real world instabilities to the political system, is not a conclusion which can be derived from the neoclassical paradigm but rather a normative assumption which stands in contrast to the analysis of that paradigm.

(3) The analytical separation of the monetary from the real sphere, which is necessary to conclude that macroeconomic policies cannot affect employment, is implausible and ultimately based on the normative assumption that there is no uncertainty.

(4) The habit of neoclassical and Keynesian analysts to derive their conclusions from analyses in comparative static terms makes these approaches inappropriate for the analysis of the options and constraints facing economic policy makers. Economic policy-making takes place in real time and policy makers hence have to be concerned with the actual dynamic behaviour of economic agents rather than the comparison of two (hypothetical) equilibrium points.

- While dominant in political and academic circles during the fifties and sixties, Keynesianism came under heavy attack from neoclassical/monetarist scholars in the seventies. The main point of critique was that the Keynesian contention that the state can increase employment by means of expansionary demand management lacks a theoretical foundation. The neoclassical labour market analysis (figure 2.1) formed the starting point of the critique. Given the capital stock, an additional unit of labour employed will have a lower marginal productivity and accordingly the real wage must be lowered. Even if the state were to engineer an increase in demand it would not be profitable for firms to employ more labour. But if the real wage could be lowered then the additional employment would be forthcoming also without expansionary demand management. According to the neoclassical critique Keynesian policies could only be successful in creating more employment under a situation of so-called 'money illusion'. Money illusion denotes a situation in which wage earners do not perceive the reduction in real wages resulting from a rise in the price level. Because a reduction in unemployment (U) requires a reduction in the real wage (W_r)(2.5), the political
authorities can only bring about a decrease in unemployment if they engineer an increase in the price level \((P)\) by means of an increase in the volume of money \((M)\) \((2.7)\) while the nominal wage \((W)\) remains fixed.

\[
dU = -a_1 dWr \quad (2.5) \\
Wr = W / P \quad (2.6) \\
dP = a_2 M \quad (2.7) \\
a_1, a_2 > 0
\]

In the *General Theory* Keynes had suggested that the labour market was characterised by a downward rigidity of money wages. Because individual groups of wage earners were primarily concerned about their relative position versus other groups of wage earners they would resist lower money wages but they would not resist a lower real wage for all groups of wage earners.\(^{56}\) Accordingly a macroeconomic policy which increased the price level would succeed in lowering real wages. "Every trade union will put up some resistance to a cut in money-wages, however small. But since no trade union would dream of striking on every occasion of a rise in the cost of living, they do not raise the obstacle to any increase in aggregate employment which is attributed to them by the classical school."\(^{57}\) But as the rapid spread of wage indexation mechanisms during the sixties seemed to indicate, wage earners were not willing to accept this government engineered reduction in real wages. In terms of figure 2.1, demand management policies forced wage earners off their supply curve to a point on \(D\) somewhere below and to the right of the equilibrium point.

In the fifties and sixties Keynesians had operated with the assumption of a stable trade-off between inflation and employment; the so-called Phillips Curve (\(P1, \text{Figure 2.2}\)). According to the Phillips Curve governments could choose between a menu of combinations of inflation and unemployment. The monetarists critique, however implied that in the longer run there was no such trade off. The Keynesian analysis was seen to have validity only in the short run, i.e. in the period between wage bargaining rounds when the nominal wage could be assumed fixed. As, in the next bargaining round workers would increase their nominal wages so as to recoup their original real wage the economy would return to the original unemployment rate, albeit at a higher price level. Rather than being negatively sloped, the long-run Phillips Curve (\(P2\)) was vertical. Governments faced no exploitable inflation/unemployment trade-off, but could only choose to increase or decrease the rate of inflation, the longer run level of unemployment - to so-called 'natural rate of

\(^{57}\) Keynes 1973, p. 15.
unemployment' (Un) - being determined by wage earners real wage demands and not by policies. In his critique of Keynesianism Friedman furthermore argued that over time wage earners would eventually come to include the present level of inflation in their wage demands so as to prevent suffering a reduction in their real wage. In order to stimulate employment in the short-run governments hence would have to engineer ever higher inflation rates. Labour PM James Callaghan, for example, echoed this analysis when he argued that the option of increasing employment by means of expansionary demand management "in so far as it ever did exist, (it) only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as a next step." In the subsequent, so called rational expectation version of neoclassical theory it was assumed that the inflation rate wage earners expect in the next period is not the present rate but that they adjust their expectations immediately in response to a change in macroeconomic policies. In that case an exploitable trade-off between inflation and employment does not exist even in the short run.

![Figure 2.2: The Phillips Curve](image)

Keynesians, both in academia and in government, in fact did not have a convincing answer to the monetarist critique that their analysis lacked a (micro-level) theoretical foundation. And that was one of the reasons why they subsumed so quickly to their critics. Starting in the seventies then the neoclassical argument of the absence of a trade-off between inflation and unemployment came to be the theoretical basis on which more and more governments argued that macroeconomic policies could not assume responsibility for employment any longer. Instead the causes of unemployment now came to be located on the micro level, an area over which governments have much less control. Simultaneously the argument that restrictive demand management policies in the longer run would

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not cause higher unemployment but merely lower inflation now came to function as a theoretical justification for a policy of disinflation. And although less sophisticated in theoretical terms, the argument that macro policies cannot stimulate employment was also used in the early twenties to justify a restrictive policy with the aim of breaking inflation. Moreover, in both periods governments came to employ the argument that inflation is the result of misguided policy attempts to stimulate employment as a justification for trying to eliminate the room for discretion in monetary policies by allowing the Central Bank a greater degree of political independence or by adhering to a fixed exchange arrangement.\textsuperscript{59}

However, the neoclassical view does not seem to provide a good ground at all for justifying a policy of disinflation or for a more independent central bank. The absolute separation of the monetary from the real sphere (see eqn. 2.1.) on which the argument rests simply means that inflation has no costs in terms of GDP and employment. In the words of Paul Krugman (1992, p. 52): "In fact, it is one of the dirty little secrets of economic analysis that even though inflation is universally regarded as a terrible scourge, most efforts to measure its costs come up with embarrassingly small numbers."\textsuperscript{60} But if this is the case, there is no reason why governments should not treat inflation with benign neglect rather than to make disinflation the number one priority of macroeconomic policies. If monetary policy affects employment in the short run while having no effects on the real economy in the long run, it must remain a puzzle why governments would ever want to pursue disinflation. Given the assumption that inflation is a purely political phenomenon and given the need to explain historical inflations, neoclassics both in the twenties and at present are prone to invoke the image of a government which, in order to increase its own popularity, resorts to inflationary measures. But especially governments concerned with their prospects for re-election should be very reluctant to depress the economy in the short run, also because neoclassical theory cannot provide a good prediction of how long the short run might actually be.\textsuperscript{61} Why should a governing party, engaged in fierce competition with a second party ever voluntarily relinquish its control of the economy and entrust it instead to an autonomous, but rule-bound central bank? Why should a government, which can affect a short term improvement in employment through

\textsuperscript{59} For the latest analyses along these lines see the Swedish public commission on "The Riksbank and Price Stability" (SOU 1993:20).

\textsuperscript{60} See also Hahn 1984, p. 316.

\textsuperscript{61} 'Moreover, in Friedman's Noble Prize Lecture, he noted that the attainment of long-term results 'may take a long chronological time ...time to be measured by quinquennia or decades, not years'. If the monetarist theory can only provide anti-inflation policy guidelines for such a long run, then we are all truly dead!' Davidson 1989, p. 5.
expansionary policies and which cannot know whether the neoclassical 'long term' will have asserted itself in time before the next election day rather embark on disinflationary policies which, even in the neoclassical interpretation, increase unemployment in the short-term. And why is it, if inflation is costless, that even Social Democratic governments with a high preference for employment would come to give priority to disinflation rather than to pursue an expansionary strategy, coupled with flexible exchange rates to neutralize the effects of higher inflation rates on trade competitiveness? Instead of actually pursuing disinflation, governments informed by the neoclassical view should have simply stabilised inflation at whatever rate it happened to be. 62

Moreover, historically the expectation of a successful disinflation without cost in terms of growth and employment has always been disappointed. As Bordo & Jonung (1994, p. 15) argued in a review of monetary regimes and inflation during the last hundred years: "In principle, if a program of disinflation is fully credible, there would be no output loss caused by disinflation. Under these circumstances, the rate of inflation can be reduced quickly and painlessly. The history of various stabilization programs to reduce high and chronic inflation shows, however, that it is extremely difficult to get instantaneous as well as lasting credibility." But given that this lesson had already been learned in the twenties it seems inexplicable why governments should embark on disinflation again. Moreover, as also in the last decades the pioneers of such policies like Germany and the Netherlands came to be plagued by durable unemployment, other governments according to the neoclassical interpretation of the economy should not have been willing to follow their example.

Nor is it clear why governments should be able to profit electorally from expansionary policies in this model. If the effect of expansionary policies indeed is to reduce the real wage against the wage earners' wishes, it would indeed be surprising if such a policy would motivate them, in their capacity as voters, to reward the government. It seems that the concept a destabilising state can only be maintained if the rejection of money illusion leads to the introduction of some sort of political schizophrenia which causes wage earners to object to the government's economic policies but yet to vote for them. But if the government, in this model cannot have an incentive to create inflation, there is no reason either why monetary policy would have to be isolated from political influences. And because governments in both disinflationary regime changes have come to put great emphasis on bringing down inflation and on reducing the political influence over monetary policies, it seems

62 See also Hahn 1984, p. 317: "If you think that you can control the rate of change in money prices by controlling the money supply, then you can set it at zero or 12 per cent and it should make very little difference - certainly not several percentage points of GNP."
that the neoclassical model can not provide a guide for understanding the policies actually pursued
Instead it seems that, historically, the argument that disinflation has no costs was useful for
governments, which for other reasons had decided to give the highest priority to low inflation.
While not providing a justification for disinflation, the argument of the separation of the monetary
from the real sector does provide a formidable defense against diluting the priority of low inflation
with any concerns for the real economy.

  - But the problems with the neoclassical paradigm run deeper than the inability to understand
the priority governments have given to nominal price stability. The postulate of the stability of the
real economy, which then leads neoclassics to locate the sources of real world instabilities primarily
in the political system, is not a postulate which follows from the neoclassical analysis. As implicit
in the discussion of the previous chapter, because neoclassical theory also attempts to understand
the functioning of the economy on the basis of the analysis of individual - i.e. micro level - actors,
it also runs into problems when trying to derive the macro properties of the system. Whereas Marx
had to exogenously assume the existence of unemployment for his micro-level analysis of
exploitation to remain valid on the macro level, neoclassical economics has to invoke an external
coordinating agent, the so-called auctioneer, to ensure that the economy does arrive at a (Pareto
optimal) equilibrium.

At the core of the neoclassical analysis of markets stands the atomized individual with a given
set of endowments. As each individual market actor is too small to affect market conditions
individual behaviour can be analysed in terms of adjustment to exogenous constraints. For individual
actors the possibility of choice and strategy does not arise because those that will not adjust optimally
to the constraints of the market will perish. Problems of strategy and choice are only seen to arise
in the case of actors, like monopolists or oligopolists, whose size is sufficient for their own actions
to change the constraints under which they operate. 63

Yet the assumption of pure competition in fact is not sufficient to arrive at the conclusion
that there is only one viable course of action for micro level actors because the external conditions
to which individual actors adjust are determined by the sum of the behaviour of other actors. 64 In
order to be able to arrive at the constraints that determine the behaviour of any one individual, the
behaviour of all other individuals has to be known. But this imply means that the dynamics of the
system as a whole are indeterminate. Neoclassical theory has to confront this problem at the point

63 Situations of oligopoly and monopoly, quite correctly so, are excluded from the pure neoclassical theory of markets.
64 See also Leijonhufvud 1968, p. 67-81.

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where it makes the step from *partial* equilibrium theory, i.e. the analysis of individual markets, to *general* equilibrium theory, i.e. the analysis of the interaction of all partial markets. The equilibrium in a partial market, for example, can be determined on the basis of the demand curve for that good. The demand curve, however, is dependent on the behaviour of all other markets, and changes in one single market hence changes the demand curve for all other markets. While on the level of partial equilibrium it is assumed that the demand curve for a particular market is given this obviously cannot be generalised to general equilibrium. At that level the equilibrium in all other markets must be known in order to be able to determine the equilibrium in one market.

It is recognized in general equilibrium theory that this reflexive process whereby individuals adjust to market conditions and thereby change the market conditions which face all other actors will establish a general equilibrium only by pure coincidence. Contrary to a widespread misunderstanding, neoclassical theory cannot show that even in a perfect world a market-driven adjustment by which prices go up in response to increasing demand and vice versa will establish equilibrium. In order to arrive at a general equilibrium in a neoclassical market economy it is necessary to introduce the auctioneer as a (fictitious) agent who operates outside of the market with the aim of coordinating the individuals' behaviour. In more concrete terms, in neoclassical general equilibrium theory the auctioneer is an extra-market agent who is assigned the task of determining the vector of prices that will establish equilibrium and make it known to market actors before trade takes place. Whereas Adam Smith suggested the notion that by means of a process of market adjustment an equilibrium position could be reached, modern neoclassical research has established that in order for general equilibrium to obtain one cannot trust on the 'invisible hand' but needs the help of the visible hand of an auctioneer. For theorists like Hahn it is clear that the auctioneer is an analytical device used to establish what conditions would actually have to be satisfied for General Equilibrium to hold rather than a description of any real world economy. In neoclassical macro-theory, i.e. the quantity theory, this insight, however, is lost as the assumption of the stability of the real economy comes to form one of the cornerstones of the analysis. Given that general

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67 See, for example, Hahn (1984, p. 308): "Now one of the mysteries which future historians of thought will surely wish to unravel is how it came about that the Arrow-Debreu model came to be taken descriptively; that is, as sufficient in itself for the study and perhaps control of actual economies. Having spent most of my life as an economist on this theory I confess that such an interpretation never occurred to me. Indeed it was clear from the beginning that we only had half a theory anyway since there was (and is) no rigorous account, derived from first principles, of how the Arrow-Debreu equilibrium comes to be established."
equilibrium theory does not support this assumption it must be considered a purely normative one, even within the terms of the neoclassical paradigm itself.\textsuperscript{68} Accordingly the habit of analysing the state as a destabilising agent is also a normative one without a good theoretical foundation.\textsuperscript{69}

- It is common in the academic and political discussion to understand Keynesianism as a theory of the short run and 'monetarism' as a theory of the long run. Indeed in the postwar period Keynesian and Neoclassical analyses were integrated in one single model - the so-called Neoclassical-Keynesian Synthesis (NKS) - which yielded Keynesian results for the short run and neoclassical results for the long run. The Keynesian short-run can be understood as the period of time prices, like, for example, nominal wage contracts, can reasonably be assumed fixed, whereas long run results apply after price adjustments have taken place. Historically this meant that much of the discussion between the advocates of the respective views was based on different judgements on the extent of price rigidities in real world economies. Are price rigidities pervasive in modern economies so that the long-run results will not materialize until very long indeed? Or is it reasonable to assume that over a period of say two to three years, after which all wage contracts have been renegotiated, prices can be treated as flexible? In other words, is the long run such a distant phenomenon that it can safely be disregarded for the purpose of policy-making or will ignorance of long term effects necessarily doom policies? As mentioned above, one of the reasons why, at least academic, Keynesians subsumed so quickly to their neoclassical critics in the seventies was that the rapid adjustment of wage contracts to inflation seemed to indicate that long run results could indeed be expected to obtain within two to three years and that, therefore, long-run effects were politically relevant.

\textsuperscript{68} See also Hahn 1984, p. 332: "The proposition that a $k$-fold change in the stock of money appropriately defined will lead to a $k$-fold change in money prices and money wages and no changes in any real magnitude is not a proposition deductible from serious theory."

\textsuperscript{69} The auctioneer problem also implies a critique of political science theories, mainly the so called rational choice school of thought, which take their methodological concepts from neoclassical economics. In rational choice theory the equivalent to the need to posit the existence of an auctioneer is that a given institutional structure has to be assumed in order to be able to determine what is rational behaviour for individuals. In order not to make the model indeterminate, the nature and persistence of this institutional framework, however, may not be considered the outcome of a continuous process of rational choice. For example, it may be possible for rational choice theory to determine what is rational for voters and politicians in a two-party system, but it would be rather difficult to identify a single rational course of action if the condition is imposed that the nature of the party system must be the result of an ongoing process of rational choice. In other words, it needs to be assumed that individuals cannot consciously change the environment under which they operate. Since it is a crucial function of politics to shape the institutional framework, it seems to follow that political science theories, to the extent that they employ concepts from economics, should look to macroeconomics instead of (neoclassical) microeconomics.
Yet, although quite generally shared, the assumption that neoclassical results are long run results is rather peculiar. For although neoclassical analysis assumes flexible prices its results with respect to the relation between policy, wages and employment rests on the assumption that the capital stock is fixed. Since firms can and do continuously (dis)invest, it is not plausible that the long run should be characterised by flexible prices but a fixed capital stock.\footnote{See, for example, Keynes 1973, p. 17-18: ".. with a given organization, equipment and technique, real wages and the volume of output (and hence of employment) are uniquely correlated, so that, in general, an increase in employment can only occur to the accompaniment of a decline in the rate of real wages. ... Thus if employment increases, then, in the short period, the reward per unit of labour in terms of wage-goods must, in general, decline and profits increase. This is simply the obverse of the familiar proposition that industry is normally working subject to decreasing returns in the short period during which equipment etc. is assumed to be constant; so that the marginal product in the wage-good industries (which governs real wages) necessarily diminishes as employment is increased." Last emphasis added.}

In terms of the neoclassical labour market analysis of figure 2.1 an increase in the capital stock would mean that the D curve shifts to the right (D2). Consequently the result that an increase in employment (E) requires a reduction in real wages does not hold any more. Assume, for example, that there is unemployment in the labour market to the amount of Un because workers are not willing to supply any more labour at that real wage. An increase in the capital stock, however, would imply a new equilibrium point at the intersection of the D2 and S curves where both the volume of employment and the real wage have increased. This however implies that, even if the neoclassical argument is right (and the Keynesians consequently are wrong) that wage earners unilaterally set their real wage according to their S curve, there is still not sufficient ground to conclude that the state cannot affect employment. Rather irrespective of the whole Keynesian/monetarist debate about the exact slope of the Phillips curve, the argument that the state cannot affect employment has to rest on the position that the state cannot affect the capital stock.

And this is indeed the crucial argument behind the NKS view.\footnote{Keynesians, for example, are prone to argue that once full capacity utilization is reached the state cannot further stimulate employment by means of expansionary policies. But this view assumes that the state cannot affect the productive capacity itself.} The proposition that the state cannot affect the stock of capital is technically known as the proposition that money is neutral in the long run.\footnote{An equivalent formulation of the question whether money is neutral in the long run or not is whether saving determines investment or investment determines saving. Is it possible for the Central Bank, by means of an expansionary policy, it induce a rise in investment and thereby an increase in income which in turn will lead to higher savings? Or does increased investment require a prior decision of households to save more?} In the simple version the argument goes as follows: The demand and supply for credit (loanable funds) is determined in standard neoclassical fashion by a downward sloping demand curve and an upward sloping supply curve (Figure 2.3). As the marginal productivity of capital is a decreasing function, industrialists can only be induced to borrow in order to expand
their capital stock by means of a lower interest rate. In order to be induced to save (i.e. supply loanable funds) instead of consuming, households need to be offered an interest rate. And as the marginal utility of consumption increases with increased saving, the supply curve is upwards sloping, i.e. households require an increasingly higher interest rate to save increasing portions of their income. In addition to holding savings, households hoon a certain amount of money for transaction purposes (real cash balances). The amount of cash balances is assumed to be a fraction of the households real income so that nominal balances will increase if nominal income increases.

If the state should want to bring about an increase in the capital stock, it would have to attempt to lower the interest rate and it can do so by means of an expansionary monetary policy. Lower interest rates will induce firms to demand more loanable funds, but the supply will not be forthcoming because households will consume more and save less. Consequently firms cannot expand their capital stock and production cannot expand either. As a result of the expansionary monetary policies households find themselves with excessive cash balances. These higher balances will not be channelled into saving but consumed. A higher demand for goods at an unchanged level of production, however, can only means higher prices. The rise in nominal incomes will induce households to hold higher nominal balances so as to maintain the same real balances. Equilibrium will be reached again at the same real interest rate, the same capital stock and the same amount of real savings but at a higher nominal income and higher nominal cash balances. Put differently, the increase in the volume of money has been completely absorbed by nominal effects.

In a world characterised by uncertainty, however, it is implausible to assume that savings (i.e. the supply of funds for investment) are purely determined by the interest rate and nominal cash balances by nominal income. As soon as there is uncertainty, lenders must take account of the possibility of debt default. Banks, for example, cannot afford to lend indiscriminately to those
willing to pay the highest interest rate but they must form an opinion about whether the potential borrower will be able to fulfil the credit contract. Given more pessimistic expectations about the future, the supply of credit to industry might be lower and cash balances (money holdings) higher despite higher interest rates.

Uncertainty, as opposed to calculable risks, can have two meanings. First it arises in the form of unpredictable exogenous events like droughts earthquakes etc. But this is hardly an interesting proposition from a theoretical point of view. Rather the fundamental theoretical problem is that uncertainty arises necessarily in a system in which the environment for each individual decision maker cannot be assumed given exogenously but is composed of the sum of the decision of other decision-makers in the system. In the words of Jan Kregel "The 'non-ergodicity' of the system then ultimately results from the fact that individual actions are constrained by the actions of other individuals which cannot be predicted with certainty and thus when taken together form an aggregate or global or macroeconomic constraint which is not the simple, linear, and, therefore, predictable summation of individual behaviour. Thus it is not macroeconomics that has to be brought into closer touch with microeconomics, but rather one must try to formulate a macrofoundation for uncertain individual decisions." (Kregel 1987, p. 528). In neoclassical general equilibrium analysis uncertainty is assumed away by means of a fictitious auctioneer who has perfect foresight.\(^73\) But, as argued above, since the auctioneer ultimately must be considered a normative construct which allows neoclassics to bring its micro level analysis in agreement with the proposition of a stable macro system, the long-run neutrality of money, i.e. the radical separation of the monetary from the real sphere, ultimately must also be considered a normative construct.

In sum, the question what role the state can and does play in the economy cannot be decided in terms of the debate, which consumed so much energy in the seventies, about the exact shape of the Phillips curve, but has to rest on a view of the long run neutrality of money. As Margaret Thatcher (1993, p. 14) realised quite correctly: "With Keith [Joseph] I had come to see ever more clearly that what appeared to be technical arguments about the relationship between the stock of money and the level of prices went right to the heart of the question of what the role of government in a free society should be." If money is indeed neutral, then macropolicies cannot affect growth and employment. Accordingly any concerted effort by the government, business and unions to

\(^{73}\) Theology commonly considers perfect foresight a characteristic of God. In view of the neoclassical auctioneer one might wonder whether the enlightenment has not in fact by-passed economics.
stimulate growth and employment is ultimately a futile effort.\textsuperscript{74} If investment is indeed determined by savings, then increased public spending will only serve to replace private with public activity. But if governments cannot affect growth and employment governments they lack some of the most important means to promote social accommodation. Rather growth and employment becomes primarily a micro level issue. Moreover, the isolation of monetary policies from short term political concerns becomes a precondition for economic stability. If money is not neutral, however, the role of the state in society, and with it the appropriate boundaries between the state and civil society, remains to be analysed.

- Quite apart from these theoretical problems with neoclassical and Keynesian theories, the comparative static analysis usually employed implies that most of their results must be treated with extreme caution when interpreting policy history. The method of comparative statics involves comparing two equilibrium points: one before and one after a change in parameters, like, for example, fiscal or monetary policy stance. Policy making however takes place in real time, as opposed to model time\textsuperscript{75} and for policy makers it hence is crucial not only to know what the new equilibrium would look like in response to a change in policy but also to know whether a dynamic adjustment path exists which will establish the new equilibrium. Take the simple example of a neoclassical market for a good with the price on the y-axis, quantity on the x-axis and the usual upward sloping supply curve and downward sloping demand curve. An increase in supply, i.e. a rightward shift of the supply curve, implies that the new equilibrium point is characterised by a lower price and higher quantity. Whether a dynamic real-time path to this new equilibrium exists, however, would seem to depend on market actors' interpretation of price changes. It is possible that a lower price will lead to more demand and to a new equilibrium. But it is not impossible either that a lower price actually reduces demand if market actors interpret the initial drop in prices as a prelude to further price changes. In that case the adjustment path may be highly unstable and erratic. The most common example for this type of unstable adjustment process, of course, is the foreign

\textsuperscript{74} To quote Margaret Thatcher (1993, p. 97) again: "But there was a crucial difference between the MTFS [Medium Term Financial Strategy] and the old style economic planning. We were seeking to secure greater financial stability, within which business and individuals could operate with confidence. We knew that we could do this only by controlling those things which government could control - namely the money supply and public borrowing. Most post-war economic planning, by contrast, sought to control such things as output and employment, which ultimately government could not control, through batteries of regulations on investment, pay and prices, that distorted the operation of the economy and threatened personal liberty. The MTFS broke with all of this."

\textsuperscript{75} For an excellent treatment of this distinction, see Skarstein 1989.
exchange market. As we will see in the next chapters, policy makers' view on how policy changes will affect perceptions of market actors and hence the stability of adjustment processes in response to policy changes, at times have played a crucial role.

2.3 The Concept of a Monetary Economy

Overlooking the three major changes in the economic views underlying the conduct of economic policies, it seems that whenever inflation became a serious problem the state embraced the view that macropolicies can only affect the price level and not the real sector of the economy.76 The promise that disinflationary policies would not affect the real economy in the longer run, however, was generally disappointed, as both the policies of the early twenties and the mid seventies ushered in a long period of mass-unemployment. Likewise the promise of an 'automatic' or 'rule-based' monetary policy did not materialize, as monetary policies remained discretionary both under the Gold Standard and during the last two decades. The advent of disinflation in turn led to the interpretation that, although restrictive macropolicies have negative effects on employment in the short-run, the level of unemployment in the long run is determined by the labour market partners and by supply-side factors in general. During the Great Depression, however, governments came to draw a rather different policy conclusion on the basis of this distinction between short-run and long-run effects. Not only were the negative short-run effects now considered a reason for abandoning restrictive macropolicies, but, more importantly, the rapid downward drift of wages and prices (deflation) now came to be considered part of the problem rather than the only possible route to restoration of full-employment and prosperity. Yet the promise of politically guarantied full-employment by means of discretionary demand management policies was equally disappointed. During the seventies, the first occasion when governments seriously tried to combat unemployment by means of deficit spending, such policies proved unsuccessful. Moreover, in neither of these three periods of regime change did the domestic distribution of power seem to have a decisive influence on the strategies pursued. Despite its strong position at the end of the first world war, the labour movement could not prevent the advent of a restrictive policy regime and mass-unemployment. And while they did manage to steer a different course for almost two decades, the quintessential Social Democratic countries of Norway and Sweden came to follow the early

76 See Kindleberger 1985, p. 41.
example of Germany and the Netherlands by the late eighties. Conversely during the Great Depression even Conservative/Liberal governments came to emphasis the need for market regulation and expansionary monetary policies.

In short, a historical interpretation of the conduct of economic policies should be able to understand why governments of different political hues at crucial historical junctures have come to give overriding priority to price stability even if it meant, as in the case of disinflation, provoking a recession in the real economy. This section provides an interpretation of the relations between the state and the economy which can do just that. It also sketches the outline of a model of a monetary economy, i.e. an economy in which, in contrast to NKS views, the monetary sector exerts a decisive influence on the real economy. Such views have a long lineage. Elements are to be found already in mercantilist thought, and in modern times in the writings of, for example, Wicksell and Fisher. In the interwar period the most important proponent of such views was, of course, Keynes himself. The version presented in this section rests primarily on the interpretations of Riese (1986, 1987 A,B), Tobin (1980), Spahn (1986) and Herr (1986). Although similar to many arguments advanced by Keynes the view outlined here is quite different from the traditional IS-LM interpretation. It is concerned not with cyclical deviations in capacity utilization at a given level of productive capacity but with the determination of the level of capacity itself. Put differently, it is a decidedly long-term rather than a short-term interpretation.

The argument, then is not that the concept of a monetary economy can be shown to be logically correct while neoclassical and Keynesian views are logically incorrect. The decision to analyse the economy on the basis of the disposition over money ultimately is a paradigmatic decision just as good, or bad, as, for example, the neoclassical interpretation of the economy as the place where households meet to exchange an initial set of endowments. Rather the claim is that on the basis of the concept of a monetary economy the changing behaviour of the state and, with it, the fate of Social Democracy becomes more intelligible than is the case for analyses based on neoclassical or Keynesian concepts of the economy.

Whereas the neoclassical analysis takes households with a given set of initial endowments as its starting point, the analysis of a monetary economy starts with a wealth-owner who is endowed with a certain sum of money, the volume of money being determined by the central bank. Each

77 See Keynes 1973, ch. 23.
78 As Leijonhufvud (1968) and Meltzer (1988) have brought to our attention again, there is much more in Keynes’ work than the IS-LM model.
wealth owner has several options with respect to the form in which this financial portfolio is to be held. In the simple case the wealth-owner has two options, either to hold money or to lend to industrialists in order for them to undertake production. Lending implies that the wealth-owner will be able to enjoy interest income whereas money holdings yield no interest. Yet, due to the need for daily transactions holding certain amounts of money will be convenient. More important, lending also involves the risk of debt default, i.e. the loss of wealth. Because each individual necessarily faces uncertainty, each lender will have to form a subjective opinion of the credit-worthiness of potential borrowers. Accordingly the level of lending activity is not purely a function of the interest rate but also of the state of expectations about future economic developments. For each given state of expectations the willingness to depart with liquidity - the so-called liquidity preference (j, Fig. 2.4) - will be decreasing as holdings of liquidity increase.

Given the liquidity preference schedule and the rate of interest (i), which is exogenous from the point of view of each individual wealth-holder, the amount of money held in portfolios and accordingly also the amount of credit wealth owners are willing to supply can be determined. In terms of figure 2.4; suppose a wealth-holder can dispose over an amount of money $O-B$. The amount to the left of the intersection of the $i$ and $j$ curves ($O-A$) will be held as liquidity, whereas the remainder ($A-B$) will be supplied to the credit market. A more pessimistic view of the future will cause the curve to shift to the right, leading to higher money balances for each given rate of interest.

On the credit market the supply by wealth owners (Gs, Fig. 2.5) meets the demand (Gd) from entrepreneurs who need finance in order to purchase physical capital and undertake production. The interaction of demand and supply determines the interest rate. Entrepreneurs at any given time have a stock of physical capital and they will have an incentive to change their productive capacity if the interest rate does not equal their expected profit rate. If an entrepreneur believes that the demand prospects for his products are so good that an extension of capacity will yield a profit rate greater than the expected real interest rate which will have to be paid to finance that investment, net investment will take place. In the opposite case capacity will contract. For any given state of

80 Put differently the credit market is not an auction market but instead is naturally rationed. Whereas firms will generally sell their goods to those who offer the highest price, banks cannot afford to indiscriminately lend to those who are willing to pay the highest interest rates. Because credit contracts, in contrast to the sale of a good, are commitments for the future, banks and lenders in general will have to determine the credit-worthiness of the borrower, i.e. will have to form an opinion whether it is likely that the borrower will be able to fulfil his commitment.
81 This figure was taken from Spahn 1986, p. 159.
82 Note that the real interest rate always is an expected value as it consists of the nominal interest rate discounted for the expected inflation for the duration of the credit contract.
expectations about the future, the demand for credit is inversely related to the interest rate because an expansion of production under these conditions is expected to lead to lower profits. The rate of investment in an economy hence comes to depend on three factors: the supply of high-powered money as determined by the central bank, the liquidity preference of wealth-holders, and the expected profit rate.

The interaction between wealth-owners and entrepreneurs, at a given volume of money, hence determines the interest rate and the capital stock. It is important to note that the equilibrium reached in the credit market is not a unique equilibrium. More pessimistic expectations about the future will lead to less demand and supply of credit, i.e. both curves will shift to the left. Figure 2.5 shows an equidistant shift to the left of the GS(0) and GD(0) curves. The new equilibrium, at the intersection of the GS(1) and GD(1) curves, is characterised by both a lower demand for and supply of credit and unchanged interest rates. As Keynes (1937, p. 118) argued: "It is not surprising that the volume
of investment, thus determined, should fluctuate widely from time to time. For it depends on two sets of judgements about the future, neither of which rests on an adequate or secure foundation - on the propensity to hoard\(^83\) and on opinions of the future yield of capital assets. Nor is there any reason to suppose that the fluctuations in one of these factors will tend to offset the fluctuation in the other. When a more pessimistic view is taken about future yields, that is no reason why there should be a diminished propensity to hoard. Indeed, the conditions which aggravate the one factor tend, as a rule to aggravate the other. For the same circumstances which lead to pessimistic views about future yields are apt to increase the propensity to hoard. The only element self-righting in the system arises at a much later stage and in an uncertain degree."

Given the level of investment, national income is determined. Because \( Y = C + I \), and because it is assumed that \( C = cY \), \( Y = 1/(1-c) * I \). At a given state of technology and given the capital stock the volume of employment is also determined, as is the real wage given that the profit rate is determined and equal to the interest rate. On the labour market then the nominal wage is set and with it the price level.\(^84\) This stands in stark contrast to the neoclassical analysis where it is the real wage and hence the level of employment which is determined on the labour market. Yet, as Keynes already had pointed out,\(^85\) because wage earners do not set prices it is not obvious that they could determine real wages. Wage earners can only signal their willingness to accept lower real wages by accepting lower nominal wages. For each individual firm a reduction in the nominal wage of its workforce will lead to a proportional reduction in its real wage costs because the overall price level can be assumed fixed. Accordingly the demand for that firm’s products, and with it employment, may be expected to rise. Yet, if wage earners throughout the economy attempt to lower real wages by lowering nominal wages, the assumption of a fixed price level is not justified any more. Rather the price level may be expected to fall.\(^86\) A falling price level, however, is apt to reduce employment. To see this, however, the effects of price changes on income determination need to be considered.

\(^{83}\) I.e. the liquidity preference [T.N.].

\(^{84}\) For a similar labour market analysis see also Layard 1986, Ch.3.

\(^{85}\) For example, Keynes 1973, p. 12.

\(^{86}\) Historically the view that, in the short run, a fall in money wages was likely to lower the price level instead of real wages was not confined to Keynes and his followers. As Blaug (1985, p. 674) notes: "Now as Keynes himself made clear in chapter 19 of the General Theory on 'Change. in Money Wages', it was orthodox doctrine that money wage cuts cannot directly affect employment in the short run because the demand for labour depends on real wages; since in the short run all variable costs are labour costs, prices must fall in the same proportion as wages, leaving real wages the same."
Above it was already argued that a change in expectations about the future will affect both credit demand and credit supply and hence will lead to a new equilibrium in the market for loans. Expectations about continued changes in the overall price level, i.e. deflation or inflation, however may cause economic actors to change their behaviour in such a way as to set in motion a cumulative process. Expectations of deflation, if left unchecked, will lead to further deflation and a complete collapse of investment activity. Expectations of inflation conversely may lead to further inflation and eventually rampant financial speculation and a so-called 'flight out of money'. If, however, such a constellation emerges, which may itself may be the outcome of economic policy decisions, economic policies will eventually face no option other than restoring the conditions under which a monetary economy can function properly by breaking the inflationary or deflationary dynamics. And, to anticipate the next three chapters, it will be argued that the need to address strong inflationary and deflationary dynamics forms the core of the explanation of why governments of different political hues, at certain critical junctures in history, implemented similar and far-reaching changes in policy regimes.

Deflation implies that money holdings, although earning no interest will in fact earn a yield. As the price level falls, money holdings will increase in value and this in itself will lead to a desire to increase money holdings. Decisive, however, is that the liquidity preference and the expected profit rate are likely to increase as a result of (expected) deflation. Deflation for industrialists implies that their real indebtedness increases and their expected profit rate accordingly decreases. The latter effect is strengthened by the time which elapses necessarily between the purchase of material for production and the sale of finished goods. Increased indebtedness and reduced profit expectations will not only reduce the demand for credit, but also its supply as it becomes less likely that debtors will be able to fulfil their commitments. Banks, for example, - a crucial category of wealth holders - will become more conservative in lending to firms which experience increased indebtedness and reduced prospects of profitability. The curtailment of credit to industry implies a contraction in income and hence a reduction in demand. This effect may be further exacerbated if consumers hold off on purchases in expectation of a future fall in prices. As Irving Fisher pointed out with reference to the Great Depression, firms having difficulties in meeting their financial commitments may resort to liquidation of stocks of products and assets in order to obtain liquidity. This process in itself,

87 See Riese 1986, Ch. 3.
88 See, for example, Keynes 1963, p. 189-90.
89 See, for example, Keynes 1963, p. 172-3.
however, aggravates deflation. If sufficiently severe the widespread debt default of industry will threaten the solidity of the banking system and cause a run of depositors on the banks. A well behaved -in the neoclassical sense- labour market, will be a major propagator of deflation. If wage earners in general react to an increase in unemployment by lowering wages, deflationary problems and hence the economic collapse are intensified. Politically this implies that in a deflationary crisis weak trade unions sooner or later must become a problem for the economy and the state. Or. to be a bit sarcastic, full price and wage flexibility in practice can only be held out as the remedy to all the economic evils as long as it does not actually occur.

There is a possible countervailing force at work, which is that deflation increases the value of money holdings and hence might stimulate spending. However, under strong deflationary dynamics this price level effect is likely to be swamped by reduced income due to reduced investment, destruction of financial wealth due to debt default and reduced consumption in expectation of further deflation. To quote Tobin (1980, p. 18): "Now expected deflation increases the demand for money, making it more attractive relative to other goods and equities in goods. This effect counters the price level effect and may be stronger. If so, deflation does not correct the initial deficiency in aggregate demand that triggered it. Then deflation has no stopping point. The symmetrical case is hyper-inflation, in which the velocity of money rises astronomically."

As Tobin suggests, inflationary process can be understood very much as the mirror image of deflationary processes. Inflation undermines the value of money holdings and hence makes them less attractive. Decreasing real indebtedness and the time-lag between the start of production and sales increase expected profit rates. High activity and rising prices will make industry more willing to borrow as it can expect a decline in real indebtedness. Inflation will hence have a stimulative effect on production as both demand and supply of credit increase. Banks will pursue a more liberal lending policy as the likelihood of borrowers being able to fulfil their commitments increases, increased demand in turn will further improve profit prospects and this effect is stronger if households decide to increase consumption in expectation of future price increases. Again, well-behaved trade unions will aggravate inflationary problems if the trade unions react to lower

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90 "The very effort of individuals to lessen their burden of debts increases it, because of the mass effect of the stampede to liquidate in swelling each dollar owed. Then we have the great paradox, which, I submit, is the chief secret of most, if not all, great depressions: The more the debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip. It is not tending to right itself, but is capsizing." Irving Fisher 1934, quoted in Herr 1986, p. 188.

91 See Keynes 1963, p. 168-78.

92 See Tobin 1980, p. 4.
unemployment with higher nominal wage demands. Moreover, as the labour market becomes increasingly tight, even centralised trade unions will be less and less able to deliver wage moderation. Just as under massive unemployment, even centralised trade unions will have difficulties preventing their members at the local level from accepting lower wages, so in times of tight labour markets and increasing profits and prices the leadership of centralised unions will find it increasingly difficult to contain wage increases at the local level.

In a deflation lenders will, of course, profit at the expense of borrowers if the latter are able to fulfil their debt contracts. As deflation continues, however, debt default becomes more and more likely with the result of a flight into money, i.e. the only assets protected against debt default as well as bank failures. Rising inflation rates, however, imply that the value of debt contracts is eroded. Yet, holding liquidity obviously provides no protection against the erosion of wealth. While in its initial stages inflation hence may stimulate industrial activity, holding real assets sooner or later becomes more attractive than lending to industry. For it is only real assets, like real estate and durable consumption goods, which provide protection against the erosion of the value of money and debt contracts. Increased demand for such assets in turn increases inflationary pressures. The result is that continued inflation leads to a so-called flight out of money, in which all wealth holders try to liquidate financial assets and money for real assets and where speculation becomes a more promising way of increasing and safeguarding wealth than financing the production of goods.

2.4 Some Implications

The concept of a monetary economy leads to an understanding of the role of the state in the economy which differs from neoclassical and Keynesian as well as standard political science analyses in 3 crucial respects. (1) Because expectations play a crucial role in determining market actors' behaviour, the influence the state can exert over the economy by means of changes in fiscal and monetary policies is more uncertain than is assumed in traditional Keynesian and neoclassical analysis. Indeed, in times of widespread expectations of continued deflation or inflation, economic policy authorities may find that their traditional policy instruments have become blunt. (2) The state, however, does exert a crucial influence over the economy by shaping expectations through its long term policy orientation - the policy regime -. A policy regime which gives priority to combating inflation by means of restrictive macro-policies will have a powerful negative impact on expectations about future growth prospects. Conversely a regime which can successfully contain inflationary pressures without recourse to restrictive policies will have the opposite effect. (3) Even though the state does exert a crucial influence over the economy, it cannot necessarily let its policies
be guided by the goal of promoting full-employment and growth. Because the possibility of cumulative processes exists in decentralised monetary economies, the government, of whatever political hue, will have to give priority to maintaining the coherence of the system. The three regime changes of this century then, can be interpreted as being ultimately driven by the need to break developing cumulative processes; an inflationary process during the early twenties and the last two decades, and a deflationary process in the Great Depression.

Given that economic actors necessarily must operate under uncertainty, expectations come to play a crucial role in determining economic behaviour. Accordingly it cannot be assumed any longer that an unambiguous relationship exists between market- or policy-signals and economic behaviour. Instead market actors will have to place these signals in a broader context, or to use a more sociological term, to attribute a meaning to them. Is a given recession just a short-term phenomenon and hence no reason to adjust longer term production or investment plans, or is it the prelude to a long period of stagnation? Is, for example, a lowering of the discount rate to be interpreted as the initial step in a durable policy of cheap money, or is it more likely to be a short term measure with no significant longer term consequences? Because market actors can change their behaviour radically in response to changes in expectations about the future, the state has much less control than is assumed in both the Keynesian view, in which discretionary macropolicies are seen to give the authorities precise control over effective demand, as well as in the neoclassical perspective, in which the Central Bank has full control over the price level. As a consequence the role of the state in the economy is adequately captured neither by the liberal concept of a disturbing factor in an otherwise stable real economy nor by the Social Democratic concept of a political determination macroeconomic policy goals and the precise manipulability of the real economy.

In the standard interpretation Keynesian demand management came to be interpreted as countercyclical policies. On the basis of an exogenously given cyclical fluctuation in demand, macroeconomic policies were assigned the task of stabilizing economic development by means of compensating for an insufficient private demand in the trough of the cycle and excessive private demand at the peak of the cycle. Keynes himself, however, after 1931, considered deficit spending not as a way to compensate for exogenously given fluctuations in private investment but as an instrument aimed at stimulating private investment by improving investors confidence about the future. From this perspective it becomes clear that deficit spending is always an uncertain remedy against recession. If deficit spending measures fail to improve confidence sufficiently, they will sooner or later have to be abandoned. Increasing public consumption without a subsequent recovery of private sector investment simply means perpetuating budget deficits, and in an open economy
quite possibly also current account deficits. Especially in a constellation of deflationary expectations fiscal deficits will not spark off private investment. Conversely, a reduction of government spending in inflationary constellations may have negligible effects on overall activity, as the reduced recourse of the state to the credit market is gladly taken up by the private sector.

Moreover, to attempt deficit spending in combination with restrictive monetary policies is to guarantee the former’s failure. In the standard Keynesian IS-LM, for example a policy which increases overall demand by increased public spending but which provokes a reduction in private investment is considered feasible. But as restrictive monetary policies discourage investment, fiscal deficit spending may mitigate a drop in overall demand but is quite unlikely to provide the initial spark for recovery of private investment and will thereby perpetuate budget deficits. Historically this has meant that the decision to employ restrictive monetary policies in order to combat inflation or maintain the fixed exchange rate as in the early twenties, late twenties and early thirties and the last two decades, necessarily also implied the failure of deficit spending strategies.

Similarly the image that the Central bank is able to precisely control the volume of money and the price level does not conform to the realities of a monetary economy. While the central bank may be able to control the volume of so-called ‘high-powered money’ it has no direct control over the activities of commercial banks and individual wealth holders nor, therefore, over the velocity of circulation. Given sufficiently strong changes in expectations and a consequent increase in velocity, inflationary pressures may emerge independent of central bank policies. Rather the central bank at that point is confronted with the choice of either accommodating the upswing or breaking it. Frequently it may find that in the case of strong inflationary of deflationary dynam. cs its usual policy instruments have become blunt. Under sufficiently strong expectations of deflation a reduction in discount rates, for example, will not induce more borrowing, while in an inflationary regime increases in the discount rate will not deter the increase of net indebtedness. Since the central bank does not control the velocity of money, the concept of a non-discretionary policy has historically been unfeasible. Historically the relation between the conduct of monetary policies and the developments of the price level has rather been inverted; the central banks pursue a discretionary policy with the aim of stabilizing a target value like inflation or the exchange rate.

93 High powered money denotes notes and coins in circulation plus the amount of commercial bank borrowing at the central bank.
But although policy authorities may find that market dynamics at time counteract economic policy measures, the state does exert a powerful influence over economic developments through the way the policy regime shapes the long term expectations of the relevant actors. Realising that the propensity to invest, and with it the prospect for growth and prosperity ultimately depends on the confidence in future prosperity Keynes stressed spontaneous shifts from optimism to pessimism; the famous 'animal spirits'. "Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits - of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities." Yet as Keynes also noted, long term expectations have frequently been more steady as would have to be expected if they were driven by spontaneous animal spirits. The emphasis on animal spirits, however, underestimates the role of the state as a common point of orientation for market actors, and hence as an agency which can shape and stabilise expectations. By explicitly embracing a specific policy 'philosophy', i.e. by prioritising some goals over others and by assigning specific instruments to specific tasks, the state embeds its short term policy activity within a longer term framework of meaning and hence provides an important focal point for the expectations of market actors. Or, as Peter Temin (1989, p.91) defines policy regimes: "The regime is an abstraction from any single policy decision; it represents the systematic and predictable part of all decisions. It is the thread that runs through the individual choices that governments and central banks have to make. It is visible even though there inevitably will be some loose ends, that is, some decisions that do not fit the general pattern. These isolated actions have little impact because they represent exceptions to the policy rule, not new policy regimes."  

During the last two decades the role of expectations and hence the importance of policy regimes has again come to occupy a prominent place in the policy debate through the work of the so-called rational expectations school. In keeping with the quantity theory, the importance of expectations here is confined to nominal effects. The rational expectations school assumes that wage earners hold the quantity theory to be correct and that they unilaterally adjust nominal wages in response to a credible announcement of a change in monetary policy. The result is that

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94 Keynes 1973, p. 161. See also Keynes 1973, p. 162: "In estimating the prospects of investment, we must have regard, therefore, to the nerves and hysteria and even the digestions and reactions to the weather upon whose spontaneous activity it largely depends."

95 See, for example, Tichy (1984) who interprets Austrian policies in such a framework.

96 See, for example, Sargent 1983.
expansionary monetary policies do not even have expansionary effects in the short run and that disinflation could in principle be instantaneous and costless in real terms. But as argued above, historically disinflations have proven to be far from costless, and also theoretically the separation of the monetary from the real sector is implausible. The regime concept used here then differs from Sargent’s view of regime in that the role of expectations is not confined to the price level but also extends to real effects.

Despite the fact that the orientation of the policy regime can exert a powerful impact on the long term propensity to invest, the state cannot make preventing recessions and stimulating growth its overriding policy preference. Because the environment in which individuals operate is largely determined by the choices made by the sum of individuals, the possibility of cumulative processes arises. The state, therefore, cannot take responsibility for continuous growth and full-employment but is primarily confronted with a coordination problem, i.e. a problem of maintaining coherence in a system characterised by uncoordinated micro level decision making. Put differently, the monetary organisation of the economy implies the inherent policy priority of preventing cumulative deflationary and inflationary processes. Instead of trying to steer the economy towards certain politically determined goals, the state will have to give policy priority to maintaining or reestablishing the conditions under which a monetary economy can function. When confronted with strong inflationary pressures this implies that the government, of whatever political hues will generally have no option but to create a recession.

Although, as the historical record indicates, the advent of disinflationary regimes is followed by durable mass-unemployment, this does in no way imply that governments are confronted with an exploitable Phillips curve trade off. Because expectations of continued inflation change the behaviour of market participants in such a way as to strengthen inflationary pressures, governments simply cannot pick a point on the Phillips curve at, let’s say 15% annual inflation, and remain there. Rather the choice they face is to either accommodate inflationary pressures, and eventually tolerate a hyper-inflation, or to break inflationary dynamics and provoke a recession. Moreover, the emergence of durable mass unemployment in response to the establishment of a disinflationary

97 Because governments, in line with Nigel Lawson’s (1993, p. 454) conclusion, have generally found that there is no stable relation between money aggregates and the price level, wage earners would have great difficulty agreeing on the likely price effects of a given change in monetary policy. But if, in the rational expectations framework, some wage earners would arrive at the ‘wrong’ nominal wage, the effects of monetary policy changes will not be entirely nominal any more. And again the problem arises, that each single wage earner can only determine what is rational if he knows what other wage earners think is rational. Apart from that, wages of course are not set unilaterally by the trade unions but negotiated in the labour market.

regime is unrelated to the neoclassical assumption of real wage rigidity. Mass-unemployment is not related to a sudden decision of wage earners to increase their real wage but is primarily a result of a restrictive policy regime which, in terms of fig 2.5, shift both curves to the left, reducing the (growth rate of) level of productive capacity and thereby the demand for labour. This is a constellation from which wage earners, in a closed economy, cannot free themselves by means of aggressive nominal wage reductions. Nor is it likely to expect a rekindling of growth and employment in an individual open economy through the channel of improved export competitiveness. Apart from the problem that such strategies cannot succeed if all countries pursue them, the policy assignment in a disinflationary regime generally is such that the Central Bank defends a certain level of unemployment as a safeguard against renewed inflationary pressures.

Accordingly the concept of a monetary economy suggest an analysis of historical political dynamics which differs from neoclassically inspired ones. In the analysis of, for example, Maier (1987) the interwar inflation comes to be interpreted as the result of the necessarily futile attempt of the political system to expand the boundaries of a exogenously given real income. The failure of political accommodation in the interwar period and its success afterwards ultimately is a result of the exogenously determined presence or absence of growth. Yet historically the position which views inflation as the result of a (necessarily) futile attempt to solve a distributional political crisis by excessive money creation suffers from the serious methodological weakness that, on the one hand, it has to maintain that restrictive policies to combat inflation will have no long term effect on growth and unemployment, while, on the other hand, it has to invoke an exogenous structural crisis in order to account for the long term reduction in growth and employment which accompany restrictive regimes. Instead of being a political phenomenon, inflation primarily has to be understood as a market phenomenon, while growth and prosperity can be understood to be largely determined endogenously by politico-economic factors.

At the same time the concept of a monetary economy may serve to remedy a deficiency in institutionalist analysis - both of the neoclassical and the historical variant - namely its inability to elucidate the driving forces behind rapid institutional and political change. There is indeed a valuable lesson to be learned from institutional analysis, namely that institutional structures prejudice specific types of policy. As will be argued below, the institutional and political changes which took place during relatively brief periods of regime changes had an overwhelming influence on the type of policy pursued subsequently. But the important question to be answered then is what causes these periods of institutional restructuring? Institutionalist analysis, however, remains silent on this question. Because institutions are seen to shape policies the concept that policies create institutions
would make the model indeterminate. Institutionalist analysis, therefore, generally allow only for incremental or path-dependent change and politics accordingly cannot appear any more as a process by which society consciously reshapes the institutional conditions under which it operates. At the same time, institutionalists would be correct to point out that the alternative to seeing politics as being solely determined by politics - which leads to an interpretation of historical change in entirely voluntarist terms - seems implausible given that institutional arrangement historically have displayed relatively long periods of stability and that policy regime changes have taken place at the same time in many countries and have displayed a similar nature. But especially from the point of view of political science it must be considered an *Armutseugen* to interpret politics as being shaped by institutions but not being able to interpret institutions as being shaped by politics, i.e. to be able to demonstrate the importance of politics only on the basis of the assumption that politics is not important. If the institutional environment is shaped by processes beyond politics and if politics is determined by institutions one must wonder what politics is about then.

Similarly the concept of a monetary economy suggests an analysis different from modern day comparative political economy. Despite its emphasis on the importance of political factors, the analytical dominance of structural economic factors is already inherent in the research methodology as the argument for the importance of politics is based on the undeniable presence of cross national variations in economic performance at any one point in time. But apart from the problem that cross national difference in economic performance cannot necessarily be taken as evidence of the relevance of political factors, such an approach almost automatically leads to an explanation of broad political changes which are shared by many nations in terms of adjustment to structural economic factors. Politics then apparently is only relevant to explain the deviations from the international trend, but has no impact on the international trend itself. Hence it is no coincidence indeed that even comparative political scientists who have analysed economic policies in a longer

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99 See also Schärpf (1987, p. 23) who concludes, with reference to the crisis of the seventies and eighties, that the conclusion that the state cannot steer economic developments would only be justified if the crisis had taken the same course and led to the same results in all countries.

100 These differences might simply be a reflection of structural economic factors like, for example, natural resource endowment or economic specialization patterns.
term historical perspective have stressed structural factors as explanation for regime changes. Yet, within the concept of a monetary economy it is not necessary to invoke exogenous economic crises. Instead the crises of the early twenties, the Great Depression and the last two decades can be understood in terms of endogenous political reactions to problems of price stability.

In more general terms, the concept of a monetary economy suggests that a historical analysis of economic policy-making will eventually have to distance itself from the assumption, common amongst political scientists as well as economists, that also policies during regime changes can be interpreted in terms of a process of political competition amongst interest groups for policy outcomes, as well as from the assumption that policy-making is informed primarily by the goal of facilitating the optimal development of the real sector, either negatively, as in the neoclassical analysis where the real sector is assumed stable and the state by means of non discretionarey monetary policies is seen to refrain from transmitting disturbing impulses, or positively, in the Keynesian interpretation where the state comes to stabilise a fluctuating real sector.

If the economic policies of the state were indeed determined by the competition of interest groups for policy outcomes it would seem to follow that the state prioritises growth and employment, because no strong domestic coalition can be identified with an interest in policies which actually reduce growth and increase unemployment. Especially in periods like the twenties when the high level of domestic conflict between capital and labour exerted a considerable strain on the polity, the state and the vast majority of civil society should have had an interest in pursuing policies which could simultaneously promote growth and real wages. But even in the absence of problems of political accommodation, what political group could possibly have had an interest in advocating a policy which reduced growth and employment just for the sake of maintaining an arbitrary exchange rate level? And if disinflationary policies indeed lead to mass unemployment and recession, why should the employers and unions not rather tolerate inflation?

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101 Consider, for example, Gourevitch 1986. The possibility that economic crises might be related to policies is eliminated from the outset as the book seeks to ".. compare the policy responses of different countries to the same "stimulus" :the crisis of the international economy." (p. 10) But then it can come as no surprise that the similarities in policy choices during major crises, which Gourevitch notes have been strong (p. 179-80, 183-84) appear as mainly determined by developments in the international economy. The policy consensus born in the Great Depression, for example, is seen to have been undermined in the seventies and eighties because: "The internationalization of production and consumption has severed the link between domestic stability and economic advantage, and the logic of the international market now applies pressure to drive down the costs to business of wages and taxes." ..... "Labour has thus lost its business allies." (p.224). See also Cerny's (1990, ch. 8) analysis of the present period where the recent shift from what he calls the 'Welfare State' to the 'Competition State' is ultimately determined by the structural process of the growing interpenetration of national economies.
Yet, historically the view that economic policies will always attempt to avoid crises and to promote growth and employment sits unease with those instances in which policy, primarily in the form of monetary restriction, attempts to reduce growth and full employment as during the return to gold in the twenties, the initial phases of the Great Depression and the disinflation of the last two decades. Amongst those who believe in the ability of macroeconomic policies to affect the real sector, such episodes of restrictive policies in times of recession have provoked mainly two responses: to deny the responsibility of the governments for the policies they pursue by invoking insurmountable external constraints or to stress the crucial impact of economic ideas on policy-making.

Confronted with instances of rapid policy change in which the state actively restructures institutions and the general rules of policy accommodation, some scholars have suggested that such political change are the result of a new set of 'economic ideas' which comes to inform the policy-making process. Especially institutionalist analysis, which postulates policies as being path dependent and hence lack the tools for analyzing rapid political change as an endogenous process, is quite naturally drawn to invoking the exogenous explanation of new economic ideas informing policy. Such a view is, obviously, the complete opposite from Susan Strange's interpretation in which economic theories serve as convenient justification for policies which are pursued for other reasons. The fundamental reference point for the view that the state structures civil society based on the development of (the) idea(s) is, of course Hegel. Stripped of its historical teleology, the view was reiterated by Keynes in the famous passage, quoted at the beginning of this chapter. In the context of a discussion of recent changes in British policies Peter Hall (1992, p. 95) argued: "The shift from Keynesian to monetarist modes of policy-making is ultimately a story about the movement of ideas, as the concept of competing policy paradigms underscores."

But, given the fact that the core propositions of Keynesianism and monetarism have been present in the policy debate for a long time, it is unsatisfactory to interpret the translation of the respective schools into policy-making in terms of the seductive power of new ideas. Moreover, the relationship between economic theories and policies pursued is too loose to justify such an interpretation. Actual policies pursued frequently do not conform to the theoretical interpretation governments claim to have embraced. Despite the fact that governments frequently have professed to pursue monetarist or Keynesian strategies, the actual policy practice frequently looked different. Keynesian deficit spending in the post 1945 period played only a minor role. During the seventies and eighties governments have chosen to ignore monetarism's two core policy prescriptions, namely
that money growth should be rule bound and that exchange rates should float freely. And, as argued above, if governments during the seventies indeed were convinced of the correctness of the monetarist interpretation, the emphasis they came to place on disinflation remains inexplicable.

In addition economic theories frequently are not specific enough to prescribe a unique set of policies. Both Keynesians and Monetarists distinguish between the short and the long run. Indeed, the so-called Neoclassical-Keynesian Synthesis regards Keynesian theories valid in the short run - during which prices remain fixed - while in the long run the rate of unemployment is determined independently of demand management policies. But if the same theory can give rise to radically different policy proposals depending on whether short- or long-run effects are emphasized, the emergence of Keynesian or monetarist ideas can neither be a sufficient nor a necessary explanation for a change in policies.¹⁰² Why, for example, did governments during the Great Depression apparently come to agree with Keynes; dictum that we are all dead in the long run instead of emphasizing that expansionary policies are impotent in the long run anyway. Conversely, why did governments in reaction to the crisis and unemployment of the seventies and eighties come to emphasize the long run impotence of policies instead of their short run effectiveness?

Instead of being an exogenous factor, changes in the economic ideas informing government policies, can be understood as an endogenous political reaction in response to serious in- or deflationary problem. The cumulative nature of the inflationary and deflationary constellations which have given rise to regime changes implied that the basic character of the new economic policies was predetermined and that the official adoption of new economic ideas in essence only constituted a passive adaptation to these requirements. If the democratic constitution of the economy requires that economic policies pursued are the result of a politically determined choice between competing goals and if a monetary economy requires the political priority of long term price stability then the state's theoretical understanding of the effect of economic policy has to change so as to bring to former requirement in accordance with the latter. In a deflationary constellation the political and economic demands upon economic policy making are not in conflict as policies aimed at halting deflation generally also improve growth and employment. Such a constellation hence almost

¹⁰² See also Sejersted 1985, p. 117-27, for a discussion of the role of the time perspective in different theories.
inevitably gives rise to an interpretation of the process of economic policy-making in terms of a stabilizing state in an unstable economy. In an inflationary constellation, however, a clear conflict is present.

If it is to prevent a disintegration of the economy and society, the state will have to pursue a discretionary policy which creates a recession and unemployment in order to break inflation, when confronted with a constellation where the organisation of civil society precludes breaking an inflationary dynamic by other means. Yet the political requirements of a democratic polity implies that such a change in policy goals cannot be identified and discussed as such. To arrive at a justification of such policies which satisfies the requirements of the polity a threefold change in the theoretical interpretation informing the conduct economic policies takes place.

Given that the proceeding loss of control over the economy and civil society impresses the need upon the state to break inflation, a theoretical argument which postulates that in the longer run, restrictive policies have no negative effects becomes a political necessity. By postulating that there simply is no trade-off between growth, employment and inflation, and that, therefore, a political debate about the relative priorities to be attached to these goals is simply pointless, the required priority of anti-inflation policies can be achieved without openly violating the political requirement that economic policies may not be seen to reduce growth and employment. That the neutrality of money postulates hence inferred in the political process also implies that inflation is costless and an anti-inflation policy, therefore, fairly irrelevant must necessarily remain a point for academic interest only. But differently, the periodic popularity of the long-run neutrality of money postulate must be seen as a reflection of the long-run non-neutrality of money.

Implicit in such an interpretation is that the inflation was caused purely by excessive monetary policy, i.e. by political factors. Hence the change in policy will be interpreted as a turn to a non-political i.e. automatic or rule based form of policy making. In the early twenties this meant that the state came to embrace the quantity theory and understood monetary policies under the Gold Standard as being automatic. In the seventies and eighties the switch in monetary policies frequently was interpreted in monetarist terms as a switch to a rule bound regime. The fear of e reemergence

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103 Kindleberger (1985, p. 41) notes that the shift from monetarist back to Keynesian positions is related to crisis and unemployment: "As always in a period of inflation, the monetarists appear to be winning the intellectual debate today, in periods of recession and unemployment, the tables are normally turned." But recession and unemployment per se do not seem to be "sufficient to bring about a regime shift. Indeed the disinflation of the twenties and the present period did lead to durable mass unemployment and stagnation but instead of lending renewed prominence to Keynesian views the effect was to complement monetarist views by a stronger emphasis on supply side policies. Rather the process of deflation during the Great Depression was decisive in bringing about a regime change."
of inflationary pressures furthermore implies that the emergence of durable unemployment and recession under the new regime does not serve to cast doubt upon the neutrality of money postulate inherent in the new understanding of politics. Instead, in a second step, the state discovers the deficiencies of the market economy as the continuing stagnation and unemployment is attributed to microeconomic deficiencies which call for supply side policies.

It is no coincidence that (a version of) the quantity theory and (various) versions of an external constraints view which argues that expansionary macroeconomic policies, though effective in principle, have become impossible due to the openness of the national economy, tend to become popular simultaneously. For the political left, the neoclassical positions is generally unattractive because it tends to blame (Social Democratic) policy mismanagement, welfare state arrangements and the trade unions for inflation and unemployment. Instead the external constraints view allows the left to maintain its conviction that expansionary demand management policies in principle are feasible and necessary, and yet to embrace the same conclusion for practical policy as their liberal opponents namely that restrictive macroeconomic policies are inevitable and that a return to growth and full employment will depend on microeconomic measures. Accordingly the blame for the actually pursued restrictive policies can be shifted to anonymous financial markets and the structural progress of telecommunications and computing technology.

Policy-makers almost immediately after the installation of a new regime are confronted with the inherent impossibility of automatic, or non-discretionary monetary policies. In a third step then the initial justification of the non-discretionary character of the new regime is abandoned, frequently in silence. With that the transformation of a discretionary regime which had to justify its actions in term of growth and employment to a discretionary regime which tolerates high unemployment and solely accept responsibility for inflation is completed.

To avoid misunderstanding, it is not implied that when confronted with serious inflationary pressures, decision makers maliciously advance the view that restrictive policies would have no negative effects on growth and employment, while knowing full well that the opposite was the case. On the contrary decision makers, in line with the standard academic interpretations do generally interpret the regime change in terms of a different method to reach the same goal. Continuous inflation, a breakdown of wage moderation and increasing financial speculation impress the need for a change in policies even on reluctant politicians. The attempt at non discretionary monetary policies is abandoned as attempt to rigidly control the volume of money rather seem to create more

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instability. With experiences of the previous inflation and or exchange rate crisis in mind it seems very obvious that either macro policy cannot be at the root of continuous stagnation and unemployment or that there is no alternative to the policies pursued. Accordingly supply side policies present themselves as the only promise for mitigating the problems. In short changes to restrictive regimes frequently ar, what Marx might call, instances where history moves behind the back of decision-makers.\textsuperscript{105}

It also follows that the 'political power of economic ideas' is confined to explaining policy continuity rather than policy change. While the emergence of a cumulative inflationary or deflationary constellation may leave the state no alternative, the trauma of these periods comes to dominate policy for a long time to come even after the original constellation which informed these policies has long gone. In other words, the new understanding of policy making prompted by a de- or inflationary crisis becomes institutionalized in a new form of economic policy assignment and hence acquires a high degree of inertia. And exactly because the core economic views informing a policy regime have the character of paradigms, i.e. are basically impossible to refute empirically\textsuperscript{106}, they tend to structure opposition to its economic effect so as to produce demands that do not question its perpetuation.\textsuperscript{107} It is a cherished Social Democratic myth that the opposition of wage earners to the high unemployment of the Great Depression prompted the change in policy regime. As long as the Gold Standard and restrictive monetary policies were considered to be a necessary safeguard against the recurrence of hyper-inflation, opposition to unemployment could not result in demands which would serve to dislodge the regime. And as will be shown below, even Social Democrats managed to shed the interpretation of economic policy which came to dominance in response to

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\textsuperscript{105} From a social science perspective it becomes necessary to argue that history moves behind the back of policy makers, i.e. to discard much of the policy makers own interpretation of the situation at the point where their accounts do not add up to a consistent theoretical whole. The only alternative is theoretical eclecticism, for example accept the quantity interpretation for the twenties and the present period and interpret the Great Depression in Keynesian terms.

\textsuperscript{106} For example, there would seem to be no convincing empirical way to refute an interpretation which holds that restrictive money has no real effect and simultaneously discovers a myriad of supply side - market deficiencies to account for the fact that unemployment never recovered from the monetary disinflation.

\textsuperscript{107} Francis Sejersted (1973, p. 19-22), in connection with Norges Bank's policy of forcing the Krone back to gold in the twenties at the cost of a massive a long drawn out recession argued that the core problem besetting macroeconomic policies was that the radical separation of the monetary and real sector in economic theory implied the lack of a framework within which a sensible discussion of the relative priorities to be attached to exchange rates and prices on the one hand and growth on the other hand could have taken place. In the light of the last decades when this radical separation of the monetary and real sector again has become the orthodox understanding it can be recognized that the problem was not one of insufficiently developed economic theory. Rather the institutionalization of this view in the twenties resulted from the experience of inflation early in the decade, a situation in which the priority to be given to combating inflation made a theoretical framework in which the trade-off between inflation and growth could not be discussed politically necessary.
the postwar inflation only post festum. Similarly at present opposition against recession and unemployment mainly takes the form of demands for more vigorous supply side policies or better redistribution of existing work rather than questioning the monetary orthodoxy. Historically the result has been that policy regimes have not been dislodged until the emergence of another period of serious monetary instability made change inevitable.

In addition the perspective of a monetary economy can help us understand why it is that despite the emphasis placed on these concepts in the political debate the distinction between interventionist and laissez-faire regimes is not a useful guide for understanding actual policy-making. Overlooking the political and academic debate about economic policy one might easily come to the conclusion that the crucial dividing line runs between those who advocate interventionist policies to correct market outcomes and those who trust in the superiority of market outcomes. While not necessarily convinced that a free market will lead to optimal outcomes, Liberals do generally hold that government intervention will rather aggravate than remedy the imperfections which free markets may have. In contrast Social Democrats generally posit that the state can and should correct market outcomes as untamed markets lead to sub-optimal growth, unemployment and unacceptable disparities in incomes.

Historically the pendulum seems to have swung in favour of these contrasting period several times. The 1920s have entered the history books as a period of liberal economic policies. In the view of Keynes the Laissez-faire of the 1920s was at the root of the economic evils of that time. Conversely the thirties appeared as a transition from the liberal Laissez-faire to a politically regulated economy. For Polanyi, for example, The thirties marked the end of the self regulating market. And also in the eyes of most Social Democrats the transformation starting with the Great Depression marked the end of Laissez-faire and the beginning of the dominance of the political over the economic system. And although the seventies and eighties have neither seen the return to a Gold Standard type of exchange rate mechanism, nor the dismantling of welfare states, the period to most observers appears to be characterized by a decisive turn towards Neo-Liberalism, deregulation and dominance of market forces in economic policy.

108 See, for example, The End of Laissez Faire in Keynes 1963.
109 See Polanyi 1957, p. 251.
110 For the SPD see Künke 1987, p. 206.
Yet, to understand the various historical policy regimes as being informed by a same desire to maximize economic performance in terms of growth and employment but by different views on how to reach this goal is seriously misleading. While it may conform to the political needs of a democratic polity to interpret policies as being driven by goals, like growth and employment, on which the overwhelming majority of the electorate agrees, such a policy orientation does not conform to the needs of a monetary economy which requires discretionary policy management with the goal of long-term price stability. Accordingly historical policy regimes cannot be usefully distinguished in terms of interventionism versus Laissez-faire because they necessarily all are interventionist. Rather they differ with respect to specific policy assignment employed to control nominal prices and thereby also with respect to their ability and willingness to pursue growth and full employment.

There are obviously major differences between the interwar Gold Standard and the present disinflationary regime. Although both regimes were established in response to escalating inflation, the interwar Gold Standard is unsurpassed in its rigidity. The decision to return to the pre-war parity for most countries implied the need to provoke a massive deflation. Moreover the absolute priority of the gold parity precluded any exchange rate adjustments during the 1920s. But while most West-European countries during the last two decades have also come to rely on a self imposed fixed exchange rate constraint as an important element in a strategy of combating domestic inflationary problems, realignments within the EMS (European Monetary System) have been frequent. Moreover, central banks during the last two decades have never even considered depressing the overall price level but have rather been content with reducing inflation rates. As a consequence the severe pressures to reduce domestic costs which resulted from the decision to return to gold and which constituted the single most important factor in precluding a societal accommodation of capital and labour have been absent in the seventies and eighties. And despite the rhetoric of some conservative-liberal governments the all-out attack on trade unions and the social security system built up during the social democratic period has generally not been forthcoming.

Yet despite these important differences the interwar Gold Standard and the disinflationary policies of the last two decades are two forms of a regime which effectively discourages growth and maintain a high level of unemployment in order to prevent inflation. The growth regime which was in force from the mid-thirties to, depending on the country, the seventies or eighties in contrast effectively relegated the concern for price stability to a host of micro level measures, foremost incomes and price policies, and thereby gained the macroeconomic latitude to pursue growth and full employment.
Even in theory a liberal policy regime did, of course, not imply the virtual absence of the state. Liberalism, traditionally recognized the need for an active and strong state. But in the liberal interpretation the role of the state consisted in providing and safeguarding the institutional framework with which a free market can operate while the state is to refrain from intervening in the operation of the market in an attempt to bring about certain outcomes. To the extent that civil society attempted to replace or supplement the economic allocation mechanism by a political one, the liberal state would have to be a strong state as it had to be able to isolate itself sufficiently from civil society as not to become a tool through which particularistic interests interfered with the process of market allocation.

Guaranteeing private property rights is recognized as central amongst the tasks of a Liberal state. In addition Liberals generally accepted maintaining the value of money and a stable financial system as legitimate tasks of the state. Yet this second task in effect is a non-liberal one as it requires direct intervention in the market and does not consist merely of providing a framework in which a market can function. The existence of a government-sanctioned monopoly in the supply of money, i.e. a central bank, and a political target for the price level are quite fundamentally non-liberal concepts. For Liberals the quantity and price of goods provided cannot be a concern of the state. A truly liberal regime should be indifferent with respect to market outcomes because the essence of liberalism is that (economic) freedom is an end in itself and not a means to an end. Within the liberal framework it is not clear at all why the market should be left to determine the quantity and price of goods except in the monetary field where the quantity of money as well as the overall price level should be politically determined. Accordingly the only consistent liberal regime would be one which awarded all commercial banks the privilege of note issue rather than to rely on the central bank, and allowed to market to find its own price level.\textsuperscript{111} Yet such a regime would stand in conflict with the requirements of a monetary economy characterized by the possibility of cumulative processes.

In practice liberals, therefore, have come to accept the management of the monetary system as a task for government because historical experience shows that money is a good the supply of which can only be left to the market at the price a great economic instability. Amongst modern Liberal thinkers it has only been Friedrich von Hayek who accepted that the principles of Liberalism

\textsuperscript{111} For a fuller definition of a Laissez-faire monetary regime see Selgin & White 1994, p. 1718-1719.
require private instead of state money.\textsuperscript{112} But whatever political influence he may have had this proposal has never been considered even by governments sympathetic to Liberalism. And even von Hayek himself later argued that the resulting instability would probably make private money unfeasible in practice. But to call for a non-discretionary or automatic monetary policy in the form of a fixed money growth rule (Friedman) or a fixed external constraint (Gold Standard) cannot serve to conceal that the acceptance of the need for a political determination of the quantity and price of money is a fundamental breach with the Liberal principle of non-interference in market outcomes. There is really no good reason for a policy which fixes the money supply at an arbitrary rate or varies the supply of money only in response to the requirements of the exchange rate should be called more market based or liberal and less interventionist than a policy which varies the money supply in response to the domestic development of growth and employment. Put differently to assign to the Central Bank the responsibility for monetary stability is an exception from the principle of non-interventionism which the requirements of monetary economy force upon Liberalism, and it is an exception, which as far as actual economic policies are concerned becomes the rule even for Liberal parties as the pursuit of monetary stability comes to dominate other concerns.

But trying to impose a specific outcome on the market, necessarily had to compromise the core principle of Liberalism as it made economic freedom a condition to be subordinated to a teleology. At the point where the political determination of the price level and or the maintenance of a fixed exchange rate became the core goal of policies the label Liberal became inappropriate. But the inability to adhere to the Liberal principle of non-interference with market outcomes went far beyond the monetary sphere. Because the so-called (neo) liberal regimes of the Gold Standard and the present period were based on the assumptions that, automatic or rule based monetary policies were a sufficient condition for monetary stability, and that restrictive monetary policies did not affect growth and employment, the inevitable disparity between theory and reality at times drew policy-makers into far reaching interventions in the economic process.

If at all there was a policy regime after 1918 which deserved the term liberal, it must apply to the period 1918-1921. Letting currencies float meant that exchange rate levels were to be determined by market forces. The rapid deregulation of wartime controls also entrusted wage and price formation to the market. Finally, the accommodating monetary policies which central banks pursued implied that the supply of money was determined by market demand. But the developments

\textsuperscript{112} Emminger (1987, p. 25), however, does not think it is contradictory to argue that a free market economy requires a state monopoly in the monetary sphere: "Ich habe es immer als große Ironie empfunden, daß ausgerechnet der Vorkämpfer der Marktfreiheit, Fr. A. von Hayek, ..., für die Aufhebung jeglicher zentralen Geldkontrolle plädiert."
of the immediate post war years soon made clear that free markets, under the optimistic state of expectations, would rather create an endogenous inflationary dynamic instead of stability, and that monetary policy hence had to be directed by the state in a discretionary manner so as to break market processes. With the decision to deflate and return to gold, the Liberal regime hence ended, and it has not returned since.

The subsequent Gold Standard and the present disinflationary regime, therefore, can hardly be termed Laissez-faire or liberal. First, restoring and maintaining the Gold Standard enjoyed absolute priority in the pre-Great Depression regime, and this required highly discretionary monetary policies. As Polanyi (1957, p. 233) noted: "Though opposed in theory to interventionism and inflation alike, economic liberals had chosen between the two and set the sound currency ideal above that of non-intervention." And a similar pattern of discretionary policies can be observed in the new policy regime since the mid seventies. If anything, the new regime has increased the need for discretionary management, especially in the fields of monetary and exchange rate policies.\footnote{113 On demand management policies in general see also Bispham 1982, p. 290: "...experience up to the late 1970s suggests that there was little real change in the way governments used their instruments. What gradually changed were the goals of policy-makers. The decade was marked not so much by a retreat from demand management as by a retreat from the short-term full employment goal towards policies aimed at controlling inflation."}

The practice of tying a currency to a foreign anchor per definition implies a discretionary policy regime. And also the so-called victory of monetarism in some larger economies in the seventies can at best only be called a very partial one as no single country ever seriously took up Friedman's two central prescriptions of floating exchange rates and constitutionally determined money supply rates. The monetarist postulate that stable money growth would lead to stable inflation in practice has been largely irrelevant. Rather policies have been conducted along the opposite principle, namely that changes in inflation function as an indicator for discretionary changes in monetary policy with the goal of keeping inflation low. As Argy, Brennan & Stevens (1990, p. 58) argue after surveying the practice of monetary targeting in nine countries: "Targets were never interpreted as monetary rules (that probably would be a revolution). Over-runs were not usually reversed; neither were under-runs, but they were far less frequent. The aggregates concerned were switched when considered necessary, and the targets themselves were ignored at times when other consideration intruded. Some countries eventually abandoned targeting altogether."

Secondly, the low growth and mass unemployment which characterized both 'liberal' regimes in combination with the intensified international competition invariably drew policy makers into supply side policies. The perceived need for supply-side policies per definition signals a distrust
in the automatic healing forces of the market. In the twenties European governments were generally convinced that rationalization of industry held the key to improved industrial performance. During the interwar period, for example the BoE became actively involved in industrial restructuring in an effort to deflate political opposition against role of banks in industrial finance and to increase exports, thereby strengthening the Pound and improving overall economic performance. \textsuperscript{114} Similarly at present most governments accept the need for active promotion of product innovation and the adoption of new technologies as important means to improve the performance of the economy.

Yet, despite the inevitable failure of a liberal policy programme it would be inappropriate to replace the liberal dichotomy of a stable economy and a destabilising polity with the dichotomy of an unstable economy and a stabilizing state, as Social Democrats are prone to do. Underlying the Keynesian notion of demand management policies in the face of a market tendency toward unemployment equilibrium or cyclical unemployment is the normative notion that the state can and should manage the economy according to the goals of growth and full employment. Yet exactly because, if left unchecked, inflations tend to become cumulative, the state cannot conform to this normative requirement but might have to create a recession and unemployment instead, i.e. act destabilising in a Social Democratic perspective. Historically the rapid unemployment in the early twenties and during the seventies and eighties is primarily the outcome of a politically induced stabilization crisis and not the result of an exogenous structural or conjunctural crisis. And also the stagnation of the twenties and the last two decades, as well as the calamity of the Great Depression are much more related to political dynamics than to exogenous economic dynamics.

While Social Democrats, and Keynesians generally do not like to dwell upon it extensively, a continued process of inflation is not possible if the state refuses to accommodate it. It is hard to see how, for example, the German hyper-inflation could have taken place without an accommodating policy by the Reichsbank. Nor is it likely that the inflationary pressures and subsequent collapse of the banking system which Norway and Sweden experienced in the eighties could have taken place if their Central Banks had followed the policy of the Bundesbank since, let's say, 1978. Moreover, as the policy orientation of the state exerts a powerful pressure on expectations of economic actors, state behaviour can be at the root of the emergence of inflationary pressures. It is likely, for example that the mild deflation which characterized most European economies in the first months immediately following World War I would not have turned into inflation if states had made clear from the outset that a restrictive policy with the aim of returning to gold was to be

\textsuperscript{114} See Bowden & Collins 1992.
pursued. Yet, as should be clear from the above, the neoclassical argument in response to these situations that, the isolation of monetary policy from 'political' concerns will improve economic stability does not follow. The ground for this contention is ultimately the assumption that no trade-off between inflation on the one hand and growth and unemployment exists. In such a case there is no basis for a political choice between two competing goals. But if such a trade off does exist, also in the neoclassical framework there is no reason any more why low inflation should enjoy unequivocal preference. Given the neoclassical assumption of the neutrality of money, it might rather be concluded that combating inflation is relatively unimportant. In line with the Social Democratic and Keynesian understanding of policy making, Liberals and neoclassics, by basing their argument for the priority of low inflation in economic policies on the absence of negative effects of restrictive policies, also display a teleological understanding of the determinants of policy making.
II Three Regime Changes
3 Why was there no Social Democratic Breakthrough in the Twenties?

3.1 Introduction

In retrospect the 1920s must be considered one of the worst decades for organized labour in this century. Despite a long-term trend towards the strengthening of its electoral base, Social Democratic parties found themselves on the defensive. The Dutch and Norwegian parties spent the decade in a rather unfruitful manner on the opposition benches. Between the Kapp-Lüttwitz Putsch of 1920 and the second Müller government, the SPD lost much of its influence, frequently feeling forced to tolerate conservative governments for fear of jeopardizing the republic. Moreover, the Müller government disintegrated within two years over the issue of reducing unemployment benefits in the face of a rapid rise in unemployment. The British Labour Party, after its withdrawal from the War Coalition in mid November 1918 would only occupy the government benches from late January to early October 1924. Labour would not return to government until June 1929 when the second MacDonald government was formed. Yet, MacDonald was equally hapless as Müller, for in slightly more than two years the government and the Labour Party would split over cuts in unemployment benefits deemed necessary to defend Sterling’s gold parity. In terms of government formation only the SAP fared better as it managed to govern - with interruptions and in a minority position - for roughly 48 months during the 1920s.

For trade unions the immediate postwar years saw a definite improvement as compared to the pre-war period. The long-standing demand for the eight hour work day was almost universally satisfied after the war. Unemployment insurance was more extensive and generous after 1918 than it had been in the pre-war years. Finally most trade unions experienced a dramatic increase in membership during or immediately after the war. In 1918 the, it seemed that organised labour stood at the beginning of an era of significant progress. Yet during the 1920s these hopes were bitterly disappointed. While full-employment and social welfare during the fifties and sixties came to be accepted as important policy priorities by virtually all major political parties, so that even a prolonged absence of Social Democracy from government by no means implied labour-unfriendly policies, the twenties presented a mirror image as even the participation of Social Democrats in government brought virtually no progress in these crucial areas. As Polanyi characterized the twenties “The intent of that decade was deeply conservative”\textsuperscript{116}

\textsuperscript{115} With the exception of the short-lived Hornsrud government in Norway. See below.
\textsuperscript{116} Polanyi 1957, p. 22.
Notes: Data for non-election years have been interpolated. SPD figures for 1919-28 include USPD votes. SPD figures for 1924 and 1932 average of the two elections in each of those years. DNA figures for 1921-24 include NSA votes.

Source: Flora 1983, Vol. 1

Only in comparison with the carnage of the first world war could the twenties be labelled "Golden". During the stabilization crisis of the early twenties unemployment sky-rocketed, reaching levels in some country which were not even to be equalled by the Great Depression. And while unemployment came down somewhat from its peak in the early twenties it remained high throughout the decade, only to increase again during the Great Depression.117

Despite high unemployment and low growth, macroeconomic policies were preoccupied with problems of exchange rate and price stability. Whereas macroeconomic policies during the first two years following the armistice were dominated by the concern to stimulate growth and employment, the decision to return to the Gold Standard, taken in most countries around 1920-21, initiated a period of restrictive monetary policies. In effect, the strongly deflationary policies which

117 Even the so called period of relative stability of the Weimar Republic (1924-1928) is no exception. See, for example, Winkler 1982, p. 52-3.
were pursued by most developed countries during the early twenties bear most of the responsibility for the rapid increase in unemployment during these years. Being dedicated to returning their currencies to the pre-war parity, monetary policies could no longer be used in support of domestic growth and employment. Instead monetary policies were be shielded from the demands of civil society, being pursued by independent central banks and or treasuries. Also as a result of the commitment to return to the Gold Standard fiscal policies were unavailable as an instrument to foster societal accommodation. Confronted with what were considered to be high budget deficits governments generally were very reluctant to embark on fiscal programmes to combat unemployment but were rather struggling to reduce expenditures.

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Notes: Norway and Sweden, percentage of unemployed trade union members. Britain registered unemployed. Netherlands, proportion of possible days' work lost due to unemployment. Germany, up to 1929 unemployed trade union members, thereafter registered unemployed.


As a result of the macroeconomic policy orientation, a durable political accommodation between the state and organised interests, in particular labour, proved impossible to reach. With the decision to give absolute priority to maintaining a fixed gold parity of the currency, adjustment of domestic prices in accordance to the exigencies of external balance became of prime importance. Accordingly the presence of strong trade unions, who through means of their bargaining power might be able to prevent rapid downward adjustment of nominal wages, had to be considered a potential obstacle to the government overriding policy goal. Moreover, as stagnation and unemployment, contrary to expectations proved to be durable, and because macroeconomic policies per se were seen to have no effects on long term developments, domestic production costs would come to figure as a prominent explanation for the economic recession. Improvement of domestic
industrial competitiveness hence quite naturally came to be considered the most promising road to economic recovery. And improving competitiveness involved increased productivity by means of 'rationalizing' industry, as well as lower wage costs and lower taxes.

Despite the widespread conviction that a rekindling of economic growth and employment would require lower wage costs, declining any responsibility to assist the unemployed was socially unacceptable also to conservative governments. Yet, the assistance provided would have to be limited so as not to endanger economic recovery through higher taxation and obstruction of downward wage adjustment. While Social Democrats in opposition were quite vocal in attacking conservative governments for their passivity with respect to unemployment, they themselves could not present a workable alternative. As a result Social Democrats throughout the twenties were doomed to play the rather ineffective political role of criticising the policies pursued while being unable to identify a viable alternative.

The failure to reach a durable political accommodation was most clearly expressed by the high level of industrial conflicts throughout the decade. As table 3.2 shows, in historical perspective the twenties stand out as a decade with an extremely high level of man days lost to industrial disputes. As compared to the teens, industrial disputes more than doubled in most cases. In Sweden man days lost even increased by more than 260% as compared to the previous decade. British labour market conflict reached its peak when the TUC called a general strike in May 1926 in support of the miners. Supported by the government, mine owners demanded a reduction in wages, the lengthening of working hours and the abolition of national agreements in the industry. To the TUC the mine owners' demands seemed the spearpoint of an attack against all the gains the labour movement had made since the war. Due in part to a low degree of unionization and institutional fragmentation, strike activity was traditionally low in the Netherlands. Yet also here the twenties witnessed a strong increase in conflicts. Especially the Metalworking strike of 1921-22 and the textile strike of 1923-24 - both erupted over employers' demand for wage cuts - were unusually large and long-lasting by Dutch standards. With a total of 3 million work days lost to labour disputes, the year 1924 set a record in Dutch history. In Norway the two biggest industrial disputes in its history took place in 1921 and 1931 respectively. What is known in Norway as 'the big strike' (storstreiken) of 1921 started with the ship owners demand for a 33% wage reduction as of April 1 and an additional 25% cut on October 1. For the LO the shipowners demands seemed as the

118 See Mowat 1963, p. 298-304.
119 Dutch Labour was organised in three main trade unions; a catholic, a social democratic and a protestant one.
opening move of a general employers attack on wages. In response LO called a general strike from which only a few sectors were exempted. All in all the strike involved about 125,000 workers and caused 1.8 million workdays to be lost.\textsuperscript{120} In 1931 employers opened the bargaining round with the demand of a cut in real wages of about 9% LO countered with demands for real wage increases and shorter working hours, and in response the employers called a massive lockout. As Keilhau (1952, p. 197) noted the main responsibility for the conflict lay with the renewed deflation. In Sweden the year 1920 saw already more working day lost to industrial disputes than during the whole preceding decade. In the next two years labour disputes remained at a higher level than at any time during the teens. The conflictual relation in the labour market became a crucial political issue which, in fact brought down two social democratic governments (in 1923 and 1926). A side culmination of labour conflicts was reached on May 14, 1931 when soldiers shot at strikers during a protest march in Ådalen.\textsuperscript{121}

As Germany pursued quite different economic policies, at least during the first half of the decade, capital labour conflicts answered to a somewhat different logic here. In contrast to the other four countries Germany decided to tolerate inflation rather than to force the currency back to its prewar parity. As a consequence both recession and mass unemployment and the need for a radical reduction in prices and (nominal) wages were absent during the early years of the decade. Also in contrast to the other countries German trade unions faced the need to defend the democratic constitution of the republic against attacks from the right. In the spring of 1920 trade unions called a successful general strike against the right wing Kapp-Lüttwitz coup d'état. With the stabilisation of the Reichsmark in 1924 mass-unemployment also became a constant feature of the German economy. In terms of Labour disputes the year 1924 broke all previous records as 36 million working days were lost. Yet in the absence of the need for deflation labour market pressures still were less than in many other countries. As the crisis intensified towards the late twenties, so did labour conflicts. Signaling the advent of the Great Depression official unemployment statistics showed more than 1 million unemployed since September 1928. Two months later the so-called Ruhreisenstreit, a labour conflict in the heavy industry of the Ruhr area, marked the beginning of the employers' general attack on wages, working hours and social security benefits.

\textsuperscript{121} See Casparsson 1948, p. 213.
Even though Sweden still experienced a major wave of labour disputes during 1932/33, the thirties saw the beginning of a secular decline in labour market conflicts. Given the attitude of the NAZI dictatorship towards labour conflicts, the radical drop in Germany is not surprising. Yet the reduction in strike activity cannot generally be interpreted as the result of the political suppression of labour, because also those countries which avoided the terrors of dictatorship witnessed a significant decrease. In Britain and the Netherlands strike activity in the thirties already was considerably below the level of the teens, and, excluding the second world war, by the fifties this was the case for all countries.

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3.2 Waiting for Keynes?

For socialists the most puzzling feature of the post World War I period has always been the failure to make any headway towards a socialized economy despite the advent of general suffrage and the presence of a strong and radicalised labour movement at the end of the war. But given the failure of Social Democrats to give a concrete content to the slogan of socialisation and the impopularity of such policies amongst the general electorate as well as within the labour movement122 such a development in fact was no too surprising. In retrospect it has become clear that a 'socialist revolution' has only been a historically relevant option in less developed economies with a radical peasant movement instead of highly developed economies with a strong labour movement. What does seem more surprising is that within three years of the end of hostilities virtually all western countries had embarked on severely restrictive macroeconomic policies at great costs to growth and employment.

122 See also Chapter 1.
According to a still widespread interpretation of economic policy-making, in the wake of the Great Depression, governments abandoned their Laissez-faire attitude and adopted Keynesian discretionary demand management which enabled them to reach and maintain full-employment. Keynesian policy proposals were considered revolutionary as they stood in sharp contrast to the prevailing orthodoxy of balanced budgets and downward adjustment of real wage costs. The role of Prügelnabne in this policy drama is invariably played by the British Treasury. According to the Treasury, loan-financed budget deficits would reduce the amount of loanable funds available to the private sector and hence crowd-out private investment rather than create additional employment. Stimulation of private activity, therefore, would require a reduction rather than an increase in spending. In political terms Keynesianism is seen to have laid the groundwork for the political accommodation between capital and labour. By stimulating overall demand, Keynesian policies managed to reduce unemployment without a reduction in real wages and hence overcame the deadlock between the socialist demand for expropriation of the bourgeoisie and the employers' insistence on cost reduction.

Although the reorientation of macroeconomic policies was absolutely crucial to the political and economic recovery from the Great Depression, as will be argued in the next chapter the Keynesian interpretation is somewhat of a myth. Budgets in general were not balanced more frequently during the twenties than during the thirties, and Keynesian demand management played at best a secondary role during the Great Depression. Rather, the recovery from the Great Depression rested primarily on a fundamental reinterpretation of the role of monetary policies which lead governments to abandon the Gold Standard, create durable political and institutional devices for halting deflation and pursue a policy of cheap money. Deficit spending at best helped reinforce the effects of the change in the monetary policy regime.

But, if the reorientation of macroeconomic policies during the thirties was the cornerstone of what has come to be known as the "Golden Age of Capitalism", it must be asked why such changes did not take place already during the twenties. If the political right and the employers were indeed prompted by the threat of labour unrest to grant long standing demands as the eight hour day\textsuperscript{123} and universal suffrage and to give up some of capital's prerogative by initiating corporatist structures\textsuperscript{124}, then it remains unclear why this cooperation could not be durably extended to the level of

\textsuperscript{123} In the Netherlands, for example, the government introduced the eight hour day shortly after Troelstra's - the SDAP's parliamentary leader - rather awkward and empty revolution threat of 11 November 1918.

\textsuperscript{124} See, for example, Maier 1988 and Cronin 1984.
macroeconomic policies along the lines of a growth-oriented regime. If, as Keynes would argue a decade later, macroeconomic management could defuse the case for socialism by combining growth and full-employment with the private ownership of the means of production, the early twenties rather than the thirties would seem the ideal political constellation for the birth of such a policy. During the early twenties unemployment in many cases reached levels similar to those of the Great Depression and social tensions were more pronounced at the end of the war than during the thirties. Yet the Great Depression saw the shift to a policy regime aimed at stimulating growth and employment while, within three years of the end of World War I, an opposite shift in economic policies took place. Why was it that the political constellation at the end of the war did not give rise to a continuation and intensification of the Liberal/Labour rapprochement - born in the struggle for universal suffrage - along the lines, arrived at after the Great Depression, of a growth oriented policy of cheap money, more flexible exchange rate management and a further extension of the welfare state? Why did Conservatives and Liberals come to hold that economic recovery required lower wages and reduced spending in order to balance the budget while Social Democrats got bogged down in vague and politically impotent notions like socialisation and 'organised capitalism'? Why did the centre of gravity of the political system shift in a direction unfavourable to the labour movement? Why did the breakthrough to a Social Democratic type of economic policy-making, which occurred in the wake of the Great Depression, not take place already in the aftermath of the first world war? Were the twenties a decade wasted in unnecessary stagnation and strife?

To those who, one the one hand, accept that macroeconomic policies can be a powerful tool to alleviate economic crises, but who, on the other hand, hold that the political dynamics of a democratic polity necessarily imply that economic policies give priority to growth and employment, the twenties must appear as a period in which policy-making was bedevilled by the dominance of outdated and incorrect ideas. It might be argued that, because Social Democrats did not yet know how to successfully pursue full-employment, their views on economic policies suffered from Marxist-inspired fatalism125 or (neo)classical laissez-faire. As witnessed by the famous passage in the final pages of the General Theory -quoted at the beginning of chapter 2 - Keynes himself was first and foremost amongst those convinced of the 'political power of economic ideas'. For Skidelsky (1967), the Labour Party’s attachment to 'Utopian Socialism' and its consequent failure to adopt 'interventionist capitalism' in the thirties constituted the major missed opportunity of interwar

125 For Sweden see Lewin 1967.
British economic policy.\textsuperscript{126} In Germany Rudolf Hilferding’s alleged adherence to Marxist ideas is frequently seen to have prevented the SPD from implementing an effective Keynesian response to the Great Depression. And, as Przeworski & Wallerstein (1985, p. 208) argued: "But in Sweden the Social Democratic Party, having won the election of 1932, broke the shell of the orthodox monetary policy. As unemployment climbed sharply with the onset of the Great Depression, they stumbled upon an idea that was truly new: instead of assisting the unemployed, the Swedish Social Democrats employed them."\textsuperscript{127}

Yet, such views are incorrect. In the case of monetary policy, it is quite clear that the view that monetary expansion could produce favourable real effects, which gradually came to be adopted in the wake of the Great Depression, did not have to await a theoretical breakthrough. As Kindleberger has pointed out on many occasions, the debate between 'monetarism' and 'Keynesianism' is not of recent origin.\textsuperscript{128} According to Keynes himself, the belief that cheap money might stimulate growth already underlay much of the thinking of mercantilist scholars.\textsuperscript{129} In 18th century Sweden a political fraction called 'the Hats' already held that expansion of the volume of money, so as to extend credit to business, would benefit the growth of the economy, and pursued economic policies accordingly.\textsuperscript{130} In the so called British 'Bullionist Controversy' of the early nineteenth century, the banking school of thought argued that expansion of the money supply was a safe policy as long as the additional means were used to finance productive undertakings.\textsuperscript{131} The Norwegian Central Bank seems to have accepted such views before 1914. While Norges Bank pursued a very restrictive policy throughout the twenties, in the period before the war it had been common to pursue an expansionary policy in times of crisis so as to stimulate the economy.\textsuperscript{132} Also in Sweden this view was not unknown. In 1908, the well-known economist Knut Wicksell had advocated plentiful credit as a measure for combating crises.\textsuperscript{133} Even the British Treasury, which

\textsuperscript{126} With respect to Britain in the thirties Gourevitch (1986, p. 139) argued that: "The most puzzling question is why the Labour party did not take up demand stimulus."

\textsuperscript{127} See also Lewin 1967, p. 59-64, who argues that Ernst Wigforss anticipated Keynes.

\textsuperscript{128} See, for example, Kindleberger 1985b, 1987.

\textsuperscript{129} Keynes 1973, Chapter 23.

\textsuperscript{130} The competing political fraction, 'the Caps', held that an increase in the money supply only creates inflation and that restrictive monetary policies have no effect on unemployment. As Kindleberger (1987, p. 132) argued this latter conviction was proven wrong when put to the test in 1766.

\textsuperscript{131} See Kindleberger 1987, p. 61.

\textsuperscript{132} Sejersted 1973, p. 21.

\textsuperscript{133} See Öhman 1970, p. 39, and Unga 1976, p. 34.
consistently refused to heed Keynes' and Lloyd George's calls for fiscal expansion during the twenties, recognized that expansionary monetary policies could have a stimulating effect. In the words of Donald Moggridge (1990, p. vii), the Treasury View entailed that "loan financed public works, unaccompanied by monetary expansion, would invariably crowd out an equivalent amount of private investment and that monetary expansion could achieve the same end without this additional piece of machinery."\textsuperscript{134}

Nor was the idea of countercyclical fiscal spending an idea which had to await the writings of Keynes.\textsuperscript{135} While the \textit{Yellow Book}, \textit{We Can Conquer Unemployment} and \textit{Can Lloyd George Do It?} may have introduced arguments which were new to the specific political constellation of Britain during the late twenties and early thirties, the argument for loan-financed deficit spending was certainly not without historical precedent. Moreover, to argue that demands for a certain type of policy can and will only be formulated on the basis of a consistent and encompassing economic theory is most certainly to strongly overestimate the role of economic ideas in policy-making.\textsuperscript{137} History provides many examples of governments pursuing policies which lack a thorough theoretical justification. And even when governments have professed their allegiance to a specific economic theory, like, for example, Monetarism in the seventies and eighties, the actual policy practice usually deviates substantially from the theoretical prescription. Furthermore, no sophisticated economic reasoning is required to arrive at the conclusion that increased government demand for the products and services of the private sector will alleviate the plight of at least some firms and workers during a crisis.\textsuperscript{138} Especially those industries which could hope to benefit directly from state procurement would hardly need to wait for the formulation of Keynesian theory to advocate increased state spending without tax increases. And even for the state itself loan-financed countercyclical spending could seem attractive as recessions are generally characterized by lower interest rates, lower wages

\textsuperscript{134} On Hawtrey's view that cheap money was the best way to bring about recovery see also Clarke 1988, p. 145-6.

\textsuperscript{135} In Patinkin's view "...many claims of anticipation of the General Theory turn out on closer examination to be claims that public works were advocated by economists before Keynes."(Patinkin 1982, p.6). While Keynes may indeed have advanced a novel and consistent theoretical justification for countercyclical fiscal policies, the politically relevant question is whether the General theory was required in order to pursue such policies.

\textsuperscript{136} \textit{Britain's Industrial Future, being the report of the Liberal Industrial Inquiry}. London 1928.

\textsuperscript{137} Since almost 60 years after the publication of the \textit{General Theory}, the debate about 'what Keynes really meant' is as lively as ever, it may be doubted whether Keynes did indeed present a clear and consistent theoretical alternative.

\textsuperscript{138} With respect to increased public spending in a crisis the (neo)classical schools finds itself in the somewhat uncommon position of employing macroeconomic arguments against what seems to be microeconomic common sense, i.e. while increased public demand might improve the lot of some firms, the fixed pool of loanable funds is seen to imply that such a strategy cannot work in the aggregate.
and lower prices.\footnote{In Sweden the state railways, already before the war, justified increased loan-financed spending during recessions on these grounds. See \textcite{Gustafsson1974}.} Also for Social Democrats fiscal spending to alleviate a crisis would be inherently attractive. In times of crisis, when employers demanded wage reductions, high unemployment weakened the trade unions, and demands for higher real wages so as improve the purchasing power of the working class had at best rhetorical value, stimulation of demand by the state might seem a convenient way to solve their predicament. Accordingly Social Democrats did not have to wait for an elaborate economic theory in order to advocate such policies. Indeed, as \textcite{Klein1975} p. 139 has argued: "The concept of public works as a remedy for unemployment is so obvious that some researchers have attempted to trace its origins to Ancient Egypt."\footnote{Cf \textcite{Axelsson1987}.}

In Britain the Minority Report of the Royal Poor Law Commission, largely written by Beatrice Webb, has long been recognized as a forerunner of countercyclical government spending.\footnote{See, for example, \textcite{Skidelsky1967}.} In contrast to the practice of relief works, which were designed to mitigate the hardships of unemployment, and which paid less than the going market wage, the Minority Report advocated a countercyclical timing of public investment so as to combat the emergence of unemployment. In an optimistic passage, which foreshadowed the Keynesian view of economic policy as dentistry, the report predicted that: "Fifty years hence we shall be looking back with amazement at the helplessness and ignorant acquiescence of the governing classes of the United Kingdom, at the opening of the twentieth century. ... We have to report that, in our judgement, it is now administratively possible, if it is sincerely wished to do so, to remedy most of the evils of unemployment."\footnote{Quoted in \textcite{Winch1969}, p. 54, emphasis in the original report.} In the same year in which the Minority Report was published (1909) the principle of countercyclical investment spending was officially accepted in the Development and Road Fund Act.\footnote{See \textcite{Winch1969}, p. 53-55.} More surprisingly perhaps, given the strenuous efforts of the Second Labour Government to cut spending in 1931, the policy of countercyclical public works was already contained in Labour's 1918 programme \textit{Labour and the New Social Order}.\footnote{Written by Sidney Webb. On the Fabian character of this programme see also \textcite{Milliband1960}, p. 62: "Shorn of its rhetoric, \textit{Labour and the New Social Order} was a Fabian blueprint for a more advanced, more regulated form of capitalism ..."} In early 1919 moreover, the use of countercyclical public works in order to prevent unemployment was endorsed by the tripartite
National Industrial Conference. Labour's pamphlet Unemployment: A Labour Policy (1921) likewise envisaged the use of countercyclical government spending along the lines of the minority report.

Similarly in Norway the idea of countercyclical policies had been part of the luggage of political parties long before Keynes. According to Ousland, the Norwegian trade unions campaigned for countercyclical spending already in 1902. The Conservative Party (Høyre), which especially after Abraham Berge became prime minister in 1923 was the driving force behind the policy of budget retrenchment, had long stressed the need for the state to run a surplus and reduce debt in good years so as to be able to stimulate economic activity by means of tax reduction in times of recession. A rather similar view was expressed by the financial spokesman of the labour party in 1922. In a passage which might have come from a Keynesian textbook, Hornsrud argued "Under growth periods we should implement high and strongly progressive taxes, pay back debt and collect the biggest possible reserves until the recession comes. At that point the state and the communes must use their reserves a.o. for increased construction of railways, roads, etc. and thereby supplement the irregular, the unharmonic speculative private activity. Our highest income we had from 1918 onward, but at that point it was not possible to get my point of view implemented." Liberal PM, and finance minister Gunnar Knudsen and the Storting's finance committee expressed their agreement with these views. During 1918-20 Knudsen himself had frequently argued that public works should be reduced in a boom so as to be able to increase them during a recession. In 1922 DNA, which was the only one of the parties examined here to have joined the Commintern, presented an eight point programme for combating unemployment. Point one calls for wages in works creation programmes to be raised to market level. The second point called for the immediate start of large

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145 See Mowat 1963, p. 36.
147 See Maurseth 1987, p. 549. Keilhau claims that by 1932 the need for anticyclical fiscal policies was commonly accepted amongst Norwegian academic economist. See Nordvik 1977, p. 293.
151 See St. forh. 1920, 7a, finansdebatten 26 April 1920, p. 1286-87.
153 In Sweden the SAP's adoption of this point in 1930 has been argued by some to have marked its conversion to Keynesianism. See below.
public infrastructural works, like road and railroad construction and power generation. Point 6 stated that the necessary financial means should be procured not only through loans but also by a 'confiscatory' tax on large wealth holdings and a progressive tax on high incomes. The demand that banking and the whole economy should be placed under strict social control is mentioned last, almost as an afterthought. An echo of this policy, was found in Hornsrud inaugural declaration upon becoming Norway's first Labour PM on January 31. 1928: "The government sees it as an essential task to combat unemployment by maintaining the state's and the communes' normal activities as much as possible and moreover to support practical measures to keep the economy going. The government will propose to increase the special grants for the reduction of unemployment and the abolishment of the system of underpaid relief work."

In Sweden the principle of countercyclical fiscal policy had already found the support of a majority of parliament and the government before the First World War. The high unemployment of 1908-9 led the Liberal government to spend an additional SEK 36 M. on railroad and canal construction. According to Gustafsson (1974, p. 121) these policies were as expansionary as those presented by the SAP government in 1933-34. Furthermore the Liberal government in 1908-9 apparently did not believe that downward adjustment of wages was the most suitable way to combat unemployment as the works creation programmes it created were remunerated at market wages.

The SAP repeatedly presented proposals to parliament for increased spending on public works so as to alleviate unemployment. In contrast to the relief works of the 1920s, which paid below market wages so as not to obstruct the allegedly necessary wage adjustment, the SAP's proposals of 1908-12 explicitly stated that the wages paid in public works programmes should match market wages. All of these proposals failed to gain the support of a majority of the Riksdag. A renewed attempt in 1912, however, was crowned with partial success. Yet, the 1912 proposal did not constitute a toned-down version of earlier demands but instead proposed even further-reaching measures. In addition to demands for short-term increases in public works so as to combat seasonal and cyclical unemployment, MAK 1912:250 also envisaged a stronger engagement of the state in the development of natural resources like hydroelectricity and forestry so as to reduce longer term

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157 According to Unga 1976, p. 25, the SAP had already in 1905 advocated communal works creation at market wages.
158 MAK 1921:250 and MFK 1912:98.
unemployment. While a large majority of the second chamber of the Riksdag accepted the proposal, the first chamber passed only the short term anticyclical measures. The usefulness of countercyclical policies was a conviction also shared by many influential Swedish economists. Eli Heckscher, who after the war would become one of the most vocal opponents of deficit spending, argued in 1906 that unemployment might be prevented by means of countercyclical government spending. In 1914, the well-known Swedish economist M. Hamilton could argue that the view that the state should initiate public works instead of reducing spending in times of depression was generally accepted by economists as well as the state. The ideas of 1908-12 were reiterated in 1919 in two motions to the Riksdag by SAP MP Asplund. It was only after 1921, when the decision to pursue restrictive policies and return to gold had been taken, that the SAP shelved its demands for countercyclical policies, not to rediscover them until 1930.

The SAP’s proposals of the early 1900s in part drew inspiration from similar policies abroad. The SAP motion MAK 1910:195 cited the SPD’s archenemy Chancellor Bismarck as a proponent of activist fiscal policies. After the war, the SPD-led ministry of economic affairs formulated an explicitly anticyclical spending programme already in late 1918 in order to counteract the collapse of domestic as well as export demand. The so-called Reichsfond was to spend RM 5 bn in order to stimulate demand for German goods and thereby foster more private investment. Although the spending programme was expected to lead to a reduction of the Reichsbank’s gold reserves,

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160 Cassel, another advocate of restrictive policies in the twenties, held similar views before the first World War. See Öhman 1970, p. 39.
161 Quoted in Öhman 1969, p. 43.
163 Using a distinction between cyclical and permanent unemployment, Landgrén (1960) claims that the policies proposed by the SAP in 1930 were qualitatively new and inspired by Keynes. Countercyclical timing of spending, according to this view, had traditionally been accepted in order to combat cyclical unemployment, the qualitatively new element introduced by Keynes was to propose fiscal expansion even under an upswing in order to combat the remaining permanent unemployment. (See Also Unga 1976, ch3). Such a distinction rather illustrates that Keynesian theories were not needed to pursue fiscal expansion in the Great Depression than to support Landgrén’s point. Since the SAP started it programme of very moderate fiscal expansion in 1932, and since no one would claim that the Great Depression as a period of upswing, the SAP could have pursued its policies without some theoretical arguments about permanent unemployment. The SAP apparently did not have permanent employment in mind as it cut back its fiscal programmes very soon, at a time when unemployment was still quite high. (See also Steiger 1971, p. 85).
164 "Wenn Notzustände eintreffen, so ist der Staat auch heute noch verpflichtet, den Leuten Arbeit zu verschaffen, und der Staat hat so weitreichende Aufgaben, daß er dieser seiner Verpflichtung, arbeitslosen Bürgern, die Arbeit nicht finden können, solche zu verschaffen, wohl nachkommen kann. Er läßt Aufgaben ausführen, die sonst vielleicht aus finanziellen Bedenklichkeiten nicht ausgeführt würden - ich will sagen, große Kanalbauten oder was dem analog ist." Quoted in Steiger 1971, p. 110-1.
this was considered acceptable in times of crisis when the role of the state should be to stimulate the economy. Similar 'Keynesian' viewpoints were expressed in the short term programme of the economy ministry of December 1918. Similar to Keynesian ideas more than a decade later, at the end of the War people like W. von Moellendorf, who were skeptical with respect to the merits of a socialist economy but found the economic plight of the working class unacceptable, could advocate macroeconomic stimulation of demand as an alternative way of reaching Social Democratic goals without a massive socialisation of industry. After the War, von Moellendorf developed the concept of 'Conservative Socialism'. He spoke of 'Socialism' because he held that the state should direct the economy towards growth, high employment and income security. He spoke of Conservative Socialism because he believed that those goals could be reached without socialisation of the means of production. In response to the rapid increase in unemployment during 1925-6 the SPD and ADGB again strongly advocated countercyclical works creation programmes. What is more surprising perhaps, the government at that time did actually pursue a policy of countercyclical deficit spending.

But even if the ideas on which expansionary policies could be based were present, the absence of such policies, in an interpretation more favourable to Social Democracy and more congenial to political scientists, might be attributed to insufficient political support. This in fact, was the explanation given by Ernst Wigforss, the main architect of SAP's economic policies from the twenties to the fifties. "Had Social Democracy been strong enough in the twenties to pursue its own policies, there can be hardly any doubt that the new policy would have already been started."Yet to attribute the misery of the twenties to the weakness of Social Democracy would be equally inaccurate. As will be shown below, Social Democratic parties, including the SAP, did not propose a macroeconomic alternative to Gold Standard policies during the twenties. More important, it is not clear what motive non-Social Democratic parties could have had to hamper political accommodation by pursuing a policy of recession. Based on their own desire to promote recovery


167 See Held 1982, p. 98.


169 'New policy' referred to the Keynesian deficit spending which the SAP is said to have pursued after it came to power in 1932. Wigforss 1967, p. 529. My translation. For Sweden this argument was first developed by Steiger (1971) and later confirmed by Wigforss. For Norway see Ousland 1949, Vol. 2, p. 192-203.
from the war, find employment for the returning soldiers, reduce the budget deficits, and facilitate political accommodation, also governments without Social Democratic participation in the first 2-3 years after the end of the war pursued a policy which gave priority to the stimulation of private investment activity rather than to the restoration of the Gold Standard. And the change in policy certainly did not come about because Social Democracy weakened.

The most widespread interpretation of the developments of the twenties, rests on some form of the quantity theory. In this view the answer to the question why there was no Social Democratic breakthrough in the early twenties is that that was economically impossible. Due to their inability to reconcile the demands of different political groups within the (exogenously) given level of national income, governments resorted to expansionary monetary and fiscal policies. Yet, following the basic tenet of the quantity theory, such a policy was doomed from the outset, as it could only result in more inflation rather than more growth and more room for distribution. The pronounced desire for political accommodation by means of growth had to shipwreck on the hard economic reality that expansionary policies cannot create growth. As Eichengreen argued: "Neither the beneficiaries of government programs nor the prospective victims of the taxes required to finance them were willing to give an inch. The deadlock left government budgets in deficit and central bank printing presses operating at full speed. Only when inflation reached intolerable levels would the compromises needed to resolve the crisis finally be reached." 170

Historically the quantity theory suffers from the peculiar necessity of having to invoke an exogenous structural crisis in the wake of anti-inflation policies in order to save the theoretical postulate of the neutrality of money. Ultimately the possibility for domestic political accommodation in this view would be determined by the exogenous growth behaviour of the economy. 171 The failure to arrive at a political accommodation reached between the mid thirties and late forties already in the twenties would hence be attributed to the lack of a rate of growth sufficient to reconcile domestic distributional claims. Unfortunately the stabilization crises of the early twenties seem to have been followed by a long period of structural crisis thereby making durable accommodation virtually impossible. And again during the seventies and eighties a similar development must have taken place. Also the expansionary policies followed since the thirties

170 Eichengreen 1992, p. 107. See also p. 126.
171 See, for example, Maier 1987, (esp. p. 168-76) who argues that durable accommodation in the interwar period failed because a path of "warranted growth" (p. 169) could not be obtained while in the period following World War 2 the problem of insufficient growth disappeared (p. 176).
apparently must, fortunately, have coincided with an exogenous increase in growth rates thereby preventing a repetition of the inflation of the early twenties. Yet this radical separation of the monetary from the real sphere is neither theoretically nor historically convincing.

Instead it will be argued here that what determined the failure to reach a Social Democratic accommodation already in the twenties was neither the lack of an adequate economic theory, nor the political weakness of Social Democracy nor the insurmountable limits of an exogenously given growth level, but the political and institutional inability to counter an inflationary constellation by other means than a restrictive macroeconomic regime. At the end of the war, West European governments generally shared the view that the needs of economic reconstruction, deficit reduction and political accommodation would require prioritising private investment, and accordingly cheap money policies were pursued. Contrary to the quantity theory’s view the problem with these policies was not that they failed to produce real effects, but rather that the real response was too vigourous. After a few months of hesitation, which primarily reflected private sector insecurity with respect to the nature of the new regime, private economic activity increased dramatically. Within two years of the war most economies found themselves in a constellation in which virtual full-employment coexisted with supply bottle-necks, and inflation accordingly turned further upward. Given the political and institutional inability to contain inflation by means of microeconomic regulations - primarily prices and incomes policies - governments had no alternative but to break the boom and create a level of recession and unemployment sufficient to halt inflation. The only politically relevant question left at this point was whether the political courage for such a policy could be mustered before or after the economy collapsed in hyper-inflation.

As the cumulative inflation confronted governments with an increasing loss of control over the economy, the view that combating inflation should enjoy first priority and that such a strategy would have no negative effects on the real economy in the longer run exerted an irresistible attraction. Moreover, as the inflationary problems now came to be interpreted as the result of irresponsible domestic policies, the Gold Standard appeared as an indispensable external constraint. For the rest of the decade the trauma of inflation would determine economic policies leading directly into the disaster of the Great Depression. While their political opponents usually took the initiative in establishing the new regime, Social Democrats generally were not able to identify an alternative course. As a result Social Democrats lost the political initiative. In one sentence, the basic dilemma of Social Democracy from the early twenties to the abandonment of the Gold Standard was that they could see no alternative to the restrictive regime while being politically unable to live with the consequences of such policies.
3.3 Boom and inflation

After the political and economic ravages wrought by the war, a policy of deflation held no appeal. Even though for Social Democrats a socialist revolution was not an option, relations between capital and labour were very tense after the war. The hardship in the trenches and at home had radicalised many, and as a result trade unions and Social Democratic parties generally recorded a rapid growth in membership. In addition, the advent of general (male) suffrage further strengthened the position of the left. In Sweden and Germany the growing strength of Labour was translated in government participation.

In Sweden the SAP entered government in 1917 as a junior partner of the Liberals. The main purpose of the coalition was to introduce general suffrage, but the government remained in office for a few months after this was achieved in 1919. In the spring of 1920, the Liberal/Labour coalition was replaced with a SAP minority government, the first Social Democratic government in Swedish history. In Germany the (M)SPD came to occupy a crucial position in the early years of the Weimar Republic. On February 13, 1919 Philippe Scheidemann became the first chancellor of the new republic and the first Social Democratic chancellor in German history.

But even in those countries where Social Democrats remained on the opposition benches, its growing strength and radicalism strongly impressed the need upon liberal and conservative parties to accommodate Labour.\(^{172}\) In Britain, the election manifesto of the Liberal / Conservative coalition of Lloyd George and Bonar Law, published in November 1918, emphasised the need to stimulate domestic production. In a famous election speech in late 1918, Liberal PM Lloyd George promised "To make Britain a fit country for heroes to live in."\(^{173}\) In order to do so production had to be increased, a massive housing construction programme\(^{174}\) started, and health care, child welfare and education improved. On the basis of this programme the coalition scored an overwhelming victory in the elections of December 1918. Although Labour did record an increase in votes and now had become the biggest opposition party, it managed to gain only 59 seats as compared to the coalition’s 484 seats.\(^{175}\)

\(^{172}\) See Cronin 1984, Maier 1988, Middlemas 1979, ch. 5.
\(^{173}\) Lloyd George election campaign speech, November 24, 1918. Quoted in Boyle 1967, p. 467.
\(^{174}\) In March 1920 the SAP government in Sweden also approved a programme of housing construction.
\(^{175}\) Due to the peculiarities of the British electoral system Labour’s share of votes was larger than its share of seats would suggest. Labour polled 2,374,385 and the coalition 5,091,128 votes. Source: Mowat 1964, p. 6.
Table 3.3: British Governments During the Interwar Period

<table>
<thead>
<tr>
<th>Prime Minister</th>
<th>Period</th>
<th>Liberals</th>
<th>Conservatives</th>
<th>Labour</th>
<th>National Liberals</th>
<th>National Labour</th>
<th>% of parliament seats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lloyd George</td>
<td>10/1/1919</td>
<td>X</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>72.0</td>
</tr>
<tr>
<td>Bonar Law</td>
<td>24/10/1922</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>55.9*</td>
</tr>
<tr>
<td>Baldwin I</td>
<td>27/5/1923</td>
<td>X</td>
<td>X</td>
<td>R</td>
<td></td>
<td></td>
<td>55.9</td>
</tr>
<tr>
<td>MacDonald I</td>
<td>23/1/1924</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>31.1</td>
</tr>
<tr>
<td>Baldwin II</td>
<td>6/11/1924</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>67.5</td>
</tr>
<tr>
<td>MacDonald II</td>
<td>6/6/1929</td>
<td>X</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>46.7</td>
</tr>
<tr>
<td>MacDonald III</td>
<td>25/8/1931</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>51.9*</td>
</tr>
<tr>
<td>MacDonald IV</td>
<td>5/11/1931</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>84.7</td>
</tr>
<tr>
<td>Baldwin III</td>
<td>7/6/1935</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td>69.8*</td>
</tr>
<tr>
<td>Chamberlain</td>
<td>28/5/1937</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td>69.8</td>
</tr>
</tbody>
</table>

Notes: * Prior to November election 54.0% * Supported only by parts of Labour  * Prior to November election 84.7%. X: Party of Prime Minister. R: Party represented in coalition.


In Norway the elections of October also reconfirmed Liberal (Venstre) PM Gunnar Knudsen, although here the Liberals now had to govern on the basis of a parliamentary minority. As in Britain also the Norwegian district system distorted the relation between votes and party seats. The Liberals and Labour roughly polled the same number of votes, yet the former were the largest party in parliament with 54 seats while the DNA only gained 18 (a loss of 1 seat). And similar to Lloyd George, to pursue a policy of the 'outstretched hand' towards labour was foremost on Knudsen mind. A central element of the accommodation with Labour was an electoral reform to introduce proportional representation. When this system was first applied in the 1921 elections, Labour increased its seats from 18 to 29 while the Liberals declined from 54 to 39. Moreover Knudsen sought to include DNA in a government coalition. In order not to alienate Labour, the Liberals excluded the possibility of a coalition only with the right party (Høyre). Since March 1918, however, DNA had come to define itself as a revolutionary Marxist party and the conditions under which it would join a coalition proved to be unacceptable for both the Liberals and the Conservatives. Accordingly the Liberals decided to continue as a minority government. In his inaugural speech, Knudsen announced social security reforms and the 8 hour working day; the latter being introduced on January 1, 1920. And like Lloyd George, Knudsen thought it important to promote housing construction although his policies were on a rather more moderate scale than what had been originally envisaged in Britain.¹⁷⁶

But even apart from any fear of working class unrest, a host of other reasons compelled governments to pursue a strategy of economic growth. Also most non Social Democratic parties felt sincerely that the soldiers should not be greeted by recession and unemployment when coming

home. Given the high debt at the end of the war, a policy of cheap money aimed at stimulating private investment would seem the most promising strategy to improve the budgetary situation. Low interest rates served to facilitate the debt service. Stimulating growth, moreover, would increase tax receipts and thereby enable governments to reduce deficits without drastic tax increases and spending cuts. In addition, four long years of wartime destruction and insufficient investment in the domestic capital stock and infrastructure had made the need for stimulating investment even seem more urgent after the war.

Table 3.4: Norwegian Governments During the Interwar period

<table>
<thead>
<tr>
<th>Prime Minister</th>
<th>Period</th>
<th>Venstre</th>
<th>Høyre</th>
<th>Frisinnede Venstre</th>
<th>DNA</th>
<th>BP</th>
<th>% of Parliament Seats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Knudsen</td>
<td>20/12/1919</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>40.5</td>
</tr>
<tr>
<td>Halvorsen I</td>
<td>21/6/1920</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>R</td>
<td>39.7</td>
</tr>
<tr>
<td>Blehr</td>
<td>22/6/1921</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>40.5</td>
</tr>
<tr>
<td>Halvorsen II</td>
<td>6/3/1923</td>
<td></td>
<td></td>
<td></td>
<td>R</td>
<td>X</td>
<td>38.0</td>
</tr>
<tr>
<td>Berge</td>
<td>30/5/1923</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>38.0</td>
</tr>
<tr>
<td>Mowinckel I</td>
<td>25/7/1924</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>24.7</td>
</tr>
<tr>
<td>Lykke</td>
<td>5/3/1925</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>36.0</td>
</tr>
<tr>
<td>Hornsrud</td>
<td>28/1/1928</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>39.3</td>
</tr>
<tr>
<td>Mowinckel II</td>
<td>15/2/1928</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20.0</td>
</tr>
<tr>
<td>Kolstad</td>
<td>12/5/1931</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>16.7</td>
</tr>
<tr>
<td>Hunsedt</td>
<td>14/3/1932</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>16.7</td>
</tr>
<tr>
<td>Mowinckel III</td>
<td>2/3/1933</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>22.0</td>
</tr>
<tr>
<td>Nygaardsvold I</td>
<td>20/3/1935</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td>46.0</td>
</tr>
<tr>
<td>Nygaardsvold II</td>
<td>22/4/1940</td>
<td></td>
<td></td>
<td></td>
<td>R</td>
<td>R</td>
<td>98.0</td>
</tr>
</tbody>
</table>


Finally, for Liberal/Conservative parties a growth oriented policy would also carry the promise of strengthening their position with respects to the labour movement. Despite the rhetoric, for the majority of the Social Democratic leadership and rank and file, socialisation of the means of production was not an end in itself but a means to improve the conditions of the working class. A successful policy of growth, by demonstrating that the assumption that no significant improvement of working class conditions under private ownership was false, would have the effect of effectively undermining the case for nationalization of industry. In such a scenario Social Democrats would have had the choice of either concentrating on 'short term' reforms which improved the situation or remain in opposition and cling to their vague slogans of nationalization while loosing the political initiative to their political opponents. In other words, on the basis of a successful policy for growth and employment, which in turn would have allowed an extension of the welfare state, it would have been possible to establish a Social Democratic model even without the government participation.

of Social Democrats. Just as the SPD after 1945 was forced to eventually abandon Schumacher’s line of insisting on the need for more planning and socialism when the deficiencies of capitalism failed to materialize and the economy of the FRG kept growing and real wages kept rising, growth and full employment in the twenties would most likely also have undermined the political viability of such Social Democratic opposition policies.\footnote{See also Winkler (1979, p. 71): "Eine andere internationale Konstellation und eine andere weltwirtschaftliche Entwicklung hätten es der Weimarer Republik wohl erleichtert, mit ihren Geburtsfehlern fertig zu werden. Die zweite deutsche Demokratie ist vor allem deshalb so viel stabiler als die erste, weil sie sich unter den Vorzeichen eines langanhaltenden wirtschaftlichen Wachstums entwickeln konnte und von den westlichen Siegern schon einige Jahre nach Kriegsende als Partner akzeptiert wurde."
}  

In sum, irrespective of the political hue of the government, the political and economic situation at the end of the war mandated a strategy which prioritised economic growth, both as a means to solve budgetary problems and as a means to prevent the emergence of mass-unemployment, to increase labour’s living standards and create the room for manoeuvre for social policy reforms.

Immediately after the War therefore, governments embarked on a policy of low interest rates.\footnote{See Eichengreen 1992, p. 106.} In Britain, Lloyd George and Conservative Chancellor of the exchequer Bonar Law were united in their desire for low interest rates. Cheap money was not only considered essential in order to prevent unemployment and industrial unrest, but also to reduce the cost of servicing the debt and facilitate the issuing of bonds for the government’s programme of housing construction.\footnote{See Moggridge 1992, p. 358 and Howson 1975, p. 11.} Accordingly the Bank Rate remained at 5% until November 1919 and was only raised again on November 6 1920 (See Table 3.3). The rate for treasury bills remained at 3.5% from February 1918 to October/November when it was raised to 5%.\footnote{Howson 1975, p. 10.} Such policies met with the opposition of Montague Norman, the governor of the BoE. For governor Norman the resurrection of the Gold Standard was the first priority. Restoring the Gold Standard for Norman was a precondition for the revival of international trade and for Britain to regain its dominant position in international finance. Moreover the Gold Standard would impose the discipline on domestic policies necessary to prevent inflationary excesses. In principle also the government was committed to a return to gold. In January 1918, Lloyd George appointed the so-called Cunliffe commission which was to report on how Sterling was to return to gold.\footnote{See Kindleberger 1987, p. 332.} The interim report, published in August 1918, recommended...
a quick return to gold. The report was met with virtually unanimous consent. Yet, as Norman pointed out to the government, a policy of returning to gold would require higher instead of lower interest rates. But Norman found few sympathetic ears within the government. For Lloyd George apparently the reconstruction of the Gold Standard was a long term policy aim which should not be allowed to override the immediate concern for economic growth.

<table>
<thead>
<tr>
<th>Year</th>
<th>Date</th>
<th>Rate(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1918</td>
<td></td>
<td>5.0</td>
</tr>
<tr>
<td>1919</td>
<td>November 6</td>
<td>6.0</td>
</tr>
<tr>
<td>1920</td>
<td>April 15</td>
<td>7.0</td>
</tr>
<tr>
<td>1921</td>
<td>April 28</td>
<td>6.5</td>
</tr>
<tr>
<td>1921</td>
<td>June 23</td>
<td>5.0</td>
</tr>
<tr>
<td>1921</td>
<td>July 21</td>
<td>5.5</td>
</tr>
<tr>
<td>1921</td>
<td>November 3</td>
<td>5.0</td>
</tr>
<tr>
<td>1922</td>
<td>February 16</td>
<td>4.5</td>
</tr>
<tr>
<td>1922</td>
<td>April 13</td>
<td>4.0</td>
</tr>
<tr>
<td>1922</td>
<td>June 15</td>
<td>3.5</td>
</tr>
<tr>
<td>1922</td>
<td>July 13</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: Morgan 1979, p. 384.

But while the BoE consistently, though without result, advocated a restrictive policy, central banks in other countries were more worried about the prospects for the real economy. After the war, Norges Bank believed that the discount rate should be kept low in order not to obstruct economic activity. It initially kept the discount rate at 6%, but decided to lower it 5.5% in May 1919 and kept it there until December 1919. (See table 3.4) Norges Bank director A. Sandberg argued that to pursue a restrictive policy in order to stop inflation and stabilise the currency would be to put the horse behind the cart. First the productive resources of the economy should be allowed to recover and only then would it be possible to achieve a stable currency and price-level. With respect to the proposal of Swedish economist Cassel "to stabilise the various currencies' price level as well as their exchange rate in order to revive production and trade both at home and between the various countries", Sandberg shared the view of the governor of the Danish central bank "who claimed that would be to attack the problem from the wrong side". "That would be the same (...) as if physicians, when people get fever because the wells are poisoned prescribe chinin and other medicines instead

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183 The final report was published at the end of 1919.
185 See Jahn et al 1966, p. 221.
of to take care that the poisoned wells are cleaned and the epidemic thus stopped."\(^{186}\) And while during the war Norges Bank had increased the volume of money, with the full consent of the government, more than it legally was allowed to, rather than to contract the money supply PM Knudsen, on initiative from Norges Bank and with the agreement of the finance council (Finansrådet)\(^{187}\) in 1919 proposed to "legalize" the new situation by changing the rules for the Bank.\(^{188}\)

<table>
<thead>
<tr>
<th>From</th>
<th>Until</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1.1917</td>
<td>12.12.1917</td>
<td>5.5</td>
</tr>
<tr>
<td>13.12.1917</td>
<td>8.5.1919</td>
<td>6.0</td>
</tr>
<tr>
<td>9.5.1919</td>
<td>17.12.1919</td>
<td>5.5</td>
</tr>
<tr>
<td>18.12.1919</td>
<td>24.6.1920</td>
<td>6.0</td>
</tr>
<tr>
<td>25.6.1920</td>
<td>5.7.1921</td>
<td>7.0</td>
</tr>
<tr>
<td>6.7.1921</td>
<td>24.1.1922</td>
<td>6.5</td>
</tr>
<tr>
<td>25.1.1922</td>
<td>17.5.1922</td>
<td>6.0</td>
</tr>
<tr>
<td>18.5.1922</td>
<td>16.8.1922</td>
<td>5.5</td>
</tr>
<tr>
<td>17.8.1922</td>
<td></td>
<td>5.0</td>
</tr>
</tbody>
</table>

Source: Norges Bank

In Sweden, where the threat of massive industrial unrest was virtually nonexistent, stimulating growth rather than returning to gold was foremost on policy-makers minds. The Riksbank lowered its discount rate in April and June 1919 (See Table 3.7). As the wholesale price level started to increase again in late 1919 after having fallen for most of the year, many Swedish economists suggested that the Riksbank should increase its discount rate. The board of the Riksbank refused on the grounds that industry had to be kept going and at all costs and that a crisis had to be avoided.\(^{189}\) Commercial banker Oscar Rydbeck, who during the debates about monetary policy of 1920-21 frequently functioned as spokesman for the position of the Riksbank,\(^{190}\) pointed out that a high

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\(^{187}\) NB ARK, Folders Hovedsetet 485, Letter from 'Direktionen for Norges Bank' to: 'Norges Bank Repræsentantskap' Kristiania, February 28, 1919. The letter is signed by Governor Bomhoff and director Sandberg.

\(^{188}\) The new rules governing the volume of money in circulation were proposed in Ot. prp 1919 (50). See Bergh & Hanisch 1984, p. 134.

\(^{189}\) Quoted in Östlind 1945, p. 342.

\(^{190}\) Östlind 1945, p. 342.
discount rate would harm industry and would cause more harm than the stabilisation of the price level would do good.\textsuperscript{191} The same refusal to increase discount rates was reconfirmed by a joint declaration of the three Scandinavian central banks in late February 1920.

Like Sweden and Norway, the Netherlands had managed not to become involved in the hostilities of the First World War. With a virtually unscathed productive apparatus, Dutch businessmen were strongly optimistic at the end of the war as they expected to have a competitive advantage in satisfying the expected reconstruction/restocking demand of other nations.\textsuperscript{192} The Catholic/Protestant coalition government did not want to pursue a policy which might hinder the expected increase in production, nor did the Central Bank. Despite some critical voices from economists who preferred a high interest rate policy, the DNB accommodated the increasing demand from the economy.\textsuperscript{193} In response to its critics, the DNB argued that the increased money supply was due to the fiscal policy of the government and that, therefore, a reduction in spending instead of an increase in discount rates was called for. The DNB’s discount rate remained at 4.5\% from July 1, 1915 to July 18, 1922. Like in Britain, there was general consensus that the Guilder should return to gold, but also for the DNB this was a long term goal which should not interfere with its accommodating policy.

\begin{table}[h!]
\centering
\begin{tabular}{llr}
\hline
From & Until & Rate (\%) \\
\hline
12.12.1917 & 31.1.1918 & 7.0 \\
1.2.1918 & 20.3.1919 & 6.5 \\
21.3.1918 & 24.4.1919 & 7.0 \\
25.4.1918 & 12.6.1919 & 6.5 \\
13.6.1919 & 18.3.1920 & 6.0 \\
19.3.1920 & 16.9.1920 & 7.0 \\
17.9.1920 & 26.4.1920 & 7.5 \\
27.4.1920 & 5.5.1921 & 7.0 \\
6.5.1921 & 5.7.1921 & 6.5 \\
6.7.1921 & 18.10.1921 & 6.0 \\
19.10.1921 & 9.3.1922 & 5.5 \\
10.3.1922 & 30.6.1922 & 5.0 \\
1.7.1922 & 8.11.1923 & 4.5 \\
\hline
\end{tabular}
\caption{The Riksbank’s Discount Rate, 1918-22}
\end{table}

The disorganisation of the economy and the extremely unstable political situation in the young Weimar Republic meant that restrictive monetary policies were out of the question for German policy-makers. The recovery of production had to enjoy absolute priority, and while the Reichsbank

\textsuperscript{191} See Thunholm 1991, p. 112-5.

\textsuperscript{192} See Keesing 1978, p. 11-14.

\textsuperscript{193} See Keesing 1978, p. 16.
strongly argued in favour of a reduction in budget deficits, it largely shared the view that economic recovery should not be hindered by a policy of monetary contraction. As Feldman (1993, p. 214) argued: "there was a basic consensus in Germany on the need to subordinate financial to economic policy for the purpose of promoting reconstruction through the systematic effort to encourage agricultural and industrial production and maintain high employment, on the one hand, and a no less concentrated effort to maintain social peace and relieve hardships, on the other." Despite rapid inflation, the discount rate was kept at 5% from late 1914 to mid 1922, and the Reichsbank continued to pursue and accommodating policy until the Stabilization of the Reichsmark in 1923.

A commitment to accommodating monetary policies, however, was incompatible with a fixed exchange rate target. As the release of pent-up import demand and the emerging boom led to a rapid deterioration of the current account in all five countries, the exchange rate with the dollar (the only currency on gold at that point) came under pressure. Instead of changing the course of monetary policies, however, currencies were allowed to float and prohibitions on the export of gold were maintained or imposed.

Rather than attempting to return to gold, Britain left the Gold Standard on March 31 1919 and let Sterling float. As Howson (1975, p. 11) notes this decision marked the defeat of the advocates of restrictive monetary policies. With the outbreak of the war, also Sweden had suspended the Gold Standard, as the Riksbank was freed from the obligation to exchange currency against gold and gold exports were prohibited. Partly as a result of Sweden’s high current account surpluses under the war, in November 1918 the Krona actually had appreciated with respect to most currencies. As the current account moved strongly into deficit after the war, the Krona started to depreciate relative to the Dollar although it largely maintained its value relative to Sterling. Whereas the pre-war parity with respect to the Dollar had been SEK 3.73/$, in November 1918 the Krona stood at SEK 3.57/$. In December 1919 the Krona had depreciated to SEK 4.68/$ and in November 1920 the lowest level was reached at SEK 5.27/$. The government did not attempt to counteract the depreciation. When the Krona reached its Dollar parity in March 1919, the ban on export of gold was maintained, which allowed the Krona to depreciate further. One month later the discount rate

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196 Britain imposed a ban on the export of gold in March 1919.
197 Since June 1919 the Dollar, as only currency maintained a fixed parity with gold again.
198 Source: Östlund 1945, p. 311.
was lowered. Although the Riksbank did not have to buy gold any more, it was still legally obliged to sell gold in exchange for currency to residents. When, in an attempt to force the Riksbank to increase the discount rate, well-known Swedish economist Eli Heckscher, in March 1920, appealed to the public to draw gold from the Riksbank, the Riksbank was also freed from the obligation to sell gold. As Östlind (1945, p. 312) notes, this meant that the final link with gold had been severed.

Similar to Sweden, also Norway had experienced large current account surpluses during the war and the Krone had appreciated relative to most currencies at the end of the war. And also in Norway authorities were not willing to compromise their domestic accommodating monetary policies by defending the exchange rate. The Krone was floated at the end of the war and, partly in response to a dramatic increase in the current account deficit, it devalued significantly with respect to Sterling. While the exchange rate had stood at NOK 15.590/£ in 1918, it reached 18.120 in 1919 and 22.490 in 1920. Like the Krona the Guilder had initially appreciated with respect to the Dollar. During 1919, however, the exchange rate fell below its parity. Despite a public controversy in which a group of 14 well-known economists published an appeal for the DNB to increase interest rates and defend the exchange rate, the DNB refused to provide gold for export. At the end of the war, the Reichsmark had already depreciated significantly with respect to the Dollar. By December 1919 the Reichsmark/ Dollar index (1913=1) had risen further to 11.14 In 1920 the depreciation of the Mark slowed down a bit as the index stood at 17.38. By the end of the hyper-inflation in late 1923 the Reichsmark had virtually lost its value.

In addition to cheap money, the rapid deregulation of postwar controls was considered an important element in a policy of stimulating growth. Unlike the post World War II period, which was preceded by increased state regulation of markets during the Great Depression, governments themselves in 1918 believed that deregulation would promote economic recovery. As Feldman (1993, p. 156) remarked with respect to the Bauer government of 1919-20 in Germany: "...the emphasis on productivity inevitably fuelled the clamor for decontrol." At the same time deregulation responded to strong political pressures. After four years of war, regulations had become

199 Norges Bank's gold reserves (valued at 1913 parity and excluding Norges Bank's gold deposits at the Riksbank (Stockholm) and Nationalbanken (Copenhagen)), for example, increased from NOK 38.4 m in 1914 to NOK 122.0 in 1918. Its foreign currency reserved increased from NOK 27.9 m in 1914 to NOK 69.8 m in 1918. Source: Rygg 1954, p. 467.


201 See van Seeusen 1945, p. 115.


203 For Britain see Tawney 1943, p. 13, 19-20.
highly unpopular with business, labour and agriculture. In Norway, for example, the impopularity
of controls was a major reason, together with inflation, for the losses the Liberals incurred in the
elections of 1918. In general both business and labour objected against the war-time regulations
because they were perceived as obstacles to seizing the opportunities which the economic situation
provided. As business in all countries expected a major upsurge in demand after the war, rationing
of imports and raw materials plus price controls seemed to stand in the way of expansion. Given
the already high inflation during the war, trade unions generally favoured maintaining price controls.
Yet at the same time they wanted to abolish constraints on wages as quickly as possible and return
to normal bargaining.

In Britain the Labour party’s immediate postwar demands called for a mixture of increased
and decreased state intervention in the economy. In its 1918 programme "Labour and the New
Social order", it proposed nationalization of land and of the key industries. Yet while these
demands seemed to confirm the common assumption of intervention-minded Labour versus
laissez-faire Liberals, it was frequently overlooked that the lifting of many of the restrictions imposed
during the wartime economy featured equally prominently on labour’s list of priorities. Part of
these restrictions concerned the lifting of wartime censorship. In the economic area, Labour
adamantly objected to the restrictions on the choice of place of employment and residence. Also
in Germany the labour movement advocated deregulation. One of the reasons for the increased
cooperation between German employers and labour, which started in the last weeks of the war, was
that both parties sought the lifting of wartime regulations which they considered to unduly restrict
their room of manoeuvre.

In Britain price controls were abolished in 1920. Controls on raw materials had already been
abolished in the spring of 1919. In March 1919 the ban on domestic capital issues was terminated
which was followed by a rapid increase in the flotation of shares. In 1919, also food rationing was
ended. In the Netherlands the apparatus of war time regulations had been completely dismantled

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204 For Germany see Winkler 1979, p. 27, for Britain Tawney 1943.
205 See Nissen 1933, p. 337 and Fuglum 1989, p. 381.
206 Railways, mines, electric power generation, Industrial insurance Companies, canals, harbours and steamship lines
as well as the retail of alcoholic drinks. See Milliband 1960, p.61.
207 See Milliband 1960, p. 63.
within 18 months of the armistice.\footnote{209} Within six months of the armistice, all restrictions on imports had been lifted in Norway. During the first half of 1919, the system of maximum prices was abolished for most goods.\footnote{210}

The priority awarded to growth, however, did not imply that governments aimed for budget deficits so as to stimulate demand. Even in the non-belligerent countries, the years 1914-18 had seen a drastic increase in state debt. In November 1918, therefore, governments generally realised that, in order to avoid a further increase in state debts, fiscal policy would have to be restrictive. Rather than attempting a Keynesian strategy of stimulating investment by means of public demand, the optimistic business expectations at the end of the war allowed governments to simultaneously cut spending and increase employment by means of accommodating a rapid rise in private investment though cheap money and decontrol.\footnote{211}

As Howson (1975, p. 23) noted, in Britain ".. budgetary measures were operating against the boom throughout its duration." Government revenues increased radically after the war from £ 889 m in the fiscal year 1918/19 to £ 1,339.6 m in the fiscal year 1919-20. During the same period spending was drastically reduced from £ 2,579.8 m to 1,6658 m. As a result the budget deficit of £ 326.2 m for the fiscal year 1919/20 was about 1/5 of what it had been during the last year of the war. In the fiscal year 1920/21 revenues increased further, although less radically, and spending fell. As a result the budget showed a surplus of £ 230.6 m.\footnote{212}

As in Britain, the Catholic/Protestant coalition in the Netherlands brought about a radical improvement in the budget in 1919. Whereas the deficit\footnote{213} had amounted to DFL 421 m in the last year of the war, in 1919 it was down to DFL 9 m. By 1920 the budget was in surplus to the amount of DFL 76 m. The advent of recession, however, also implied a deterioration of the budget. In 1921 the surplus had shrunk to DFL 3 m and in 1922 a deficit of DFL 248 m was recorded.\footnote{214} Unlike in Britain, the improvement in the budget took place despite an increase in spending. Also for the Dutch governments improvements in housing, education and social welfare enjoyed high priority after the war. As a result spending increased from DFL. 333 m in 1918 to DFL 444 m in 1919 and

\footnote{209} See Keesing 1978, p. 64.
\footnote{211} Confronted with a big budget deficit and the need to reduce unemployment the SAP pursued in similar policy after 1982.
\footnote{212} Source: Pollard 1962, p. 66.
\footnote{213} Current accounts plus the budget for crisis measures.
\footnote{214} Source: Keesing 1978, p. 55.
DFL 613 m in 1921. Due to a booming economy, revenues largely held pace without the need for drastic tax increases. In 1919 revenues increased to DFL 466 m as compared to DFL 329 m in the previous year. In 1920 revenue amounted to DFL 614 m.

<table>
<thead>
<tr>
<th>Prime Minister</th>
<th>Period</th>
<th>RKSP</th>
<th>ARP</th>
<th>CHU</th>
<th>LSP</th>
<th>VDB</th>
<th>SDAP</th>
<th>% of parliament seats</th>
</tr>
</thead>
<tbody>
<tr>
<td>de Beerenbrouck I</td>
<td>9/9/1918</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>50.0</td>
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<tr>
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<td>18/9/1922</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>59.0</td>
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<tr>
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<td>R</td>
<td>X</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>54.0</td>
</tr>
<tr>
<td>de Geer I</td>
<td>8/3/1926</td>
<td>R</td>
<td>R</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>54.0</td>
</tr>
<tr>
<td>de Beerenbrouck III</td>
<td>10/8/1929</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>53.0</td>
</tr>
<tr>
<td>Colijn II</td>
<td>25/5/1933</td>
<td>R</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td>65.0</td>
</tr>
<tr>
<td>Colijn III</td>
<td>31/7/1935</td>
<td>R</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td>65.0</td>
</tr>
<tr>
<td>Colijn IV</td>
<td>23/6/1937</td>
<td>R</td>
<td>X</td>
<td>R</td>
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<td></td>
<td></td>
<td>56.0</td>
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<tr>
<td>Colijn V</td>
<td>24/8/1939</td>
<td>X</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>29.0</td>
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<tr>
<td>de Geer II</td>
<td>9/8/1939</td>
<td>R</td>
<td>R</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>68.0</td>
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</table>


The Swedish Liberal/Labour government was as successful as Lloyd George in turning around the budget. Whereas the budget for 1918 had shown a deficit of SEK 139 m, the following year's budget was in surplus to the amount of SEK 227 M. In the year 1920, which saw a Social Democratic government from March to October, the surplus was SEK 170 m.\(^{215}\) The ministry of finance during these three years was headed by a Social Democrat, first Rickard Sandler and as of July 1, 1920 by F.V. Thorsson.\(^{216}\) In contrast, the Liberal government of PM Knudsen in Norway was not as successful as its British and Swedish counterparts. Whereas the fiscal years 1915/16 and 1916/17 had seen a surplus, the fiscal years 1918/19 showed a deficit of NOK 62 m. The fiscal year 1919/20 showed a significant improvement but there still was a deficit to the amount of NOK 30 m. Largely as a result of the crisis, the deficit increased dramatically to NOK 232.8 in the year 1920/21.\(^{217}\) Although Knudsen did not think the deficits of the first two postwar budgets a cause for alarm, he strongly expected that the boom of 1918-20 would soon be followed by a deep recession.\(^{218}\) Especially given the increased radicalism of Labour, policies to reduce unemployment in the coming recession would be of crucial political importance. In the budget debates of 1919 for example, he argued that if the state would not be able to provide means to reduce unemployment " it might

\(^{215}\) Source Östlind 1945, p. 423-4.
\(^{216}\) On Thorsson see Vennerström 1926.
\(^{217}\) Source Fuglum 1989, p. 390.
\(^{218}\) See also Fuglum 1989, p. 377, 393.
happen that unemployment leads to other calamities which society surely would like to avoid.\textsuperscript{219} Therefore the state should save now so as to be able to pursue more expansionary fiscal policies when necessary. Under the boom conditions of the first years, the majority of Storting, however, did not share Knudsen's views. Repeatedly Knudsen, therefore, had to accept increases in spending against his wishes. When unemployment did indeed increase rapidly in the early twenties, Christian Hornsrud, DNA's economic policy spokesman and later prime minister, argued that the Social Democrats had advocated increasing fiscal reserves in good years so as to be able to increase spending in bad year.\textsuperscript{220} Yet during those good years also DNA rather advocated more spending. The Knudsen government stepped back in June 1920 when a majority consisting of DNA and the Conservatives voted against increased spending on road construction.

German governments, in contrast, did not manage to balance the budget. As table 3.9 shows, the budget was in deficit from the end of the war until the end of hyper-inflation in late 1923. While the deficit was significantly reduced in 1920, it increased again in 1921, but was virtually halved in the next year. By 1923 the level of 1922 had been reached again. Economically the reparations payments imposed after the war constituted a major obstacle to deficit reduction. At the same time, reparations constituted a political obstacle to balancing the budget. As German society generally considered reparation demands to be absurdly high and unjust, the willingness to bear tax increases and spending cuts was not very pronounced. Yet despite these political obstacles, the policy of the Social Democratic/Catholic coalitions of the first years of Weimar did not rest on fiscal profligacy. In late 1919 and early 1920, SPD minister of finance Mathias Erzberger passed a reform package which provided for drastic tax increases, while at the same time trying to promote income equality in Germany. As Erzberger wrote in 1919: "Every individual German will be burdened with taxes up to the limit of his capacity, up to levels previously considered fantastic. Such a burden will only be borne if complete equality and absolute conformity is guaranteed."\textsuperscript{221} The core of Erzberger's reform was a progressive tax on personal and corporate income. In addition, an emergency levy on property was assessed in late 1919. That despite these drastic measures Germany's public finances did not improve strongly was mainly the result not of reparations but of inflation. As Webb

\textsuperscript{219} Quoted in Nissen 1933, p. 345. My translation.

\textsuperscript{220} See the previous section.

\textsuperscript{221} Quoted in Webb 1989, p. 36.
(1989, p. 42) argued: "With extended price stability, the budget would have had small deficits, perhaps even surpluses. Inflation, on the other hand, quickly forced the government to borrow to cover most of its expenses."

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditures</th>
<th>Revenues</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1919</td>
<td>8643</td>
<td>2496</td>
<td>6147</td>
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<tr>
<td>1920</td>
<td>7998</td>
<td>3171</td>
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<tr>
<td>1921</td>
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<td>6237</td>
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<td>1922</td>
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<tr>
<td>1923</td>
<td>6543</td>
<td>2589</td>
<td>3954</td>
</tr>
</tbody>
</table>

*Note: 1919 figures for last three quarters only.

In sum, the economic policy regime at the end of the war was such as to greatly facilitate a political accommodation between capital and labour. Instead of trying to depress their economies and return to the pre-war gold parity, the three smaller countries oriented their exchange rate policies toward Britain. Since British monetary policy was relaxed at the end of the war, this did not imply the need for restrictive policies at home. Accommodating monetary policies allowed for a strong growth in private activity and a reduction in unemployment. At the same time economic growth meant that improvements in housing, welfare and education could be undertaken without incurring unsustainable budget deficits. And as a growing economy defused the more radical tendencies within labour and mitigated distributional conflicts it would lay the groundwork for a cooperation between capital and labour which could endure beyond the bourgeoisie’s fears of massive unrest in the first postwar months. Like the Social Democratic parties during the Great Depression which strongly believed in the need for greater economic planning in the long run and initially saw the new macropolicy regime which was to remain in force for almost four decades as a short term palliative, there seemed to be a distinct possibility during the first postwar years that the logic of domestic political accommodation would lead governments to unwittingly embark on a growth regime and thereby de facto would relegate the return to gold to an ever more distant future. As a result the accommodation which was eventually initiated in the wake of the Great Depression, might have commenced a decade earlier. Instead the twenties and early thirties would be characterised by restrictive policies to restore and maintain the Gold Standard. The breakdown of the nascent political accommodation of the late teens was primarily due to the fact that the policy choices of the postwar years left governments no other instrument than macroeconomic restriction to break an inflationary spiral.
As the experience of the years after 1945 would show, a successful transition from a war-time to a peace time economy required that the government maintain an extensive battery of regulations for some years. Without measures to bind or freeze liquidity, the monetary overhang would create the possibility of a sudden and drastic increase in demand. And the quite optimistic state of expectations at the end of the war assured that banks would be more than willing to lend to industry so that the liquidity would be channelled into a rapid increase in private investment. Whereas after 1945 most countries kept tight controls on imports and hence, by rationing raw materials and investment goods could prevent a too sudden increase in investment, such an instrument was no longer available by 1919. The rapid increase in demand for investment and consumption goods, given the existing bottle-necks, was bound to lead to price increases. As unions tried to defend their real wage such a profit inflation would easily set off a price-wage-price spiral. Yet as normal bargaining procedures were reinstituted after the war, unions aimed for much more than to defend the real wage they had in 1918. Despite price controls, the war had generally led to a quite significant drop in real wages, which trade unions sought to undo after the war. The strong increase in union strength and the good liquidity position of business after the war, hence, made high wage agreements virtually inevitable. The decision to float the currency further contributed to inflationary pressures. And as the boom got under way tight labour markets provided an additional strong impulse to inflationary pressures.

As table 3.1. shows unemployment remained relatively low in Germany from 1916 to 1922. And while unemployment rose in 1918 and 1919 it fell below 2% in 1922. In Norway unemployment was below 2% in 1919 and at 2% in Britain in 1920. Also in the Netherlands unemployment declined during the boom although it remained at a relatively high level. According to the figures in Table 3.1, the boom in Sweden was not reflected in a noticeable reduction of unemployment. Yet as the boom took place mainly during the last half of 1919 and the first half of 1920, annual data overestimate the amount of labour market slack. Most industrial sectors in Sweden showed a strong drop in unemployment starting with the third quarter of 1919. And whereas in the first six months of 1919 only 10% of industrial firms reported labour scarcity, by the second half of the year the figure had risen to 18.5%, and to 25.4% in the first six months of 1920. In the second half year of 1920 the figure dropped to 8.7%.

But governments and business came to realize that extensive regulations were required to prevent a post-war inflation spiral only after 1945, as a result both of the 1918-20 experience and the increase in micro level regulation prompted by the Great Depression. After 1918 the mounting of inflationary pressures was initially interpreted as a temporary phenomenon mainly related to the abnormal scarcity of supply. As the war-time distortions would disappear, inflation was expected to disappear with it. Deregulation and a policy of stimulating investment in general, hence, could even be understood as a policy which reduced inflationary pressures as it promoted a recovery of supply. Furthermore as imports became more readily available, supply problems could also be expected to become less pressing.

But without measures to contain demand and prices also wages policies would be impossible. Unions had generally experienced the restrictions on wage bargaining as a restriction of their market power and they favoured a return to free bargaining after the war. Moreover, unions quite naturally resisted unilateral wage moderation as a way to halt inflation. As DNA MP Buen argued, the on-going wage spiral (lønnskrufen) was a result of the rise in prices, partly due to the depreciation of the Krone. In order to stop inflation, hence prices rather than wages had to be halted first. Not even Social Democratic governments did seem to have an advantage in enlisting the cooperation of the Unions. At a meeting of the LO(S) leadership 28-29 April 1991, SAP minister of finance Thorsson argued that Unions should show some moderation in their wage demands, but his suggestion was not greeted enthusiastically. Furthermore as speculation spread in the wake of escalating inflation, any incomes policy would have been interpreted as an attempt to contain worker's wages while some people were allowed to get rich quick and effortlessly.

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223 See, for example, the argument of Norges Bank director A. Sandberg in "Saken som nu beskjæftiger vor Handelsstand sterkest", Verdens Gang, Nr. 304, Lørdag 6 December 1919, page 9. And also Social Democrats agreed on that point. DNA’s financial spokesman Hornsrud, for example, argued during the finance debate in parliament on April 26 1920, that the only way to get rid of inflation (dyrtiden) was to increase production (See St. forh, 1920, 7a Finansdebatten 26 April 1920, p. 1290.)

224 Norway at the end of the war had the apparatus to pursue wage policies. The Liberal government, with the votes of the Conservatives decided in 1919 to prolong the wartime practice of compulsory mediation in wage bargaining, DNA objected strongly. Yet, under the circumstances of 1919-20 it could not do much to contain nominal wage increases. Given the labour market situation and the radicalism of labour the state mediators awarded nominal hourly wages increases by nearly 25%


226 LO Archives, Sekretariatet Representantskapsprotokoll, Box A2A:2.

227 On Unions views on speculation see, for example, Olstad 1990, vol. 1, p. 267.
Figure 3.2 and 3.3. show the development of wholesale and consumer prices for four countries during the postwar years (Figures for Germany will be presented in section 3.5). In all countries except the Netherlands wholesale prices rose from the end of the war and started to fall afterwards. Britain showed the strongest increase in these two years with 37%. Wholesale price increases were more moderate in Sweden and Norway with 12% and 6% respectively. In the Netherlands the decline in wholesale prices started already in 1920. Consumer prices in all countries rose to a peak in 1920 and came down thereafter. Moreover consumer prices showed a stronger increase as compared to wholesale prices. In the Netherlands and Sweden they rose by 17 and 20% respectively. For Britain and Norway the figures were 22% and 24%. In all countries, furthermore, inflation was accompanied by widespread speculation in securities, commodities and real estate.\footnote{228 See Thomas 1936, 1.7, Mowat 1963, p. 25-6, Howson 1974, p. 89.}

Nominal wages showed a similar pattern. The Swedish index of nominal wages in industry, construction and trade rose from 200 in 1918 (1913=100) to 294 in 1920. By 1923, however, this index had fallen to 202 again.\footnote{229 Source Östlind 1945, p. 452.} In the Netherlands the index of nominal wages (1913=110) which
had stood at 167 in 1918 rapidly increased in the next 3 years to reach its peak of 274 in 1921.\textsuperscript{230} In the UK the money wage index rose from 72.0 in 1917 (1930=100) to 162 in 1920. After 1920 nominal wages declined sharply to reach 100 in 1923. Especially in the period 1918-20 nominal wages increased rapidly. In 1918 they grew by roughly 19% in 1919 by 30% and in 1920, the last year of inflation by 34%.\textsuperscript{231} Reliable figures for German nominal wages during the first year after the war are not available. By February 1920, however, the index stood at 6.0 (1913=1). By February 1921 it had risen to 10 and in February 1922 it stood at 20.3.\textsuperscript{232} In Norway average hourly wages for men in manufacturing rose by roughly sixty percent from 1918 to 1920 and fell afterwards. They reached their 1918 level again around 1928.\textsuperscript{233}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{cost_of_living.png}
\caption{Cost of Living/Consumer Prices}
\end{figure}

Compared to the rates of the seventies, the inflation of 1918-20 may seem rather moderate and no cause for alarm. Yet for governments who had expected price stability or even a moderate deflation the rise in prices which set in around mid 1919 was a clear sign that something had to be

\textsuperscript{230} Source Keesing 1978, p. 39.
\textsuperscript{231} Source Middlemas 1979, p. 124.
\textsuperscript{232} Source: Laursen & Pedersen 1964, p. 134.
\textsuperscript{233} Source Hodne 1983, p. 27.
done. More important than the actual extent of price increases was that the onset of inflation for governments who had just divested themselves of the war-time control apparatus meant a threatening loss of control over the economy. To Governments which lacked the ability to directly interfere with wage and price setting the onset of inflation had to appear as a more serious problem than, for example, the prices rise during the first years after 1945. To governments who observed widespread speculation, an explosion in bank lending, highly optimistic entrepreneurs and strong and radical trade unions, the onset of inflation could not appear as a temporary problem which would peter itself out. In addition the examples of Germany and Austria, where hyper-inflations were about to develop, became frightening examples of what might happen if the financial and monetary system was not brought under control. In February 1920 Otto Niemeyer of the BoE, for example, argued in response to pressures to lower instead of increase the discount rate: "...a reversion to cheap money will undo all the educative effect of even 6%. People will say: scarcity is over: money is cheap: there is no need for economy: and rush down the steep place of inflation until the shilling goes the way of the franc and the mark."235

 Yet, despite the fact that governments perceived inflation as a serious problem they hesitated for about one year before changing the course of monetary and exchange rate policies. The emergence of inflation as a serious policy problem meant that governments now had to face the dilemma of either abandoning the policy of stimulating growth and employment or risking a runaway inflation. Most government were not convinced until mid-1920 that there was no way to avert this choice and that combating inflation had to be given priority.

 Based on the British case, where the BoE called for more restrictive monetary policies right at the end of the war, the belated reaction to rising inflation is often attributed to the fact that governments instead of central banks were ultimately in charge of monetary policies. If, so the argument goes, Central Banks had had full control over monetary policies, the boom would not have had the chance to develop as far as it did and consequently the subsequent bust would have been more moderate or even absent.

 But, the experience of Britain is not representative for the smaller countries. In those countries central Banks, just as governments perceived a dilemma between, on the one hand, the desire to stimulate growth and investment, and, on the other hand the need to contain inflationary pressures

235 Quoted in Howson 1975, p. 19.
and speculative finance. Central Banks, and not even the BoE\textsuperscript{236}, did not interpret inflation in a neoclassical manner as a mechanistic response to the increase in the volume of money. The boom clearly thrived on a radical change in expectations after the war, which had led banks to rapidly increase their lending activities. Accordingly central banks would not have the option of fine tuning the rate of inflation without hurting the real side of the economy. Modest increases in discount rates would not deter further borrowing and a change in monetary policy strong enough to affect expectations would imply a recession.\textsuperscript{237} Furthermore, high interest rates were likely to have their most immediate impact on the productive sector while leaving speculation and the public sector relatively unscathed. Using an argument which is also at present advanced by some central banks, G. Vissering, president of the DNB, initially rejected higher interest rates in order to combat inflation and speculation because budget deficits were seen as the root cause of inflationary pressures, and restrictive monetary policies would harm private business while having only negligible effects on government spending.\textsuperscript{238}

In short, since both governments and central banks interpreted speculation and inflation not as being caused by destabilising monetary policies but by a radical change in behaviour of market agents they faced the dilemma of either accommodating the boom, and with it inflation, or to break the boom and provoke a stabilization crisis.

Echoing a view held by many governments, Liberal Norwegian PM Gunnar Knudsen explained that the argument that the increase in the money supply had caused the inflation was to confuse cause and effect. Rather the inflation had necessitated an increase in the money supply so as not to hinder production.\textsuperscript{239} Accordingly the best way to combat inflation was to try and change price setting behaviour of market agents rather than to administer a dose of restrictive monetary policy. For Knudsen this, first of all, implied a more active policy in fighting trusts and cartels. As he explained the war had led to a strong increase in the number of cartels and trusts, yet they had not disappeared at the end of the war.\textsuperscript{240}

\textsuperscript{236} See, for example, the quote by Otto Niemeyer above,
\textsuperscript{237} See also Eichengreen 1991, p. 111-2.
\textsuperscript{238} See Keesing 1978, p. 16, and van Seenus 1945, p. 119.
\textsuperscript{239} St. forh 1920. 7a, Finansdebatten 27 April 1920, p. 1334.
\textsuperscript{240} See Storting forhandlinger 7a, 27 Januar 1920, Trontalen, p. 83.
Central banks in this situation attempted to avoid having to compromise their policy of cheap money while keeping inflation in check by appealing to commercial banks, the general public, and the government to show moderation. By applying moral suasion to commercial banks, central banks first tried to induce them to bring about a voluntary form of credit rationing, in the sense that only productive undertakings should be financed and not financial speculation.\(^{241}\) And as the boom developed further central banks appealed for a general restriction in lending.

In May of 1920, the Riksbank addressed a letter to commercial banks urging them to restrict lending. In effect, the Riksbank appealed to commercial banks not to use the opportunities the market offered them: "However good profit expectations may be, given the present situation in the money market, this is not a sufficient reason for approving loans to a new business transaction or a new industrial company. Nor should the fear for losing a customer one would have liked to keep or gain be decisive with respect to the question of approving loans. If a reduction of the pressure on the Riksbank cannot be brought about by voluntary moderation of the banks lending... the Riksbank will have to use stronger measures (tvångsmedel)."\(^{242}\)

Already at the end of 1918, the Norwegian Finance Council (Finansråd), headed by central bank governor Bomhoff, argued that an increase in discount rate would not be able to stem speculation. Accordingly other means had to be found and the council proposed a concerted action of the commercial banks so as to reduce lending on the collateral of stocks.\(^{243}\) In February 1920 Bomhoff repeated his appeal for commercial banks to exert moderation in their lending practices, but now also the need for a general reduction by the state and society in general was strongly stressed.\(^{244}\) On July 8, 1920, shortly before the boom broke, Norges Bank again issued a widely noted appeal to 'the Norwegian public' in which it called for moderation from the public, commercial banks and the government.\(^{245}\) But because appeals to the public to reduce consumption did not have the desired effect and both the commercial banks and Norges Bank remained skeptical with respect to an increase in interest rates, the reintroduction of import restrictions was proposed. In a letter from Norges Bank plus 64 private banks, dated September 7 1920 it was pointed out that: "Several

\(^{241}\) For the Federal Reserve see Eichengreen 192, p. 111.

\(^{242}\) Quoted in Östlind 1945, p. 353. For similar attempts of the DNB to persuade commercial banks to reduce lending see van Sceneus 1945, p. 119.

\(^{243}\) See "Betalønninger over pengeværdien og valutaspørmaalene" av Arbeidsutvalget i det Norske Finansraad, Kristiania 1918, p. 16 and Tidskrift for Bank- og finansvaesen (p. 181, 1918).

\(^{244}\) See Rygg 1950, p. 6.

\(^{245}\) NB ARK Folder Hoveds. Akt U32, 8/7/1920, "Til den Norske Almenhet" See also Rygg 1950 p. 7.
sides have appealed to the public in the strongest possible words without the desired results. Now the state authorities must take action." The banks, therefore, proposed to the government "to impose without delay restrictions of imports and rationing of some of the big import activities. "It is unfortunate that restrictions have to be imposed on the citizens of the country and their freedom (handlefrihet) has to be constrained, be we think it is necessary if the good reputation of Norway is not to be lost."246

At the same time fiscal policies became a target of criticism for Central Banks. Because they shared the government's reluctance for a restrictive policy which was likely to harm private investment, calling for a reduction in government consumption and investment seemed a logical way to reduce demand pressures. In his appeal of July 8, 1920 governor Bomhoff, for example also argued strongly that the public sector should reduce consumption and investment and that commercial banks should lend to communes only for projects which were absolutely necessary. Yet it was quite unlikely that a reduction in public spending would calm down the economy. The boom was not based on expectations of increased government spending. As was shown above, budgets were actually in surplus in Britain, the Netherlands and Sweden. What was required to end the boom was to break the optimistic expectations about future demand and a continuing rise in prices. And this was what governments resolved to do in 1920.

3.4 Deflation and the Return to Gold247

During 1920-21 the policy regime changed in all countries but Germany. Contrary to expectations, inflation did not recede as supply recovered. Rather the economy moved into a self-reinforcing inflationary cycle with ever stronger speculative overtones. The widespread optimism about future growth kept investment demand up and as investment increased expectations were confirmed. Tight labour markets drove rapid nominal wage increases and given the ample availability of money and tight demand conditions, employers had no problem in passing higher wages on into prices. And the experience of inflation itself invited speculation on even higher prices. As R.H. Tawney (1943, p. 15) graphically described the mood in Britain at that time: "That the future will necessarily resemble the immediate past: that trees, if left alone, will grow into the sky; and that upward movements, once started, will continue for ever, seems to be, if not the first


247 Technically the interwar Gold Standard was a Gold-Exchange Standard as not only gold but also foreign exchange reserves were considered acceptable coverage for the note issues. As the word Gold-Exchange Standard is a bit cumbersome, this essay will simply used Gold Standard.
article of the practical man’s faith, at least a superstition on which, given the opportunity, he is not averse from acting. To these believers in perpetual motion it appeared to be sound sense to buy with borrowed money, provided that the interest did not exceed the rate at which prices were thought certain to continue to raise for the cogent reason that they were already rising. So they bought, borrowed, and drove them still further up, with shrill cries of excitement, as of children on a merry-go-round."

Apparently the postwar developments had proven those who argued that cheap and plentiful money was bound to lead to inflationary chaos right. Amongst economists and central bankers the postwar developments rapidly came to be interpreted as evidence of the destabilising effects of political intervention in the monetary sphere. Governments, however, generally did not interpret the developments of post-war years in terms of an inherently stable economy which had been destabilised by misguided policies. Instead economic actors were seen to have behaved perversely. Rather than to use the monetary leeway for reconstruction and expansion of productive resources, luxury imports and financial speculation had become rampant. In some sense governments felt betrayed; they had tried to provide favourable conditions for reconstruction by deregulating and by accommodating the monetary demand necessary for investment, but while doing so they had also unwillingly accommodated frivolous and speculative activities. The moralists' overtones accompanying the installation of the new regime were difficult to overhear. Especially in Protestant countries the reaction of governments to inflation and speculation was frequently to diagnose civil society and market agents as suffering from a consumerist or speculative moral deficiency. In a way, market agents had 'sinned' as they had preferred quick money to honest hard work. And as even appeals for moderation had sorted no effects, the state would have to impose discipline by imposing strict and inviolable monetary constraints. Certainly such measures would hurt in the short run, but they seemed the only way to restore discipline to the economy.

And because politicians had primarily experienced the boom in terms of an economy which would indulge in speculative excesses if monetary discipline was not tight, merely administering a dose of dear money was not enough. Rather governments wanted to prevent a repetition of inflation and direct the economies energies to productive rather than speculative purposes by institutionalizing a durable and inviolable constraint. The Gold Standard was to serve this function. Under the Gold Standard, monetary policies would not be a matter for day to day politics but would be tied indefinitely to an external constraint. Governments, then, voluntarily abdicated control over the most crucial instrument in their economic policy arsenal so as to provide stability to the economy.
Given that at the end of the war the general presumption amongst politicians and central bankers was that currencies would eventually return to gold, the restrictive monetary policies on which governments embarked during 1920 might easily seem inspired by the desire to realise this policy goal. In this view the return of the European currencies to the Gold Standard in the twenties was rooted in the inability of policy-makers to perceive any alternatives to such arrangements. The favourable economic developments of the prewar decades had made the return to gold an unquestioned and unquestionable dogma.\textsuperscript{248} The first post-war years, in this perspective, then would appear as a mere delay caused by the special economic and political problems of those years but not by any doubts about the system as such. And accordingly the Gold Standard system first had to be discredited by the economic problems of the mid to late twenties and the Great Depression in order for politicians to be willing to try out, or even think of, alternative arrangements.

Yet, the experience of the postwar years suggests differently. In November 1918 the elites of Europe had realised that, in terms of political and social relations, the old Europe had disappeared for good in the trenches of the war. It was not clear at all from the outset that the Gold Standard would not also fall victim to this need for change. As argued above, the commitment to a long term goal does not necessarily have to have implications for short-term policies. Accordingly government made no effort to defend or restore the gold parity in the first years, quite the contrary. Rather than the Gold Standard being discredited by the subsequent economic developments, the inflationary boom of the postwar years served to discredit a policy regime which prioritised domestic growth and which operated without an inviolable exchange rate constraint. It was the experience of the runaway inflation which again made the Gold Standard seem indispensable. And given the economic disorganisation, the pre-war Gold Standard now by many came to be seen in a more rosy light than contemporaries had.\textsuperscript{249}

It also follows that the neoclassical interpretation, and the interpretation of many central bankers at that time, of the Gold Standard as a device which served to free monetary policy from political intervention does not capture the essence of the policy change. In theory it is quite impossible to isolate monetary policies from the political process both because the decision to reconstruct the Gold Standard had to be a political one and because countries at any point in time were free to abandon their exchange rate commitment again. And even in countries where the

\textsuperscript{248} See, for example, Hirsch & Oppenheimer (1977) for an overview.

\textsuperscript{249} It should be noted that before the calamity of the early thirties the term 'Great Depression' referred to the crisis of 1873-1896.
central banks legally enjoyed political independence, matters of exchange rate regime were the prerogative of the government. In addition the central bank law itself of course could be changed by political decision. The resurrection of the Gold Standard, then, was not primarily an attempt to isolate the central bank from politics but a voluntary abdication of control from a political system which feared to set free uncontrollable economic dynamics without such a constraint. Although the high interest rates and deflation required to restore and maintain the Gold Standard by no means enjoyed unanimous political support, such opposition was generally impotent as virtually no political party during the twenties and up to the Great Depression was willing to advocate abandoning it. And the fear of having to face an uncontrollable economy without the Gold Standard constraint also explained why governments were so desperately trying to maintain it even in the midst of the Great Depression. If governments had held, in line with the neoclassical interpretation that the boom and inflation of 1919-20 merely was a response to an undue increase in the money supply, such a rigid constraint would not seem necessary. Surely, for example, British or Swedish politicians had enough confidence in themselves to believe that they would be able to refrain from setting the printing press in motion even without the discipline of the Gold Standard.

And because the resurrection of the Gold Standard was an attempt to institutionalise the decision in favour of restrictive monetary policies rather than restrictive monetary policies being brought about by a desire to return to gold, it also follows that whether and at what parity currencies were on gold did not necessarily have to have consequences for the policy regime. During 1920-21 a policy regime was established based on the conviction that control of inflation was the sole responsibility of the central bank and that growth and employment were determined by microeconomic factors, and not by the macroeconomic policy orientation. Such a policy conviction could very well survive without a fixed exchange rate constraint. As table 3.10 shows, most countries only actually returned to the Gold Standard in the mid twenties. Norway would not manage to do so until 1928. Yet the actual linking to gold did not imply a change in regime. And as shall be argued in the next chapter, even after the Gold Standard was abandoned in the early thirties such a policy conviction in many countries lived on for some months. Conversely, as the experience of Bretton Woods would show, a fixed exchange rate in itself did not have to imply a restrictive policy

250 This does not apply to Sweden where matters of exchange rate policy are the prerogative of the central bank. But the central bank, since it foundation has been subjected to parliamentary control, and in practice to government control during this century.
regime. At a time when western countries generally shared the conviction that macroeconomic policies did have responsibility for growth and employment, fixed exchange rate would confirm rather than undermine such a policy orientation.

Particularly in Britain, the stagnation an mass-unemployment which characterised the twenties, in retrospect, came to be attributed to the mistake of having established too high a parity. Given the downward inflexibility of wage costs, so the argument went, the reestablishment of the pre war parity made British industry uncompetitive. Britain, hence, would have fared better if it had followed the example of, for example, Belgium and France and pegged to gold at a devalued parity. Yet although Britain certainly might have fared better at a devalued parity, mass unemployment and stagnation were general characteristics of all European economies during the twenties and not just of those that had reestablished the pre-war parity. As the experience of the Great Depression would show in several countries, downward wage flexibility might rather mean intensified deflation than lower wages and more investment. More important, the policy regime established in 1920-21, by signalling an unmistakable commitment to restrictive money served to prevent the emergence of positive expectations about growth and thereby would make stagnation and mass-unemployment inevitable.

<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Return to Gold Government</th>
<th>Date</th>
<th>End of Gold Standard Government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>1923</td>
<td></td>
<td>July 15, 1931 (Beginning of pervasive exchange controls)</td>
<td>Brüning, Presidential Cabinet</td>
</tr>
<tr>
<td>Netherlands</td>
<td>April 28, 1925</td>
<td>Colijn I, ARP</td>
<td>September 26, 1936</td>
<td>Colijn IV, ARP</td>
</tr>
<tr>
<td>Norway</td>
<td>May 1, 1928</td>
<td>Mowinckle, Venstre</td>
<td>September 27, 1931</td>
<td>Kolstad, Farmers Party</td>
</tr>
<tr>
<td>Sweden</td>
<td>1924</td>
<td>Trygger, Hoire</td>
<td>September 27, 1931</td>
<td>Ekman II, Liberals</td>
</tr>
<tr>
<td>U.K.</td>
<td>April 28, 1925</td>
<td>Baldwin II, Conservative</td>
<td>September 21, 1931</td>
<td>MacDonald, National Government</td>
</tr>
</tbody>
</table>

Except in Sweden, Social Democrats were sitting on the opposition benches when the decision for a reorientation of monetary policies was taken. In Norway the beginning of the new regime can be dated to June 25, 1920. At that date Norges Bank raised the discount rate from 6 to 7%, -the highest level it had been at in forty years - and again admonished banks to reduce lending. At the same time the Bank, which at that time still had commercial banking operations instructed its offices to reduce their lending. The local offices of Norges Bank from now on required permission from the board in Oslo in order to extend larger loans. As in Sweden the onset of inflation in mid-1919 had provoked increasingly intense criticism from Norwegian economists, especially from Jaeger. By late 1919, most Norwegian economists were publicly advocating higher interest rates. At Norges
Bank, Nicolai Rygg, who was to become Governor on November 1, 1920 and would dominate monetary policies for almost two decades, was the driving force behind the policy reorientation. Whereas Governor Bomhoff and Director Sandberg in 1919 had proposed to relax the rules governing the gold and reserves backing of the money in circulation, 251 Rygg opposed such a change. Rygg instead presented an alternative proposal to the Storting’s finance committee which called for more restrictive policies. 252 PM Knudsen had originally supported Bomhoff and Sandberg’s proposal. But while he had argued that monetary policies were not the cause of inflation, by mid summer 1920 also he had changed his mind. In June Knudsen argued that money was out of control and that more restrictive policies were needed. 253 The Norwegian government never took a formal decision to return to gold at the pre-war parity. Yet because Rygg’s view on the subject were well known, his appointment as Governor, which had to be approved by parliament, can be considered the equivalent to such a decision. And in spite of frequently very vocal opposition against Rygg’s policy of deflation and appreciation, parliament and government never decided to revoke this initial decision.

Also in Britain it was the inflation and widespread speculation, which set in around April 1919 and lasted for slightly more than a year, which eventually made Lloyd George give in to the pressures from the Treasury and the BoE for higher interest rates and a return to gold. As in other countries a rapid increase in bank lending financed much of the boom. Given that business felt that the outlook was quite bright at the end of the war and banks shared this view, both the demand and the supply of credit increased rapidly. As R.H. Brand of Lloyds Bank noted: "My impression of Board meetings at that time was that we ladled out money; we did it because everybody said they were making and were going to make large profits, and while you had an uneasy feeling yet you thought that while they were making large profits there could be nothing said about ladling out money." 254

The inflation started as a 'profit inflation', as the rapid increase in demand drove up prices. Wages would soon follow, especially since Britain enjoyed full-employment since late 1919. And the inflation itself promoted a further reduction in money holdings and the speculative buying of real assets. The reduction in money holdings, i.e. the increased monetary velocity, meant that for

251 Ot. prop. 50, 1919, see above.
252 See Bergh & Hanisch 1984, p. 134.
253 Storting’s forh, 1920, d. 8. O. Nr. 112, p. 890.
254 Quoted in Howson 1975, p. 10.
the boom to start no change in central bank policy was required. However the boom could not have assumed such proportions if banks, and wealth holders in general, had not been able to procure additional liquidity. They could do so by running off their holdings of state debt. Much of the debt had been financed by short term (3 months) Treasury Bills. If the public, in the aggregate decided to reduce its holdings of state debt, the government would be forced to refinance itself at the BoE in order to acquire the necessary liquidity. As the experience of Germany would show, inflation by itself meant that the public would become less willing to hold government debt. In order to stop fuelling inflation, the government hence needed to induce the public to hold state debt, which required higher interest rates. By the end of 1919 the developing boom had convinced the government of the need for a change in policy. While de facto having ignored the Cunliffe committee’s recommendation, on December 1919, the Chancellor of the Exchequer announced that it accepted the need to stop borrowing from the BoE and to return to gold. While interest rates had been raised already in November 1919, another increase became necessary as the government experienced difficulties in selling treasury Bills.\(^{255}\) The boom broke shortly afterwards.\(^{256}\) As in Norway and Sweden, British economists, including Keynes, were strongly in favour of more restrictive policies. Keynes in fact was willing to go further in raising the interest rate than the Treasury.\(^{257}\) But also after he had written the General Theory, Keynes still held that, because all controls had been abandoned, restrictive monetary policies had been inevitable at that point.\(^{258}\)

From early 1920 onwards leading Swedish Social Democrats were amongst the most vocal advocates of more restrictive monetary policies and a return to gold. In response to Hecksher’s newspaper article of March 11, 1920 which had encouraged the public to withdraw gold from the Riksbank, the latter immediately asked the government to be freed from it obligation to sell gold. The Branting government one day latter presented a proposal to that extent to the Riksdag. Yet Social Democratic MP’s like Wigforss, Sandler and Örne, joined the by now united front of Swedish economists and strongly protested. The government presented its proposal on a Saturday and, as Wigforss (1950, p. 15-2) recounts in his memoirs, it would probably have passed both chambers of parliament if ne and SAP MP Anders Örne had not proposed a postponement. The next Monday

\(^{255}\) See Howson 1975, p. 23.

\(^{256}\) Tawney (1942, p. 15) described the effects of higher interest rates as follows: "Then the incredible happened. The government betrayed uneasiness. Bank-rate was raised - too late - to 6\(\%\) in November, 1919 and to 7\(\%\) in April 1920. It was evident that an attempt was about to be made to recover control of the monetary situation. The change of policy was a pinprick, not an earthquake; but coming when it did, it let the gas out of the balloon.

\(^{257}\) Howson 1975, p. 20.

(March 15, 1920) a public protest meeting was organised at which, amongst others, Wigforss and Hecksher gave speeches. At the meeting Wigforss likened the Riksbank’s policy to that of a counterfeiter. In the Riksdag debate Wigforss argued that inflation had to be stopped and the Krona linked to gold again. Anders Örne claimed that the most important effect of a raise in the discount rate would be to reduce the possibility of making profits off the poor. Moreover he pointed to the examples Austria and Germany as support for his view that the discount rate should be increased.\(^{259}\) Despite the opposition, the Riksdag did free the Riksbank from the obligation to sell gold, but only until September 30, 1920. Immediately afterwards the Riksbank increased the discount rate by a full percentage point.

In response to continued inflation and the heated debate about monetary policy, the Branting government on April 30, 1920 appointed a committee of experts to study Swedish monetary policy.\(^{260}\) Its report was published in August 1920, when Swedish prices were still rising. The committee proposed that energetic measures be taken to stop inflation followed by measures to depress the price level and that the Krona be linked to gold again. At the same time the committee noted that it might not be possible to return to gold immediately given the slender reserves of the Riksbank. By now the resistance within the SAP government against more restrictive monetary policies had disappeared. When the government in September 1920, in agreement with the commission’s proposals, suspended the Riksbank’s obligation to buy and sell gold for another three months, it declared that it agreed fully with the expert committee’s recommendations. At the same time the discount rate was raised again. This then marked the decisive change in monetary policy orientation.\(^{261}\) Wholesale prices started falling in the same month and as of October unemployment increased rapidly.

The recession gave rise to a renewed discussion about monetary policy. Should the Krona return to gold at is prewar parity or at a devalued parity? On April 19, 1921 the Riksdag’s banking committee’s (bankoutskottet) presented a report which argued that deflation was very costly for the economy and that it really did matter at what parity the Krona was linked to gold as long as the domestic price level was stabilized. The Social Democratic newspaper *Social Demokraten* summarized the committee’s views on deflation as follows: "The economic and social consequences of the deflation can mainly be summarised as follows: Production has decreased, business


\(^{260}\) Emil Sommarin was the SAP representative.

\(^{261}\) See also Östlind 1945, p. 353.
profitability has fallen, the value of all capital assets has been reduced, the purchase of capital goods for productive firms has been made more difficult, the business initiative has been overcome by despondency, the credit restriction has reduced purchasing power and exacerbated the fall in prices, stoppages have increased in number and size, bankruptcies and defaults are rising, unemployment has grown, the reduction of wages which has followed the deflation has caused extensive industrial disputes and consumption and investment goods have decreased.262

Yet despite the fact that the committee attributed unemployment, labour conflicts and lower wages to deflation, the only member which voiced a deviating opinion was Ernst Wigforss.263 For Wigforss it was unacceptable that the gold value of the Krone should be reduced below its old parity. The government and the overwhelming majority of the Riksdag shared Wigforss’ views. Also the Social Democratic speakers in the parliamentary debates unanimously expressed their desire to return to the old parity. Not only Örne, Wigforss, and Möller, but also Hjalmar Branting saw no alternative to the return to the pre-war parity.

And despite the fact that it felt the effects of the crisis immediately, the majority of LO’s board reluctantly accepted the restrictive monetary policies. In April 1921 LO’s Chairman Arvid Thorberg stated that it was unavoidable to return from a price level which had been bloated by the abnormal circumstances of the war to a more normal price level. And since it was unavoidable that the price level be reduced, LO could not necessarily be expected to support all strikes which were staged for the purpose of preventing a reduction in wages.264

At a LO board meeting later the same years Cruse (Typografförbundet) argued instead that a reduction in the value of money was the only effective solution to the crisis. Cruse, also held that "if Sweden would print SEK 200,000,000 additional paper notes that would have no disadvantageous effect on the currency but would give the possibility to create value in the country." Linde (Träarbetareförbundet) argued that high interest rates significantly contributed to the problem and that LO should demand a reduction in interest rates. Yet Cruse and Linde were in the minority. J.O. Johansson (Metall) felt that Cruse should look at Russia and other central European countries


263 Ten years later, however, also Wigforss recognized the dangers of deflation Nylander, and Kreuger already pointed out in 1921: "Det kunde ändå vara möjligt att diskutera en återgang til guldmyntfot, om den inte krävde några offer. Men at vi skola köpa den till priset av en fortsatt deflation, med sjunkande priser och stigande arbetslöshet, med en allt mer tryckande skuldbörda för stat, kommuner och enskilda företag, är inte rimligt krav. Inom de breda folklager, som skulle betala priset för denna heroina penningpolitik, kan den vinna anhängare endast så länge man undviker att klargöra dess verkliga innebörd." (Wigforss 1931, reprinted in Wigforss 1980, p. 388-389)

where the currency presses were operating at full steam. Certainly workers were not better off there. Edv. Johanson, (landsekretariatet) argued that an increase in the volume of money would lead to inflation. Therefore one should not mislead the people with talk about increasing the money stock. 265

Although perhaps a bit more outspoken, the SAP’s advocacy of more restrictive policies and the Gold Standard corresponded to the views of its sister parties. Given that their core electorate has a high preference for full employment, it is common amongst political scientists and others to assume that Social Democrats will generally advocate more expansionary economic policies than the parties to its right. But this was certainly not the case in the twenties. Governments generally encountered little opposition against the decisions of 1920 to increase interest rates and return to gold. 266 And the little opposition that was voiced mainly came from business circles, although also businessmen generally hesitated to advocate outright abandoning the Gold Standard.

In Norway director Jebsen of Bergens Privatbank had already warned in early November 1918 that any attempt of Norges Bank to reduce lending activity by means of higher interest rates might have dangerous consequences for the economy. 267 As of the mid-twenties the majority of Norwegian business felt that the Krone should indeed go back to its old parity but at a very slow pace. Some businessmen, mainly in shipping and forestry, actually advocated devaluation, but this was a very small minority. 268 Also Dutch commercial bankers were amongst the most vocal opponents of restrictive policies. When 14 Dutch economist issued a public appeal for restrictive monetary policies, 17 so-called ’practical men’, mainly bankers and businessmen, responded arguing that restrictive policies would have dire consequences for the economy. One of the signatories to this counter-appeal was the President of the Rotterdamsche Bank who, in the bank’s annual report for 1919, had in fact argued that expansionary monetary policies were not inflationary as long as the additional liquidity was employed to finance productive undertakings. 269 In Sweden, financier and industrialist Ivar Kreuger, who would become world famous when his financial empire crashed in 1932, was opposed to deflationary policies in the early twenties. But not only bankers

265 LO Arkiv, Representantstkapsprotokoll, Box A2A:3; 1920-22, 10-11 Oktober 1921. Dagordningens punkt VIII, Behandling av det nuvarande krisläget och därmed sammanhörande frågor.
266 For Norway see, for example, Hanisch 1979, 239.
267 See “Dokumenter offentliggjort av Arbeidsutvalget i det Norske finansraad: Pengevaerdien - valutaspørsmalene, Kreditgivning til utlandet. Kristiania 1918, p. 34.
269 See van Seenus 1945, p. 115.
and financiers but also Swedish industrialists spoke out against high interest rates and deflation. During the Riksdagsdebate in April 1921, Liberal MP and chairman of the Swedish Export Association, Nylander was one of the very few who believed that linking the Krona to the Gold Standard was not necessary in order to prevent a resurgence of inflation. He in fact argued that, given the high unemployment, a recovery of business would not lead to labour scarcity and hence also not to the wage-price spiral characteristic of inflations. In Britain industrialists’ opposition against restrictive policies would become a constant feature as recession continued throughout the twenties. But also in the early twenties industry voiced its skepticism with respect to the course of economic policies. In June 1920, the Federation of British Industries, for example, suggested to Lloyd George to appoint a new committee on monetary policy matters, and unlike the Cunliffe Committee industry should now also be represented.

For Social Democrats the most important reasons to advocate restrictive policies was that inflation undermined real wages. Already since the last years of the war, unions and Social Democrats had complained vocally about the rising price level. In Stockholm and Oslo large demonstrations were held. On a more moderate scale the Dutch NVV trade union organised a protest meeting against inflation in 1919. Especially since price controls had been abandoned at the end of the war, restrictive monetary policies seemed the most appropriate way to halt inflation.

DNA held that the depreciation of the Krone since the end of the war had lead to higher prices and hence to lower wages. In the budget debates in April of 1920, Hornsrud argued strongly that the depreciation of the Krone was a sign which called for a change in policy. Earlier that years also DNA MP Buen had called for energetic policies against inflation. The change in policy in mid 1920 and the onset of deflation hence were initially greeted by DNA as a development which would benefit the income position of workers. As Nysæter (1973, p. 21) has shown, during 1920-21 the labour MPs were in full agreement with Norges Bank’s policy of a slow contraction of the volume of money. In the theoretical Journal of the Swedish labour movement, SAP board member Nils Karleby similarly advocated deflation. According to Karleby the business community prefers inflation as this allows it to reduce wages through price increases. In a deflation, on the other hand,

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271 See Östlind 1945, p. 361.
272 See Boyce 1987, p. 36-38.
273 Storting’s Forh. 1920, 7a, Finansdebatten 26 April 1920, p. 1288.
274 Storting’s Forhandlinger 7a, 27 Januar 1920, Trontalen, p. 62.
275 See also Sejersted 1973.
labour gains at the expense of capital. The widespread idea that deflation has a negative effect on the economy is, according to Karleby (1921, p. 303), therefore, false and simply an expression of the fact that: "The ideas of the ruling class are always the leading ideas in society." And also in the Netherlands the argument that inflation undermined real wages was decisive in leading the majority of the SDAP to support restrictive policies. During the debate of the parliamentary group of the SDAP on the restrictive policies of H. Colijn, minister of finance in the government Ruijs de Beerenbrouck II, in September 1922 SDAP chairman Vliegen argued that inflation ran counter to the interests of the working class as it led to real wage reductions. Accordingly also the reduction of public employment and the cuts in public service wages which Colijn held necessary in order to defend the gold parity were, tacitly, supported by the SDAP. Prominent SDAP members, Albarda and Sannes, had similar views while only Troelstra was skeptical.\textsuperscript{276} The SDAP apparently also held that monetary policy was best left in the hand of an independent central bank as it rejected to include the demand for socialisation of the DNB in its programme because this would merely lead to more printing of money.\textsuperscript{277}

In addition, the widespread financial speculation of the boom was a strong reason for organised labour to call for more restrictive policies. During the war labour had urged governments to take more action against war profiteering. And most labour movements suggested that a drastic duty be imposed on war profits. The financial speculation after the war was equally objectionable, especially in a time of low real wages which were further being undermined by inflation. It seemed that the economy had been taken over by speculators who were making quick money while workers suffered from a low living standard.\textsuperscript{278} Many Social Democrats in 1919-20 came to argue that the monetary policies pursued had stimulated speculation and that restrictive policies were hence required to put a halt to it. For some Social Democrats, finally, the resistance of some parts of business against deflationary policies may have been helpful in determining their own position on these issues. If, so some argued, capitalists opposed restrictive policies, that had to mean that such policies were in the interest of labour.

But despite Karleby's view that deflation would benefit the working class, most Social Democrats did believe that restrictive policies would lead to a rise in unemployment. According to Wigforss (1951, p. 151) "the dilemma between an inflationary boom and deflation was clearly

\textsuperscript{276} See Perry 1994, p. 301.

\textsuperscript{277} See Nekkers 1985, p. 107

\textsuperscript{278} See, for example, Ousland 1949, Vol. 2, p. 13.
understood..." Yet, in line with what virtually all economists and politicians thought, the crisis and the rise in unemployment were not expected to be as strong and as long lasting as they actually turned out to be.

But even if Social Democrats had been able to look into the future in 1920, it is highly unlikely that the restrictive policies initiated then could have been avoided. Without an extensive control apparatus, including incomes policies, there eventually was no other alternative than to break the boom and provoke a stabilization crisis. What was avoidable, were the additional pressures put on the economy by the decision to deflate the price level so that the pre war parity could be restored, and the institutionalisation of restrictive policies by means of the Gold Standard.

Also after mass-unemployment had emerged, Social Democrats generally did not call for a change in policy. For many Social Democrats deflation would help reduce unemployment because it would increase competitiveness of the domestic industry.\(^\text{279}\) On the face of it the argument seemed plausible, as the price level was falling in most European countries, those that would not join in the trend would suffer a loss of export markets. Yet such an argument could hardly be considered decisive. A lower rate of domestic deflation would only result in reduced competitiveness if the country in question was linked to its competitors by means of a fixed exchange rate. Germany, which suffered from massive inflation from 1918 to late 1923, actually experienced an improvement in export competitiveness because frequently the exchange rate of the Reichsmark would depreciate faster than the domestic price level rose. In fact, one of the reasons why Swedish Labour had to be especially concerned about competitiveness during the early twenties was that its industry in many areas directly competed with German industry. Deflation hence could only seem an argument in favour of promoting employment once the decision to return to gold had been accepted by the Labour movement.

The Gold Standard, however, was never questioned by Social Democrats, not even during the Great Depression. The British Labour Party actually hoped that the resurrection of the Gold Standard would promote exports and hence employment. In 1924, for example, it argued that restoring gold would mean a revival of international trade and hence a revival of British trade and a reduction in unemployment.\(^\text{280}\) But the revival of trade did not constitute the main reason for Social Democrats to support deflation and the Gold Standard. The experience of the postwar boom

\(^\text{279}\) Norges' Bank Governor Nicolai Rygg also saw this as one of the arguments in favor of deflation. See Derry 1973, p. 308.

had discredited, in the eyes of Labour like in those of the other parties, a policy regime which was based on cheap money and the absence of an external constraint. In 1926 Karleby (p. 277) argued that the crisis had actually been caused by a too lax discount policy. Using a version of overproduction theory, he argued that cheap money stimulated excessive investment. Inevitably the new productive capacity would not be able to realise sufficient profits so as to repay the loans, at which point the economy would move into recession. And although the standard recipe of Social Democrats to these economic fluctuations was 'more planning', in practice also they accepted the Gold Standard as a mechanism which would prevent instability. And from the concern for economic stability also flowed the preference for restoring the Gold Standard at the old parity. If the Gold Standard had to function as a constraint, then the parity chosen should seem 'natural' rather than arbitrary, and the obvious choice then was the pre-war parity. Wigforss’ (1951, p. 152) reason to press for the return to the pre-war parity was that it was difficult to find some other value for the Krona "which would not seem even more arbitrary."

Also in line with standard thinking among politicians and economists, the durable mass unemployment of the twenties was not, up to the Great Depression at least, interpreted as the outcome of a policy choice. Rather for most Social Democrats, the duration of unemployment seemed to confirm their view that capitalist systems were inherently crisis-prone.

Once the Gold Standard was accepted, Social Democratic demands for political control of monetary policies necessarily were rather void of content, as it remained obscure why such political control would be necessary and to what ends it would be used. Changing its views of the 1920's, the SDAP congress of 1933 had come to advocate the nationalization of the DNB. In early 1934 SDAP MP van Waerden presented a proposal for nationalization of the DNB to parliament. Yet, while van Waerden, on the one hand, stressed that cheap credit was required to bring about industrial recovery, he simultaneously expressed his conviction that the DNB should focus primarily on maintaining the parity of the currency and that matters of exchange rate and monetary policy should remain the exclusive domain on the central bank. Is his -negative- response to the motion, Minister

282 See also Wigforss 1951, p. 155 where it is argued that the Gold Standard was to be preferred to "a managed monetary system" because of the inevitable human weakness.
283 In the UK Maxton of the ILP proposed nationalising the BoE to parliament in 1926. See Boyce 1988, p. 135.
284 The demand for nationalization of the DNB was also included in the 1935 Plan van de Arbeid of the SDAP and NVV.
of Finance Oud did not hesitate to point out this inconsistency. Similarly the DNA starting with its crisis programme of 1922, had advocated the establishment of a 'currency council' (valutaråd) which was to remove monetary policy from Norges Bank and bring it under social control. And immediately after the devaluation of 1931, the DNA renewed its demands for increased social control in order to contain the inflation and speculation which was expected to follow.

The Norwegian Labour party seems to have been an exception to the widespread acceptance of the Gold Standard and restrictive monetary policy. In response to the recession of the early twenties, DNA apparently radically changed its views concerning monetary matters. Although the decision to go back to gold was taken in 1920, the actual pre-war parity was not established before 1928 (See figure 3.4). The main reason for this long delay was that the initial deflation produced a banking crisis which forced the central bank to temporarily abandon its deflationary line in 1923-24. Monetary and exchange rate policies, therefore, were at the forefront of the economic policy discussion up to 1928.

**NOK in % of its pre-war Dollar Parity**

![Graph showing NOK in % of its pre-war Dollar Parity from 1920 to 1927.](source: Hanseth 1979, p. 247, 252.)

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286 Oscar Torp in "Diskontoen og Prisene", *Arbeiderbladet*, October 7, 1931.
While having initially supported Norges Banks’ restrictive policies, during the budget debates of 1922 Hornsrud now argued that the printing press had been used under the boom to promote speculation but “for God’s sake don’t stop the printing press now that the crisis has come. Everything possible has to be done to keep the economy (arbeidslivet) going.”287 In the same debate DNA MP Krogh, rather than claiming that expansionary monetary policies would be inflationary, instead argued that under a system of flexible exchange rates it is "the monetary policy which the Bank pursues which for a significant part determines to what extent business, production and employment shall be kept going or whether it shall stagnate"288 At the same time DNA favoured linking the Krone to gold at a parity which would not require further domestic deflation. Yet despite Madsen’s argument that under flexible exchange rates the Bank had a decisive influence on unemployment, it is unlikely that a DNA government would have established a new policy regime. If it had had a chance to do so, the DNA might have stabilised the Krone at a value corresponding to the domestic price level and thereby might have spared Norway a lot of economic hardship. Yet it was at no point willing to float the currency because it, and in particular Hornsrud, who had a decisive influence over the party’s economic policy positions, feared that that would lead again to inflation, speculation and lower real wages. In contrast to the farmers party, which advocated devaluation, DNA emphasised the need to cancel part of the debt burden of farmers and fishermen. Accordingly it also had to accept restrictive monetary policies if the defense of the Krone had so required. As will be shown in the next chapter, DNA ’s first reaction to the devaluation of 1931 was to warn against inflation. Moreover, DNA’s unwillingness to float or devalue the currency actually was indirectly responsible for the fall of the Hornsrud government after 18 days in office in 1928. During 1927 the Krone had again started to appreciate rapidly and had reached its pre-war parity in 1928. In the election campaign, DNA strongly emphasised its disagreement with the exchange rate policy of the Bank. The election was a great success and Hornsrud was called upon to form the first Social Democratic government in Norway. Together with the Farmers’ party the Social Democrats had a majority in parliament. Because the farmers were at least as much opposed to the exchange rate policy of Norges Bank, financial markets quite naturally came to expect a devaluation, and capital started flowing out. Yet Hornsrud refused to devalue and as two major commercial banks came

287 Quoted in Nysæter 1972, p. 27. My translation.
288 Quoted in Nysæter 1972, p. 27. My translation.
into trouble because of capital outflows, he refused to give his consent to a support scheme proposed by Norges Bank. On initiative from the central bank governor and the leader of the Liberal party, the Hornsrud government was then toppled by a vote of no confidence.

It is obvious that the recession of 1921-22 for small and highly trade dependent economies like Norway, Sweden and the Netherlands cannot be solely, or even largely, attributed to the shift to restrictive policies at home. By December 1919, the Federal Reserve had decided to break the boom, and during early 1920 such policies spread to the United Kingdom. With the advent of restrictive policies in major economies abroad, a reduction in export demand and some amount of recession was unavoidable for smaller countries. Even in Sweden, where the wholesale price level had started to fall and unemployment increase immediately after the Branting government had announced its goal of deflation, the volume of exports had been falling since July. Yet even for the smaller countries it would not be correct to characterise the recession as an undesired but inevitable import. Confronted with a recession abroad, economic policies in principle could seek to counteract the effects on the domestic economy by letting the exchange rate depreciate and by pursuing more relaxed monetary policies. But by late 1920 also the three smaller economies had become convinced that, in order to halt inflation restrictive policies and an eventual return to the Gold Standard would be required. Rather than attempting to mitigate the effects of the recession abroad, economic policies met the recession with a strategy of appreciation and monetary contraction. In Germany, on the other hand, a policy which created a recession in order to break inflation was politically impossible. In sharp contrast to the other countries, the German economy, therefore, recovered rapidly from the recession of 1920-21. But as the subsequent experience of hyper-inflation showed, to prioritise growth and employment and ignore the inflationary consequences in the longer run is not an available policy choice in a monetary economy.

3.5 The German Hyperinflation

"The inflation in Germany until 1923 was not the result of a policy, but rather a lack of policy." (Laursen & Pedersen 1964, p.123.)

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289 Swedish wholesale prices started to fall in September 1920, unemployment started to rise in October. See Östlind 1945, p. 341, 416.

In the end, only Germany failed to give priority to combating inflation. Whereas the other countries in 1920-21 acted to reverse the depreciation of the currency and the rise in prices, German monetary policies remained accommodating. The result was a spectacular hyper-inflation (Table 3.11). From 1919 to 1920 wholesale prices already rose by more than 250% while consumer prices ‘only’ rose by somewhat more than 140%. In mid 1922 prices were already rising at more than 50% per month. One year later, the monthly inflation rate exceeded 1000%. The exchange rate depreciated at a similar pace. In November 1923, when the currency was stabilised one dollar bought 4.2 billion Reichsmark.

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The interpretation of what had caused the German hyperinflation would have profound consequences for the policies leading up to the Great Depression, and not only in Germany. In the view of those in charge of German economic policies after 1923, and especially in the view of German Central Bankers, fiscal profligacy was the root cause of the inflation. For some the inflation was the outcome of a sinister plan to convince the allies that Germany could not pay the reparations burden. Rather than to tax society, German governments had chosen to set the printing press in motion so as to create an economic chaos which could be exploited to convince the allies of the unreasonableness of their demands. For others the recourse to the printing press rather was the result of the weakness of the German state vis a vis civil society. Confronted with a virulent conflict between capital and labour and with widespread rejection of the institutions of the Weimar republic, the state had seen no other option than to try and accommodate competing and irreconcilable claims of the German national product by means of fiscal spending. Depending on who had to shoulder them, raising taxes would either have alienated the working class or the business community. The government could not raise taxes for fear of alienating working class. Maintaining interest payments on the war debt was essential in order not to provoke the middle class. Finally, extensive spending on welfare programmes and food subsidies were unavoidable to pacify Labour. But since this additional spending financed by printing money could not increase the size of the national product and hence could not mitigate distributional conflicts, hyperinflation was the inevitable result.
But irrespective of whether the German government had been unable or unwilling to balance its budget, the way to prevent a repetition was the same: the state should be denied access to the Central Bank. In response to allied demands presented at the reparations meeting on January 13, 1922 in Cannes, the Reichstag on May 26, 1922\textsuperscript{291} passed a law which made the Reichsbank independent of the government by revoking the right of the latter to issue directive to the bank.\textsuperscript{292} Yet, as this did not lead to a change in monetary policies because the Reichsbank shared the views of the government,\textsuperscript{293} the allies decided to interfere not only with the form but also the substance of German monetary policy. The Dawes Plan of August 30, 1924 envisaged a radical reduction of Germany’s ability to perform an autonomous monetary policy by placing the Reichsmark on the Gold Standard and introducing a strong element of foreign control over the Reichsbank. Under the provision of the Dawes plan the parity of the Reichsmark was fixed at RM 4.20 to the Dollar.\textsuperscript{294} Forty percent of the note issue was to be covered by gold and foreign exchange reserves and the rest by qualified commercial bills. Like the arrangements in other countries, temporary violations of the 40% coverage requirement were not entirely ruled out. In such a case, however, the Reichsbank would have to pay a penalty to the government.

The new Reichsbank law of August 30, 1924 replaced the executive body of the Reichsbank with a general council consisting of seven German and seven foreign members. Henceforth the executive body of the Bank was to be appointed by the general council. The government was not to have any influence on the composition of the general council: its German members were instead to be elected by the private shareholders of the Reichsbank. § 25 placed a strict upper limit of RM 100 m to the Reichsbank’s lending to the government. In addition § 19 provided for the appointment of a foreign commissioner for the note issue\textsuperscript{295} who was to ensure that the Reichsbank would abide to the rules of note issue as laid down in the Dawes plan.\textsuperscript{296}

The initial change in Central Bank law had failed to bring about a policy change. The second change was not decisive either as also German politicians themselves, by the time hyperinflation had run its course, had become convinced that tying the currency to the Gold Standard and balancing

\textsuperscript{291} The law went into effect on July 24, 1922.

\textsuperscript{292} See Ehrenberg 1991, p. 79-80 and Goodman 1991, p. 32. The government, by the way, had never used its right to issue directives.

\textsuperscript{293} CF Feldman 1993, p. 404. See also Webb 1989, p. 123.

\textsuperscript{294} Which equalled RM 2,784 to one kilogram of gold.

\textsuperscript{295} The Dutch Professor G.W.J. Bruins was appointed to this post.

the budget should enjoy absolute priority. For other countries the spectacle of German inflation had the effect of strengthening the conviction that the Gold Standard and balanced budgets were the cornerstones of sound economic policies.

Yet the view that the state must be considered primarily as a potentially destabilising factor in the economy does not fit well with the experience of the German hyperinflation. First of all, as many central banks would discover again in the seventies and eighties there is no clear-cut relation between money growth and inflation. After the currency reform of 1923, the supply of money in Germany increased more than ten times from November 16, 1923 until July 31, 1924 while the price level stabilized. As Eichengreen argued (1992, p. 146): "...inflation depends not just on the supply of money but on the public’s willingness to hold it." But if the increase in the volume of money is not a sufficient condition for inflation, the monetary financing of budget deficits cannot be held directly accountable for the observed inflation.

Eichengreen, nevertheless, concludes that the budget deficit was the main cause of the German hyperinflation as budget deficits created expectations of inflation by creating expectations of future increases in the money supply, whereas the political agreement on balancing the budget which was reached late in 1923 eliminated such expectations, and consequently also inflation even though the volume of money kept growing. Such a view seems unsatisfactory, however, because if it is assumed that budget deficits create expectations of inflation to the extent that they are considered to lead to an increase in the volume of money, a continued rapid growth in the money supply should maintain inflationary expectations even if the budget is brought under control. In other words, in a model in which the volume of money ultimately is considered the determining factor of inflation, changes in expectations should be related to monetary policies and not to fiscal policies.

Secondly, as the example of countries like Britain and Sweden showed, budget deficits were no necessary precondition for a reduced willingness to hold money and for the emergence of inflationary pressures. In Sweden, as we have seen, the budget had turned strongly positive already in 1919 and remained so in 1920. Yet inflation escalated in this and the following year. The successful fiscal retrenchment led the commercial banks to turn to the Riksbank to a larger extent, since late 1918. In the UK the monetary expansion of the late teens and early twenties seems to have been primarily demand-determined as banks increased their lending activity by reducing their

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297 Riese p. 226
298 Östlind p. 312.
reserves and by drawing on the BoE. Similarly in Norway commercial banks rapidly increased their lendit and reduced their liquid reserves after 1918. In 1918, private banks had net assets at Norges Bank of NOK 51.9 m but in the next year their net borrowing from Norges Bank amounted to NOK 6.5m. Put differently, expectations concerning money holding could change irrespective of budgetary policies, and as long as the Central Bank was willing to remain accommodating the boom could continue also without budget deficits.

Thirdly the view of a weak state forced into deficit spending to accommodate civil society does not fit well with the Erzberg tax reform package of 1919-20. As noted in the previous section, this reform package meant a rather drastic increase in tax rates which would have balanced budgets if prices had been stable. To quote Steven Webb (1989, p. 38), again: "Government spending was not extravagant. Net of expenses mandated by the Versailles Treaty and expenses taken over from the states, the central government spent about the same as before the war. Social spending after the war replaced the military spending of the pre-war arms race."

Finally the contention that monetary expansion merely created inflation and did not enhance the distributional space by stimulating the real economy as well as the conclusion that stabilisation of prices would, therefore, also have no significant real costs for the economy do not seem to be borne out by the facts. Initially the German government's refusal to initiate a stabilisation crisis meant that the German economy performed better in terms of growth and employment during the early twenties than its neighbours. Even Bresciani-Turroni, who provided the standard neoclassical interpretation of the German hyperinflation, had to admit that inflation had had a stimulating effect on production. Initially the Net Domestic Product in Germany fell sharply from RM 42.1 bn for 1914-17 to Rm 34.2 bn in 1919. During the next three years production rose sharply to reach Rm 42. bn again by 1922. The last year of hyperinflation, however saw a drop to Rm 37.9 bn. At the same time unemployment remained relatively low. While the difficulties of the postwar year increased the unemployment rate, it recovered soon thereafter. Especially during the years 1920-22, the German unemployment rate was significantly below the level in other countries. During the last months of hyperinflation and during stabilization, unemployment shot up rapidly and production collapsed. Durable mass-unemployment now also appeared in Germany.

300 See Laursen & Pedersen 1964, Chapter 7 and Hanisch 1979, p. 254-267.
as the low figures of the 1920s would not be reached again until the mid thirties. Laursen & Pedersen (1964, p. 85-88) compared output developments during the hyperinflation with those in countries that pursued a restrictive policy in order to break inflation. They concluded: "In Germany production was also low. However, it did not fall but rose or was maintained during the inflation years."

In sum, both because the budget deficits cannot be considered decisive for the inflationary developments and because inflation stimulated the economy while disinflation had rather drastic economic consequences, the role of the state cannot be captured adequately in terms of a destabilising agent in a stable economy. The German government did not, willingly or reluctantly, provoke an inflation, but rather decided to accommodate inflationary pressures for fear of the economic and political consequences of a disinflation strategy. After the war, inflationary impulses mainly came from two sources. First the Reichsmark depreciated rapidly, thereby causing a rapid increase in prices of imported goods. For German policy-makers at the time, like, for example, Karl Hellferich, the depreciation of the exchange rate was the favourite culprit because it shifted the blame from the government to the allies. The unreasonably high reparations payments, so the argument went, had caused the depreciation and forced the government to accommodate price rises in order not to create a recession. Yet, reparations were certainly not the only source of depreciation, given the sorry state of the German productive apparatus at the end of the war and the acute food crisis, Germany had a huge demand for imports and little capacity for exports, even without reparations. Moreover, exchange rate depreciation did not necessarily have to lead to inflation. If the increase in import prices had not given rise to adjustment of domestic wages and hence prices, - i.e. if the depreciation had been not only nominal but also real - no inflationary spiral would have emerged but rather a once and for all price increase. Yet, wages did not lack behind price increases. Given both the acute food shortage and the radicalisation Labour had undergone during the war, it was not willing to great the armistice with and additional cut in wages. Moreover, increasing nominal wages constituted an autonomous source of inflation as wages rose

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303 Sweden, Britain, and the UK.
304 For an overview see Hardach 1973.
305 See Matthews 1986.
slightly faster than the consumer price index from November 1918 to July 1919. Accommodating monetary policies allowed to pass nominal wage rises onto prices, and in this way a spiral was set in motion by which wages and prices would drive each other up during the next few years.

The stimulative effect of inflation implied that as time progressed, labour scarcity would come to add powerful pressures for the acceleration of nominal wages. During 1922 the unemployment rate fell below 2%. And as inflation eroded the willingness to hold money, the result was an increase in the supply of money even irrespective of Reichsbank’s policies. Budget deficits undoubtedly added to already high demand pressures. But, as we have seen, the Erzberger reforms failed to balance the budget mainly as a result of inflation. From 1920-21 onwards, budget deficits hence mainly became a consequence rather than a cause of inflation. Rapid inflation reduced the real value of tax receipts. Moreover, as inflation continued, the public became less willing to hold government debt, i.e. nominal assets subject to rapid depreciation. The result had to be a greater recourse to the Reichsbank.

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<th>DVP</th>
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<td>Presidential Cabinet</td>
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Notes: a After DDP rejoined in October 78.1%. b Tolerated by SPD and DNVP. c Tolerated by USPD. d Tolerated by USPD, including Bavarian Farmers League. e Tolerated by SPD. f Tolerated by SPD. g Tolerated by SPD. h Supported by DNVP, after 1930 elections 31.3%, including DNVP and excluding DDP, Middle class party. See also table 3.3. Source: Flora et al 1983, p. 173.

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306 See Laursen & Pedersen 1964, p. 57.

The crucial difference between the German strategy and the one followed by other countries was, therefore, not primarily that Germany did not try to balance its budget, but that the German authorities were not willing to reorient monetary policies so as to break the inflationary tendencies in the economy. In other countries the spectacle of German hyperinflation strengthened their resolve to pursue restrictive monetary policies. Yet when German policy-makers looked across the border to determine the likely effects of such a strategy they were strengthened in their resolve not to follow a similar course. As argued above, it is a weakness of the view that restrictive monetary regimes have no effects on real variable that it has to invoke the occurrence of structural crisis in the wake of such strategies in order to explain rising unemployment and recession. All countries which pursued such strategy in the early twenties suffered from serious recessions. In Sweden, for example, the unemployment amongst trade union members shot up to more than 25% in the crisis of 1920-21. This meant that, in terms of unemployment, the crisis of the early twenties was more severe for Sweden than the Great Depression. And as Laursen & Pedersen (1964, p. 86-8) computed, the USA, the UK and Sweden all suffered a drop in real per capita income to below pre-war levels during the stabilization crisis. Given the radical impoverishment Germany had suffered as a result of the war, German policy makers were simply not willing to risk the consequences of such a strategy.

In short, the political situation in Germany during the hyperinflation was fairly unique in that it prevented governments from creating a recession in order to stabilise the price level. Yet, at the same time the German experience also showed that a political willingness to tolerate inflation ultimately does not allow a country to escape recession and unemployment. At the point where the confidence in the Reichsmark had been eroded so much that it would not serve any more as a medium of credit contracts and finally did not even purchase goods any more, inflation lost its stimulative effects. Without an acceptable monetary medium for credit contracts and the purchase of goods, the economy collapsed. The collapse hence started not as a result of a policy to combat inflation, but as the final result of inflation itself. During the final months of hyperinflation unemployment rose from 3.5% in July 1923 to 19.1% in October of the same year. But with that,

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308 See Myhrman & Söderström 1982, p. 80.
309 See also Feldman (1993, p. 211) who argues that the control of inflation "... is in truth, nothing more or less than a manifestation of political power by a government that feels secure enough to pursue a stabilization policy despite what seems to be its unavoidable economic and social consequences; namely, an economic crisis with its attendant high unemployment and weakening of labor's ability to secure improved wages and working conditions."
also the rationale of the inflation regime had been exhausted. In November 1923 the now largely functionless Reichsmark was replaced with a new currency and the price level could be stabilised. As the German polity had not been able to overcome political resistance against a policy of creating recession to break inflation, inflation brought about the recession and thereby made a new policy regime politically possible. Because inflation, rather than a feared counter-inflationary policy, now had become the cause of recession, business and agriculture in the summer of 1923 gave up their resistance to such policies.\textsuperscript{312} Like in the other countries, the regime was based on strict adherence to gold, balanced budgets and high unemployment. Hence German economic policies finally converged with those of its neighbours.

3.6 The Social Democratic Dilemma

With the change in macroeconomic regime the possibility of reaching an accommodation between capital and labour based on the increasing distributional space in a growing economy fell by the wayside. Unemployment everywhere increased sharply after stabilization and generally remained high. As the new regime turned the relations between capital and labour into a zero-sum game, a high level of labour market conflict was unavoidable, at least as long as the effects of mass unemployment had not yet robbed the trade unions of their ability to pursue effective industrial action. While during 1919 strike activity was mainly informed by the problem of inflation and the general feeling of dissatisfaction which characterised labour at the end of the war, by the end of 1920 strikes in most countries except Germany attained a defensive character. The advent of crisis and mass unemployment inevitably signalled the beginning of a business offensive to reduce wages and social security benefits and to make undone some of labour’s recent gains like the eight hour day. The social gains labour had made during and after the war now came to be seen by employers as (politically supported) obstruction to their profitability.\textsuperscript{313} Lacking a sympathetic government and given the high unemployment labour increasingly had to concede to employers’ demands.

Inevitably, the new regime implied the end of macro corporatist arrangements between capital and labour which had developed during or immediately after the war. Under mass-unemployment, employers tended to favour a return to local bargaining. While from the employers’ view, national bargaining in times of tight labour market might help prevent mutual reinforcing local wage

\textsuperscript{312} "Erst 1923, als die Bevölkerung die Mark nicht mehr als Zahlungsmittel akzeptierte bzw. als keine wichtige Interessengruppe mehr Vorteile aus der Inflation ziehen konnte, wurde der Versuch einer Stabilisierung unternommen. Ambrosius 1990, p. 41. See also Leutschen-Seppel 1981, p. 93-4.

\textsuperscript{313} See Maier 1987, p. 169.
escalation, decentralisation in times of high unemployment held the promise of facilitating wage cuts. Yet the new regime did not lead to an across the board intensification of capital-labour conflicts. The cooperation which had emerged during the previous years now frequently shifted to the micro level as improving competitiveness through rationalization now came to appear as the most promising way to reduce unemployment. Because it eliminated the need for direct wage cuts and thereby eliminated a major source of conflict, increasing firm-level competitiveness through increased productivity was a strategy inherently attractive to business and labour. Yet cooperation on this level in practice had to remain confined to pockets of modern export-oriented firms.

In Germany the first victims of the stabilization were the eight hour day and the cooperation between employers and labour in the so-called Zentralarbeitsgemeinschaft (ZAG). The ZAG was a bipartite national level body of employers and unions which had been founded in late November 1918 during the political revolution following Germany’s military defeat. The agreement establishing the ZAG, instituted the 8 hour day, granted trade unions full bargaining right and established works councils (Arbeiausschüsse) in firms with more than 50 employees. The most important task of these works councils was to ensure that the terms of collective agreements were respected. Moreover, business agreed to no longer support company unions. After the war, Unions had been rather skeptical with respect to plans for socialisation as they feared it would lead to a breakdown of the economy. The ZAG hence appeared as an arrangement which realised some long-standing demands while at the same time promoting economic recovery. The rapid increase in unemployment during the last stages of the hyper-inflation, however, unleashed a general offensive of business against the 8 hour day and wages. At the same time the position of the unions weakened dramatically because the inflation wiped out virtually all their assets and the onset of mass unemployment provoked a dramatic loss of members. As business was no longer willing to adhere to the terms set out in the ZAG, the unions decided to withdraw in January 1924.\footnote{Maier, (1987, p. 204) notes that "The end of inflation meant the end of tacit union-industry partnership" This does not seem entirely correct. In fact the stage at which inflation no longer stimulated the economy but rather provoked its collapse seems to have marked the end of union-industry partnership.}

Somewhat similar to the ZAG, the Dutch Catholic employers and trade unions attempted to institutionalise corporatist cooperation after the war. The joint Easter Manifesto of 1919 envisaged the creation of works council and a national level council of firms. The bipartite council were to have responsibility for a.o. wages, prices and employment. After a good start, employers’ interest in this form of cooperation waned quickly in the face of recession and unemployment. By 1921/22
the short-lived corporatist experiment had come to an end. The end of the war also brought the establishment of a tripartite national body, the so-called High Council of Labour (Hoge Raad van Arbeid, HRA) whose purpose was both to advise the government on matters of social legislation and to provide a meeting ground for business and labour. In the same year (1919) the minister of social affairs Aalberse, who had played an important role in creating the HRA, introduced a law which limited the workday to 8 hours and the workweek to 45 hours. With the onset of depression, also Dutch employers mobilized against the 8 hour day. By June 1922 they had managed to convince the government, and the legal work day was lengthened to 8.5 hours and the workweek to 48. At the same time the deterioration of labour market relations since 1920 condemned the HRA to remain largely irrelevant. Only in the wake of the Great Depression, when the government recognized a need for public intervention so as to stabilise wages, would this body gain more importance.

Building on a trend set in motion during the war, tripartite cooperation in Britain took the form of the National Industrial Conference. The first one was held in February 1919, and was fairly successful. The first conference also resolved to institutionalize this meeting on a permanent basis, but the NIC would not survive the strains of economic crisis. Within two years of its inception it was abandoned. The same year the NIC was disbanded saw the start of a massive employers’ initiative aimed at a return to local instead of national bargaining.

Norwegian employers had steered a conciliatory course after the First World War, but labour relations deteriorated markedly after 1920. When the Krone finally reached its old parity in 1928, and the need for deflation had temporarily disappeared, Norwegian labour relations improved again. The Norwegian employer’s association (NAF) again took a more conciliatory stand towards the LO and abandoned its absolute insistence on wage cuts. With the onset of depression and renewed deflation, labour relations in the early thirties relations again deteriorated rapidly.

As the experience of the Great Depression would show, crisis and unemployment did not necessarily have to coincide with declining fortunes of Social Democracy. Nor did a high level of employment necessarily have to lead to more hostile relations between business and labour. As states, during the Great Depression, started to intervene with the aim of halting the downward drift

316 The so-called Arbeidswet Aalberse.
317 See chapter 4 and Windmuller et al 1985, p. 64-66.
318 See Middlemas 1979, p. 139-41.
319 For a somewhat different interpretation of the improvement in labour relations since 1928 see Dahl 1981. See also Knutsen 1984 and Galenson 1949.
of nominal wages and prices, they not only laid the groundwork for more cooperative state labour relations, but also enabled labour and business to take a more conciliatory stand with respect to each other. But in a policy regime which excluded macroeconomic stimulation and instead pursued macroeconomic restriction for fear of rekindling inflation and jeopardizing exchange rate targets, Social Democracy could not thrive. The decision to institutionalize the Gold Standard policy regime not only implied that the state lacked effective instruments to try and foster social accommodation between capital and labour, it also seemed to establish a convergence between the interest of the state and employers at the expense of labour.

In accordance with Kindleberger’s observation that monetarists seem to gain the upper hand in times of inflation, the lesson drawn from the first postwar years was that preventing a resurgence of inflation should be the overriding priority for macroeconomic policies. There was apparently incontrovertible evidence that a relaxed macroeconomic stance would inevitably lead to inflationary mayhem. To be sure, the arguments were not exactly the same across the political spectrum. While Liberals tended towards the view that monetary policies needed to be isolated from political influences, some Social Democrats would rather argue that, unless disciplined by tight monetary policies, capitalists would engage in unproductive financial speculation. In each case the conclusion was the same, namely that the resurrection of the Gold Standard regime provided the best safeguard for a repetition of inflation. Yet the acceptance of restrictive monetary policies and the return to the Gold Standard implied the institutionalisation of a political dilemma which would haunt Social Democracy until the thirties.

The decision to deflate and return to gold meant the institutionalisation of exchange rate stability as the overriding priority to which all policy instruments had to be oriented. Restrictive monetary policies, budget cuts and a fall in prices and nominal, as well as real, wages now became the economic policy priorities. Politically the initial need for a substantive fall in prices and continued downward flexibility of domestic costs so as to adjust to external imbalances and improve industrial competitiveness, implied that collective organisation of economic interest quite inevitably came to be considered a potential obstruction to the state’s macroeconomic policy goals. Industrial or agricultural cartels, but particularly strong trade unions increasingly became the target of government intervention in the twenties. In addition to its effects on wage setting, a strong labour movement also appeared as a threat to balanced budgets and hence the exchange rate, because of its resistance to cuts in unemployment benefits and its pressure for more effective measures to combat unemployment.
At the same time, the reigning policy orientation meant that the state would not be successful in removing the main cause of labour market strife, namely stagnation and high unemployment. Because the regime created unemployment and at the same time excluded the possibility of macroeconomic stimulation, the state had to regard unemployment primarily as a problem which was to be solved on the micro-level by the labour market parties. But as argued in chapter 1, a regime which tries to rely on cost cutting and improved productivity for reducing unemployment while macro policies are committed to a restrictive orientation in order to prevent the reemergence of inflationary pressures, cannot succeed.

Politically the implication of the new regime was that labour lost its allies. The coalition between labour and Liberals, based on a common interest in electoral and social reform, could no longer be maintained. As the new economic policy interpretation implied that a strong labour movement was a hindrance to economic recovery, the Liberals would evidently place the interest of the economy, ahead of the interest of labour and these parties would drift apart. At the end of March 1921, for example Lloyd George ended state control of coal mines because the subsidy, which had allowed owners and miners to reach a modus vivendi, became too heavy a burden on the budget. The immediate result was a massive labour dispute. In Sweden, Liberals now felt that the state should use its works creation programmes so as to facilitate downward wage adjustment and promote strike-breaking. In Norway relations between DNA and the bourgeois parties reached an absolute low in 1927 when a new law concerning labour disputes was passed. The law made exerting pressure against strike breakers an offence punishable by imprisonment. In addition the law held unions financially responsible for illegal strikes unless they had done their utmost to prevent such strikes.

In the Netherlands and Germany the new regime implied that a political rapprochement between Catholic parties and labour would be impossible. Partly due to their own working class constituency and papal teachings on social policy, Catholic parties in principle could agree with labour on the need for more extensive social welfare and better labour legislation. Indeed their shared views on social reform had provided much of the cement for the SPD-Zentrum coalition in the early Weimar republic. But under the new policy regime, social reform for Catholic parties necessarily had to take a back seat. By the time Catholic politician Brüning formed his cabinet of 1930-32, deflation had become the first policy priority and this required social cutbacks instead of social reform. In the Netherlands the Catholic party remained opposed to forming a coalition with

\[\text{\footnotesize 320 I.e. the encyclicals Rerum Novarum and Quadragesimo Anno}\]
the Social Democrats until shortly before the second world war. But because the confessional parties (i.e. Catholics and Protestants) came to dominate the political system after the electoral reform of 1917, Labour might have expected a more positive approach towards social reform. After 1945 these parties would indeed become the main driving force behind the massive extension of the Dutch welfare state. Yet the exigencies of the interwar economic policy regime meant that the political dominance of confessional parties did not imply significant welfare state expansion.

But the Social Democratic political paralysis was not primarily due to its inability to muster political allies. As also Social Democrats came to consider the Gold Standard regime inevitable, they were hard pressed to find effective answers to the policies of the parties to their right. Given the fundamental economic policy choice the Gold Standard regime implied, Social Democrats would almost inevitably be torn between what were now considered to be the exigencies of the economy and the demands of its own constituency. Basically this left them only two options. Either they criticised the government and proclaimed the superiority of socialism from the safety of the opposition benches. Or they assumed office and risked alienating their constituency whenever the defense of the exchange rate required more wage and budget cuts. This was the basic dilemma which was to determine the political fate of Social Democracy up to the Great Depression.

Between the regime change in the early twenties and the regime change in the wake of the Great Depression, Social Democrats took office, either alone or as part of a coalition government, nine times in the five countries examined here. Seven out of nine governments fell over issues of economic policy. In the Netherlands, the attitude of the confessional parties spared the SDAP from having to make a choice of its own. After a spell of 18 days in office in 1928, DNA returned to the opposition benches. Førsund’s (1978, p. 30) remark about the parliamentary debates in 1930 also fairly accurately characterises DNA’s policies from 1922 onward: "DNA’s answers to the bourgeois policy were criticism, motions of no-confidence, but no proposals for an alternative policy." The SAP vacillated for much of the decade between, on the one hand, letting other parties take the blame for policies it thought inevitable, and, on the other, trying to limit the damage to the labour movement by assuming office itself. The second British Labour movement split the Labour party over its defense of the Pound in 1931. The SPD confronted an even more unpleasant dilemma because the need to defend the feeble democracy of Weimar made outright opposition frequently impossible. In October 1923, the SPD members temporarily left the coalition over the issue of abolishing the

321 General male suffrage was introduced in 1917, limited female suffrage in 1919.
322 See Zimmerman 1986, p. 58.
eight hour day. In March 1930, the Müller government stepped down because the unions refused to go along with the further cuts in unemployment benefits proposed by the DVP. But even after Müller had resigned, the SPD found itself unable to consistently oppose the fiercely restrictive policies of 'Hunger Chancellor' Brüning for fear of helping the Nazis to power. The two exceptions were the fall of the first Labour government in October 1924 and the withdrawal of the SPD from the Grand Coalition under Stresemann in October 1923. MacDonald's government fell after nine months in office over the so-called Campbell case, a rather insignificant affair which the Liberals and Conservatives however thought to betray Labour sympathies for communists. The SPD withdrew from the Grand Coalition when Stresemann decided to remove the state governments in Sachsen and Thüringen from office, where the communist party was preparing a revolution while refusing to interfere against the Bavarian state government, where the extreme right was preparing to overthrow the Weimar republic.

While having been the only Social Democratic party to have initiated the new regime, the SAP would also be its first victim. The same Branting government, who had accepted the need for deflation in the spring, realised in October that such policies are best observed from the opposition benches rather than pursued. The decision to step back was taken at the SAP board meeting (partistyrelsen) on October 13, 1920.\textsuperscript{323} The leadership generally agreed that the present economic situation called for austerity and wage cuts. Yet at the same time it was deemed politically impossible for a Social Democratic government to advocate such a policy. Accordingly the best policy for the SAP at the moment would be not to pursue a policy at all but go into opposition. Finance minister Thorsson argued: "It is going to be difficult for any government to govern under the coming period, but it is going to be most difficult of all for a Social Democratic government. We would be forced to violate too many points of our policy programme if we continued to govern. That would only lead to an unprecedented gloating in the country. ... It has to be said that there now has to be an end to talk about higher wages. But the question is, do we have the courage for that? A different economic policy than we are able to pursue is simply necessary. We, therefore, serve the country best if we step back. The economic situation of the country is really precarious. Only by means of austerity (sparsamhet) and rationing can the situation be improved. But the Social Democrats cannot do that. Isn't it better if we get a government which can solve the economic problems?"\textsuperscript{324}

\textsuperscript{323} See also Unga 1976, p. 58.

Ernst Wigforss was no less outspoken: "We are unfit to govern. We do not agree on the economic questions, we very simply don’t have a policy for the present situation. The government must go. The economic problems have to be solved according to the bourgeois recipe." \(^{325}\)

Although it had declared itself unfit to govern in 1920, it was politically difficult for the SAP to remain voluntarily in opposition at a time when some of the most vital interest of its core constituency were threatened, especially so given that the SAP had consistently polled the most votes since 1917. The Gold Standard dilemma, which at the same time made it unavoidable and impossible for the SAP to assume government responsibility, was the main reason for the rapid succession of governments in Sweden during the 1920s. Tage Erlander (1972, p. 172) - who was to become SAP prime minister after the Second World War, summarised this conflict between the SAP’s economic analysis and its general ideological outlook succinctly when he remarked that: "Social Democracy experienced (…) an arduous conflict between the scientist’s theoretical analysis of reality and feelings of justice (rättfördighetskänslan) which revolted against this reality." \(^{326}\)

Wigforss’ contention that the economic problems needed to be solved according to the 'bourgeois recipe' was only partly right. The 'bourgeois recipe' would not be able to solve the economic problems, at least not the unemployment problem, but it was the only course compatible with maintaining the Gold Standard. Acceptance of returning to the pre-war parity implied that Social Democrats would have to agree with nominal wage cuts. And, as was shown above, for LO(s)’s Chairman Arvid Thorberg this meant that the Union could not generally lend support to strikes which were aimed a halting wage cuts. Soon after the regime change, however, also real - as opposed to nominal - cost reduction would seem unavoidable. In a regime where the insight had been lost that macroeconomic policies actually do have a crucial impact on employment, the micro-level strategy of improving the competitiveness of domestic industry would also for Social Democrats appear to be the only feasible way to reduce unemployment. \(^{327}\) Increasing competitiveness, however, might not only imply lower taxes on business, and higher productivity (rationalisation), but also lower real wages. Accordingly the new regime implied that it would become difficult for Social Democrats to justify their resistance against any type of wage cuts. The


\(^{326}\) My translation.

\(^{327}\) For the UK see, for example, Boyce 1987, p. 150.
SDAP, for example, would admit openly that wages were too high.\textsuperscript{328} And as Tage Erlander (1972, p. 171-2) recalled in his memoirs, during the twenties also the SAP did not have alternative to the view that unemployment was mainly caused by high wages.

The remaining two SAP governments of the twenties fell over the issue of wages, more precisely over the question of how the labour market measures used to relieve unemployment should relate to the unions’ efforts to prevent wage cuts. Labour market policies were the responsibility of a public commission - Statens Arbetslöshetskommision (SAK) - created in 1914 in order to mitigate the unemployment that arose after the beginning of the war. From its inception the SAK had operated on the principle that public works were to be preferred to unemployment benefits.\textsuperscript{329} The wages paid at public works programmes were the same as those paid for comparable work in the regular labour market. But as unemployment increased rapidly since the fall of 1920, the SAK changed its wage principles, and the wages in the public works programmes now were kept below market wages. Moreover, in order to prevent crowding out of regular employment, SAK was only to finance projects which were not likely to be undertaken in the near future. SAP and LO in principle advocated market wages in labour market programmes. In 1912, for example, the SAP had proposed public works at market wages and from 1930 onwards this again became one of the core points in its policy programme. Indeed its demand of 1930 for productive public works at market wages is generally seen to signal its acceptance of Keynesianism, because more demand rather than lower wages now was considered the best solution to unemployment.\textsuperscript{330} Yet, given that the SAP had embraced the need for deflation it also had to accept the new SAK policy. Put differently, the need for deflation implied that the state, in those areas where its policies directly affected wage setting, had to try and promote a fall in (nominal) wages, and to pay market wages for public works programmes was incompatible with this goal.\textsuperscript{331} Moreover such a policy would also help contain public spending, which seemed rather urgent given the rapidly rising budget deficit since 1920. But at the same time, it would be politically very difficult for the SAP, especially in view of fierce protest of LO, to pursue a policy which undermined the already weakened bargaining power of the trade unions.

\textsuperscript{328} See Dehen 1980, p. 162, 353.
\textsuperscript{329} See Öhman 1973, p. 103.
\textsuperscript{330} See, for example, Axelsson et al 1987, p. 36, Öhman 1970, p. 81-83 and Steiger 1971.
Despite the fact that such policies were unpopular, the SAP agreed with SAK’s new pay principles. Yet the party could not go along with the SAK’s policy on industrial disputes. The generally accepted principle was that the SAK should be neutral in industrial disputes, but business and labour had quite different views on what neutrality entailed. The issue revolved around two questions: (1) Whether the SAK should suspend assistance, both in the form of unemployment benefits and public works, to sectors in which an industrial dispute was going on (2) and whether the SAK should be allowed to instruct unemployed workers to take employment at firms where the regular workforce was on strike. The logic of the new regime suggested that the answer to both questions had to be affirmative, because both types of measures were likely to promote downward wage adjustment. Yet the SAP could not agree with such a type of labour market measures because, unlike the policy of paying below market wages for public works, the interference of the SAK in industrial disputes directly threatened the ability of the trade union to effectively operate.

Initially the Branting II government had agreed with SAK’s proposal to cut off assistance to all unemployed workers in an industry where a labour dispute took place because this would make it impossible for SAK to use unemployed workers as strike breakers. It soon turned out, however, that such a policy put excessive pressure on the finances of the unions concerned. On initiative from the LO, in February 1923 the Branting II government proposed a change in policy to the extent that those who had been unemployed uninterruptedly for at least six months should continue to receive support. The bourgeois parties in the Riksdag, including the Liberals voted down the proposal and Branting left office. Sandler’s government fell in June 1926 over a similar conflict. In early March 1926, SAK had granted a request from the Stripa mine in the town of Linde to be allocated workers on unemployment assistance in order to replace the striking workforce. Again mainly in response to pressure for LO the government decided to annul the decision of the SAK, yet this decision in turn was voted down by the bourgeois Riksdag majority on initiative from the Liberals. According to Tage Erlander (1972, p. 169) the Stripa conflict "was for me and surely many others the end of hopes about a cooperation between liberalism and social democracy."

Finally the decision in favour of a restrictive policy regime also implied that fiscal policies would be unavailable as an instrument to reduce unemployment and foster social accommodation. The stabilization crisis of the early twenties by itself aggravated debt problems due to the normal mechanism of reduced tax receipts and increased spending, in particular on unemployment benefits. And, with exchange rate policies unavailable, fiscal policy, along with domestic cost cutting, was

332 See, for example, Jörberg & Krantz 1986 p. 316 and Hamilton 1989. ch.3.
one of the main instruments for restoring current account balance. High interest rates and a falling price level, moreover, implied a higher real indebtedness and accordingly a higher share of government receipts to be spent on debt service. And as under the Gold Standard regime budget balance came to be interpreted as the first as most important indicator of a government’s willingness to pursue 'sound' policies, fiscal austerity in general was unavoidable in order to maintain the credibility of the exchange rate commitment. Especially in Germany, which became quite dependent on US capital import after the stabilisation of the Reichsmark, politicians feared that budget deficits would be interpreted as a return to inflationary policies and hence would destroy the credit-worthiness of the country. British policy makers had similar fears as they continuously needed to revolve a large short term debt stemming from the first world war.

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<td>Pettersson</td>
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Source: Flora et al 1983. Note: * Tolerated by Liberal Parties. See also table 3.3.

For the SAP the advent of the new regime meant that its early demands for fiscal expansion as a way to relieve unemployment without relying on wage cuts had to be shelved. As Tage Erlander (1972, p. 176) pointed out, one of the reasons why the SAP did not pursue its earlier ideas on combating unemployment during the twenties was that the early part of the decade was completely dominated by the debate about problems of inflation. The DNA still proposed deficit spending partly to be financed by loans in its 1922 crisis programme but the issue was forgotten afterwards and not to be revived until 1933. And also the SDAP could offer no alternatives to budget cuts. During 1923 the SDAP had vigourously campaigned against increasing the budget for the Navy at a time of general reduction in spending. But as chairman Vliegen remarked at a meeting of the
party leadership in October 1923, even without additional spending for the Navy the budget could not be balanced and austerity would hence also have been a necessity for a government with SDAP participation.\footnote{See Perry 1994, p. 306.}

The emergence of restrictive fiscal policies did not mean that all fiscal programmes of particular interest to labour were to be reduced. Especially during the rapid rise in unemployment during the early twenties most governments allocated additional means, above the automatic increase implied by higher unemployment, to works creation programmes or unemployment insurance.

Despite cuts in social services, to which Labour was bitterly opposed, Lloyd George's government found room within a reduced overall budget to extend both the period for which unemployed workers could collect benefits and the amount of borrowing from the Treasury the Unemployment Insurance Fund was permitted. In addition spending on relief programmes like road construction was stepped up.\footnote{See Mowat 1963, p. 128.} As Morgan (1979, p. 285) noted with respect to British policies in mid 1921: "Generally, there was widespread agreement that the government must play a more vigourous part in stimulating public works and industrial enterprise, lest a wholly unacceptable sum of tens of millions be spent to maintain a permanent army of over a million unemployed workers." But while British budgets were balanced in the 1920's with the exception of 1926 (See table 4.5), the Norwegian state recorded sizeable deficits financed by borrowing.\footnote{See Hanisch 1978.} And also here part of the deficit was due to discretionary spending increases on unemployment relief. The number of workers in emergency work creation programmes (\textit{Nødsarbeid}), for example, increased from 13,856 in 1920-21 to 58,434 in 1921-22.\footnote{Source: Ousland 1949, Vol. 2, p. 205.} The Swedish reaction to the rapid rise in unemployment showed a similar pattern. Public spending on works creation programmes rose from SEK 26.8 m in 1921 to SEK 43.8 in 1922.\footnote{Source: Unga 1976, p. 80.} Both the caretaker cabinets of de Geer and von Sydow plus the Branting II government allocated additional means to improving the communication infrastructure with the specific aim of reducing unemployment.
In Germany the high unemployment of 1925/26 even led the bourgeois coalition to pursue what was in fact a Keynesian countercyclical policy. Politically the need for such a policy was perhaps greater in Weimar than in other countries given the additional strains an economic recession would exert on the polity. Economically such policy was possible because the state budget was actually in surplus. The countercyclical programme of 1926 initially was centred on substantial tax cuts for business but soon was complemented by export subsidies. Later in the year a works creation programme was added, which consisted not only of increased spending on unproductive emergency works programme but also of the rather traditional Keynesian measure of spending increases for productive purposes like infrastructure and housing construction.\footnote{On the countercyclical policies of 1926 see: Hertz-Eichenrode 1982, Blaich 1977, Leuschen-Seppel 1981, Chapter 2.5.}

But this initial reaction to rising unemployment could not be sustained. As argued in chapter two fiscal expansion pursued in combination with a strong commitment to a restrictive regime is unlikely to spark off increased private investment. While the relief programmes of the early twenties, and the mid twenties for the case of Germany, certainly helped mitigate unemployment, the failure of the economy to recover meant that such programmes put increasing strains on the budget and thereby also came to be considered as a potential threat to the exchange rate parity. As mass unemployment failed to disappear the commitment to gold hence implied that considerations of containing the growth in budget deficits had to become paramount. Despite continued high unemployment, governments, therefore, saw no option but to reduce spending on unemployment relief. In Norway the number of workers in emergency relief programmes, for example, was reduced from 58,343 in 1921-22 to 5,270 in 1925-25 and 4037 in 1926-27. Yet in 1921-22 about 17\% of trade union members were unemployed, whereas the figures in 1926 and 1927 were 24.3 and 25.4 respectively. In Sweden spending on emergency works creation dropped for SEK 26.8 m in 1921 to SEK 3.1. m in 1924. By 1924 unemployment had come down significantly from their level of 26.6 \% in 1921, but with an unemployment rate of over 10\% the reduction in relief spending was more than proportional.

In Germany the spending programmes of 1926, indirectly caused the fall of SPD Chancellor Müller in 1930 -the last democratic government of the Weimar Republic. The rapid increase in unemployment since 1925 caused doubts whether increased productivity (rationalisation) could indeed be a strategy to improve the labour market situation. Fritz Tarnow, for example, - chairman of the woodworkers union, and one of the authors of the famous expansionist WTB plan of 1932 -
revised his earlier enthusiasm about rationalization during these years. At the same time the ADGB argued that spending on productive works was to be preferred over the unproductive emergency works creation programmes. In Sweden and Norway the constantly high rate of unemployment of the twenties and the onset of the Great Depression has a similar effect on Social Democratic thinking, and eventually led both parties to advance Keynesian-type programmes. As will be shown in the next chapter, Scandinavian Social Democrats were only called upon to put such programmes in practice after the Gold Standard had been abandoned.

The failure of the economy to recover sufficiently in response to the German programmes of 1926, however, had the implication for the Müller government that it inherited a budget deficit from its predecessor. In addition the onset of the crisis had led to a rapid increase in unemployment in the winter of 1928-29 and as a result the government needed to finance a sizeable deficit in the unemployment benefits programme. Given that the flow of foreign capital had largely dried up, the deficit had to be financed domestically. Under the pressures of the economic crisis, however, the compromise between the SPD and the industry-friendly DVP disintegrated. The ADGB proposed an increase in both employer and employee contributions. Yet the SPD' coalition partner DVP insisted that the burden to industry should be eased and demanded a reduction in the level of benefits. As the ADGB was not willing to accept that, the SPD withdrew from the government and a presidential cabinet under Heinrich Brüning of the Catholic Centre Party was formed.

The second Social Democratic government to fall over fiscal spending was the Second Labour Government of Ramsay MacDonald. While Labour still had advocated extensive countercyclical programmes in 1921, enthusiasm for such measures became much less pronounced after its experience in government during 1924. Given the depressed state of the economy, local authorities, who should have carried out most of the programmes, could not afford to do so. And at the national level, the rapidly increasing expenditure on the national unemployment insurance fund and the decided aim of returning to gold eliminated an available room for more aggressive fiscal spending against unemployment. Indeed the inability to find an effective cure for unemployment, despite the high hopes it had created when assuming office, marked the most conspicuous failure of MacDonald's first term as Prime Minister. In response, for example, the ILP started campaigning for more government intervention in industry and immediate measures for establishing a planned economy.

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340 The ILP's drive culminated in the report Socialism in Our time of 1926.
MacDonald’s second government fell in August 1931 as he, similar to Müller, failed to obtain the approval from the party for radical cuts in unemployment benefits so as to balance the budget and thereby relieve pressure on Sterling. In late July, the May Commission predicted in its report that, if no change in policy was brought about, Britain would have a budget deficit to the amount of £120 m by next spring. The Pound had been under pressure more or less continuously since 1928 and the European banking crisis of the summer of 1931 intensified outflows. The publication of the May report further undermined confidence in Sterling, which successive increases in the discount rate were apparently not able to restore. For MacDonald and his chancellor of the Exchequer Snowden, and indeed for most of the country, radical budget cuts in order to avert a deficit would seem the only way to prop up the Pound. The Labour party had been able to reach internal agreement on spending cuts of £56 by mid August, a significant part of which was to come from savings on the unemployment insurance fund. The conservatives and the Liberals, notwithstanding Lloyd George’s plans for deficit spending, held these cuts to be insufficient. MacDonald and Snowden in response proposed additional cuts on unemployment benefits, yet the cabinet, and especially those ministers close to the trade unions, felt unable to accept the new proposals as they seemed to place an unfair share of the burden on labour. Unable to secure cabinet approval, MacDonald resigned and with support from Conservatives and Liberals formed a so called National government. In response to what was considered a ‘betrayal’, both MacDonald and Snowden, who was to remain Chancellor of the Exchequer under the National Government, were expelled from the party.

In sum, because the Gold Standard regime implied the need for wage cutting, fiscal austerity and a policy of trying to revive growth through stimulating firms, the state tendentially seemed to be more favourably predisposed towards employers’ than labour’s demands.341 Because the economic policy orientation was largely determined by the decision to institutionalize a restrictive regime, it could not make a crucial difference whether the government benches were occupied by Social Democrats or their 'bourgeois' counterparts. For Social Democrats, the Gold Standard regime instead implied a rather fundamental political dilemma. It was not until the Gold Standard was abandoned that the dilemma could be overcome.

341 This, of course, in no way implies that the regime as such could be characterised as being more in the interest of employers than of labour. It is difficult to see how business in general can profit from stagnation and high unemployment.
4 The Creation of the Social Democratic Consensus

4.1 Introduction

Unlike the crises of the early twenties and the seventies and eighties, the reconstruction of European political economies which took place between the early thirties and late forties caused the orientation of economic policies to change in ways beneficial to organised labour. The Great Depression caused the centre of gravity of the political system to shift decisively again, but this time in a Social Democratic direction. Liberal, Conservative and Christian Democratic parties likewise came to accept, and frequently spearhead, the need for economic policy interventionism and the political correction of market outcomes. As Samuel Beer remarked in 1965 about the policy of the British Conservatives in the thirties: "In their reassertion of state power over the operation of the economic system as a whole, they not only broke with fundamentals of British policy in the previous hundred years, but also created many patterns of government action which, in spite of important modifications, have been followed since that time."

During the thirties it had initially seemed that West European economies, rather than converging on a Social Democratic mixed economy, would travel sharply divergent trajectories. While Scandinavian Social Democrats came to establish political and ideological dominance, the Nazi dictatorship destroyed the organized labour movement. In Britain and the Netherlands the liberal regime of the twenties seemed to have survived with only minor alterations. Yet despite the vastly different political fate of Social Democratic parties in the thirties, the new policy regimes all shared a basic rejection of the 'liberal' political economy of the twenties. As Temin argued; "The Depression ushered in an age of moderate socialism, albeit in many variations." And after the defeat of the Nazi regime, political convergence was added to convergence in economic policies.

In the eyes of many contemporaries, and many scholars since, the thirties marked the change from a regime based on the trust in the forces the free market to a regime which recognized the inherent deficiencies of markets and the responsibilities of governments to correct market outcomes. During the Great Depression, it seemed that the political asserted its autonomy over the economic. That the goal of internal equilibrium rather than maintaining a fixed parity now achieved priority

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343 See, for example, Gourevitch 1986 and Luebbert 1991.
345 See, for example, Gourevitch 1986, p. 166-68.
might seem as the logical, if somewhat belated, consequence of the advent of general suffrage. In a democratic polity, it seemed, the desires of the broad electorate rather than the prejudices of haute finance would have to inform economic policy-making. As the outcomes of unfettered markets were socially and politically unacceptable to the majority, society reacted by discarding the old dogma of the primacy of the economic.  

Proclaiming the primacy of the political, however, conflicted with the core assumption of neoclassical and Marxist theories alike that political interventionism at best was futile and at worst would lead to serious economic disturbances. The inflation of the late teens and early twenties, convinced not only liberal politicians that the attempt to impose political preferences on market systems must fail. Rather inflation seemed to confirm the interpretation of the market system as a distributional zero sum game. For the majority of policy makers the lesson from the post war inflation was that an attempt to ease distributional conflicts by means of expansionary policies would not provide stronger growth but instead would disintegrate the monetary system. Accordingly, monetary policies had to be removed as far as possible from the sphere of politics. For Marxists the same type of analysis simply showed that the position of the oppressed could not be improved within the confines of the capitalist system. In short, the quantity theory of money reigned supreme from the left to the right of the political spectrum.

How then, could the alleged reassertion of the primacy of politics during the Great Depression have ushered in the longest growth period in the history of modern economies? Why did the decline of the Gold Standard, the balanced budget dogma and independent central banking not produce the inflationary chaos they were seen to have produced one decade earlier? Why was it that in the middle of the Great Depression governments embarked on policies which increased public control over the economy and which de facto strengthened the wage bargaining powers of the trade unions without being confronted with serious opposition from employers? Why did employers not require a further weakening of trade unions power so as to improve competitiveness, as happened during the twenties and would happen again in the seventies and eighties?

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346 Perhaps the most ambitious interpretation of the epochal nature of this change was provided by Karl Polanyi (1957), for whom the Great Depression signified the final failure of the market economy and the transformation to a more regulated system.

347 See, for example, Polanyi 1957, p. 25: "Whether the gold itself has value for the reason that it embodies labour, as the socialists held, or for the reason that it is useful and scarce, as the orthodox doctrine ran, made for once no difference. The war between heaven and hell ignored the money issue, leaving capitalists and socialists miraculously united."
The fascist reaction to the Great Depression seemed to lend itself easiest to interpretation within the old zero-sum framework. Marxists were not alone in arguing that by destroying the organisations of labour, fascism accomplished the radical reduction in real wages which business had demanded throughout most of the twenties but found impossible to obtain within a democratic polity.\textsuperscript{348} But the interpretation that the crisis was solved by radically reducing the part of the national product accruing to Labour could not claim general validity as it ran afoul of the West European democracies and especially of those countries where Social Democratic parties came to power. In the latter countries economic recovery proved to be possible while the political and economic influence of labour was actually strengthened. Capitalism obviously did not require the radical suppression of the working class in order to survive.

Yet, still it might be possible to accommodate the new policies in the old zero-sum framework by arguing that the different fate of European countries in the thirties reflected different political preconditions for reducing the claims of organised Labours. In this interpretation Scandinavian Social Democracy was successful because its coming to power led labour to accept a reduction in wages which conservative parties had found impossible to bring about. As Bo Gustafsson argued with respect to the policy of the SAP since 1932: "The "new" policies were first of all a new form of wage cuts."\textsuperscript{349} Instead of reducing real wages by means of reducing money wages, they now would be reduced by increasing the price level. In the Weimar polity, however, it might be argued, such a policy could only be implemented under dictatorship. As, for example, Charles Maier (1987, p. 104) argued: "Now it did not require fascist institutions to contain wage pressure; In Great Britain wages remained low despite major union offensives. But in Italy and Germany the "opening" of the political system in the postwar period and the tumultuous advent of mass political parties and powerful unions seemed to preclude similar stabilization. Fascism seemed to provide the necessary political framework."

\textsuperscript{348} See also Neumann 1972, p. 266-1: "The aims of the monopolistic powers could not be carried out in a system of political democracy, at least not in Germany. The Social Democratic Party and the trade unions, though they had lost their aggressive militancy, were still powerful enough to defend their gains. ... It was one of the function of National Socialism to suppress and eliminate political and economic liberty by means of the new auxiliary guarantees of property, by the command, by the administrative act, thus forcing the whole economic activity of Germany into the network of industrial combinations run by the industrial magnates." For DNA MP Alfred Madsen the essence of fascism is that it wants to maintain the capitalist economic system by subduing the working class. See St. forh., 7a, 1931, Trontale og Finansdebatt, p. 96.

\textsuperscript{349} Gustafsson 1974, p. 141. My translation.

\textsuperscript{350} See also p. 97 and James 1986, p. 418.
Eventually - during the fifties - the accepted analysis of the Great Depression came to postulate the discovery of a new economic paradigm; Keynesianism. Social Democrats interpreted the Keynesian postulate that free markets tend towards unemployment equilibrium and that the state, through anticyclical fiscal policies, was the only guarantee of full-employment, as a confirmation of their view that capitalism needed to be tamed by the state. Neoclassics could embrace the new orthodoxy only after they had integrated it into their framework by attributing the possibility of an unemployment equilibrium to stickiness of nominal wages. In line with the real wage interpretation of the recovery from the Great Depression mentioned above, expansionary macroeconomic policies were seen to be effective because they brought about a real wage decrease by increasing the price level under stable nominal wages. Keynes himself, at times suggested such an interpretation. As Keynes (1973, p. 15) wrote: "Every trade union will put up some resistance to a cut in money-wages, however small. But since no trade union would dream of striking on every occasion of a rise in the cost of living, they do not raise the obstacle to any increase in aggregate employment which is attributed to them by the classical school." And even Marxists came to make peace with a theory which argued that government interventionism could rid capitalism of its crisis tendencies. While German Marxists maintained the postulate of the inevitable decline of capitalism by arguing that Keynesian policies would necessarily transfer the class antagonism to the political sphere, American Marxists were satisfied by adopting the rather more puritan argument that the growth and consumption made possible by Keynesianism is wasteful, meaningless and irrational. Kalecki, in turn, predicted that the economic possibility of growth and full employment by means of expansionary macroeconomic policies would remain politically stillborn. As continued full employment would strengthen the working class, business would - somehow - engineer a crisis so as to reinstate unemployment as an instrument of political discipline.

Yet, these interpretations were inaccurate. In essence the problem of the Great Depression was a problem of deflation. This was not a crisis which could only be resolved by radically changing the distribution of GDP between the major social groups. The core problem was not that wages were too high to allow for profitable production (classic unemployment) or too low for output to be absorbed (underconsumptionist theories). Nor was the core problem that the high interest demands of rentiers strangled the economy or that support to agriculture kept prices and wages too

353 Kalecki 1977.
high. Instead the process and policy of price deflation was driving the economic collapse. Not only would deflation reduce consumption (Mundell effect), but, much more important, under (expectations of ) continued deflation the undertaking and financing productive investment would seem too risky a venture.

The Great Depression was primarily a policy-induced crisis, the emergence of which can only be understood in the light of the inflationary crisis of the years following the first world war. By assigning macroeconomic policies the sole task of preventing renewed inflation and by linking currencies rigidly together by means of the resurrection of the Gold Standard, the stage was set for a disaster in which restrictive policies would cascade through the international economy. Despite massive deflation, the fear of a repetition of the postwar inflation dominated economic policies up to the 1930s. And despite widely publicised programmes for fiscal expansion, Social Democrats shared the same interpretation of monetary and exchange rate policies. In the 1930s Social Democrats did not have to be convinced of Keynes’ point that deficit spending might alleviate unemployment. Rather they had to be convinced that the abandonment of gold and a cheap money policy would not lead to renewed inflation.

In short, the historical task governments faced during the Great Depression was not to reduce the claims of Labour on the national product or to abandon the balanced budget doctrine, but to institutionalise downward rigidity of prices in a system which was being ruined by deflation. As a closer look at the economic recovery would show even the policies of the NSDAP did not rest on radically reducing labour’s share of the national product. And despite, its political and theoretical attractiveness also Keynesianism in practice was not important in the recovery from the Great Depression. Instead it was the deflationary constellation which determined the character of the new regime. Despite wide cross-national variations, the new regime came to rest on three pillars. (1) A proliferation of institutional devices designed to promote downward nominal rigidity, in particular agricultural price stabilisation agreements and cartels backed up by tariffs, and, in some countries, a deliberate effort to strengthen the wage bargaining power of the trade unions in a period

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354 "The fear of inflation prevented the various German governments under the Weimar republic from adopting after 1929 effective measures designed to put an end to the depression, and this failure led in the end to the breakdown of the political and social system in Germany. The same train of thoughts was behind the herostratic efforts of the labour government in Britain to balance the budget and to prevent the central bank from maintaining liquidity during the financial crisis in the summer of 1931. Had not the experience of the German inflation taught a sufficiently clear lesson as to what financial leniency and irresponsibility would lead to?” Laursen & Pedersen 1964, p.11. See also Temin 1989.

355 See also Luebbert 1991, p. 274: "Fascists, at least in Germany and Italy, seem to have understood that this harnessing of the working class required that workers experience some measure of integration into the new order. This integration had both a psychological and a material dimension."

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of massive unemployment. (2) Abandoning the Gold Standard and stabilising (or reflating) the domestic price level instead of the exchange rate. (3) Cheap money policies aimed at stimulating private investment.

And due to the deflationary character of the Great Depression a new regime which increased state intervention on the micro level and even strengthened labour would have the effect of promoting societal accommodation rather than intensifying conflicts. After the prolonged deflation of the late twenties and early thirties, employers, banks and agriculture would all benefit from halting the fall in the price level, and this dovetailed with organised labour’s desire to reduce unemployment and stop the fall of nominal wages.

Yet, most contemporaries would not interpret the Great Depression as a problem of nominal prices, but would rather understand it in distributive terms. Partly this was so because the deflation and subsequent reflation were uneven in character. Not all prices fell simultaneously. Some markets, like agriculture were subject to rapid deflation while other prices, like housing rents might remain relatively stable. Whereas prices for (industrial) output might change on a daily basis, nominal wages were only renegotiated periodically. The result was often an increase in real wages despite a substantial fall in nominal wages. And industrialists obviously interpreted the wage level as a major impediment to recovery. Conversely efforts at reflaction could be interpreted as a way to bring about real wage reduction given sticky nominal wages.\(^{356}\) Organized labour instead frequently complained about the failure of housing rents and prices for services to fall in line with nominal wages. And after stabilisation of agricultural prices the high cost of food was bemoaned. In response Social Democrats often demanded a consistent deflation, i.e. an equal fall in all prices.

But to attribute the crisis to excessive wage demands was to confuse cause and effect. A further weakening of trade union’s bargaining power could only serve to increase deflation and hence intensify the depression. And for that reasons consistent deflation also was not on the historical agenda during the Great Depression. Ultimately since Brünings’s policy of forcing a fall in prices by decree, it became clear that more deflation would rather aggravate than improve the situation.\(^{357}\)

Unlike some Keynesian analyses, which suggest that a new set of policies was consciously adopted,\(^{358}\) the new regime did not emerge in response to a well conceived master plan. Instead most of the policy measures making up the new regime were introduced as short-term emergency

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\(^{356}\) For the British Treasury this was the main motive behind its policy of reflaction. See Booth 1987.

\(^{357}\) See also Brugmans 1983, p. 536 who argued that is was fortunae that Colijn’s policy of domestic adjustment did not succeed completely because such a rapid deflation would have made matters worse.

\(^{358}\) See, for example, Gourevitch’s (1986) analysis of the policies of the SAP during the Great Depression.
measures. Governments moved to regulate agricultural markets when major parts of the sector seemed to be on the verge of total collapse. The gold parity was abandoned when speculation against the currency could not be stemmed any longer. The rules of orthodox monetary policy were broken when banking systems started to collapse. It was hence only in retrospect that the coherence of the new regime came to be discerned.

The outcome of the Great Depression was the inversion of the policy assignment of the Gold Standard period, as stimulating growth and employment now came to be a task of macropolicy while the concern for price stability was delegated in large measure to micro level measures. By the beginning of the Second World War the view that monetary policy should be conducted in isolation from the government and in disregard of the developments of the real sector had been discarded. The deflation had convinced most politicians of the left and right that monetary policies, far from being neutral, did exert a powerful influence on growth and employment and hence should not be conducted independently, but should be subjected to the governments overall policy goals. Closely related, the view that unemployment primarily had to be considered as a problem of excessive wage costs or insufficient rationalization also fell victim to the Great Depression. Unemployment gradually came to be seen as a problem which governments could and should combat by means of macroeconomic policies. Instead of attempting to reduce unemployment through wage cuts governments politically guarantied wages and strengthened the wage bargaining power of trade unions.

Moreover, by abandoning the Gold Standard and institutionalising a regime which did not need to (threaten) continuous macroeconomic restriction in order to maintain the parity or stabilise the price level, the groundwork was laid for a dramatic increase in growth and investment. Consequently the next four decades would utterly embarrass predictions of an inherently crisis-prone or stagnant capitalism. In large part due to rapid growth, social welfare systems could be vastly expanded during the next decades. Most, important perhaps, the thirties inaugurated a radical change in the relationship between the state and interest groups. Under the Gold Standard regime, states necessarily had considered collective organisations of economic interests which obstructed downward price flexibility as a potential threat to their macroeconomic goals. Now, however, such organisations came to be seen as playing in important role in fostering economic as well as political stability. Macro-corporatist tendencies, which had been doomed to remain politically irrelevant under the Gold Standard regime, now increasingly came to characterise European politics. As a result of all these developments the political accommodation between labour, capital and the state, which European societies had sought in vain since 1918, could be achieved.
The almost haphazard manner in which the new regime came about implied that new policies measures were frequently interpreted as short-term measures. In the standard interpretation of economic policy Keynesian policies worked either because in the short-run nominal wages were fixed and a policy-induced increase in the price level meant a decrease in real wages, or because investment activity was assumed to exhibit short term cyclical fluctuations which could be evened out by government spending. Keynes himself contributed to the interpretation of the new policies as being short run by his famous dictum that we are all dead in the long run. For many Social Democrats the new policies were just a first step in taming the capitalist system. Expansionary macro policies had been necessary in the Great Depression to combat the crisis. The longer run task which, in the view of most Social Democrats now presented itself on the political agenda, was to prevent crises and that could only be achieved through strongly increased public planning of production and investment.

But the new regime was just as much short term in character as the anti inflation policies of the twenties and seventies and eighties were a strategy for long term growth and employment. Rather than indicating something about their time horizon, labelling the new policies as short term was the way in which those views in which there was no place for the nominal dynamics of a monetary economy solved the contradictions between their own interpretations and the problems of the real world. By relegating the superiority of free (neoclassical) markets or the necessity of the transformation to socialism to the long-run the radical new policies could be supported without a corresponding radical break in ideology.

While the outcome of deflation in Western Europe was a general move towards politically guarantied wages and interventionist macropolicies aimed at stimulating growth, not all Social Democratic parties could initially draw political advantage from the new regime. In Britain, the fall of the Second Labour government over budget cuts in order to defend the gold parity split the Labour Party and made it a non contender for government participation for the next decade. In Germany the institutionalisation of price stabilization regime could not be implemented in time to prevent the political disaster of NAZI rule. A conflict over social policy between mainly union affiliated SPD MPs and SPD government members, similar to the conflict which brought down the Second Labour government, caused the SPD to leave the coalition in 1930 and it was not to return to the government benches until 1966. Despite a fundamental change in views concerning economic policies, the traditional aversion of the 'confessional' parties against Social Democracy kept the SDAP out of government until 1939. Unlike Labour the Scandinavian parties had the great luck
of being out of office when their currencies were forced off gold. While in 1932 they were not more willing to abandon gold than Labour, they had the good fortune of not having to address this decision while being able to reap the fruits of it.

In the short term it was mainly a combination of the specific domestic political constellation plus sheer luck which determined whether Social Democratic parties could profit from the change in regime. Yet in the long run the advent of the new regime could not fail to promote the ideological dominance of Social Democracy. As the conservative and liberal parties had to abandon their emphasis on downward nominal adjustment as the only appropriate policy in the face of deflation, the liberal orthodoxy forfeited its chance for ideological and political preeminence. No matter that the regime of the twenties had been very discretionary, the conservatives and liberals now had to pay the price for equating nominal downward adjust with the free play of the market and laissez-faire. The recognition of the destructiveness of deflation hence implied ideologically the recognition that market solutions and laissez-faire were bankrupt.

**Figure 6.1: Parliament Seats (%)**

In a period in which the historical experience seemed to confirm the Social Democratic tenet of the superiority of a politically controlled market economy, electoral progress and governmental tenure came easy to most Social Democratic parties. In 1945 the British electorate awarded Labour an absolute majority in parliament. After the 1945 respectively 1940 elections DNA and SAP also commanded an parliamentary majority (See figure 4.1). In the Netherlands the Catholic party
overcame its traditional aversion and formed a government in 1939 with the SDAP. Only the SPD would not manage to enter government until 1966, but the CDU/CSU’s acceptance of the concept of soziale Marktwirtschaft (social market economy) meant that Germany embarked on a similar policy course.

4.2 The Creation of the Great Depression and the Absence of Keynesian Policies

While the new regime arising in the early twenties did successfully eliminate inflation, it did so at the price of creating a serious deflationary bias in the international economy. The general acceptance of the view that the postwar inflation had been caused by misguided fiscal and monetary policies, led governments to pursue restrictive policies long after the economic constellation driving the inflation had disappeared. The postwar inflation had become a trauma which continued to inform economic policies even though inflation had given way to deflation.\(^{359}\) Moreover, resurrecting the Gold Standard in an effort to place an external constraint in the way of ‘irresponsible’ domestic policies had the effect of rigidly tying currencies and policies together. Under the Gold Standard domestic austerity and deflation were the only available adjustment mechanism in times of serious balance of payments imbalances. While the Bretton Woods system and even the EMS, to different extents, allowed for exchange rate changes in order to accommodate different domestic developments or absorb external shocks, the rigid construction of the Gold Standard meant that restrictive policies from one of the major economies would rapidly ripple through the system, as the other members would respond to the threat to their currency by restrictive policies themselves. And because exchange restrictions were ruled out, as international capital flows were considered to function as a welcome safeguard against domestic inflationary policies, the emergence of serious external imbalances due to speculative movements was an ever present possibility.

What gave the Great Depression its particularly catastrophic character was that the decade of the Gold Standard had seriously weakened those institutions which could provide a safeguard against excessive downward nominal flexibility. The wage bargaining position of most trade unions had seriously been undermined after a decade of mass-unemployment and government policies aimed at promoting downward adjustment of wages. Similarly a decade of recession and falling prices served to undermine the agricultural sector. Being strongly dependent on seasonal credit,\(^ {359}\) As, for example, Wigforss (1980A, p. 393) noted about the period immediately following the Krona’s devaluation of September 1931, "...the memories from the previous period with a currency freed from gold still were so much alive, that a paper currency in the widest circles was seen to imply serious risks for a strong and immediate price rise." My translation.
falling prices implied a steady increase in real indebtedness. Moreover, deflationary pressures were exacerbated by a tendency to produce more in response to lower prices so as to maintain the same level of income. Finally the policies of the twenties had also weakened the banking sector. Many countries had already experienced bank failures during the deflation of the early twenties, and the policies of the rest of the decade were not conducive to a recovery. In short, the resurrection of the Gold Standard on the basis of a restrictive policy regime meant that the threat of a cumulative cycle of deflationary policies was ever present. The disaster was waiting to happen and it did so with the Great Depression.

After a period of relative price stability from the mid-twenties to the late twenties, a renewed deflation set in around 1928. Within a span of three years wholesale prices fell at least 15% from their 1928 level (See figure 4.2). The fall in wholesale prices was most pronounced in the Netherlands. Between 1928 and 1932 prices fell by approximately 38%, and continued to fall, albeit at a slower pace until reaching 60% of their 1928 level in 1935. Despite Brüning's ferocious deflation policies, Germany did not manage to match the Dutch deflation. Here the bottom was reached in 1933 when wholesale prices stood at about 69% of their 1928 level. Reflation would set in soon after the coming to power of the NSDAP. Those countries which abandoned the Gold Standard in September 1931 managed to contain the extent and duration of deflation. In Norway prices were already stabilised in 1931 at about 79% and by 1937 the 1928 level had been reached again. The Swedish wholesale price index kept falling after 1931, albeit at a slow pace, to reach bottom in 1933 at about 72%. In Britain deflation of wholesale prices was halted in 1932 at around 72% of the 1928 level.

In terms of consumer prices a similar picture emerges. (See figure 4.3). Again the extent and duration of deflation was most pronounced in Germany and the Netherlands. Dutch consumer prices fell continuously until the Guilder was cut loose from gold in 1936. At that point the CP index stood at about 77% of its 1928 level. In Germany stabilisation already took place in 1934 when the CP index bottomed out at about 81%. Deflation was much less pronounced in the remaining three countries and recovery too took place earlier. Norwegian and British prices fell by about 15% and stabilised already in 1933. The Swedish index stopped falling in the same year at about 90% of its 1928 level. Reflation also was more pronounced in these three countries. In Germany and the Netherlands the CP index stood at about 80% at the end of the decade whereas Britain, Norway and Sweden had roughly reached the 1928 level again at that point.
The fall in national product roughly matched the deflation picture (See Table 4.1). Hardest hit were Germany and the Netherlands. But while recovery set in in Germany already around 1933
the Netherlands had to wait three more years. Moreover, the Netherlands were the only country where the national product by the end of the decade failed to substantially exceed its 1930 level. The recession was least pronounced in the UK and Norway, although the latter country had started the decade with a quite depressed economy. Sweden recorded a comparatively strong recession but German levels were not reached. As in Germany recovery set in in Sweden in early 1933.

<table>
<thead>
<tr>
<th>Table 4.1: Index of Real National Product 1930-1939</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1930=100)</td>
</tr>
<tr>
<td><strong>Germany</strong></td>
</tr>
<tr>
<td>1930</td>
</tr>
<tr>
<td>1931</td>
</tr>
<tr>
<td>1932</td>
</tr>
<tr>
<td>1933</td>
</tr>
<tr>
<td>1934</td>
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<tr>
<td>1935</td>
</tr>
<tr>
<td>1936</td>
</tr>
<tr>
<td>1937</td>
</tr>
<tr>
<td>1938</td>
</tr>
<tr>
<td>1939</td>
</tr>
</tbody>
</table>

*Notes:* Britain, GNP at constant prices. Netherlands, Germany, NNP at constant prices. Norway, Sweden GDP at constant prices.


Table 4.2 gives an indication of the extent of unemployment during the Great Depression. As Mitchell he himself cautions, cross country comparisons are difficult on the basis of these indicators because Swedish and Norwegian data refer to unemployed trade union members while for Germany (after 1929) the Netherlands and Britain registered unemployed are measured. Since trade unions were over-represented in industry, where the crisis hits hardest, the Scandinavian figures probably somewhat exaggerate the extent of overall unemployment. Nevertheless table 4.2 gives a fair indication of the catastrophic impacts of the Great Depression. Germany recorded the most dramatic increase from 8.6% in 1928 to over 40% in 1932. But Germany also showed the most dramatic recovery, by 1937 unemployment had fallen below its 1927 level. In the Netherlands, on the other hand, unemployment kept rising until the Gold Standard was abandoned. As a consequence mass-unemployment was still rampant at the end of the decade. The effects of Norges Bank’s parity policy are shown by the very high unemployment rate in 1927. After a brief recovery between 1928 and 1930 unemployment started to rise again dramatically in 1931. Despite its

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stronger fall in national product, unemployment in Sweden was lower than in Norway. Recovery set in in both countries around 1933-34. With 15,6% the peak of British unemployment, reached in 1932, was lowest of the countries examined here.

The downward slide of the world economy was initiated by restrictive policies in Germany and the USA during 1927-28. Since 1927 the Reichsbank, under its president Schacht, aimed to discourage long term capital import into Germany. The Reichsbank had become increasingly worried about large capital inflows into Germany, in particular because the favourable balance of payments situation undermined Germany’s claim that she could not pay reparations. Reparations agent Seymour Parker Gilbert agreed with Schacht but for the opposite reasons. In the view of Gilbert reduced capital inflows would force German authorities to pursue more restrictive policies and this would lead to less imports and an improved trade balances. Accordingly Germany would be better able to pay reparations. Together Gilbert and Schacht managed to close the American capital market to German borrowing for some time during 1927.

<table>
<thead>
<tr>
<th>Year</th>
<th>Germany</th>
<th>Netherlands</th>
<th>Norway</th>
<th>Sweden</th>
<th>Britain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1927</td>
<td>8.8</td>
<td>7.5</td>
<td>25.4</td>
<td>12.0</td>
<td>6.8</td>
</tr>
<tr>
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<td>8.6</td>
<td>5.6</td>
<td>19.1</td>
<td>10.6</td>
<td>7.5</td>
</tr>
<tr>
<td>1929</td>
<td>13.3</td>
<td>5.9</td>
<td>15.4</td>
<td>10.2</td>
<td>7.3</td>
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<tr>
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<td>22.7</td>
<td>7.8</td>
<td>16.6</td>
<td>11.9</td>
<td>11.2</td>
</tr>
<tr>
<td>1931</td>
<td>34.3</td>
<td>14.8</td>
<td>22.3</td>
<td>16.8</td>
<td>15.1</td>
</tr>
<tr>
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<td>43.8</td>
<td>25.3</td>
<td>30.8</td>
<td>22.4</td>
<td>15.6</td>
</tr>
<tr>
<td>1933</td>
<td>36.2</td>
<td>26.9</td>
<td>33.4</td>
<td>23.3</td>
<td>14.1</td>
</tr>
<tr>
<td>1934</td>
<td>20.5</td>
<td>28.0</td>
<td>30.7</td>
<td>18.0</td>
<td>11.9</td>
</tr>
<tr>
<td>1935</td>
<td>16.2</td>
<td>31.7</td>
<td>25.3</td>
<td>15.0</td>
<td>11.0</td>
</tr>
<tr>
<td>1936</td>
<td>12.0</td>
<td>32.7</td>
<td>18.8</td>
<td>12.7</td>
<td>(')</td>
</tr>
<tr>
<td>1937</td>
<td>6.9</td>
<td>26.9</td>
<td>20.0</td>
<td>10.8</td>
<td>7.8</td>
</tr>
</tbody>
</table>

Source and notes, see table 3.1.

In the USA instead the Federal Reserve worried about domestic speculation and engineered its own monetary contraction in 1928. The result was a radical reduction of capital outflows from the USA. But the drying up capital flows to the rest of the world forced other countries into restrictive

363 The Dawes plan provided for reparations to be handed over to the reparations agent in German currency. The actual payment to the allies would only take place if the reparations agent judged that the Reichsbank had sufficient gold and currency reserves for a transfer not to jeopardize the parity of the Reichsmark. If the Reichsbank's reserves were not deemed sufficient the first RM 2 bn were to be invested in short term German paper while amounts in excess of 2BN (with a maximum of RM 5 bn) would be invested in long term paper. Capital inflows, of course, would improve the Reichsbank's currency reserve and hence make transfer more likely.
policies in order to maintain the gold parity of the currency. Hardest hit initially were less developed primary producers dependent on foreign capital inflows, but their effort to increase export in order to improve the trade balance only increased deflationary pressures.  

As of mid 1928 the BoE felt forced to tighten monetary policy in order to defend the parity, and the Pound remained weak basically until it was depreciated on September 21, 1931. Whereas the Second Labour government had come to power on a promise to effectively combat the unemployment which the Conservatives seemed to have no recipe against, the weakness of the Pound meant that MacDonald actually had to meet the crisis with more restrictive fiscal policies. Instead of an aggressive reduction in domestic interest rates to stimulate activity, the Bank Rate had to be kept high and drastic fiscal cuts had to be implemented as an additional means of propping up the Pound. The government fell on August 21, 1931 as MacDonald and Chancellor of the Exchequer Philip Snowden failed to reach agreement within the cabinet on a 10% reduction in unemployment benefits. In response a national government, under the leadership of Ramsay MacDonald but relying on the political support of the Conservatives, was formed in order to push budget cuts through parliament.

The drying up of American capital flows since the second half of 1928 was particularly problematic for Germany, as the country had come to rely on such capital imports during the previous years. Whereas the quarterly average value of Germany’s bond flotations abroad had still been RM 578 M from 1927 III to 1928 II, it fell to RM 75 m in 1929 II.  

Chancellor Müller believed that strict adherence to the schedule for reparations payments was the best way to promote a downward revision of the overall reparations burden. The reduction in capital inflows meant that if Germany were to pay reparations it would have to run a substantial surplus either on the trade or capital account. Since both the provision of the Dawes plan and Germany’s own fear of renewed inflation made devaluation out of the question, improvement of the balance of payments would have to be achieved by means of a domestic recession. The immediate result of reduced capital inflows was a sharp reduction in public investment. Since public investment exceeded private investment in the latter part of the twenties, this was a major blow to the economy. At the same time the Reichsbank’s policy of high interest rates and credit contraction discouraged private investment.

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As a result the Great Depression started already in 1928 in Germany. These restrictive policies were so 'successful' that despite a major recession in the world economy the German trade surplus actually increase between 1928 and 1930. 369

As restrictive policies proliferated through the international system the Great Depression took shape. By 1931 banking systems started to collapse under the pressure of deflation. The first was the Austrian, precipitated by the failure of the Creditanstalt, closely followed by the German. In March 1933 newly elected president Roosevelt had to declare a bank holiday in the USA.

During the postwar period it became generally accepted that the policy making experience since the Great Depression had shown Keynes' contention that procyclical fiscal policies would only aggravate a recession and that countercyclical policies instead were required in order to sustain full employment to be correct. Some countries like Sweden were seen to have applied the new Keynesian remedy already during the thirties while others, like Britain were not converted until the mid forties. In retrospect the Great Depression hence came to be seen as a historical divide which had ushered in the age of Keynesian macroeconomic policies. Politically the advent of Keynesian policies, was seen to have cleared the way for an accommodation between capital and labour. Whereas the pre-Keynesian remedy for unemployment was said to rely primarily on reductions in real wages so as to increase profits and investment the Keynesian emphasis on increased aggregate demand stressed the identity of interest of both capital and labour. Conversely, the regime change which took place during the seventies and eighties frequently became interpreted as the result of an economic constellation which made Keynesian countercyclical policies either politically or economically unfeasible. 370

The view that the period from the Great Depression to the seventies was characterised by widespread adherence to Keynesian countercyclical policies is one of the more persistent misinterpretations of the history of economic policy. In fact, Keynesian countercyclical fiscal policy has been a rare species which has mainly thrived within the confines of textbooks. Keynesian policies were absent in response to the Great Depression and largely irrelevant during the so called 'Golden Age' from the mid forties to the early seventies. As Peter Temin (1989, p. 108), analyzing the policies of France, Germany, the U.K. and the U.S., argues: "The 1930s were not a test of

Keynesian theory because Keynesian policies were not used."\textsuperscript{371} In his conclusion to a volume on the influence of Keynesian ideas since the thirties Peter Ha! (1988, p. 367) argues: "One of the most striking findings of this study is the degree to which Keynes' ideas about demand management were resisted or ignored in many nations." In effect Keynesian countercyclical demand management policies were only pursued in Germany during 1926,\textsuperscript{372} and on a broader scale during the seventies. In both cases such policies largely proved to be unsuccessful and short-lived.

<table>
<thead>
<tr>
<th>Year</th>
<th>Netherlands</th>
<th>Norway</th>
<th>Sweden</th>
<th>Netherlands</th>
<th>Norway</th>
<th>Sweden</th>
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<td>648</td>
<td>945</td>
<td>-1.06</td>
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<tr>
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<td>1032</td>
<td>746</td>
<td>1116</td>
<td>-5.44</td>
<td>-3.62</td>
<td></td>
</tr>
<tr>
<td>1922</td>
<td>1123</td>
<td>585</td>
<td>933</td>
<td>-4.14</td>
<td>-3.60</td>
<td></td>
</tr>
<tr>
<td>1923</td>
<td>807</td>
<td>505</td>
<td>778</td>
<td>-5.78</td>
<td>-4.46</td>
<td>-2.98</td>
</tr>
<tr>
<td>1924</td>
<td>737</td>
<td>478</td>
<td>775</td>
<td>-1.19</td>
<td>-2.84</td>
<td>-1.27</td>
</tr>
<tr>
<td>1925</td>
<td>699</td>
<td>486</td>
<td>714</td>
<td>-0.49</td>
<td>-1.86</td>
<td>-0.68</td>
</tr>
<tr>
<td>1926</td>
<td>689</td>
<td>445</td>
<td>758</td>
<td>0.62</td>
<td>-1.53</td>
<td>-1.15</td>
</tr>
<tr>
<td>1927</td>
<td>645</td>
<td>395</td>
<td>810</td>
<td>1.42</td>
<td>-0.73</td>
<td>-1.45</td>
</tr>
<tr>
<td>1928</td>
<td>698</td>
<td>397</td>
<td>740</td>
<td>1.66</td>
<td>-0.78</td>
<td>-0.35</td>
</tr>
<tr>
<td>1929</td>
<td>729</td>
<td>397</td>
<td>792</td>
<td>0.50</td>
<td>-0.81</td>
<td>-0.58</td>
</tr>
<tr>
<td>1930</td>
<td>738</td>
<td>376</td>
<td>811</td>
<td>0.22</td>
<td>-0.44</td>
<td>-0.31</td>
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<tr>
<td>1931</td>
<td>865</td>
<td>374</td>
<td>819</td>
<td>-0.34</td>
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<td>-0.40</td>
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<tr>
<td>1932</td>
<td>883</td>
<td>361</td>
<td>894</td>
<td>-3.86</td>
<td>-1.09</td>
<td>-1.83</td>
</tr>
<tr>
<td>1933</td>
<td>993</td>
<td>309</td>
<td>1067</td>
<td>-5.35</td>
<td>-1.24</td>
<td>-3.85</td>
</tr>
<tr>
<td>1934</td>
<td>932</td>
<td>302</td>
<td>973</td>
<td>-6.00</td>
<td>-0.57</td>
<td>-2.04</td>
</tr>
<tr>
<td>1935</td>
<td>989</td>
<td>341</td>
<td>1148</td>
<td>-2.58</td>
<td>-1.05</td>
<td>-2.45</td>
</tr>
<tr>
<td>1936</td>
<td>935</td>
<td>384</td>
<td>1113</td>
<td>-3.33</td>
<td>-0.66</td>
<td>-1.85</td>
</tr>
<tr>
<td>1937</td>
<td>938</td>
<td>422</td>
<td>1199</td>
<td>-2.22</td>
<td>-0.15</td>
<td>-2.10</td>
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<td>1938</td>
<td>1045</td>
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<td>1372</td>
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<td>0.03</td>
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<td>1939</td>
<td>1182</td>
<td>567</td>
<td>1578</td>
<td>-2.77</td>
<td>-0.51</td>
<td>-2.45</td>
</tr>
</tbody>
</table>


Table 4.3 gives the figures for central government expenditure and budget deficits for the three small countries during the twenties and thirties. High budget deficits during this period have most frequently been the unintended outcome of recession rather than the result of activist anticyclical policies. All four countries suffered high budget deficits during the early twenties as well as during the early thirties while deficits were reduced during the late twenties and thirties until armament spending took off. The deficits of the early and mid twenties were the outcome of the stabilization crisis which occurred in most countries in the wake of the effort to reduce post-war

\textsuperscript{371} Hence efforts to explain why other countries failed to follow the Scandinavian lead of fiscal expansion during the 1930s are unlikely to increase our understanding of the changing nature of economic policy-making. See, for example, Weir and Skocpol 1985.

\textsuperscript{372} See McNeil 1986, Chapter 4 and Hertz-Eichenrode 1982.
inflation and restore the gold parity. The high deficits of the early thirties, of course, reflect the onset of the Great Depression. In neither country did the ascendancy of governments who broke with the old economic policy orthodoxy lead to a decisive fiscal stimulus.

Strongly supported by the Social Democrat's reading of their own history, Sweden has long been considered the best example of a shift to the new Keynesian strategy of countercyclical fiscal management. After the SAP came to power in 1932, the doctrine of balanced budgets was replaced with the view that budgets should balance over a business cycle instead of over the fiscal year. In order to reduce unemployment, a loan-financed public works programme was implemented, inspired mainly by the ideas of Gunnar Myrdal & Ernst Wigforss. Yet, by now, it has almost become commonplace to note that the fiscal stimulus, after the change in government, was too small and came too late in order to be able to explain the recovery from the Great Depression. Compared to the first three years of the Social Democratic government, budget deficits were larger during the depression of 1921-23 when the doctrine of balanced budgets still reigned supreme. After the strong increase in the budget in 1933, budget deficits were gradually reduced again in the following years. While the original intention was to amortize the debts incurred for the fiscal spending programme in seven years, the SAP government already did so in three years. Despite high unemployment, "amortization payments surpassed expenses already during the budget year of 1935/36." When looking at total rather than central government expenditures, the fiscal stimulus looks even less impressive. According to the figures given by Bergström (1969, p. 43, 129), the total deficit for the fiscal years 1933/34 was not significantly larger than for the two preceding years, while the total budget for the years 1936-38 showed a surplus again as the government repaid the debts it had incurred the preceding years. Moreover since governments in the twenties, despite their official adherence to balanced budgets, de facto used reserves accumulated as a result of the budget surpluses of the late teens to finance the deficits that occurred in the crisis of the early twenties, one might argue that the real difference in fiscal policies was related to the terms in which governments justified policies rather than to the substance of policies.

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373 See, for example, Erlander 1972.
374 See, for example, Steiger 1971.
376 Gustafsson 1973, p. 128.
377 See also Beckman 1974, p. 40.
378 See Beckman 1974, p. 39-41.
For the case of Norway, there are even less indications of a dramatic change in fiscal policies in the wake of the Great Depression. Mainly as a result of Norges Bank's restrictive policies, budget deficits during every year from 1921 to 1926 were considerably higher than during any other year of the interwar period.\textsuperscript{379} Although these deficits to a large extent purely reflected the collapse of revenues, the catastrophic situation of the economy did prompt governments repeatedly to violate the norms of balanced budget doctrine by appropriating relief programmes (especially for agriculture). After the Krone had been pushed up and the domestic price level down enough to return to gold in 1927, the budget situation improved and fiscal policies reverted to a more consistently restrictive course in order to allow for the repayment of debts incurred during the previous years. The renewed increase in deficits during the Great Depression was much less dramatic than compared to the twenties. The so called cow-trade between the DNA and the Agrarian Party, which enabled the Social Democrats to build a government with majority support took place in 1935. Yet it does not seem to have given rise to more pronounced deficit-spending. Although the public advocation of loan-financed deficit spending by the DNA since 1934 did represent a significant change in discourse, it can be maintained that in practice the DNA governments in the thirties adhered more strictly to the doctrine of balanced budgets than had been the case for the conservative governments of the twenties. Nygaardsvold could only implement 76 million of the proposed 140 Million Kroner programme. Since most of these in turn were financed through taxes, the expansionary effect was negligible.\textsuperscript{380} As a result budget deficits actually declined after 1935.

In the Netherlands the view that the recovery from the Great Depression was due to the changing character of fiscal policies has virtually been absent. Although, budget deficits were generally higher in the thirties than was the case for the Scandinavian countries, this rather reflects the longer duration of the crisis as the Netherlands desperately clung to the Gold Standard until 1936. The depressing effects which resulted from a five year long policy of trying to depress the domestic price level in order to maintain competitiveness relative to countries which had floated their currencies, did prompt the Colijn governments into additional spending in the form of relief programmes to industry and agriculture. At the same time Colijn attempted to compensate for these additional expenditures by cuts in other parts of the budget. Despite the enormous emphasis Colijn placed in his public speeches on the importance of a balanced budget, he in fact was largely

\textsuperscript{379} The accumulated central government debt actually declined from 1,565 million in 1930 to 1,464 million Kronor in 1939 while the restoration of gold had "involved an approximate doubling of the real debt burden." (Hanisch 1978, p. 147).

\textsuperscript{380} See Nordvik 1979, Beckman 1974, p. 39 and Hodne 1983, p. 94.
unsuccessful.\textsuperscript{381} Under the pressure of very high unemployment rates, in 1934 Colijn even implemented a modest work creation programme which, in contrast to the Scandinavian programmes paid below market wages. In fact this programme reflected the characteristic inconsistency of a policy regime which saw downward nominal adjustment of wages and prices as the most promising solution to the crisis and yet was not able to completely accept the domestic social and political consequences resulting from this goal. When the Gold Standard finally was abandoned in 1936 and a modest recovery of the Dutch economy took place, the doctrine of balanced budgets had survived unscathed. In effect, the Keynesian view of countercyclical fiscal policies only led a short life in the Netherlands as it did not gain political acceptance until the early sixties and was abolished during the late seventies.

It is generally accepted that also after September 1931 British governments were unwilling to resort to deficit financing.\textsuperscript{382} For the national government, maintaining a modest budget surplus was seen as a contribution to creating the optimistic expectations which were required in order to bring about economic recovery. Budget deficits might be interpreted as a commitment to inflation and hence might cause undue pressures on the Pound, thereby jeopardizing the cheap money policy. In addition it was argued that fiscal expansion would only contribute to a growth in aggregate employment and demand if its was accompanied by an expansion of the supply of money. However, the cheap money policy pursued by the national government in itself would stimulate private activity and it was, therefore, unnecessary to take the circuitous route of budget deficits.\textsuperscript{383} As table 4.4. shows, the British central government accounts were generally in surplus during the twenties and thirties. It is only in the run-up to the second World War when the needs for rapid rearmament are allowed to override fiscal caution that sizeable deficits appear.

In Germany the NAZI regime did clearly abandon the balanced budget principle. The works creation programme approved in June 1933 provided for a reduction of taxes on automobiles, income tax reductions for those employing domestic aids, and additional spending on housing and road construction. In total the Nazis spent about RM 5.1 bn on works creation during 1933-34.\textsuperscript{384} However, this amounted to about 1\% of GNP and was hence too small to explain the rapid recovery

\textsuperscript{381} See also Klein 1975, p. 129.

\textsuperscript{382} In 1935, for example, Lloyd George proposed a "New Deal", of deficit-financed public works, but the government rejected it.

\textsuperscript{383} See Howson 1975, p. 92. This, of course was a view which Hawtrey, the main exponent of the Treasury View, had already expressed in 1925. See Clarke 1988, p 52.

\textsuperscript{384} Source Stadermann 1987, p. 230.
which led Germany to reach full-employment already in 1936.\textsuperscript{385} Armament was of more importance. Armament spending increased from RM 700 m in 1933 to RM 3.5 bn in 1934 and RM 5.2 bn in 1935.\textsuperscript{386}

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Receipts</th>
<th>Total Expenditures</th>
<th>Deficit (-)</th>
</tr>
</thead>
<tbody>
<tr>
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<td>1053</td>
<td>964</td>
<td>89</td>
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<tr>
<td>1921</td>
<td>1020</td>
<td>982</td>
<td>38</td>
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<tr>
<td>1922</td>
<td>934</td>
<td>865</td>
<td>69</td>
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<tr>
<td>1923</td>
<td>859</td>
<td>783</td>
<td>76</td>
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<tr>
<td>1924</td>
<td>803</td>
<td>769</td>
<td>34</td>
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<tr>
<td>1925</td>
<td>816</td>
<td>794</td>
<td>22</td>
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<td>1926</td>
<td>812</td>
<td>820</td>
<td>8</td>
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<td>1927</td>
<td>341</td>
<td>789</td>
<td>52</td>
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<tr>
<td>1928</td>
<td>857</td>
<td>804</td>
<td>53</td>
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<tr>
<td>1929</td>
<td>864</td>
<td>838</td>
<td>26</td>
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<tr>
<td>1930</td>
<td>872</td>
<td>882</td>
<td>-10</td>
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<tr>
<td>1931</td>
<td>874</td>
<td>906</td>
<td>-32</td>
</tr>
<tr>
<td>1932</td>
<td>912</td>
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<td>26</td>
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<tr>
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<td>45</td>
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<tr>
<td>1934</td>
<td>878</td>
<td>828</td>
<td>30</td>
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<tr>
<td>1935</td>
<td>890</td>
<td>867</td>
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<tr>
<td>1936</td>
<td>921</td>
<td>907</td>
<td>14</td>
</tr>
<tr>
<td>1937</td>
<td>987</td>
<td>989</td>
<td>-2</td>
</tr>
<tr>
<td>1938</td>
<td>1036</td>
<td>1145</td>
<td>-109</td>
</tr>
</tbody>
</table>


Yet it would be difficult to equate the NAZI programme simply with Keynesianism.\textsuperscript{387} Rather the deficit spending programme was part of a much wider and 'un-Keynesian' change in economic policy regime. As was argued above deficit spending had occurred at several instances in the twenties but generally failed to be successful (See also Table 4.4). That the deficit spending by the Nazis did coincide with rapid economic recovery, hence most likely is to be attributed to the ensemble of policy changes taking place. As we shall see in the next section, Keynes argued at times that deficit spending under the Gold Standard should be financed by means of loans so as to put to use 'idle balances' which had allegedly accumulated in the banking system. The Nazi spending programme, however, coincided with a radical reorientation of monetary policy in which the Gold Standard emphasis on deflation and monetary contraction were decisively rejected. After the Nazi takeover, the Reichsbank became willing to resort to monetary financing of deficits. It is the rejection

\textsuperscript{385} See Maier 1987, p. 97.

\textsuperscript{386} Source Jaeger 1988, p. 185.

\textsuperscript{387} See Also James (1989) p. 243: "The Nazi experience then could only really be described as 'Keynesian' with the very loose usage of terminology in which Keynesian simply means simply budget deficits but does not involve the other features associated with post-1945 demand management."
of the Gold Standard type of monetary policy which was of greater importance than deficit spending and which in fact allowed deficit spending to exert positive effects on the economy. Moreover, the Nazi spending programme did not aim at increasing consumption so as to spark off private recovery, but rather became the prelude to a state-run economy which discouraged investment.\footnote{388}

<table>
<thead>
<tr>
<th></th>
<th>1926/7</th>
<th>1927/8</th>
<th>1928/9</th>
<th>1929/30</th>
<th>1930/1</th>
<th>1931/2</th>
<th>1932/3</th>
</tr>
</thead>
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<tr>
<td><strong>Total Revenue</strong></td>
<td>18412</td>
<td>21307</td>
<td>22816</td>
<td>23205</td>
<td>23104</td>
<td>20694</td>
<td>16684</td>
</tr>
<tr>
<td><strong>Total Expenditure</strong></td>
<td>20397</td>
<td>22460</td>
<td>25043</td>
<td>25736</td>
<td>25400</td>
<td>21971</td>
<td>18168</td>
</tr>
<tr>
<td><strong>Balance</strong></td>
<td>-1985</td>
<td>-1153</td>
<td>-2227</td>
<td>-2531</td>
<td>-2296</td>
<td>-1277</td>
<td>-1484</td>
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<tr>
<td><strong>Increase in Public Debt</strong></td>
<td>1742</td>
<td>1075</td>
<td>3561</td>
<td>3159</td>
<td>2704</td>
<td>155</td>
<td>170</td>
</tr>
<tr>
<td><strong>Total expenditure as % of GNP</strong></td>
<td>26.9</td>
<td>26.8</td>
<td>28.4</td>
<td>29.6</td>
<td>32.1</td>
<td>33.3</td>
<td>31.8</td>
</tr>
<tr>
<td><strong>Increase in Debt as % of GNP</strong></td>
<td>2.3</td>
<td>1.3</td>
<td>4.0</td>
<td>3.6</td>
<td>3.4</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td><strong>Budget balance as % of GNP</strong></td>
<td>-2.6</td>
<td>-1.4</td>
<td>-3.5</td>
<td>-2.9</td>
<td>-1.9</td>
<td>-2.6</td>
<td></td>
</tr>
</tbody>
</table>

Source: Computed from James 1986, p. 52.

Nor were Keynesian policies pursued to any serious extent during the first two postwar decades. Keynesianism, with its emphasis on fiscal policy and consumption simply did not address the problems governments expected to be confronted with after the war. Instead of the prioritisation of consumption implicit in a Keynesian strategy, governments felt that the first priority in a destructed Europe should be to rebuild the stock of physical capital. Furthermore, in a period of acute shortage of convertible currency limiting consumption in order to allow for the import of investment goods seemed more appropriate. And also after the immediate postwar years did Keynesian policies prove to be rather irrelevant. The new regime’s commitment to growth and its ability to contain inflation without recourse to unemployment and macroeconomic restriction, generally meant that private investment and growth remained very high. The cycle of boom and recession which would call for Keynesian countercyclical policies simply did not appear. Cairncross’ (1981, p. 374) conclusion on British fiscal policies in the first postwar decades also has validity for most other West European countries. "government never had to handle a situation in which full employment was in serious jeopardy. ... The posture of the government was essentially, therefore, one of holding back demand to prevent excessive pressure on the economy quite as much as of seeking to top up demand to the full employment level. The techniques of demand management were shot through with Keynesian views; but demand management itself operated on buoyant market forces and even then only within narrow limits."  Rather than having to combat

\footnote{388 See also Overy 1982, p.52-3.}
unemployment, the vigourous private sector activity confronted government with the threat of potential overheating. In this constellation fiscal policies generally came to aim at a budget surplus in an effort to contain demand pressures.\textsuperscript{389}

To be sure, those who wanted to see a Keynesian revolution could nevertheless do so.\textsuperscript{390} Booth (1984, p. 264) argued that the absence of deficit spending could not be taken as proof of the absence of Keynesian policies because "there is nothing inherently "Keynesian" about a budget deficit, either in theory or practice". Moreover, it could be argued that a "empting to reduce overall demand by means of budget surpluses after all is also an instance of a policy which tries to influence the economy by discretionary management of the budget. For the Netherlands, for example, Knoester (1989, p, 95-99) interpreted the restrictive fiscal policies in 1951 and 1956 as examples of Keynesian policy-making.

But denying that deficitary budgets were in practice unrelated to Keynesianism by pointing out, correctly, that such practices had appeared long before Keynes, implies assuming that Keynes must have proposed policies which had no historical predecessors. Moreover, almost sixty years after publication of The General Theory there is still widespread disagreement about the 'correct' interpretation. Accordingly the label Keynesian may be applied differently according to different interpretations, but at that point the discussion ceases to be one about the character of policy making and becomes one about 'what Keynes really meant'. Even if there are some good reasons for questioning the centrality of countercyclical budget deficits in Keynes views\textsuperscript{391}, to claim that Keynesianism is unrelated to the proposition that countercyclical fiscal policies can safeguard full employment in the face of a market tendency towards unemployment equilibrium contrasts too much with both Keynes' advocacy of fiscal expansion in the early thirties and the common understanding of the term amongst policy-makers, as, for example, revealed in the initial reaction to the rising unemployment since the early seventies. If the term 'Keynesianism' is understood in this common sense, then one must concluded that such policies were not important in the first postwar decades.

\textsuperscript{389} See, for example, Beer 1965, p. 195-6 and Hatton & Chrystal 1991, p. 68 for the UK, Bergh 1989 on Norway.

\textsuperscript{390} Especially in Britain there has been an extensive debate on whether there was a 'Keynesian revolution' in economic policy after 1945, see Booth 1983, 1984, 1985, Rollings 1985, 1988 and Tomlinson 1981, 1984.

\textsuperscript{391} The British coalition government's White Paper on Employment Policy (1944), for example, did not envisage fiscal policies to play the central role in maintaining full-employment. Moreover the General Theory itself contained only very few remarks about countercyclical policies. See Cairncross 1985, p. 407, and Meltzer 1988, p. 4.
Even in Keynes’ native Britain fiscal deficit spending was absent and British fiscal policy, mainly exerted a contractive influence on consumption. Writing in 1968, Matthews (p. 556) concluded that ".. throughout the post-war period the Government, far from injecting demand into the system, has persistently had a large current account surplus. This surplus has varied in amount, but government savings have averaged about 3% of the national incomes." A similar constellation of vigourous growth in Sweden led to the formulation of the Rehn-Meidner model in which short term demand management was explicitly assigned a restrictive role so as to avoid overheating and maintain the cohesion of centralised bargaining. The first serious attempt at Keynesian policies in Sweden occurred in the mid seventies when policy-makers tried to bridge over the international recession. The same applies for Norway. In Norway the budget showed a deficit in 1945 and 1946 but by 1949 the budget surplus amounted to 6.9% of GDP. From 1949 until 1962 the budget was continuously in surplus with the exception if the year 1954. And also for the period 1962-1973 budget surpluses were common.

In the Federal Republic Keynesian concepts of policy-making gained importance in the economic policy debate only in the mid sixties. In accordance with how fiscal policies were pursued in other countries, Keynesianism in Germany was initially discussed as an additional instrument to help contain inflationary pressures rather than as a policy to reduce unemployment. Keynesianism was officially accepted only in 1966 when the SPD took office in a grand coalition with the CDU/CSU. Keynesian deficit spending was first used during the next year, when it was widely credited with the quick recovery from the recession, a recession which itself had been provoked by restrictive monetary policies. The rising unemployment in the wake of the first oil price crisis prompted deficit spending also in Germany. Finally, also in the Netherlands the need for deficits spending in order to alleviate unemployment was not felt until the early seventies.

4.3 Fiscal Expansion and the Gold Standard

In the light of the Keynesian orthodoxy of the postwar decades it became well-nigh incomprehensible how politicians could so desperately have clung to the previous orthodoxy while

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392 See also Hatton & Chrystal 1991, p. 74-7.
it was clear that their policies were only further aggravating matters.\textsuperscript{396} As the Keynesian interpretation of the Great Depression became the accepted view in the post-World War II period the reluctance of the SPD and Labour to embrace the (proto) Keynesian proposals advanced by the ADGB trade union in Germany, and Keynes and the Liberal party in the UK has frequently come to be considered a tragic mistake. For the case of Labour Robert Skidelsky (1967, p. 44), for example, argued: "The Labour leaders thus accepted the 'conservative' remedy for postwar unemployment on all its essential. The traditional export industries were to be revived by deflation and rationalisation; the return to gold at the pre-war parity would assist the recovery of world trade. ... They rejected a Government investment loan for national projects. There was no discussion of a possible diversification of industry, the role of banking institutions, or the effects of the Gold Standard on credit. On all these points Snowden led the Labour Party unthinkingly along the paths of strict orthodoxy." But especially in Germany the SPD, in retrospect, has been harshly criticised. While the SPD rejected the WTB plan, Gregor Strasser of the NSDAP embraced works creation in his famous speech to the Reichstag on May 10, 1932. Works creation proved to be a point of electoral appeal for the NSDAP, and hence it has been argued that, if the SPD had appropriated it, this might have weakened the NSDAP and possibly prevented the advent of the Third Reich.\textsuperscript{397} Wladimir Woytinski for example, the main driving force behind the WTB plan, complained bitterly that the SPD, and in particular former minister of finance Rudolf Hilferding, proved to be quite unresponsive to the proposals for a new policy.\textsuperscript{398} Gates (1973) followed Woytinski's interpretation arguing that the SPD in fact promoted the downfall of the Weimar Republic because of its support for Brüning's deflation policies and its rejection of the WTB plan.\textsuperscript{399} In contrast the SAP has been showered with praise for its receptiveness to new ideas about economic policy management.\textsuperscript{400}

Because Keynesian policies were not employed during the Great Depression the rejection of fiscal reflation in retrospect was fairly irrelevant from a policy point of view. Rather than fiscal policy the crucial issues was monetary and exchange rate policy. But especially for many current Keynesians, who have become convinced that expansionary macroeconomic policies have become

\textsuperscript{396} See, for example, Pollard 1973, p. 245.

\textsuperscript{397} See also Gerschenkron 1970, p. 3: "it is plausible to assume that if effective anti-depression measures had been taken and a period of economic recovery initiated, the mortal threat to German democracy would have vanished as quickly as it had arisen."

\textsuperscript{398} As Held 1982, p. 10, 125 points out Woytinski's aversion against Hilferding may have tempted him to give a not entirely accurate account.

\textsuperscript{399} See also Gourevitch 1986, p. 143-4.

\textsuperscript{400} See, for example, Gates 1973, p. 208.
impossible in a world of free international capital movements, the refusal of the SPD and Labour to change course should seem rather sensible. Indeed from the perspective of the 1990s, it again seems to have become quite intelligible why governments, which faced large and growing budget deficits as a result of the economic collapse, were under constant threat of capital outflows, had to cope with a restrictive international environment, and were tied to a fixed exchange rate, would persevere in restrictive policies. One only has to read the presently burgeoning literature on external constraints on economic policies to find an almost embarrassing multitude of arguments why a turn to expansionary policies is simply not possible in such a situation. But, as would become clear after the demise of the Gold Standard, the argument that abandoning the fixed exchange rate and pursuing expansionary monetary policies would lead to rampant inflation and speculation on the currency, was wrong in the Great Depression (as it is today). In short, the problem was not that Social Democrats had to be convinced that deficit spending might alleviate a crisis. In line with Conservative and Liberal parties, they rather had to be convinced that abandoning the Gold Standard was not tantamount to inflationary mayhem.

As argued in Chapter 3, adherence to gold meant that plans for fiscal expansion were in fact rather illusory. Rather than being the result of an ideological conversion to the balanced budget dogma, the emphasis governments came to place on fiscal restriction during the twenties was primarily a necessary corollary of the decision to turn to a restrictive monetary regime. And because fiscal austerity was a necessary consequence of the choices made in monetary and exchange rate policy, rejection of fiscal expansion during the Great Depression did not necessarily have to be based on the conviction that it was principally impossible to affect growth and employment by way of fiscal means. Similar to the present period, when most Keynesian come to rule out fiscal expansion as a practical possibility, so also during the Great Depression fear of the exchange rate consequences of such a policy might outweigh the expected positive benefits in terms of employment.

Even though Keynesian deficit spending did not play a crucial role in bringing about the recovery from the Great Depression, the debate about such policies was of importance for the political fate of Social Democratic parties. First of all, being able to advocate concrete and seemingly novel plans was a great political asset in a time of deep crisis when most government saw few, if any, alternatives to restrictive macroeconomic policies. Moreover, by embracing fiscal spending Social Democrats gained a policy programme which allowed them to distinguish themselves from conservative/liberal parties without chasing off potential new voters as no fundamental interference
with property rights was conceived. Thirdly, having proposed deficit spending already in the Great Depression benefited the party’s appeal in the postwar period when Keynesianism became the generally accepted economic orthodoxy.

While having been shelved in the wake of the stabilization crisis of the early twenties, proposal for deficit spending reemerged again in the late twenties. The first to aggressively introduce such proposals in the policy debate was Lloyd George in Britain in his so-called Yellow Book and the pamphlet We can conquer Unemployment of 1928. Keynes\(^{401}\), as is well known, came out strongly in favour of Lloyd George’s proposals, and the issue became an important topic in the campaign for the general elections of 1929. Lloyd George’s proposed additional annual spending of £100,000,000 on infrastructural projects -amounting to 2.5% of national income - to be financed by loans and the savings which would result from lower unemployment. In a motion to parliament (MFK 1930:108\(^{402}\)) in 1930 the SAP embraced similar policies. The 1930 proposal envisaged additional spending of SEK 20 M in order to reduce the continuously high level of unemployment. By 1932, when the Great Depression had also hit Sweden, proposed spending had risen to SEK 91 M and in 1933 SEK 195 m were proposed. As was the case for Lloyd George’s proposals, financing was to be found primarily through loans. In Germany the first concrete proposals for deficit spending were brought forward by Ernst Lautenbach, a civil servant in the ministry of economic affairs. Lautenbach’s plan, which was published in March 1931 proposed a RM 3 billion stimulus to be financed by foreign borrowing. As the crisis progressed the ADGB became the strongest advocate of fiscal expansion. The famous WTB-plan,\(^{403}\) which advocated deficit financed public works to the amount of Rm 2 bn was accepted by the ADGB in April 1932\(^{404}\) but eventually rejected by the SPD. The plan was to be financed by loans, savings on unemployment insurance, and if necessary by money creation.

In contrast to the other three countries, Dutch and Norwegian proposals for increased spending formed part of broader plans which envisaged a longer term reorganisation of the economy along more planned lines. The Dutch Plan van de Arbeid\(^{405}\) was presented by the SDAP and NVV in late

\(^{401}\) See, for example, Keynes 1963, part II, ch. 4.

\(^{402}\) The same motion was presented to the second chamber as MAK 1930:186.

\(^{403}\) WTB stands for its authors Woytinski, Tarnow and Baader. It was published on January 26, 1932.

\(^{404}\) The national council (Bundesvorstand) accepted the WTB plan on February 16, 1932, the ADGB 'crisis congress' did so on April 13, 1932.

October 1935. Its main sources of inspiration were the Belgian *Plan de Man*, the WTB Plan and the plan *Umbau der Wirtschaft* of the German AFA union. As far as government spending was concerned, the plan proposed additional annual spending on infrastructural projects to the amount of DFL 200,000,000 for three years in a row. The plan was to be financed by borrowing on the capital market. In contrast to the works creation policy pursued by the Colijn government, wages at public works projects should be equal to normal market wages. An additional increase in purchasing power was to come from a reduction of housing rents, mortgage costs and lease payments. To further reduce unemployment the plan also proposed shorter working hours and early retirement. In contrast to many other proposals, the plan did not find a budget deficit on the current account acceptable. Only for the purpose of investment projects (i.e. the capital account) was loan financed expenditure acceptable. In order to balance the public sector’s current accounts, the plan in fact proposed a combination of cutting expenditures and raising revenues which was to yield DFL 54 m.\(^{406}\)

DNA’s first proposals for increased spending were presented in 1932 in a brochure written together with the LO entitled 'The Crisis Demands of the Working People' (*Det Arbeidende Folks Krisekrav*).\(^{407}\) The programme lay great emphasis on the need for more planning and social control of money and credit. The spending proposals contained in the programme were rather modest - NOK 35 m in addition to the government’s budget - and could hardly be said to be Keynesian in character. Increased spending was not to be financed by loans but by reduced spending in other areas and increased taxes. Moreover, apart from spending on infrastructural works the additional means were also to be employed for reducing the debt burden of fishermen and farmers, and for support to communes in financial difficulties. Loan-financed spending was first proposed in the so-called ' 3-Years plan'\(^{408}\) of 1933 and the budget proposals of January 1934. At this point DNA proposed an additional NOK 140 m of which roughly 60% was to be financed by means of loans.

That Social Democrats in the early thirties rediscovered fiscal spending as a way to combat unemployment again was largely due to the parties’ need to increase their electoral appeal and to trade unions’ demands for effective short term measures against unemployment. For Social Democratic parties, embracing fiscal stimulus as their main policy proposal was to some extent a tactical response to the prevailing political and economic situation. Far from being convinced that

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406 See Klein 1975, p. 127.
408 Colbjørnsen & Sømme 1933.
discretionary fiscal policies would constitute a sufficient means to maintain full-employment and improve wages, Social Democrats, until long after the Great Depression held on to their view that a durable cure to the maladies of capitalist production would require, if not socialisation of the means of production, far-reaching microeconomic planning. Yet, given the staunch defense of individual property rights mounted by the parties to their right, and the lack of enthusiasm in their own ranks for socialisation in the midst of a crisis, mustering a political majority for such a programme would seem utopian. But, if Social Democrats did want to increase their electoral appeal, they could no longer be content with denouncing the policies of the parties in government while simultaneously arguing that an amelioration of the situation would have to await the advent of socialism.

For the SDAP for example, the policy reorientation was initiated by the disappointing election results of 1933 in which the party’s share of the vote was reduced from 23.8 to 21.4%. In the first meeting of the party leadership after the election, chairman Albarda argued that the party needed to advance concrete proposals against the crisis and that the policies proposed hitherto were too negative and too vague. In early 1934, after the publication of the Belgian Plan de Man, Albarda argued that, although not suitable for Dutch purposes, the party needed a set of proposals similar in from to the Belgian plan. On April 7, 1934 the SDAP then decided to commission what was to become known as the Plan van de Arbeid.\textsuperscript{409}

As Tingsten (1941, p. 331) has shown, the SAP leadership in 1931 fully realised that socialisation was not a feasible measure against the crisis but rather a policy which would serve to undermine the electoral popularity of the party. With respect to socialisation, board member Sköld argued."It is better to sit with arms crossed than to do something crazy."\textsuperscript{410} At the 1932 SAP congress, for example the leadership used the fact that the socialisation commission had not yet produced a final report as an argument not to propose any concrete measures of socialisation during the crisis. Board members Sköld and Møller warned against socialisation of firms in economic difficulties.\textsuperscript{411} Within the SAP especially younger Social Democrats felt that there was a painfully wide gap between its socialist principles and its practical policies. In 1929, for example, Rickard Lindström of the SAP youth movement argued that the party’s emphasis on the class struggle lead

\textsuperscript{409} On the discussion within the party leadership see Meijer 1977.
\textsuperscript{411} See Tingsten 1941, p. 338-41.
it into political isolation.\footnote{412}{See Tingsten 1941, Vol. 1, p. 323-4.} For Tage Erlander (1972, p. 178) the new policy proposal of deficit spending marked the liberation from the dilemma of not having a feasible policy to address unemployment.

Perhaps more important than the parties’ need to develop a feasible policy alternative for electoral reasons was the strong pressure trade unions exerted in most countries for immediate measures against unemployment. The durable mass-unemployment of the twenties quite naturally had weakened the unions bargaining position considerably. Instead of improving the position of their members, the trade unions in the constellation of the twenties often seemed to have no choice but to acquiesce in demands for lower wages in order not to jeopardize the employment of their members. In addition the need to enforce deflation necessarily meant that governments had to be unsympathetic to trade unions’ attempt at halting wage reductions. Already weakened by a decade of mass unemployment the new crisis threatened to completely destroy the unions’ ability to function as an interest organisation of labour. The presence of mass unemployment meant that for workers in individual firms it would be difficult to resist employers’ demands for wage cuts. For the trade unions hence the rapid increase in unemployment became an acute threat to their organisational coherence, more so than for Social Democratic parties.

The position of Johan Nygaardsvold, DNA prime minister from 1935 onward, may serve as a clear illustration of the problems Trade unions faced. While Nygaardsvold in line with the view of the DNA rejected wage cuts in the crisis, he advocated a wage reduction in favour of the main employer (and his own former employer) in his native town of Hommelvik when this seemed the only way to keep the firm alive.\footnote{413}{See Bermsen 1991, p. 276.}

Confronted with an acute threat unions quite naturally sought to enlist the support of the Social Democrats. At this point the Social Democratic inability to propose alternatives to the restrictive policies became intolerable for trade unions. Being under severe labour market pressures unions could no longer be satisfied with a party which denounced the capitalist crisis but which had to postpone any effective measures against unemployment until that mythical time when conditions were ripe for socialism.\footnote{414}{On the ADGB see Zollitsch 1982.} As ADGB economist Gerhard Colm noted: “We [the ADGB] cannot wait for a reconstruction of the economy in order to be able to reduce unemployment; rather the concern of the moment is to restore the functioning of the capitalist economic process with all
its defects." Because trade unions were under more pressure from the crisis, they had to be less concerned with theoretical debates about the long term consequences of alternative economic policy. The argument, for example that fiscal expansion in the longer run would merely replace private with public unemployment could not exert a convincing force in an acute crisis situation. Put differently, in the labour market situation of the early thirties, trade unions’ proposals for alternative policies quite naturally focused on measures which could bring short term relief to their members.

As Pollard (1973, p. 246) argued comparing the policy position of the SPD and the trade unions in the early thirties: ""[The trade unions] themselves were, however, as organisations less encumbered by useless and deceptive ideological baggage; they were more directly representative of and responsive to working-class needs and demands, now concentrated on ending the scourge of depression and unemployment; they were a pressure group more directly concerned with this than any other, as the economic consequences of the depression threatened to undermine their whole power and influence, and, when men are driven to the wall, they discover merit in ideas that will assist them to fight even if their logic seems weak to others." As the crisis intensified the initiative in proposing alternative policies hence shifted more and more to the trade unions.

In most countries trade unions, therefore, became the driving force behind the policy reorientation of the Social Democrats. And even though LO(s) unlike the ADGB, LO(n) and the NVV did not produce its own crisis plan, its pressure was decisive in the SAP’s adoption of the ‘new’ policy in 1930. Starting in 1928 LO argued in favour of public works at market wages, because the existing practice of works creation programmes at below market wages, in the eyes of the LO, increasingly served to replace regular work and to intensify downward pressures on wages. Moreover, just as the ADGB had started to develop its plan for public works after the radical cuts in unemployment insurance since 1930, also the LO regained interest in such policies when it became clear that the SAP’s plan for a comprehensive unemployment insurance scheme would not find a parliamentary majority. Finally while plans for fiscal expansion developed outside of the British Labour movement, it was mainly the TUC which came to voice doubts about the wisdom of adhering to the Gold Standard, although even the TUC shied away from advocating outright devaluation. Moreover it was the decisive influence of the TUC which led the Labour Party to reject MacMillan and Snowden’s budget cuts of late August 1931 and to expel them both from the party after the formation of the National Government.

415 Quoted in Moses 1986, p. 159.
416 See Unga 1976, ch. 9 and Steiger 1971, p. 135-42.
From an ideological point of view it would seem ideal for organized labour to answer the employers' demand for lower wages in times of crisis with an argument which made the increase in wages the precondition for economic recovery and hence postulated an identity of interests between labour and society as a whole. Using underconsumption theory it could be argued that an increase in real wage would mean increased consumption and hence increased demand and employment. Especially before World War II such underconsumptionist theories did appear frequently in Social Democratic ideology.\(^{417}\) In the SPD, Wladimir Woytinski, who later became one of the most vocal exponents of expansionary policies, had argued in 1927/8 that a recovery from unemployment would require higher wages and unemployment benefits, together with works creation programmes. At the SPD congress in May/June 1931, Fritz Tarnow of the ADGB advocated an increase in real wages so as to revive consumption.\(^{418}\) The most influential advocate of this view was probably Fritz Naphtali who argued in 1930 that an increase in real wages by means of not reducing nominal wages to deflation would result in increased employment.\(^{419}\) In 1930 the ADGB tried to convince German business that maintaining the purchasing power of wages was in everyone's interest, but to no avail. Business held that high costs rather than insufficient demand was the root cause of the problem.\(^{420}\) In Norway SAP MP Alfred Madsen argued, for example, in 1931 that increased real wages would help mitigate the crisis.\(^{421}\) In the 1890's Swedish Social Democrats had pointed out already that higher wages would both increase output through higher consumption and promote rationalisation of industry by exerting pressure on profits.\(^{422}\) In the 1920s the view that high wages would promote employment enjoyed popularity within the LO.\(^{423}\) In Britain the I.L.P., in two reports published in 1926\(^{424}\) had argued for the immediate introduction of a minimum wage plus family allowances in order to stimulate domestic demand. But although the I.L.P kept advocating these policies for the next few years, under the Gold Standard it proved impossible to convince MacDonald and the Labour Party of their feasibility.

\(^{417}\) Held (1982, p. 103) traces underconsumptionist theories in the Labour movement back to the writings of S. de Sismondi (1773-1842).


\(^{419}\) See Könke 1987, p. 204.

\(^{420}\) See Moses 1986, p. 158.

\(^{421}\) See Stort. forh, 7a, 1931, Trontale og Finansdebatt, p. 90.

\(^{422}\) See Unga 1976, p. 35. In a slightly different form the argument that high wages promote structural adjustment of industry would return after World War II in the so-called Rehn-Meidner model. See below.

\(^{423}\) See Unga 1976, p. 59.

\(^{424}\) Socialism in Our Time and The Living Wage.
But however attractive from an ideological point of view it was to argue that economic recovery hinged on higher real wages, in practice this view was stillborn. Under the conditions of the Great Depression when trade unions frequently lacked the strength to prevent a reduction in real wages, proposals to pursue aggressive wage policies so as to increase real wages were utopian.\textsuperscript{425} The Norwegian LO in 1931 actually tried to put underconsumptionist theories in practice as it answered the employers' demand for a 9% cut in real wages with demands for higher real wages on the ground that this would increase purchasing power and hence help mitigate the crisis.\textsuperscript{426} Yet LO was defeated in the ensuing lockout and eventually had to accept a real wage cut of about 7%. The Norwegian episode of 1931, however, was largely an exception, as generally underconsumptionist theories remained a rhetorical device. As argued in the previous chapter, most Social Democrats agreed that higher wages would rather threaten unemployment than create it. In Norway Einar Gerhardsen of the DNA actually advised against the LO strategy of 1931 as he though it was unsolidaristic with the unemployed.\textsuperscript{427} Colbjørnsen & Sørme (1933) likewise realized that increases in the real wage during a crisis would provide no viable remedy. Instead the increase in purchasing power should result from increased employment while higher real wages would be realised as a \textit{result} of the economic upswing.\textsuperscript{428} Especially in open economies an increase in real wages during times of intensified international competition and depressed profits would be seen as a threat rather than a boost to employment also by many workers. As one member of the Swedish LO board put it "Wages- I'm speaking of real wages-can be raised only insofar as improvements in production methods and economic organisation create conditions therefore. For us to believe that the unions' influence alone is decisive for wage increases is as much folly as it would be for the rooster to believe the sun rises because he crows."\textsuperscript{429} The increases in real wage that did occur were rather the result of an inevitable time lag between deflation and the adjustment of nominal wages.\textsuperscript{430}

\textsuperscript{425} For Germany see Könke 1987, p. 204-5. The ADGB itself realised that realisation of its demand of a 40 hour work-week might lead to reduced competitiveness. See Schneider 1973, p. 227.

\textsuperscript{426} See Maurseth 1987, p. 465.

\textsuperscript{427} Maurseth 1987, p. 465-6.


\textsuperscript{429} Quoted in Pontusson 1992, p. 42.

\textsuperscript{430} In Germany, for example, average annual money wages fell from RM 1925 in 1929 to RM 1546 in 1932 and RM 1483 in 1933 while the real wage index of those in employment (1900 = 100) increased from 105 in 1929 to 115 in 1932 and decreased to 111 in 1933 (Source Pollard 1974, p. 242-3). That means that the German employees registered a significant increase in real wages at the height of the depression and when chancellor Brüning was pursuing a policy of wage reduction by decree. This was not a time when labour enjoyed a strong labour market or political position.
As the Labour movement had to realise that proposal based on underconsumptionist views were politically and economically unfeasible, deficit spending by the state seemed an obvious way to transcend the zero sum game between capital and labour because it would benefit the unions without leading to increased costs for industry. But whereas deficit spending may have seemed the solution to overcoming the deadlock between capital and labour, such policies were incompatible with the Gold Standard regime. As long as Social Democrats did not openly advocate abandoning gold, fiscal expansion was not viable either, as deficit spending, whether effective in alleviating unemployment or not, was likely to undermine confidence in currency. What set apart the SPD and Labour from the DNA and SAP was not so much the former’s refusal to shed some of their antiquated ideological ballast but their unwillingness or inability to ignore the inconsistency of a position which advocated fiscal expansion while declining to abandon the gold parity. Sitting on the opposition benches the SAP could avoid having to address the choice between deficitary budgets or maintaining the Gold Standard. For Labour this was, unfortunately perhaps, not possible as it happened to be in government when Sterling came under severe pressures in the summer of 1931. And for the SPD, with the recent experience of hyper-inflation, it was impossible not to discuss the likely monetary policy consequences of the proposed plans for fiscal expansion. DNA finally did not propose loan-financed spending until 1934, at which time it had already become clear that abandoning the Gold Standard and a more relaxed monetary policy did not spell inflation.

Despite Lloyd George’s and Keynes’ vocal advocacy of alternatives in fiscal policy, it is not clear whether in practice theirs was a viable alternative as long as the Gold Standard was maintained. Lloyd George himself did not advocate abandoning gold in order to pursue his plans for expansionary fiscal policies. And Keynes endorsed this view, quite possibly for the reason of not wanting to disqualify his proposals for fiscal expansion by linking them to the political taboo of devaluation. But whatever the exact reasons, be they political or theoretical, for Keynes’ espousal of this view, the failure to propose abandoning gold meant that his fiscal proposals were not practically feasible.

431 Economically it certainly was not viable as a recovery from the crisis did not require an increase in real wages or demand but rather and end to deflation.
432 See also Garside & Hatton 1985, p. 83: "It makes little sense to consider domestic demand expansion without simultaneously considering policies for the exchange rate."
Keynes, in line with the Treasury View as developed by Ralph Hawtrey, preferred low interest rates as the best remedy against recession and unemployment. He considered expansionary fiscal policy a second best alternative which primarily became relevant because low interest rates were ruled out by the need to defend the parity of Sterling.\textsuperscript{434} And for the Treasury abandoning gold was obviously anathema. Accordingly the pre September 1931 debate between the Treasury and the Lloyd-George/Keynes position came to focus on the question whether it was possible to expand aggregate demand without an expansion of the money supply. Keynes answered in the affirmative and his answer rested on the concept of 'idle balances' Even without more expansionary monetary policies, financing for an increase in aggregate demand could be found if the velocity of circulation increased, or put differently if wealth holders could be induced to reduce the amount of liquid assets in their portfolio. According to Keynes funds had accumulated in the commercial banks which were not put to productive use, the so-called idle balances, and these funds might be put to productive use by loan-financed public works. Hawtrey in theory agreed that this was possible but thought it had little practical relevance.\textsuperscript{435} In practice the Treasury Position was that the increased borrowing for public works would divert funds from other uses and hence lead to no aggregate increase in demand.

Now, it might be possible that wealth-holders would reduce their liquidity in response to an offer of public debt, which obviously had to be considered safer in the Great Depression than private debt, and that aggregate demand indeed could be increased. The practical problems were twofold. If the increased public demand would not spark off an increased willingness to invest also in private industry, the reduction in unemployment could only be sustained at the price of continuous budget deficits. Keynesians would hence have to trust on the exogenous recovery of the economic cycle in order to avoid permanent deficits, but the depressed conditions of the twenties of course were not the manifestation of a cyclical downturn.\textsuperscript{436} Given a monetary regime devoted to restrictive policies such a recovery of optimism was hardly likely. Monetary policy would hence have counteracted a fiscal expansion programme and the resulting institutionalisation of deficits would have been unsustainable in the long run.

\textsuperscript{434} See Clarke 1988, p. 74-75 ff, and chapter 4.
\textsuperscript{435} See Clarke 1988, p. 52. Hawtrey acknowledged this possibility already in 1925, i.e. long before the Yellow Book.
\textsuperscript{436} As Skidelsky (1967, p. 37) noted: "The two 'socialistic' policies it [the Labour Party] had inherited from before the war - the taxation of the 'surplus' and the counter-cycle policy - became irrelevant; there was little surplus and no cycle."
Secondly, a policy of increasing budget deficits in the middle of a recession might easily disrupt the confidence of domestic as well as international investors and at that point even more restrictive monetary policies would be required in order to stabilise the currency and find subscribers to public debt.\textsuperscript{437} It was this practical fear of the loss of credit, rather than a dogmatic adherence to budget balanced which drove both Snowden\textsuperscript{438} and also Hilferding in Germany. Partly in response to critique from Keynes and others, the Treasury in 1930 and 1931 increasingly came to stress the possible loss of confidence in the Pound, rather than the crowding out view as the decisive argument against proposals for fiscal expansion.\textsuperscript{439} In short irrespective of the theoretical merits of the idle balances concept, a policy of debt financed fiscal expansion in combination with adherence to the Gold Standard was impossible as the priority of the exchange rate mandated more fiscal and monetary restriction rather than expansion.

In practice this was exactly what happened. As mentioned above, British monetary policy became more restrictive since mid 1928 in an effort to maintain the parity. The Pound remained weak for most of the time from mid 1928 to late 1931. Initially Labour had expressed some sympathies for Lloyd George's plans. In the election campaign of 1929, Labour "simply annexed Lloyd George's programme, claiming that it could carry it out better than he."\textsuperscript{440} And because the Second Labour government had to rely on the Liberals for a parliamentary majority, the prospects for a programme of deficit spending initially did look good. Although to a smaller degree than envisaged by Lloyd George, by mid 1930 the Labour government did indeed provide increased means for public works schemes.\textsuperscript{441} In addition the rapid increase in unemployment contributed to

\textsuperscript{437} See also Tomlinson 1981, p. 79: ". . . the space for any national economic policy is greatly constrained by the high level of integration with the world economy implied by adherence to gold. For example, a commitment to budget deficits to finance public works would be likely to provide a rapid flight of gold from the country pursuing such a policy..."

\textsuperscript{438} See, for example, Howson 1975, p. 69-71.

\textsuperscript{439} Politically this position had the distinct merit of exploiting a potential weak spot in the views of the advocates of reflation. Even if one agreed, the Treasury could argue, that deficit spending in principle might alleviate unemployment, the emerging deficit might easily be seen by international financial markets as an indication of abandonment of the principles of sound finance. The ensuing capital outflows would force the government to employ more restrictive policies in order to defend the currency, thereby defeating the original purpose. Since the twenties had seen many instances of hot money flows the argument that international finance might react to the slightest indication of policy changes carried quite some weight. Invoking the unstable state of expectations of holders of Sterling balances also meant that it would be quite difficult to construct a convincing theoretical counterargument. For, even if it could be shown that international financiers would have no 'rational' reason to react in such a way to deficit spending, the notion that international finance reacted in rational and predictable ways to the fundamentals of the economy was not apt to be convincing in the twenties and early thirties. See also Clarke 1988, p. 159-60.

\textsuperscript{440} Mowat 1963, p. 350.

\textsuperscript{441} By June 1930 the second Labour government had approved more than £ 100 m for public works schemes. See Clarke 1988, p. 153.
a deterioration of the budget through increased expenditure for the Unemployment Insurance Fund. Given the unwillingness to raise interest rates radically\textsuperscript{442} or to float the Pound, budget cuts were the only alternative to prop up the currency.

It is significant that even Keynes himself, in the months preceding September 21, 1931 was not willing to solve the policy dilemma by clearly advocating a break with gold. On the one hand, he rejected a policy of consistent deflation but on the other hand he also indicated that budget cuts might be required in order to defend the parity. At the April 16 meeting of the Economic Advisory Council (EAC), for example, Keynes warned that a call for internationally coordinated reflation might be interpreted as a sign of British weakness. Moreover he rejected Bevin’s (TUC) suggestion to abandon gold by reference to the detrimental effects this would have for the City.\textsuperscript{443} The report of the MacMillan commission (1931), an official inquiry into British monetary policy which has become famous for its confrontation between Keynes on the one hand and the Treasury and the BoE on the other hand, clearly rejected devaluation. Addendum I to the report, of which Keynes was one of the authors, concluded that the disadvantages of a devaluation, would greatly outweigh its benefits.\textsuperscript{444} Bevin, in contrast, supplied an addendum to the report advocating devaluation. The MacMillan Report was published on July 13, 1931. By early August 1931, however, Keynes had come to regard devaluation as inevitable. As he wrote in a letter to PM MacDonald, dated August 5, 1931: "... it is now nearly certain that we shall go off the existing gold parity at no distant date. Whatever may have been the case some time ago, it is now too late to avoid this."\textsuperscript{445} One week later he seems to have changed his mind somewhat as he argued in another letter to PM MacDonald, dated August 12, 1931:"I believe that it is still possible for us to keep on the Gold Standard if we deliberately decide to do so but, if this is the case, we should have to conform our whole policy accordingly. Personally I should support for the time being whichever decision we made, provided the decision was accompanied by action sufficiently drastic to make it effective."\textsuperscript{446} And also after the fall of the Labour government Keynes did not argue that an expansionary policy aimed at combating the crisis would require freeing Sterling from its golden fetters. As late as September 16, 1931 Keynes argued that devaluation was just one of the three policy alternatives the government

\textsuperscript{442} Especially during the latter months of the Gold Standard the Treasury and the BoE feared that an increase in interest rates would only be interpreted as a sign of weakness.

\textsuperscript{443} See Boyce 1987, p.303-4.

\textsuperscript{444} McKibbin 1965, p. 110-1, 114. See also Skidelsky 1992, p. 393.

\textsuperscript{445} Quoted in Howson & Winch 1977, p. 89. Emphasis in the original.

\textsuperscript{446} Quoted in Kunz 1987, p. 96.
should consider; the other two being: import controls and an international conference "for giving the gold standard countries a last opportunity." As Skidelsky (1992, p. 394) has noted, Keynes’ hesitation on the matter confirmed MacDonald in his policy of defending the parity by means of restrictive policies.

From within the Labour movement, in fact only Ernst Bevin and Walter Citrine of the TUC and Oswald Mosley 448 of the ILP unequivocally advocated abandoning the Gold Standard. The latter was fairly uninfluential, but Bevin and Citrine, of course, wielded considerable power. Yet, despite the TUC’s refusal to accept the August 1931 cuts in the Unemployment Insurance Fund, Bevin and Citrine did not propose so during the talks with MacDonald on August 20, 1931. It was only at the TUC conference of 7-8 September, hence after the formation of the National Government, that Bevin proposed to abandon gold. 449 Hubert Henderson, co-author with Lloyd George of the famous Liberal pamphlet "We can Conquer Unemployment" (1928) and a kindred spirit of Keynes, by mid 1930 already had come to reject fiscal expansion because it might trigger a flight out of the Pound. 450

Especially in Sweden the adoption of a deficit spending programme by the SAP government in 1932 has come to occupy a crucial place in the Social Democratic interpretation of history. By adopting deficit spending, the SAP is not only seen to have delivered Sweden from the ravages of the Great Depression, but also to have provided an example for the rest of the world to emulate. Given the generally accepted importance of the SAP’s new policies, much scholarly energy has been devoted to the question whether the idea of deficit spending, first contained in MFK 1930:108, was a homegrown product or a British import. 451

Given the only very limited Keynesian pump-priming that actually took place after the SAP came to power in 1932 it might be wondered whether the importance of MFK 1930:108 is such as to merit all this attention. Moreover, from the point of view of policy analysis it must seem peculiar to place so much emphasis on a single parliamentary motion advanced in a situation where it was

447 Quoted in Howson & Winch 1977, p. 93.
450 See Clarke 1988, p. 159-60.
451 For contributions to this debate see Landgren 1960, Lewin 1967, Öhman 1969, Steiger 1971, Unga 1976, Wigforss 1967. For a summary Axelsson 1987, p. 36-44. Norway, in more moderate proportions, has known as similar debate. With reference to the argument that the crisis programme of 1934 was based on Keynesian ideas, Nordvik argues that "there is reason to emphasise the independent Norwegian contribution to the new economic policy of the 1930s." Nordvik 1977, p. 294. My translation.
sure not to command a majority. Parliamentary activity responds to different requirements of theoretical consistency than academic debate. The SAP, like any other major political party can and does frequently take the liberty of advocating internally inconsistent policy remedies and a single motion hence cannot serve as a sufficient indicator of a change to Keynesian beliefs. As has been argued above, while officially advocating socialisation as a remedy to the evils of capitalism, the SAP government stepped back in 1920 as it in fact could not identify an alternative to the 'bourgeois recipes' for handling the economic crisis.

In order to evaluate whether the adoption of MFK 1930:108 really implied a fundamental change in the SAP’s views about economic policy, and the character of the change in economic policy views this motion allegedly heralds, it is crucial to consider the SAP’s views on both fiscal and monetary policies. In 1930 Sweden still adhered to the Gold Standard and it is far from clear that the SAP, when confronted with a situation where the Krona were threatened to be pushed off gold, still would have been willing to advocate increasing the budget deficit.

So, what were the SAP’s views on monetary policy in the late twenties and early thirties? Like Tom Jonson and the rest of the Labour Party the SAP did not perceive the Gold Standard as a policy decision which could be altered if considered desirable. From the early twenties up to September 17, 1931, the SAP never spoke out publicly in favour of abandoning the Gold Standard. As the protocol of its meetings shows, the board of the SAP during the twenties and up to September 27, 1931 never discussed exchange rate policy as an instrument which might be employed to further Social Democratic policy goals. In fact there is virtually no mention of the Gold Standard at all. But also when the Krona was taken off gold, the SAP initially did not see this as an opportunity to pursue different policies. In line with the sentiments in other countries, also the SAP initially feared that the end of the Gold Standard implied the danger of a resurgence of inflation. As Gustav Möller, board member and future minister of social affairs in the SAP government later that year, explained on May 7, 1932 in a parliamentary debate about exchange rate policy: "It must be considered completely self-evident that at the moment Sweden abandoned the Gold Standard, and in the period right after it, inflation was the danger present."\(^\text{452}\) In order to counter this perceived threat of inflation the Riksbank, on the day the Krona was floated increased the discount rate from 6 to 8%, a quite

drastic step at that point. Both the SAP and LO agreed with this policy. Yet as long as SAP and LO were willing to advocate restrictive policies, plans for fiscal expansion could not be a relevant policy option.

This impression is further strengthened by looking at the contact between the Riksbank and the SAP immediately after devaluation. The day after the Gold Standard was abandoned the members of the SAP leadership present in Stockholm at that time\textsuperscript{453} were asked to attend a meeting with the leadership of the Riksbank in order to discuss the new situation. On September 29, the SAP board wrote a letter - signed by Gustav Möller and not intended for publication - to Social Democratic journalists which was to serve as a guide-line for the reporting about exchange rate policy.\textsuperscript{454} Möller argued that the party should not be committed to a certain position, but that a wait-and-see attitude should be taken. "Whether we should go back to the Gold Standard, whether we should attach to gold again where we left it or at another value, whether it would be right to make all efforts to maintain the internal purchasing power of the Krona, all these should be, for the time being, open questions." Möller implicitly admits that maintaining the Gold Standard would have required further wage cuts as he notes that: "It was felt that the party press, as already happened in the great majority of newspapers, should underline that the basis for a wage reduction policy of the employers has disappeared." Yet in the seven years Sweden was on the Gold Standard the SAP never argued that the Gold Standard should be abandoned because it required wage cuts.

The most interesting paragraph, for our purposes, however comes towards the end, when Möller argued that the papers should not write anything which might contribute to some kind of panic. "The economic condition of the country, overall, is quite healthy. (friskt och sunt). The state budget is in a more satisfactory condition than in the majority of countries." But if Möller thought that a country with an unemployment rate in excess of 20% is overall quite healthy and that large budget deficits would have implied an unhealthy economy which would have led to more serious exchange rate problems, then it is unlikely that the SAP would have found the courage to abandon gold itself rather than to shelve its policies for fiscal expansion.

In line with what happened in other countries, the SAP only came to realise that the end of the Gold Standard did not imply a new inflation but the possibility to pursue more expansionary monetary policies and to terminate a highly destructive deflation after a few months of experience with a floating currency. In May 1932, the SAP agreed with the Riksdag banking committee and

\textsuperscript{453} Those were Engberg, Wigforss, Höglund, Branting, Möller, Sköld and Örne.

the majority of the Riksdag to bring about a moderate reflation of the wholesale price level. It was at that point, rather than with the publication of MFK 1930:108, that the SAP shed its economic policy view of the twenties. Since in May 1932 the overwhelming majority of the Riksdag had accepted the need for reflation, and hence more expansionary monetary policies, the new SAP government of the fall of 1932 faced radically different preconditions for fiscal policy-making than had been the case at the beginning of the year. Freed from the need for deflationary policies and on the basis of a now generally recognized need to reflate rather than deflate, the compromise between the Agrarian party and the SAP along the lines of support for agriculture plus deficit spending became possible. The return of the SAP to government in 1932 did make significant contribution to the rapid recovery of Sweden. First, because it signalled the decisive defeat of the old regime. Secondly because, unlike British policies the SAP was willing to extensively use the room for manoeuvre which had become available after September 1931, both by monetary and fiscal policies. Yet the economic and political success of the SAP ultimately depended on a decision they did not take and probably would not have taken.

DNA did not have to confront the problem of a potential contradiction between its call for increased spending and the stability of the currency. In contrast to the SAP, DNA developed the first plans for increased public spending - taking up proposals from the 1922 crisis programme - only after the Krone had been floated.455 Still the proposals of 1932 did not envisaged a loan financed deficit, but rather proposed to finance spending by reduced spending on defense, increased taxes, and slower repayment of the state debt. The argument that increased public investment might be financed by an increase in the circulation of money without causing inflation appeared first in Colbjørnse & Sømme’s ‘3-year plan’ of 1933.456 Yet in the 1934 DNA budget proposals to the Storting, monetary financing of spending was not mentioned.

While the DNA hence did not rediscover its old proposals for fiscal expansion until after the end of the Gold Standard, it is not likely either that, if the DNA had been in government in 1931, it would have rather abandoned gold than to pursue a restrictive policy in defense of the parity. Arbeiderbladet, the main newspaper of Norwegian Labour, made the point quite clearly after devaluation: "That the Krone’s convertibility with gold has now been suspended must actually be considered a disaster (ulykke), brought about by external circumstances."457 In particular Norwegian

455 See Mauseth 1987, p. 559.
457 "Valutakrisen og Arbeidslønnen." Arbeiderbladet, October 12, 1931.
Labour, which had experienced the effects of deflation more severely in the twenties and which had come to advocate a policy of domestic price stabilisation in the mid-twenties, might have been expected to greet the demise of the Gold Standard. But instead of reading 'An End to Deflation?’, *Arbeiderbladet* opened with the headline "Ferocious Price Increase on the Way?" the day after devaluation. And although the increase in the discount rate following devaluation was bemoaned, the dangers of renewed inflation -in line with the views of Norges Bank - were emphasized much more strongly in the days following devaluation. The fear of a renewed inflation continued to dominate the Social Democratic press’ comments on the devaluation of the Krone in the following days. On September 28 Hornsrud argued that a strict control of prices is the most important task of the moment. Labour’s support for agricultural price stabilization schemes, however, was not considered to be in conflict with the fear of a high level of the cost of living. On the contrary, *Arbeiderbladet* argued that price regulations would actually prevent the rise in bread prices which would otherwise surely have followed the devaluation. Furthermore, without being tied to gold, the Krone was feared to become the subject of speculation which would further add to inflationary pressures. In addition the uncertainty which results from the devaluation is said to be detrimental to the economy. MP Alfred Madsen was one of the few to hint in the early days that reflation may stimulate production, yet he simultaneously warned strongly against the dangers of inflation.

458 "Voldsom prisstigning i anmarsj?" *Arbeiderbladet*, September 28, 1931.

459 See, for example, The interviews with M.P.s Alfred Madsen and Oscar Torp, "Den Nuærende Diskonto er Unødig Høi" *Arbeiderbladet*, September 30, 1931, and "Diskontoen og Prisene." *Arbeiderbladet*, October 7, 1931.

460 The dilemma is pointed out most clearly in "Valutakrisen og Arbeidslønne." (Arbeiderbladet, October 10, 1931), where, after having argued that the dangers of inflation and speculation loom large, it is remarked that "The discount rate has been increased strongly in the Nordic countries (...). The intention is to slow down the appetite for speculation, but at the same time the discount rate is a mortal break on all activity."

461 *Arbeiderbladet* September 1931, p.1. Oscar Torp makes a similar argument on October 7, 1931. See "Diskontoen og Prisene" *Arbeiderbladet*.

462 "If corn and flour now, as in 1914, had been subject to the usual speculation, something else would have happened. The price of flour would have risen and bread prices would have followed." *Prisstigning-Samfundskontrol*, *Arbeiderbladet*, September 29. 1931, p. 4.

463 "Valutakrisen og Arbeidslønnen." *Arbeiderbladet*, October 12, 1931. The same article actually argues that the devaluation on September 1931 has returned Norway to the same unstable situation which dominated from the first world war to 1928.

464 "Vår Linje", *Arbeiderbladet*, October 1, 1931, p.4.

In the Netherlands the demand for more activism in economic policies was already formulated in 1923 by the ambitious young chairman of the NVV Roel Stenhuis.\textsuperscript{466} For Stenhuis the political opposition against proposed spending increases on the Navy proved a welcome alternative target towards which to direct NVV activism. In later years Stenhuis' dissatisfaction with the passivity of the SDAP would lead him to propose a reorganisation along the lines of the British Labour party, thereby giving the NVV a greater influence over the SDAP. While Stenhuis failed with his plans and eventually had to resign in 1928, the pressure from the NVV did not stop. In the early thirties the NVV started campaigning for works creation programmes to be financed by a tax on higher incomes, and against further cuts in wages and unemployment benefits.\textsuperscript{467} Yet at the same time the NVV did not doubt the wisdom of holding on to gold, at least up to 1934. Noordhoff for example, a member of the executive board of the NVV argued in 1934 that to devalue the Guilder would be "giving Deterding a DFL 50 million present."\textsuperscript{468}

Up to 1934 also the SDAP unanimously supported Colijn's policy of maintaining gold. In W. H. Vliegen's brochure \textit{of March 1934, Van Woord tot Daad}\textsuperscript{469}, which according to Perry (1994, p. 391) was hailed in the SDAP as the first constructive contribution to combating unemployment, abandoning the Gold Standard is not mentioned but instead a policy of import substitution is proposed. Yet during 1934 opposition against the Gold Standard also rose within the SDAP. Since now neither the SDAP nor the NVV could internally agree on the desirability of abandoning the Gold Standard, even four years after the British had taken the step, the whole issue was copiously avoided. The first Dutch MP to publicly suggest devaluation of the currency, in fact, was the liberal S.E.B. Bierema in the fall of 1933.\textsuperscript{470} Although the \textit{Plan van den Arbeid}, did advocate an extension of credit, it did not advocate abandoning the Gold Standard nor did it discuss the monetary policy consequences of the proposed extra spending of Fl. 600 m over the course of three years. Even within the SDAP some doubted openly whether the Plan could actually be realised without devaluation.\textsuperscript{471}

\textsuperscript{466} See Perry 1994, p. 305.
\textsuperscript{467} Vliegen, a central figure in the SDAP leadership feared that this would cause capital flight. See Perry 1994, p. 381.
\textsuperscript{468} Quoted in Fritschy & Werkman 1987, p. 71. Deterding was the chairman of Royal Dutch Shell and a vocal advocate of devaluation.
\textsuperscript{469} Literally: From Word to Deed.
\textsuperscript{470} Cf Vlak, 1967, p. 36.
\textsuperscript{471} See Abma 1981, p. 175.
Prime Minister’s Colijn’s response to the plan harked on exactly this contradiction in labour’s views. His main objection was that the plan might hamper the downward adjustment of domestic prices. The latter however, was considered absolutely crucial in order to maintain both gold and the competitiveness of Dutch industry.\textsuperscript{472} The economic spokesman of Colijn’s ARP, Diepenhorst, argued that the additional spending provided for in the Plan might perhaps lead to a limited recovery, yet it was also quite likely that the deficit would disrupt business confidence and hence worsen instead of improve the situation.\textsuperscript{473}

When the ADGB published its WTB plan in 1932 the Reichsmark had been protected by increasingly severe exchange controls for a period of about ten months. Moreover, ADGB and SPD could observe since late September that abandoning gold did not mean a resurgence of inflation. Expansionary policies at that point were less likely to threaten the currency and even if they did, it could have been argued that a devaluation apparently did not have the inflationary consequences feared. The failure of the SPD to embrace the WTB plan might hence indeed seem a missed opportunity.

Yet, it is questionable whether a change of mind of the SPD would have brought about a change in policy. The Brüning government was not in the least inclined to adopt such policies seriously. Its own public works programme, which it implemented under pressure from the ADGB proposals only amounted to RM 135 m. As labour minister Adam Stegerwald argued the WTB plan would be inflationary. Moreover, Brüning was not prepared to jeopardize his overriding aim of abolishing reparations by adopting a policy of deficit spending. The SPD did tolerate the presidential Brüning cabinet but there is no reason to assume that the withdrawal of support would have brought a more sympathetic government. The fear of a takeover by the extreme right, after the spectacular gains of the NSDAP in the 1930 Reichstag elections had been the SPD’s main motive for tolerating Brüning, and the ’cabinet of aristocrats’ under Chancellor Franz von Papen, which replaced Brüning in the summer of that year, seemed to confirm the correctness of this analysis.

Yet the SPD’s initial rejection of the WTB plan was based primarily on doubts about its economic soundness rather than on political considerations. The SPD certainly did not share the British treasury’s view that additional public spending would merely lead to a reduction in private activity. Instead the SPD, since 1926 had interpreted crisis and unemployment in terms of

\textsuperscript{472} Handelingen Tweede Kamer, 12 November 1935, p. 281.
\textsuperscript{473} Nekkers 1985, p. 57.
overproduction.⁴⁷⁴ Since the consumptive capacity of the economy had failed to keep pace with its productive capacity, a recovery from the crisis required increasing both public demand as well as improving the purchasing power of the 'masses. In the crisis of 1926 Hilferding himself had proposed public works programmes. Given that the spending programme of 1926-7 seemed to have saddled the state with a higher budget deficit without having sparked off economic recovery, the SPD had good reasons to be skeptical. Yet despite this skepticism, the SPD in the desperate economic situation of 1932 did propose loan-financed public works programmes. In the summer of 1932, an agreement on works creation was reached between the SPD and ADGB, which was presented in a series of motions to the Reichstag in August and September 1931. Instead of the WTB’s RM 2 bn, only RM 1 bn was to be spent on works creation. The proposals were to be financed by means of loans, taxes and reduced spending in other areas. The first time the proposals were submitted to the Reichstag in May 1932. In August-September 1932 they were submitted a second time but this time a forced loan was envisaged.⁴⁷⁵

The main reason for the SPD to reject the WTB plan was not a dogmatic adherence to fiscal orthodoxy or a Marxist-inspired conviction that a capitalist economy cannot be cured by government policies, but the fear that monetary financing of spending programmes would be inflationary.⁴⁷⁶ The fear of inflation and weakening of the currency had already led Hilferding, in line with the majority of participants to reject the Lautenbach plan, at a secret conference held by the Reichsbank on September 15, 1931.⁴⁷⁷ For Woytinski it was quite difficult to allay fears of inflationary consequences, because he had earlier argued quite vocally that deflation was crucial in bringing about recovery and that central banks should do so by expanding the money supply. And although he argued in response to the criticism that the effects on the price level would be negligible he failed to convince.⁴⁷⁸ The main reason was that the WTB plan envisaged, if necessary, to finance part of the programme by printing money. Given the collapse of international lending and the sorry state of German capital markets, Woytinski et al felt that it might not be possible to secure the necessary loans, and in that case the Reichsbank should help out.

⁴⁷⁵ The concept of a forced loan in fact was quite Keynesian as it attempted to mobilise idle balances in the banks.
⁴⁷⁶ See also Gates 1973, p. 214, 220. Moreover the SPD believed that inflation would primarily benefit farmers and industrialists. See James 1986, p. 327.
⁴⁷⁷ See Salin 1964, p. 23. Like Henderson in Britain, Ernst Lautenbach, by the way, had changed his mind after the currency turbulences of mid 1931 and now argued that monetary financing of budget deficits "would damage us in the eyes of foreigners and for that reason is in practice impossible." Quoted in James 1986, p. 340.
⁴⁷⁸ Cf Könke 1987, p. 211-12.
The majority of the SPD leadership, however, feared that a return to the principle of financing spending by the printing press would mean a return to inflation. And in the proposal presented in May and August-September 1932, monetary financing was not mentioned any more. The fear of the SPD was not so much that, for example a 5% increase in the money supply would cause a 5% increases in prices without improving the economy. In such a case the SPD might have been willing to take the risk. Rather its main fear was that money expansion would set off an uncontrollable inflationary process. Like governments in general during the early twenties, also the SPD had experienced the inflation, not in the neoclassical fashion as a mechanistic process determined by the change in money supply, but as a dynamic market process which overwhelmed policy makers. Gregor Strasser, on the other hand, did not fear a cumulative inflationary process if the state would embark on money creation in order to stimulate the economy. In his Reichstag speech of May 10 he argued that a danger of inflation did not exist as long as a "clean and strong" state would change course in time. The SPD, which did not plan to place the economy, including wage bargaining, under militaristic control may have been less confident in the ability of the state to contain such a process.

Monetary financing of budget deficits was a principle which neither Keynes/Lloyd-George, nor the SAP, nor the DNA advocated. Admittedly, the possibility was envisaged in Colbjørnsen and Sønme's "3-year Plan" but it did not appear in the proposal submitted to Storting by the DNA. It then seems unreasonable to expect that the SPD, in view of the Germany hyper-inflation, should embrace such a principle while its sister parties were not willing to do so.

In sum, under the Gold Standard regime Social Democrats could not pursue an economic policy programme consistent with the interests of their main constituency. Politically Social Democratic parties found it difficult to accept wage, and social security and spending cuts. Yet the fear of a resurgence of inflation and the consequent priority given to fixed exchange rates implied the necessity of such policies. As a result the twenties were a decade in which Social Democrats were politically on the defensive and ideologically in confusion. As long as Social Democrats did not find the courage to renounce the Gold Standard mentality, embracing fiscal expansion could

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479 And this was a fear also shared by many in the ADGB, yet the acute labour market situation and the resulting threat to trade unionism seems to have enticed the majority of the ADGB to overcome this fear. See, for example, Schneider 1974 and Zollitsch 1982.


482 The Australian Social Democratic party was the only one to openly propose abandoning gold in order to be able to stimulate the economy. See McKibbin 1975, p. 97 on the Theodore Plan of early 1931.
not show the way out of their dilemma either. Even if Social Democrats and governments in general had explicitly recognized, say in 1929, that deficit spending might reduce unemployment, it is doubtful whether the actual course of policies would have been different. As long as preventing a resurgence of inflation and maintaining a fixed parity was considered the prime responsibility of macroeconomic policies, fiscal expansion was not feasible. And after monetary policies had been freed from their 'golden fetters' there was much less need for fiscal expansion.

That some parties openly came to advocate 'Keynesian' policies during the Great Depression while other were more hesitant consequently was of little relevance for the policies pursued as well as for the subsequent fate of Social Democrats. The moment when DNA and SAP embraced fiscal expansionism is widely seen to mark their turn from a politically ineffective verbal radicalism to a feasible reformist strategy. By giving these parties a broader electoral appeal and by making them acceptable as a coalition partner, the policy of promoting overall prosperity by means of fiscal expansion, rather then only the welfare of the working class, was the foundation on which both parties' spectacular successes in the following four decades were built. Yet, had they been in government in 1931, both parties most likely would have had to take the humiliating step of withdrawing their fiscal expansion programmes in order to defend the currency. Like the fate of the proposal which the DNA advanced as late as 1922, the new 'Keynesian' policies might have been politically and economically stillborn under the Great Depression, leaving the parties with no feasible alternative.

Yet although it was the main cause of the cataclysm of the Great Depression, it is difficult to characterize the adherence to a restrictive policy regime as the result of blind, unthinking dogmatism. Similar to our present period, when the experience of the inflation of the seventies has come to dominant policy-making in the eighties and nineties, the adherence to a policy regime which assigned macropolicy the sole task of combating inflation was based on the lessons of the late teens and early twenties. As the accommodating monetary policies of the postwar years had led to inflation and currency depreciation, the view that only the imposition of a strict monetary framework could prevent a repetition seemed almost inevitable. Moreover, the skepticism with respect to deficit financed public spending was quite understandable as the increased spending with which many governments initially met the crisis of the early twenties rather contributed to undermining the

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483 Cf Glynn & Oxborrow 1976, p. 133.
currency than to creating employment. It was these experiences which had formed the outlook of politicians like Snowden and Hilferding. In reaction to the inflation, Snowden, for example, had argued during 1920: "Government borrowing in this country has reached a point which threatens national bankruptcy."\(^{485}\) Especially in Germany, with its reparations problem and its extreme dependence on foreign capital, the skepticism with respect to policies which would threaten to undermine the credit-worthiness of the Reichsmark was only too understandable.

That the early experience of the Second Labour government did not become typical of the fate of Social Democracy and that the Great Depression would produce political and ideological outcomes quite opposite from the crisis of the early twenties and the seventies and eighties was essentially a result of governments’ eventually overcoming their fear of inflation and abandoning the corset of the Gold Standard in the face of massive deflation. Abandoning the Gold Standard mentality meant opening up the possibility of a policy prioritising growth and employment. This was the necessary condition for the Social Democratic success of the following decades. Yet, abandoning the Gold Standard was a feat towards which Social Democrats did not contribute significantly. In fact, the foundations on which they were to build its successes were laid by others.

4.4 The Demise of the Gold Standard: Policies to Promote Nominal Rigidities

While Social Democratic parties were groping their way towards short term crisis measures which would leave private property rights intact, the parties to their right overtook them from the left. Beginning in the late twenties, Conservative, Liberal and Farmers’ parties, with differing degrees of enthusiasm, would come to engage in far-reaching micro level regulation of some product markets, giving the state and private interest groups the right to set prices, control production, monopolize foreign trade and force individual producers to join collective market regulation schemes. With little respect for the property rights of the individual producers, the state would come to promote encompassing cartels in a host of individual product markets so as to suppress the mechanism of supply and demand. Ironically their justification for doing so would be diametrically opposed to the thinking of Social Democrats. In the eyes of Social Democrats, in the long run market forces would have to be suspended in order to achieve genuine progress, while some short term relief could be obtained through fiscal measures. The parties to the right of them instead

\(^{485}\) Quoted in Skidelsky 1967, p. 43.
argued that, while in the long run free competition was the only guarantee for prosperity and democracy, short term relief would require the temporary suspension of the forces of free competition.

Commonly measures aimed at halting the fall in prices would be introduced in the agricultural sector first. Because of their substantial seasonal demand for credit, farmers were very sensitive to the increasing real indebtedness implied by a drop in the level of prices. The standardized character of their products and the presence of a large number of independent producers made agricultural markets more vulnerable to downward price competition. Moreover, unlike business, small farmers in particular lacked the possibility of trying to recoup the costs of rising real indebtedness by reducing wages. In the case of business the presence of labour implied that restrictive macroeconomic policies in general could lead to two possible outcomes: either the wage claims of labour were accepted and the opposition was directed against the state, or economic policies were accepted as a datum, in which case labour's distributional claims had to be opposed. \textsuperscript{486} Given that during the Gold Standard regime, as well as in our present days, the state does its utmost to exclude monetary policies from the issues over which it will enter into policy bargaining with civil society, the second alternative would necessarily seem more promising. The problems of collective action inherent in a concerted attempt to alter state policies provide further incentives for business to focus on labour costs instead. For those farmers, however, who did not rely on wage labour to a significant extent, the state was the only possible addressee for their grievances. And because farmers could not be suspected of spearheading an attack on the institution of private property, Conservative and Liberal governments would be more receptive to their demands for far reaching market regulation.

Given their sensitivity to deflation and their defense of private property, it is not surprising that the farmers' parties rather than the Social Democrats would arrive at the earliest formulation of the character of the new regime, and of the ideology of a corporatist mixed economy which would come to dominate postwar Social Democratic thinking. In a quite interesting speech to the Storting during the crucial crisis debate of March 1934, Jens Hunseid, chairman of the Norwegian Farmer's Party, outlined the mixed corporatist economy. On the one hand, he rejected the liberal notion of free competition because it led to unacceptably low incomes, bankruptcy and foreclosures. "Free

\textsuperscript{486} The more self confident Central Bankers have used the possibility of wage reductions as an argument to plead innocent to the accusation of being responsible for economic recessions, i.e. no matter how restrictive monetary policy is, no cost increase would have occurred if labour only had reduced wages sufficiently.
competition becomes the freedom to be ruined.\textsuperscript{487} "What is the use of freedom if it leads to conflict and competition, one against all and all against one, to a destruction of the market and the income from labour, and, therefore, also to debt, dependence and foreclosure?\textsuperscript{488} But at the same time he rejected Social Democratic demands for planning and called for a system in which ample room for private initiative is balanced by strong collective organisation. "A possible danger with the big transformation process which is now taking place is that the baby may be thrown away with the bathwater - i.e. that private property rights and the private initiative will be curtailed too much. It is necessary to arrive at an interplay (smaspill) between individualism and collectivism, between the state, science and organisations on the one side, and the right to private property and initiative on the other.\textsuperscript{489}

While starting in the agricultural sector, policies to prevent downward flexibility of prices commonly spread out from there to industry and wages. Although suffering perhaps most from deflation farmers were not the only ones to do so. As the Great Depression progressed, also industry came to realise more and more the desirability of stabilising the price level. The term commonly used to convey the destructiveness of a deflationary constellation was 'ruinous competition'. Ruinous competition referred to a market constellation in which each individual firm's efforts to maintain demand for its own product be lowering prices would, because pursued by all firms, rather lead to more economic difficulties for all firms. At the same time the logic of deflation also implied that stabilisation of nominal wages would be beneficial to the economy. As long as labour in individual firms would be willing to accept lower wages to safeguard its employment, stabilisation of industrial prices would be difficult. For if a single firm could convince its labour force to accept lower wages, it would gain an advantage over its competitors and might be tempted to increase its market share by lowering prices for its products. Whether business explicitly realised it or not, in the reigning deflationary constellation its interests were served by a labour movement which had the ability to put a floor under nominal wages rather than by a radical weakening of trade unions. In sharp contrast to the inflationary constellation of the early twenties and the seventies, the effect of deflation thus was to exert a powerful pressure for closer cooperation between the state and

\textsuperscript{487} Quoted in Ousland 1949, v.3, p. 158. My translation. For similar sentiments amongst British farmers see Cooper (1989, p. 134): "The weaknesses in existing marketing practices in Britain had become so obvious that many farmers were coming to the conclusion that their present liberty to sell their produce individually, in completely unregulated amounts, amounted to licence for their exploitation by other interests." For Sweden see Rothstein 1992.

\textsuperscript{488} Quoted in Ousland v3. p. 157. My translation.

\textsuperscript{489} Quoted in Ousland, v.3 p. 158. My translation.
economic interest organisations. Most important, because the demands of business, agriculture and labour for stable prices/wages were not incompatible with each other, such closer cooperation between state and civil society would rather promote than hinder social accommodation. Most Social Democrats initially were skeptical about the spread of price stabilisation agreements, as they seemed to imply a coalition of farmers (business) and the state aimed at increasing the cost of living for workers. Yet at the same time the spread of state intervention to stabilise markets could not fail to strike an ideological chord with them. This ambiguity about the new regime however, would soon make place for acceptance as it became clear that the new policies did not imply solving the crisis at the expense of workers, but rather contributed to a general improvement in economic conditions.

Government intervention to stabilize agricultural prices displayed a similar logic in all countries. Tariffs and import quotas frequently constituted the first break with the principle of market formation of prices. Imposing a tariff and/or quota had the double advantage of placing no additional burdens on the budget and avoiding direct intervention with production or marketing. These two features made such measures more palatable to Liberal parties. Yet, in the face of fierce competition between domestic producers, restricting import would prove insufficient to prevent further deflation. Moreover, in the case of agricultural exporters, the spread of trade restrictions throughout the world economy would serve to increase domestic deflationary pressures as the loss of export markets outweighed the gains from restricting imports. Halting deflation in agricultural markets, therefore, would require direct intervention with domestic price setting, production and marketing. In several product markets domestic producers would attempt to stabilize prices and production by means of voluntary marketing schemes. Yet, under the depressed economic conditions of the interwar period such voluntary organisation generally proved unable to solve the free-rider problem.490

In his own view PM Colijn, who dominated Dutch economic policy from 1933 to 1939, was a convinced economic liberal. While, like other liberals, he did not advocate Laissez-faire monetary policies, he strongly believed that the state should interfere minimally with the economy.491 Yet, during the Great Depression Colijn’s convictions did not seem to determine his economic policies.

490 On the failure of voluntary agriculture associations under the deflationary policies of the early twenties in Britain see Pollard 1962. As Pollard notes, the failure of these schemes "strengthened the growing belief that in agriculture, where innumerable producers competed freely with each other and usually with importers as well, organized marketing could survive only with the help of statutory compulsion." (Pollard 1962, p. 137).
491 See, for example, Bank & Vos 1988, p. 88-9.
Also for Colijn the superiority of a liberal policy was relegated to the long run while the exigencies of the short run seemed to require ever more direct intervention in markets (micro level). And also here the crucial change in government intervention was prompted by the problems in the agricultural sector. The policy of price stabilisation in agriculture had already started in 1930 under Colijn’s catholic predecessor Ruys de Beerenbrouck. The most important of these early measures was the Wheat Act which required millers to mix in a minimum percentage of domestic flour. Legislative activity speeded up after the devaluation of the Pound. Already on October 29, 1931 minister of trade Verschuur presented a framework law to parliament which would allow the government to impose import quotas for sectors which had been particularly hard hit by the crisis. Yet protection of the domestic market could not be sufficient for export-oriented Dutch agriculture. Moreover, guaranteeing minimum prices would eventually also imply the need for the government to regulate the quantities produced. A new stage of interventionism was reached with the Dairy Act of 1932. The act guarantied farmers a a certain subsidy per litre of milk to be financed by a surcharge on fats. As Klemann (1990, p. 140) notes, such a method of support strongly counteracted deflationary pressures. Moreover agricultural subsidies implied additional spending and hence counteracted the attempt to balance the budget. With this law then, the contradiction between the government’s macro policy of deflation and its micro policy of price stabilisation became quite apparent. Despite the fact that Colijn placed the defense of the Gold Standard at the core of his economic policies, his new government formed in May 1933 did not attempt to turn back the previous measures. On the contrary, the Agricultural Crisis Act of August 1933 constituted a further intensification of price stabilisation. The law attempted to integrate the separate measures into one centralised framework. At the same time it marked the government’s realization that intervention in agricultural markets would be of a more permanent nature than originally envisaged. In the end, then, the Colijn government found itself guaranteeing minimum prices and regulating production for most agricultural products, while in some cases even trade was monopolised.

The pattern for agricultural intervention in Norway was set in June 1930 when the Liberal Mowinckle II government passed the Marketing Act. The act was a response to the failure of cooperatives to stabilise prices on a voluntary basis. Moreover, tariffs had proven to be relatively ineffective as domestic overproduction still led to falling prices. The Act aimed at promoting the centralised marketing of agricultural products by imposing a levy (ommsetningsavgift) on the relevant products.492 During the following months, the law was employed to create centralised

marketing schemes for pork, and most important, milk. The national marketing board gained a monopoly to sell milk at uniform prices. To solve collective action problems it was granted the right to collect contributions, even from non-members, which were used to support the equalization fund. The BP government then subsequently passed additional laws to reduce supplies of milk by requiring butter to be mixed into margarine.\footnote{See Hodne 1983, p. 77.} Towards the end of the decade a similar principle was applied to the fishing industry (Raw Fish Act of 1938). Also the fisheries proved unable to organize a viable cartel without legal enforcement. But while the farmers took the initiative for the dairy marketing board \textit{(melkesentrale)}, the government took the initiative in the case of fish.\footnote{See Nordby 1992, p. 121.}

With Heinrich Brünning of the Catholic Centre party, who replaced Müller in 1930, Germany got a chancellor who placed as much emphasis on deflation as the solution to economic problems as Colijn did in the Netherlands. During the twenties, the Centre party, whose electorate spanned across all social groups, had placed great emphasis on the need for social reforms, so as to improve the position of labour. Yet under the pressure of the Depression the concern for labour disappeared from the policy agenda of Brünning. The combination of reparations payment, increased budget deficits, and the drying up of foreign capital flows in the late twenties posed an acute threat to the financial position of the German state. As a result Brünning embarked on a policy of radical expenditure cuts and deflation. By giving priority to balancing the budget, Brünning not only hoped to avert the impending collapse of German state finance, but also hoped to be able to convince the allies that Germany really was not able to pay reparations. If, so Brünning reasoned, the German state would do its utmost to pursue the conservative fiscal policy desired by the allies, it would be able to convince them that the burden was indeed too heavy. Deflation, along with fiscal retrenchment, constituted the other main pillar of Brünning policies. By forcing the price level down, Brünning, in accordance with common neoclassical thinking, hoped to improve the trade balance. In particular after Britain and many smaller countries had floated their currencies, reduction of the domestic price level became of crucial importance so as not to jeopardize the export competitiveness of the German economy.\footnote{Cartel prices already had been the target for a deflation decree on July 26, 1930.} The emergency decree of December 8, 1931 provided, for example, that all existing collective wage agreements be reduced to their level of 1927, but not by more than 10%. In addition all housing rents and many prices were to be reduced by 10% while long term
interest rates up to 8% were lowered to 6% and higher rates cut proportionally. For such policies Brüning could not find a parliamentary majority. In response he dissolved the Reichstag and went on to govern by presidential decree.

Yet, despite his emphasis on deflation, Brüning did not advocate deflation for the agricultural sector.496 Already under the Müller government agriculture had received an increasing amount of support in the form of subsidies, export credits, tariffs and quotes. Under Brüning’s chancellorship the so-called Osthilfe programmes were expanded massively. Originally the subsidies were mainly intended for the agricultural areas in east Prussia but were extended to all the regions east of the Elbe in 1931. In addition measures to reduce the debt burden of agriculture came to form an important part of Brüning’s policies. Local East-Elbian authorities (Landräte) were given the right to selectively reduce interest rates on outstanding loans to agriculture, postpone repayment or even reduce the principal. But despite extensive financial support, the Osthilfe did not successfully stem the fall in agricultural prices. The NSDAP dictatorship, however, did (See Table 4.6).

| Table 4.6: Prices of German Agricultural Products 1925-1937/39 (1925=100) |
|---------------------------------|-----------------|----------------|
|                                  | 1927/29 | 1933 | 1937/39 |
| Wheat*                          | 101    | 76   | 83      |
| Rye†                            | 113    | 75   | 90      |
| Oats*                           | 132    | 68   | 84      |
| Barley*                         | 100    | 81   | 92      |
| Potatoes*                       | 156    | 64   | 123     |
| Oxen*                           | 118    | 74   | 86      |
| Hogs*                           | 96     | 51   | 67      |
| Butter*                         | 93     | 58   | 70      |

Notes: a, average annual prices Breslau. b, for animal feed. c, average annual prices Halle. d, average annual prices Berlin.
Source: Rolles 1976, p. 748.

In the democratic countries a comprehensive system of agricultural prices support emerged in a piecemeal fashion rather than as the result of a pre-conceived masterplan. The ideological resistance of liberal and conservative governments against measures which interfered directly with micro-level price setting and production meant that price regulation was generally only introduced for a product when the economic survival of producers seemed acutely threatened. The NSDAP, however, did not need to overcome a reluctance with respect to micro level regulation. With the Act Concerning the Provisional Organisation of the National Corporation of Agriculture of September 13, 1933, they devised a nation-wide system of regulation which was to cover all aspects

from prices and quantities to distribution, marketing, wholesaling and retailing. As in other countries, the authorities charged with prices setting would also have the right to enforce compliance by individual producers.\textsuperscript{497}

In Britain state assistance for agricultural price stabilisation was started with the Labour government’s Agricultural Marketing Act of 1931 which was presented in response to the failure of voluntary cooperative organisations to stabilise prices. Under the act, the formation of collective marketing schemes was encouraged by enabling the government to make such schemes binding on all producers.\textsuperscript{498} Yet these efforts were fairly unsuccessful given the absence of protection against undercutting by imports and domestic producers. While frequently blamed for having failed to embark on a new policy course,\textsuperscript{499} in reality also the British National Government embarked on a major reorganisation of agriculture and industry in order to strengthen the level of collective organisation and thereby prevent further deflation. The Conservatives had already agreed with the general philosophy of Labours’ Agricultural Marketing Act,\textsuperscript{500} and their agricultural policy in the subsequent years developed these principles further. However, the Conservative approach differed from Labour’s in that, in order to allay farmers’ fears of state domination, it reduced the powers given to the minister of agriculture in favour of a more important role for the interest organisations.\textsuperscript{501} In this, British agricultural policies followed the common pattern of government assisted marketing schemes to control prices production and distribution. The revision of the Agricultural Marketing Act in 1933, allowed producer organisations to control prices and production and enabled the government to promulgate tariffs and quotas in support of such schemes.\textsuperscript{502} The Wheat Act of 1932 followed a different route as it introduced direct subsidization out of government funds in order to guarantee a minimum price. According to Peden (1985, p.103) the cost to the government of these agricultural policies were of the order of magnitude of 3-4\% of total expenditures. Legislation aimed at stabilizing agricultural prices was not without precedent in Britain. The Corn Production Act (1917) and the Agriculture Act (1920) guarantied minimum prices and wages. Yet, in the early

\textsuperscript{497} For a good description see Holt 1975, Chapter, 17, and Nathan 1971, Chapter 4.

\textsuperscript{498} Pollard 1962, p. 139.

\textsuperscript{499} See, for example, Mowat 1955, who entitled chapter ten of his book: ”Sitting it Out: Economic Recovery and Political Apathy, 1931-1935.”

\textsuperscript{500} See Cooper 1989, p. 127, 131.

\textsuperscript{501} See Cooper 1989, p. 131.

\textsuperscript{502} Cf Peden 1985, p. 102. Some of the more important schemes which were organized in the wake of this act: Milk Marketing Board (1933), Bacon and Pig Marketing Board (1933), Potato Marketing Board (1934).
 twenties stabilization of agricultural prices and wages had to be abandoned in the face of the policy of returning to the Gold Standard.\textsuperscript{503} In the early thirties, on the contrary, monetary policies would come to be subordinated to the policy of stabilizing domestic prices.

Also in Sweden deflation led to a rapid growth in government intervention. In 1930 the Conservative government resolved to subsidize growers of sugar beet. As this measure proved insufficient, an agreement was reached in 1932 by which the dominant private sugar producer Svenska Sockerfabrik AB agreed to pay a guarantied minimum price for beet in exchange for being rewarded a monopoly on the import of sugar. In order to maintain demand for domestic grains, importers of flour and domestic millers as of 1930 were required to use a specified minimum percentage of Swedish grain. But again securing domestic demand proved insufficient in halting the fall in prices and a minimum price needed to be enforced. Whereas price stabilization of sugar could take place through the pre-existing de facto private monopoly of Svenska Sockerfabrik AB, stabilization in the grain market required closer cooperation between the individual producers as well as the individual millers. In 1931 the Liberal government granted the newly formed organisation of Swedish millers the import monopoly in return for agreeing to buy grain at a government determined minimum price.

Most important for the Swedish agricultural sector was the milk regulation of 1932, passed under the Liberal government. Also in the milk market prices had been falling rapidly, due to both a dramatic fall in the export price for butter in 1931 and ferocious competition in the domestic market for consumption-milk. Following the Norwegian example, the solution reached consisted of giving the agricultural interest organisation SAL the right to impose a duty on all domestic producers which could be varied individually so as to prevent undercutting of the minimum price. Part of the proceeds of the levy were used to finance the export of excess milk. The milk market regulation was completed in 1933 under the SAP government by the creation of an import monopoly for dairy products.\textsuperscript{504}

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\textsuperscript{503} The Corn Production and Agriculture Acts were repealed in 1921. See Pollard 1962, p. 134-5. British agriculture in the twenties frequently complained that governments did lend support to stabilisation of wages through wage boards but refused to support agricultural price stabilisation. See Boyce 1987, p. 140.

\textsuperscript{504} For useful overviews of Swedish agricultural policies during the late twenties and early thirties see Hellström 1976, Chapters 4-8 and Seyler 1983, Chapter 4. On the regulation of the milk market see also Rothstein 1992.
Table 4.7: The Main Agricultural Price Stabilization Measures

<table>
<thead>
<tr>
<th>Year</th>
<th>Britain</th>
<th>Germany</th>
<th>Netherlands</th>
<th>Norway</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td></td>
<td>Gliding tariff on wheats, rye, oats and barley</td>
<td></td>
<td>Eggs Marketing Scheme (Eggesentsrale)</td>
<td>Milling and Blending quotes for domestic wheat and rye (Inmalningsvanget for Spannmål)</td>
</tr>
<tr>
<td>1930</td>
<td></td>
<td></td>
<td></td>
<td>Marketing Act (Omsetningsloven)</td>
<td>Guaranteed minimum price for Grain. Grain import monopoly (spannmålsreguleringen)</td>
</tr>
<tr>
<td>1930</td>
<td></td>
<td></td>
<td></td>
<td>Horticultural Products (Gartnerhallen)</td>
<td></td>
</tr>
<tr>
<td>1931</td>
<td>Agricultural Marketing Act</td>
<td>Osthilfegesetz (March)</td>
<td>Wheat Act (Tarwewet)</td>
<td>Milk Marketing Scheme</td>
<td></td>
</tr>
<tr>
<td>1931</td>
<td>Horticultural Products (Emergency Duties) Act</td>
<td></td>
<td>Crisis Import Act (Crisisvoerwet)</td>
<td>Butter Act (Småinblandning)</td>
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<td>1932</td>
<td>Wheat Act</td>
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<td>Crisis Dairy Act (Crisiszuivelwet)</td>
<td>Pork Marketing Scheme (Flesk)</td>
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<td>1932</td>
<td>Import Duties Act</td>
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<td>Crisis Pigs Act (Crisisvarkenswet)</td>
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<td>Crisis Import Act (Expanded) (Crisisvoerwet)</td>
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<td>1934</td>
<td>Cattle Industry (Emergency Provisions) Act</td>
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<td>Meat and Pork Marketing Scheme (Kjøtt &amp; Fleske)</td>
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<td>1936</td>
<td>Sugar Industry (Reorganisation) Act</td>
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<td>1937</td>
<td>Livestock Industry Act</td>
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<td>1938</td>
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<td>Raw Fish Act (Råfiskloven)</td>
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### 4.4.1 Price Stabilisation, Social Democrats and Liberals

The norms of political science require that the economic policies pursued be derived from the political balance of power. In that perspective the advent of tariffs and price stabilisation policies in all countries would point to the pivotal position of agricultural interests in the political process. Agricultural price stabilisation did not seem to be in Labour's interest. Agriculture's interest in high prices for its products conflicted with Labours' preference for low food costs. During the twenties European Social Democrats had advocated free trade exactly because tariffs would increase the workers' cost of living.⁵⁰⁵ Agricultural price support would also reduce the budgetary space

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⁵⁰⁵ For Germany see, for example, Leuschen-Seppel 1981 p. 257, 263.
available for spending on public works programmes. And while Social Democrats generally recognized that agriculture should be assisted in the deep crisis it was undergoing, their preferred solution mirrored the solution they advocated for industry, i.e. increased competitiveness through increased efficiency and productivity rather than 'artificial' price protection.\footnote{506}

In Germany, for example, the SPD discovered the domestic agricultural sector as a source of demand for industrial goods, in the wake of the crisis of 1926, which was interpreted as a crisis of 'overproduction'. Increasing the income of the agricultural sector would hence also benefit labour, but only if the increase in income could be brought about by means of higher productivity and stable or falling prices. For Hilferding and Baade increasing agricultural productivity was in the interest of both classes, and it was on the basis of this argument that the SPD during its congress in 1927 adopted the slogan of the 'identity of interest between agriculture and labour.'\footnote{507} The British Labour government initially envisaged a similar solution to the crisis in agriculture. The second Labour government's Land Utilisation Bill of 1930 hoped to stimulate an increase in agricultural productivity by setting up model farms to experiment with new methods of cultivation.

At the same time agricultural price stabilisation would not seem to be in the interest of industry. Higher food prices were likely to lead to higher wage demands and hence would threaten export competitiveness. Moreover, agricultural protection might provoke retaliation in the form of industrial protection. That price stabilisation nevertheless became the dominant policy would hence point, from the point of view of political science, to the ability of agricultural interests to block a labour-business coalition against such policies.

And agriculture indeed did seem to occupy a crucial position of power in many countries. In Germany the political revolution of 1918/19 had failed to dislodge the East Elbian Junkers from their traditionally strong political position. The cabinet of von Papen, for example, had a disproportionately high representation of East Elbian aristocrats. In the Netherlands agricultural products traditionally accounted for a disproportionately high share of exports. Moreover, the strong organisation within the agricultural sector gave farmers a disproportionate access to the Catholic and Protestant parties. In the elections of 1933 the farmers' organisations advised their members not to vote for parties which were seen to be skeptical with respect to agricultural support (i.e. in particular the Liberals, Social Democrats and Communists). According to Liberal (VDB) Chairman Oud the disappointing results of his party in these elections were partly due to the Farmer's negative

\footnote{506}{For Sweden see, for example, Thullberg 1974.}
\footnote{507}{See Leuschen-Seppel, part 2, Chapter 4, especially p. 208-9 and Holt 1975, p. 111.}
advice. In Scandinavia the agricultural sector still employed more workers than industry during the Great Depression. For both Social Democratic parties agricultural workers, and fishermen in Norway, formed an important potential electorate. Moreover, in Scandinavia farmers had organised in separate political parties. It was through the support of these parties that the SAP (in 1932) and the DNA (1935) were able to assume government responsibility.

Yet, it would be incorrect to argue that the pivotal political position of agriculture was decisive for the policies pursued during the Great Depression. Economically a labour-business coalition built around a rejection of agricultural price stabilisation plus deficit spending would have had to fail because it would have implied continued deflation. Traditional political analysis of the Great Depression however easily misses this point because the conflicting claims on the national product of specific groups form the basis of the analysis. It would seem self-evident that conflicts of interest should function as the starting point for political analysis, for amongst groups which hold no conflicting interest political bargaining would seem irrelevant. Yet with this mode of analysis political science in effect adopts a neoclassical analysis in which changes in relative prices are considered crucial while changes in absolute prices are epiphenomenal. In this perspective Labour, for example, would be indifferent with respect to a situation in which real wages remained unchanged as all prices and wages fell at the same rate and a situation in which real wages remained unchanged as all prices were stable. The crux to understanding the political outcomes of the Great Depression is that those two situation were not equivalent. Continued deflation implied recession whereas price stability was a prerequisite for recovery. A political coalition based on lowering prices hence could not be durable under the Great Depression because it would be confronted with the failure of its policies to halt the crisis.

Historically, the advent of agricultural market stabilization even in Britain, might have served to dispel the notion that the emergence of such policies depended on the political resources agricultural interests could muster. Agriculture in Britain was very small and politically unimportant ever since the repeal of the Corn Laws in the 19th century. Both Conservatives and Labour might have successfully pursued the argument that agricultural protection was to the detriment of the consumer/worker. Yet neither party had in interest in the destruction of British agriculture and towards the early thirties it had become clear to both of them that guaranteeing its future in the short term would require increased organisation and price stabilisation.

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508 See Klemann 1990, p. 144.
509 For Sweden see Andersson 1990, p. 19.
Nor can the policy of protection for agriculture in Sweden and Norway be interpreted as the political price reluctant Social Democrats had to pay in order to be able to form a government and pursue their programmes of fiscal expansion. Indeed, on the basis of the assumption that Social Democrats placed the highest priority on fiscal expansion and saw agricultural protection primarily as a threat against real wages, the decisive political battle would be over fiscal policies, and one should have expected the formation of a Liberal/Social Democratic rather than a Farmer/Social Democratic coalition. With respect to the proposed fiscal means to combat the crisis, DNA's views were closest to those of Venstre. DNA's 1934 crisis proposals envisaged spending of NKR 140 m in addition to the normal budget. The Liberal proposal was the next highest with NKR 42.9 m while the farmers' party only proposed NKR 15 m. The conservative party declined to propose any concrete figures.\textsuperscript{510} Having assimilated by now some of Ragnar Frisch's and Keynes' views on the beneficial effects of budget deficits, the DNA proposed to finance about 60% of the additional budget in the form of loans. Venstre also had come to accept the principle of loan-financed deficits but was not willing to go as far as the DNA and only proposed to finance about 30% by means of loans. For the farmers party, however, loan-financed deficits were out of the question and the additional budget would have to be financed by increased revenues.\textsuperscript{511}

Moreover, relations between DNA and BP had become quite hostile during the latter's government tenure from May 1931 to March 1933. In reaction to the many strikes of 1931 the BP government proposed a more restrictive Labour legislation which would curtail the trade unions' ability to engage in industrial disputes. As late as May 1933, BP chairman Jens Hunseid in a speech to the Storting had openly questioned the right of labour to organize as he argued that the tyranny of the trade unions threatened the interests of society.\textsuperscript{512} Defense minister Vidgun Quisling became one of the most hated persons within the labour movement, after he had ordered armed forces to the town of Menstad in response to a riot over strike-breakers at a Norsk Hydro plant during the strike of 1931.

Finally, the Liberal and the Farmers party in Norway, found it difficult to agree on the necessary measures to support agriculture. Under the impression of the acute crisis in agriculture the Liberals, reluctantly had agreed to direct regulation of prices and quantity, understood as a temporary measure to bridge the trough of the crisis. In the longer run the solution was to be found

\textsuperscript{510} See Nordvik 1977.
\textsuperscript{511} See Nordvik 1977.
\textsuperscript{512} Quoted in Ousland 1949, Vol. 3, p. 126.
in increased productivity (effektivitetslinje). The farmer party Government of 1931-33 pursued a policy of price stabilisation (lønnsomhetslinje) which displayed a more pronounced enthusiasm for more extensive and more durable regulation of agricultural prices. DNA for a long time considered tariffs and agricultural price stabilisation as a threat to real wages. In the 1926 Storting debate about corn prices for example, it objected strenuously to the Farmers Party’s proposal for higher prices which were seen to constitute a plunder of workers and smallholders.\textsuperscript{513} DNA’s Christian Hornsrud called the turnover tax (omsetningsafgift) of 1931 a tax on the poor man (fattigmannsskatt). Also in this area, then, Venstre and DNA seemed to be closer than DNA and the farmer’s party. Indeed in March 1933 the time for closer cooperation between Labour and the Liberals seemed to have arrived as the BP government under Jens Hunseid was toppled by the Liberals with the help of the DNA because it proposed new cuts in spending plus a new tax to support agricultural price stabilisation. The Mowinckle III government which replaced Hunseid initiated the new public works programme.

Similarly in Sweden an agreement between the Liberals (Frisinnade) and the SAP would have seemed more likely. In terms of additional spending to combat the crisis the difference between the two was negligible. The total spending package the SAP and the farmers party agreed on in 1932 was SEK 485.5 m whereas the Liberals had proposed SEK 484.5 m. Of this amount both the SAP/Farmer Party and the Liberals proposed to allocate SEK 100 m to public works programmes. The Conservatives instead only proposed SEK 57 m.\textsuperscript{514} But given that the spending programmes were basically the same, the SAP should have preferred an agreement with the Liberals because they shared its preference for free trade. In the late twenties the SAP had still rejected tariffs to protect agriculture on the grounds that these would benefit also those who were not in need and that they would increase the cost of living.\textsuperscript{515} Instead the SAP proposed to lower tariffs on industrial goods because this would allow agriculture to buy its equipment more cheaply. In June 1930 the Liberals and the SAP had cooperated to vote the Conservative Lindman government out of office when the latter proposed higher tariffs in order to protect agriculture.

That a Liberal/Labour coalition based on additional spending on public works, low food prices and free trade nevertheless did not emerge in response to the Great Depression was due to the fact that by the early thirties both Liberals and Social Democrats had come to realise that price

\textsuperscript{513} See in Hveding 1982, p. 148.
\textsuperscript{514} See Unga 1976, p. 167-8.
\textsuperscript{515} See Thullberg 1974, p. 144.
stabilisation might be the only way to stave off the total collapse of the agricultural sector. Despite its emphasis on market adjustment and increased productivity as the solution to agriculture's problems, it was the Liberal government of Mowinckle II which introduced far reaching market regulation in Norway through the Marketing act of 1931. An increase in productivity was not a solution to the acute problems of a deflationary crisis which had emerged since the late twenties. And even the Liberals realised that in order to assure that there still would be an agricultural sector in the longer run, short turn price stabilisation had to be brought about by means of state support for collective interest organisations. To be sure, the law was conceived as a temporary measure in a situation of acute distress. But, as has been remarked several times before, to label certain measures as short term while emphasising the importance of different solutions in the long term generally is the way in which political movements justify measures which seem inevitable but are hard to incorporate within their ideological outlook. Similarly in Sweden Liberals had come to accept that price stabilisation through market regulation was a necessity. It was a Liberal government which passed both the minimum price for grain and the milk regulation. As Rothstein (1992) has pointed out, Swedish Liberal politicians argued that the depth of the crisis required a break with the Liberal principles of market adjustment.

And by the early thirties also Social Democrats had abandoned their position that agricultural price stabilisation was to be rejected because it increased the cost of living. As argued above, during the twenties Social Democrats de facto came to place their hopes for a reduction of unemployment on rationalisation; i.e. improved competitiveness through increased productivity. Hence it would only seem logical that they would resist a strategy which aimed to help agriculture by obstructing market adjustment through artificially high prices and administratively reduced supply. Yet, the Great Depression generally convinced the labour movement that rationalization could not be the solution to the unemployment problem. Instead especially trade unions started to push for government intervention. But ultimately at that point it became difficult for Social Democrats to oppose agricultural price stabilisation. A strategy which aimed to overcome the anarchy of the market by means of collective organisation and government intervention could hardly be rejected by a movement which after all held that organisation and regulation were superior to markets. Put
differently, the same forces which would push Social Democrats to propose direct government intervention to solve the unemployment problem also pushed them to revise their views on agriculture.\footnote{516}

In Norway the DNA took this step whole-heartedly. Like all other parties in the Storting, DNA voted for the Marketing Act of 1930. DNA maintained that marketing boards actually served to withdraw part of production from the capitalist, profit-oriented, sector. And as they also maintained that organized production was superior to markets, marketing boards were argued to benefit both producers and consumers.\footnote{517} Within the Swedish SAP the advent of crisis and more intense government intervention initially led to a split on agricultural questions. Per Edvin Sköld - the SAP's spokesman on agriculture and minister of agriculture since 1932 - had advocated rationalization as the best solution in the twenties. The acute crisis which developed since the late twenties made him support price stabilisation measures. Together with Ernst Wigforss and a host of other Social Democratic MP's he voted in favour of the sugar subsidies of 1930. As Wigforss noted the Riksdag's discussion about sugar "marked a step on Social Democracy's road away from the liberal economic policy."\footnote{518} At the same time the sugar subsidy made clear that price stabilisation might be conducive to some of Social Democracy's own goals. The SAP managed to pass a motion in the Riksdag which stated that since the state guarantied the price for sugar beets the wage of workers in the sugar beet sector should also be guaranteed.\footnote{519} As in the case of sugar the SAP parliamentary group was also split on the question of blending in a minimum percentage of domestic grain. The SAP voted against the Milk Regulation of 1932. But as Sköld pointed out this was not because he was against compulsory organisation. On the contrary, he argued, compulsory organisation was quite correct and in accordance with what the trade unions had always argued, namely that it was not just that the organised workers paid dues and fought for a better wage level which then also benefited those who refused to pay dues.\footnote{520} Instead Sköld's main reason to vote against the milk regulation was that he feared foreign retaliation, but after the Ottawa conference

\footnote{516} Just as the difficulties in reaching more than a micro-level accommodation between capital and labour was primarily an outflow of the orientation of macro policies rather than some deep structural - economic or political - antagonism, the perhaps equally crucial conflicts between labour and agriculture in the interwar period were also shaped by the reigning macroeconomic regime.

\footnote{517} See Hveding 1982, p. 197.

\footnote{518} Wigforss 1951, p. 292. By late 1931 Wigforss argued that the SAP's policy of rejecting help to agriculture which places any significant burdens on the budget would have to be abandoned. See Partistyrelsens sammansammar 9-14 November 1931. Arbr. Ark, SAP rulle 5 A:1:A 17-19, Partistyrelsens protokoll 1931-1939.

\footnote{519} Wigforss 1951, p. 293.

\footnote{520} Quoted in Thullberg 1974, p. 162.
in 1932 this reason also disappeared. Within the SAP Anders Örne was the main advocate of the view that agricultural protection harms consumers and workers. But Örne’s position was somewhat contradictory as he, like any good social democrat, also supported the idea of regulation and government intervention in order to overcome the inherent problems of markets. As Thullberg (1974, p. 156-7) points out his proposals for organisation within the diary sector were rather similar to those of the SAL. In sum, that the SAP came to accept agricultural protection in the famous ‘cow trade’ with the farmers party in the summer in 1933 was not primarily a tactical moved inspired by the wish to remain in government.\footnote{See also Rothstein 1992.} Rather the change in agricultural views fitted perfectly within the general reorientation in economic policy views prompted by the Great Depression.

That the political outcome in Swedia and Norway was a Labour/Farmer coalition based on agricultural support and fiscal expansion rather than a Labour/Liberal coalition based on the same programme was largely due to the ideological problems the latter had in justifying a policy of micro level market regulation. Whereas Social Democrats could embrace a policy initiated by Liberals as fitting within their vision of a regulated economy, Liberals themselves had increasing ideological difficulties in justifying the continuation of a policy which had been implemented as a short term exemption from accepted doctrines prompted by an acute crisis situation. In Norway the renewed concession the Liberal made in 1934, four years after the initiation of market regulation, in the form of a levy on margarine and rationing of fodder, created strong internal tensions in the party to the extent that there was talk of a split in the party.\footnote{See Bjørgum 1970.} A significant fraction held that the party had gone too far in pursuing non-liberal policies. The reason why the Liberal government was replaced by a DNA government, with BP support, in 1935 was that PM Mowinckle had proposed a cut in support to agriculture. Mowinckle was aware that his proposals would most likely mean the end of his government. Yet the reason for pursuing this policy anyway was that he did not want to expose the party to more internal strain by pursuing interventionist policies. Moreover, he believed that if DNA were given a chance to govern the electorate would soon realise the hollowness of DNA’s promises. In Sweden the BF decided to strike the famous ‘cow deal’ with the SAP in 1933 because it had more trust in the Social Democrats’ continued adherence to market regulation, especially so since the smaller liberal party opposed such policies, as did some within the Frisinnade.\footnote{Rothstein 1992.}
In sum, the Great Depression in Scandinavia was an instance where the policies pursued determined what party was to hold government rather than the other way round. The exigencies of a monetary economy meant that a policy regime which was bent on producing deflation sooner or later had to be abandoned and replaced by a regime which promoted price stability. In Germany, unfortunately only the fascists proved able to pursue such policies. In the Netherlands this meant that a staunch Liberal like Colijn was continuously forced to act in violation of his principles. In the UK the shift to more micro level intervention and a monetary policy which prioritised domestic growth and employment coincided with the shift from the Labour government to the Conservative government. In Norway and Sweden the pursuit of similar policies implied that the Liberals were sent into the political desert and Social Democracy started its four decade long hegemony.

4.4.2 Industry and Wages

While agriculture may have been most sensitive to its effects, industry suffered just as well from deflation. Accordingly recovery from the Great Depression required as a precondition that also industrial prices be stabilised. And as the SAP’s early experience with the regulation of Swedish sugar beet prices suggested, stabilisation of prices could be combined with stabilisation of wages, thereby benefiting both business and labour. In fact, wage and price stabilisation were mutually interdependent: without stabilising prices wage stabilisation would necessarily meet with determined opposition from business, but without stable wages price stabilisation would be difficult to maintain. This however meant that the state’s attitude towards trade unions would undergo a radical transformation. At the moment the state came to recognize deflation as the economic problem, strong interest organisations appeared as a stabilizing feature in the political economy. Whereas under the Gold Standard regime the alleged tendency of trade unions to hold real wages at too high a level was considered a threat to growth and competitiveness, the unions’ ability to stabilise nominal wages now became of crucial importance. And whereas Social Democrats initially interpreted the advent of price stabilization as an attack on real wages, in fact it heralded an age in which unionized wage bargaining would come to be recognized as a valuable rather than potentially obstructive element in the political economy.

With the possible exception of Nazi policies, stabilisation of industrial prices and wages did not give rise to as far reaching government intervention as agricultural price stabilisation. As long as the fixed exchange rate was in force, price stabilisation could not be extended beyond agriculture. And when the Gold Standard had been abandoned and monetary policies assumed an expansionary stance, the organisational strength in the industrial sector frequently proved sufficient so that the
state was not required to strengthen or even create collective organisations. Yet some countries seized the opportunity of the Great Depression to embark upon policies which increased the degree of organisation in the industrial area.

In the UK the quest for price stability together with the conviction that British industry suffered from a structurally inefficient organisation led to a new type of industrial policy. Again, protectionist measures were a crucial tool to increase domestic nominal rigidities both by preventing price-stabilization from being undercut by foreign competition, and by making their imposition contingent upon the collusion of domestic producers. The first of these measures was the Coal Mines Bill introduced by the second Labour government in late 1929. The bill offered the possibility of cartel arrangements so as to prevent a further fall in prices and wages. Under the National, and later Conservative, government the effort to organize industry increased significantly. As Winch (1969, p. 213) notes: ".. schemes for fostering combination among producers and sellers for the purpose of abridging competition, restricting output, price-fixing, and the elimination of excess capacity, were encouraged tacitly and explicitly in every major British industry in the 'thirties'." The main targets for government intervention were coal mining, cotton, shipping, iron and steel. At the same time British industry during the thirties increased its own efforts at greater organisation, with the consent of the government.

In Germany, depression and deflation had been much more severe than in Britain and hence a greater need for industrial organisation existed. At the same time the fascist ideology strongly pushed for more thorough organisation. The cartel decree of the NSDAP regime of July 15 1933 allowed cartels to enforce prices on non compliant producers. At the same time the ministry of economic affairs was given the right to create compulsory cartels. The official justification for this decree argued that "Intensified competition and the low price level resultant therefrom ... have brought nearer the point at which the ruin of enterprises valuable to our national economy is threatened. ... The compulsory order, with the help of the state's sovereignty, gives the cartel a power which it could not obtain on a voluntary basis."

525 See Mowat 1955, p. 364.
526 See Booth 1987, p. 512.
527 "The price cutter can thus be exterminated by private power with the sanction of the state." Neumann 1972, p. 264.
528 Quoted in Neumann 1972, p. 266.
Because the Dutch government decided to maintain deflationary macro policies for much longer, the need for microeconomic measures to halt deflation was felt perhaps more urgently here than in other countries. Yet politicians generally did not link the two phenomena. One of the reasons why the Catholic champion of Industrial Organisation Gelissen got the post of minister of economic affairs in 1935, was that he was rather indifferent with respect to the question of the Gold Standard and merely wanted to pursue his industrial policy plans. His predecessor Steenberghe instead had come to believe that recovery of industry required abandoning gold, and hence had to leave the Colijn cabinet.\footnote{Post festum the Council of State, an advisory body to the government, came to share a similar opinion, as it advocated toning down the proposed Bedrijfsvergunningenwet, because business had already started to revive after the devaluation of September 1936. See de Hen 1980, p. 208.}

Rather than seeing government assisted market regulation as a crisis measure which had become necessary due to the pursued deflationary policy, the need for market regulation was primarily seen to arise because of inherent weakness of a system of decentralised competition. Demands for the 'organisation of industry' materialised first in the RKSP but soon spread to other parties. Already in 1923, Catholic politician Verschuur had argued that the organic organisation of the economy was to be preferred above the individualistic Liberal principles.\footnote{See de Hen 1980. p. 192.}

Such views naturally struck a chord with the SDAP.\footnote{The SDAP had traditionally advocated organisation of industry, and embraced the policies pursued in its Plan van de Arbeid of 1935. Yet its views of 1935 do constitute a break with previous views. Previously state assisted organisation of industry was seen as a device to protect consumers from cartels, while protecting producers was the primary aim of the policies of the thirties.}

The Crisis Import Act of December 1931, which allowed the government to impose import quotas after consultation with industry was the first step to increased industrial organisation. The centre-piece of the legislation was the cartel law of 1935. With this law the government acquired the right to make cartel agreements binding on all firms in a sector upon a request from industry.\footnote{DNB president Trip opposed this law because it would hamper downward reduction of prices. See de Hen 1980, p. 200.}

In addition the Firm Licensing Law (Bedrijfsvergunningenwet) of 1937 allowed governments to protects firm from competition by making the establishment of new producers dependent on a government license. Private industry was generally quite enthusiastic about acquiring the ability to prevent 'murderous competition'.\footnote{This was a popular expression amongst Dutch business at the time. See for example, De Nederlandsche Werkgever, January 25, 1934, p. 39. Quoted in De Hen 1980, p. 203.}
between firms with the help of the state, although they preferred to impose regulation as much as possible through their own organisations and opposed giving union representatives a seat on the commissions which were to implement the various laws.\footnote{See de Hen 1980. CH. 5, also Brugmans 1983, p. 522-535.}

Also in the area of wage bargaining it is useful to distinguish two sets of countries. In Britain, Norway and Sweden, trade unions were generally still strong enough to stabilise wages on their own once the change in macroregime had taken place. The acceptance of price stabilisation as an economic policy goal in these countries simply implied that the state stopped its efforts to try and undermine the union's bargaining power. In Sweden the Social Democratic government changed the guide-lines for SAK's unemployment policies so that they would no longer exert downward pressure on wages. SAK was now directed to pay wages at market levels and it was no longer permitted to direct unemployed workers to firms which were boycotted by the unions. In addition unemployment benefits now became available for all the unemployed whereas under the previous system they had covered only about 50%. In Norway compulsory unemployment insurance was introduced by the DNA government in 1935, and in Britain the National government reversed MacDonald’s cuts in unemployment benefits in 1934.

Given the new attitude of the state to macroeconomic policies and labour market relations it was not surprising that the level of labour market conflict radically decreased. In 1928 Sir Alfred Mond, Chairman of the Mond-Turner conference between British business and the trade unions, had remarked that, "the whole country from the Prime Minister on down was anxious that peace be restored between Capital and Labour; but there was really no point in trying so long as monetary policy ensured an indefinite continuation of industrial disputes, unemployment and depression."\footnote{Boyce 1987, p. 156-7 referring to an article by Mond in The Times, of April 19, 1928.} Mond’s remarks certainly did not have validity only for Britain. Also in Norway and Sweden governments during the twenties had repeatedly called bi- or tripartite conferences in an effort to foster labour market conciliation, yet with little success. In the thirties however, the new policy regime lay the necessary groundwork for the "peace accords" which Norwegian and Swedish labour market partners reached in 1935 and 1938 respectively, and which were to form the basis of cooperative labour relations for decades to come.

In the Netherlands and Germany where trade unions had traditionally been weaker as in the other three countries and where the Great Depression had been much more severe, the state actually moved to strengthen the wage bargaining position of labour in a time of high unemployment.
Moreover, state intervention to strengthen wage bargaining had the tacit consent of the business community as the erosion of the trade unions market power eventually became an obstacle to industrial price stabilisation. In Germany, of course, such a policy was implemented by a dictatorial regime which eliminated existing trade unions and created its own labour market institutions, whereas in the Dutch case a democratic government moved to assist the existing trade unions.

As mentioned above, stimulating a fall in wages was an important aim of the public works programme (Werkfonds) the Colijn government started in 1934. By 1937 the government, however, had made a 180 degree turn. In 1937 a law was passed\(^{536}\) which enabled the minister of social affairs to make collective agreements between capital and labour binding on non-union members as well. This law came about one year after the law which gave the government the right to sanction industrial cartels and make them binding on all relevant domestic producers. The history of the law on collective agreements dates back to 1918. In the relatively tense situation after the First World War the government announced that it would present a law regarding collective agreements. Such law was presented in 1927 but from the Unions point of view it was quite disappointing. The only improvement the law provided for was that an employer who was already bound by a collective agreement had to apply this agreement to all his employees and not just to the unionised employees. One the one hand this provision provided some protection to wages in a single firm, but on the other hand, unions feared that, given the high level of unemployment, it would deter workers from joining a union. The reason why the trade unions could not reach their goal that collective agreements were to be declared binding on a sector was twofold. On the one hand, the government believed that high domestic wage costs were the main cause of unemployment and hence it did not consider a law which would strengthen wage bargaining appropriate. The unions’ argument that the employment and wages of workers in firms which were bound by a collective agreement would be threatened by lower wages in other firms unless such agreements were made binding on everyone, hence, necessarily had to fail to convince the government. More important perhaps was that employers strongly resisted a law which would have made collective agreements binding on a whole sector. While employers obviously welcomed the downward wage pressure which resulted from

\(^{536}\) "Wet op het algemeen verbindend en onverbindend verklaren van bepalingen van collectieve arbeidsovereenkomsten"
non-binding agreements, they also feared too large a role for the state. Furthermore they expected the ministry of social affairs to be rather sympathetic towards labour. Yet by 1937 such a law was passed and employers had largely given up their resistance.\textsuperscript{537}

Why did the government and employers change their mind in the late thirties? In 1935, partly in response to pressure from business, the Colijn government passed the cartel law. The rationale for business to press for more extensive state regulation was, as in all price stabilisation measures of this kind, that they found it difficult to enforce cartel agreements on all the relevant firms on a voluntary basis. On the one hand the cartel law of 1935 implied that it would become difficult for the state and employers to maintain their resistance against a law which would provide for as similar arrangement in the labour market. For the state considerations of social fairness and legitimacy were certainly of importance; if the state moved to stabilize prices in the economy it would seem unfair to exclude the price of labour. Yet apart from considerations of social fairness the law also answered an economic need. Just as the experience with price stabilization in agricultural had shown that promoting cooperation between producers was necessary in order to prevent undercutting, wage stabilization would also require strengthening the wage bargaining organisations in a similar way. Given the low unionization rate and the generally weak state of the unions, the falling nominal wages exerted severe strains on industrial cartels. Without the ability to stabilize nominal wages, cartel agreements would be more difficult to enforce as individual firms could attempt to obtain an advantage by pressing down the wage costs of their labour force. One of the arguments used in support of the Dutch law of 1937 was exactly that it protected employers from unfair competition. Furthermore, it was argued that since the law was going to be used to raise wages, preventing downward wage competition was beneficial since the level of effective demand was too low.\textsuperscript{538}

It might seem rather misplaced to argue that the Nazi regime initially actually strengthened the wage bargaining power of labour. As is generally known, the NSDAP regime was extremely hostile towards the labour movement while being rather more sympathetic towards the organisations of business. After it had come to power the NSDAP immediately moved to destroy organised labour. The Communist Party (KPD) was the first target. Its Chairman, Ernst Thälmann, was arrested on the third of March 1933 and five days later the parliament seats of the party were annulled.

\textsuperscript{537} The 1937 collective agreement for the metal sector was also the first one in which works councils (ondernemingsraden) were mandatory.

\textsuperscript{538} See Windmuller et al 1985, p. 71-75.
In the same month some trade union offices were occupied by SA forces and police. On May 2, 1933 the ADGB and AFA trade unions were effectively destroyed by the NSDAP. After some months of terror the SPD was declared illegal on June 22, 1933.

The NSDAP's hostility towards labour has led to the interpretation that its economic policies were inspired to a large extent by the desire to bring about a radical drop in real wages. In line with a neoclassical interpretation of the Great Depression, the Nazi terror hence would have brought about the real wage reduction which was required to solve the unemployment problem but which had been prevented by the strength of the trade unions, and partly by government policies, under the Weimar Republic. But, looking at the figures for real hourly wages in table 4.8 this contention does not seem to be borne out. Real weekly wages rose slightly in 1929 but then decreased steadily under the Brüning/von Papen/von Schleicher governments. The coming of the Nazi regime in 1933 actually saw an improvement in real weekly wages as compared to the previous years. Real hourly wages instead increased from 1928 to 1931, but during the last year before the Nazi takeover the gains of the previous years were lost. The first year of the Nazi regime saw a slight decrease in hourly real wages, after which they were stabilised while unemployment decreased rapidly.

The rise in real wages during 1929-1931 would seem to provide evidence for the contention that one of the problems of Weimar was that unions were too strong. And the increase in real hourly wages would then also explain the decrease in real weekly wages as it provoked a reduction in labour demand, i.e. employees worked fewer hours per week. According to this interpretation, however, the significant change came already in 1932 and not 1933. Yet it is a mistake, based on the neoclassical inability to analyse a world in which contracts are set in money terms to interpret the increase in real wages as a sign of strong trade unions. Wage contracts are not negotiated in terms of baskets of goods but in money terms, and because trade unions do not set the price level they cannot directly control the real wage. Given the radical increase in unemployment and the policies of the Brüning government, it would be difficult to argue that the years 1929-31 witnessed a strengthening of the trade unions. Indeed if one looks at nominal hourly wages, the variable over which unions have a direct influence, one sees a rather significant drop. During 1929-31 deflation simply outpaced nominal wage reductions but by 1932 the relation was inverted. Increasing real wages were not so much a cause of recession and an indicator of trade union strength, as a symptom of a deflationary constellation. And as long as deflation continued, investment would continue to collapse. It was exactly this cause of the depression which the Nazis removed.
Table 4.8: Gross Wages, Germany 1928-36 (1936 = 100)

<table>
<thead>
<tr>
<th></th>
<th>Gross Wage Income</th>
<th>Cost of living</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Nominal</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hourly Weekly</td>
<td>Hourly Weekly</td>
</tr>
<tr>
<td>1929</td>
<td>129.5 128.2</td>
<td>104.7 103.6</td>
</tr>
<tr>
<td>1930</td>
<td>125.8 118.1</td>
<td>105.7 99.2</td>
</tr>
<tr>
<td>1931</td>
<td>116.3 103.9</td>
<td>106.4 95.1</td>
</tr>
<tr>
<td>1932</td>
<td>97.3   85.8</td>
<td>100.7 88.5</td>
</tr>
<tr>
<td>1933</td>
<td>94.6   87.7</td>
<td>99.8 92.5</td>
</tr>
<tr>
<td>1934</td>
<td>97.0   94.1</td>
<td>99.7 96.7</td>
</tr>
<tr>
<td>1935</td>
<td>98.4   96.4</td>
<td>99.6 97.6</td>
</tr>
</tbody>
</table>


It, hence, seems difficult to interpret fascism as the 'last stage of capitalism', i.e. as a political movement which safeguarded the interests of German business by bringing about the radical wage reduction which proved impossible to achieve in a democratic system like the Weimar Republic. The enmity of the NSDAP towards organised labour was political rather than economic in nature. Both the SPD and the trade unions had been the staunchest defenders of the hated Weimar Republic. In March 1933, the SPD, in contrast the centre and right wing parties, voted against Hitler’s enabling act (Ermächtigungsgesetz). Moreover, a dictatorial movement like the NSDAP per definition cannot tolerate other movements with a different world view. While it was an urgent concern for the NSDAP to eliminate labour as the most powerful rival political organisation, it was an equally urgent concern to gain the allegiance of the broad majority of workers. As is shown, for example, by the fact that the production of consumption goods was maintained at a surprisingly high level even during the last period of the Second World War. Throughout its twelve-year reign the NSDAP regime was very anxious not to provoke massive spontaneous labour unrest in response to a dramatic decrease of living standards, as had happened in 1918 when the Kaiserreich was swept away. Moreover, for some time after it had come to power the NSDAP feared a general strike, like had happened in response to the Kapp-Lüttwitz putsch of 1920. The NSDAP’s dual policy of destroying the political organisations of the labour movement while simultaneously trying to gain the allegiance, or at least tacit toleration of the working class might easily have been frustrated if the economic nature of the Great Depression had been such that recovery would have required a substantial reduction in real wages. At the same time this would have complicated the efforts of the fascist

539 See also Luebbert 1991, p. 272-77.
540 See also James 1986, p. 367.
labour organisations, NSBO and primarily DAF, to gain legitimacy amongst wage earners. Instead the deflationary nature of the Great Depression meant that stabilization of nominal wages and prices was not incompatible but conducive to economic recovery.

It is useful to distinguish two distinct phases in Nazi wage policy. After 1936 when full employment was reached the main task of wage policy became to prevent an escalation of wages in a situation of tight labour markets. From this point onward there is no doubt that the Nazi regime quite significantly weakened labour's bargaining strength. When the Nazis assumed power, however, the situation they found was one of massive unemployment and falling nominal wages. Under the NSDAP regime the law of May 19, 1933 replaced wage bargaining between labour and business with a so called board of trustees which was to unilaterally determine wage contracts. In contrast to the collective bargaining agreements during the Weimar Republic the wage decrees of the board of trustees were conceived as minima, i.e. employers were allowed to pay higher but not lower wages. In addition firms with more than 20 employees were required to create a works council (Vertrauensrat) which was to have the right to take the employer to court if (s)he paid wages below those decreed by the trustees. The system of labour trustees hence put a floor under nominal wages as it implied the institutionalisation and enforcement of binding sector-wide wage levels. The official justification for the law of May 19, 133 was that the institution of a board of trustees was necessary in order to 'avoid the social and economic dangers which might result from an abuse of power by the employers'.

This, however, stood in sharp contrast with the previous years. As will be remembered, under Chancellor von Papen employers were actively encouraged to underbid the existing wage contracts. And in contrast to Brüning's policies of lowering wages by decree, the board of Trustees, during the first years of the regime, basically prolonged existing contracts.

As table 4.8 shows, the system of Trustees succeeded in its goal of stabilising wages. Hourly nominal wages, after a radical decline during the latter years of the Weimar Republic, started to move upward moderately after 1933. For weekly wages this trend is more pronounced, but this is mainly due to an increase in hours worked per week after the turnaround in the economy in 1933.

The new system of wage bargaining was not unwelcome to employers. As Schweitzer (1964, p. 400-1) argued: "During the Depression declining wage rates enabled employers to reduce their prices. Price competition disintegrated cartels, since some of the members became outsiders. In

541 Quoted in Siegel 1982, p. 70. For a shortened, English version of this article see Siegel 1985.
542 See James 1986, p. 368.
543 During 1933 DAF and NSBO were trying to prevent cuts in wages. See Mai 1983, p. 608.
small business, the level of prices shifted downward for whole industries when independent unions were suppressed, and wage rates tended to fall to the level of unemployment compensation. Many employers suddenly discovered that unionized wage rates had put a floor under the prices of their products. Thus, instead of realizing an advantage from the abolition of unions producers experienced extreme price competition in product markets." While the massive unemployment of the last years of the Weimar Republic, plus direct government interventions in wage bargaining had largely undermined the Union’s ability to stabilize nominal wages, the victory of the NSDAP and the ensuing destruction of Labour’s organisations removed the last dikes. The result might easily be increased deflation, intensified price competition and increased pressure on business cartels. While the system of sectorally binding wage decrees hence fitted well with employers’ policies in the cartelised sector, the attitudes of employers in the small non-cartelised sector were more similar to the views found, for example, in Swedish dairy farming. In these sectors employers lacked the ability to stabilise prices on a voluntary basis. Yet as they recognized cut-throat competition (i.e. deflation) as the main threat to their existence, the result was that the business organisations exerted pressure on the state to enforce price stabilisation on unwilling members. It were hence mainly the organisations of small business which tried to influence the Nazis to put a floor under wages. And as Mason (1974, p. 329) has shown the state was wiling to comply. "They (artisans and small employers) not big business saw in the coming to power of the Nazis a welcome opportunity to deteriorate the position of wage labour immediately and decisively - but in this they met the united opposition of the Trade inspection (Gewerbeaufsicht), the DAF, the Reich Ministry of Labour and occasionally also the Gestapo."

4.5 Cementing the New Regime I: Cheap Money

With the Gold Standard in place the possibility of political accommodation along the lines of a concerted effort to halt the downward drift of prices and wages combined with expansionary macroeconomic policies could not be exploited. Yet, not even Social Democratic parties seized the opportunity to cut through the Gordian knot of political conflict by abandoning the rigid external constraint. It was not too uncommon for the same politicians to defend microeconomic price stabilization with reference to the destructive effects of deflation, while maintaining that a violation

544 See also Mason 1974.
545 See Schweitzer 1964, p. 401.
546 My translation.
of the Gold Standard constraint would most definitely lead to a resurgence of inflation. In the form of a prolonged adherence to gold in the middle of a deflationary crisis, European countries now paid the price for embracing the view that the absence of a rigid constraint on monetary policies had caused the post World War I inflation and that monetary policies hence should be exempted from political interference but rather should provide the framework to which other actors had to adjust.

Instead of being abandoned by direct political decision, the commitment to the Gold Standard was hollowed out from the inside through the spread of microeconomic policies to halt deflation. The outer shell was instead smashed by the international financial markets, and in some cases by the threat of the collapse of the domestic banking system. The mounting contradiction between the unwillingness, on the one hand, to abandon the parity and, on the other hand, to pursue consistent policies required to defend the parity could not fail to arouse the suspicion of financial markets.

The first victim of this suspicion was Britain which was forced off gold in September 21 1931 after a prolonged period of intense international capital flows. Worn out by a decade of crisis and an increasingly overt doubt about the healing powers of the market, the BoE declined to mobilize its defense and finally let the Pound float. While Norway and Sweden initially were resolved to maintain their parity, their ability to stay on gold in the face of the domestic economic crisis and the devaluation of their main trading partner, was judged so low by financial markets that they were swept away by massive capital outflows within a week. The Swedish Krona had already come under heavy pressure during the German banking crisis of July- August 1931, and outflows continued afterwards. At the end of August, when the worst of the German banking crisis was over, the Riksbank still had SEK 127 m of foreign exchange reserves; by the time the Pound devalued, the reserves had shrunk to SEK 38 m.547 Confronted with rapidly shrinking reserves, the Riksbank from early September 1931 on tried to raise a loan for the defense of the Krona. Yet foreign lenders seemed not to have much confidence in the longer term ability of the Riksbank to maintain the gold parity. Similarly Norges Bank had seen its exchange reserves dwindle as a result of capital outflows. From NOK 70 m in April they fell to NOK 38 m in August.548 As it became clear on September 27 that no foreign loan could be secured, floating the currency was inevitable. And once Sweden, and Denmark had decided to devalue, Norges Bank felt it had no other choice but to follow.

547 Source Kjellstrom 1934, p. 27.
548 Source Nordvik 1990, p. 17.
The Netherlands were rather unfortunate not to have shared in the distrust with which international financial markets eyed the declarations of the British, Norwegian and Swedish governments to maintain the gold parity in September 1931. Based in part on its long term reputation as a hard currency and the domestic political stability of the Netherlands, the Guilder came to be considered a safe haven for international hot money flows. While Swedish and Norwegian governments failed to obtain a foreign loan to support their currency in the week following September 21, 1931, private capital inflows swelled the gold reserves of the DNB from roughly DFL 450 m in the second quarter of 1931 to about DFL 900 m by the end of the year and to more than DFL 1 bn by the third quarter of 1932.\textsuperscript{549} As international financial markets failed to present the Dutch with a fait accompli, it was up to the government to decide whether to follow the example of other countries or to intensify domestic deflation so as to maintain the gold parity and recover competitiveness with respect to the devalued currencies. As had been the case in the UK, Norway and Sweden, both governing and opposition parties could not muster the courage to abandon their self-imposed external constraint by means of a conscious political decision. For PM Colijn of the protestant ARP, the British devaluation was no example to emulate. Colijn had been named minister of finance in 1923 in order to balance the budget. For him the postwar inflation had been caused by the government’s attempt to buy social peace by means of public spending.\textsuperscript{550} Accordingly he believed that balanced budgets and the discipline of the Gold Standard were necessary conditions for preventing a repetition of the immediate postwar developments. In accordance with orthodox economic thinking Colijn thought that the devaluation of the Pound undoubtedly would lead to inflation in Britain, thereby undoing any competitive advantage. Moreover Colijn had great confidence in the ability of the Netherlands to maintain is competitiveness by depressing the domestic price level. But even after it became clear that devaluations had not sparked hyperinflation, but rather a moderate recovery abroad, while the crisis progressively deepened at home, still abandoning the parity was not seriously contemplated. After Belgium had left the Gold Standard on April 1, 1935, Steenberghe, the catholic minister of economic affairs advocated a similar step for the Guilder, and as he failed to obtain a majority in the cabinet resigned. In his answer to Steenberghe on April 15, 1935 Colijn maintained that abandoning gold would create “complete chaos in the monetary field”.\textsuperscript{551} In the end it would take almost exactly five years from the British

\textsuperscript{549} Source: Klein 1975, p.135.

\textsuperscript{550} See Bank & Vos 1987, p. 68.

\textsuperscript{551} Quoted in Vlak 1967, p. 38.
devaluation before the Guilder was cut loose from its Golden Fetters. On the night of Sunday September 26, 1936 the Dutch government finally gave in, one day after the French and Swiss devaluations had left the Guilder as the only remaining currency on gold.\textsuperscript{552}

Germany, on the other hand, never officially abandoned the gold parity. Yet as the deflationary policies led to a collapse of the banking system in the summer of 1931, heavy exchange controls were imposed from 15 July 1931 onward which isolated the financial sector from foreign pressures to such an extent that the Reichsmark de facto became an inconvertible currency. The reason for the imposition of foreign exchange controls was the collapse of the banking system under the weight of deflation. By 1931 the economic crisis had reached such proportions that German business was not only undertaking no more new investment projects but even failed to compensate for the depreciation of the capital stock. The massive wave of debt defaults which accompanied such a contraction created suspicions with respect to the solidity of the German banking system amongst domestic as well as foreign lenders. Partly due to the efforts of the Reichsbank to restrict long-term borrowing abroad, Germany's short term foreign debt had increased significantly since the late twenties. But the short-term maturity of the debt implied increased vulnerability. The spectacular gains of the NSDAP in the 1930 Reichstag elections, for example, had caused a wave of capital outflows. The same happened one year earlier during reparations negotiations (Young Plan). The increasing distrust of domestic as well as foreign depositors put the Reichsbank under double pressure. On the one hand, the increased liquidity preference implied a reduction of the velocity of money and a higher demand for cash. On the other hand, capital outflows reduced the gold and foreign exchange reserves of the Reichsbank. As will be remembered, the provisions of the Dawes Plan of August 1924 stipulated that at least 40% of the German note issue be covered by gold and/or foreign exchange. Increasing demand for notes and decreasing foreign exchange reserves however soon threatened to push the coverage of the note issue to below 40%. The sensible thing for the Reichsbank to do in the spring and summer of 1931 would have been to restrict capital outflows and ignore the 40% limit.\textsuperscript{553} The 40% minimum coverage was one of the pillars of the Gold Standard regime in Germany, it was seen as the obstacle to irresponsible monetary policies. In order to defend

\textsuperscript{552} Eventually, the communists were amongst the very few who did not welcome the depreciation in 1936. They voted against the law on the prohibition of gold bullion and specie exports which the government presented to the second chamber on September 29, 1936. One gets the impression that the Communists feared that the depreciation would indeed lead to an improvement of the economic \textquoteleft{}uation. MP Henk Sneevliet, for example, argued that\textquoteright{} The social policy of this government is of such a character, that it should be given no chance whatsoever to enjoy the new elixir of life which it has received [by means of the prohibition of gold exports, T.N.]\textquoteright{} Quoted in Vlak 1967, p. 44.

\textsuperscript{553} During the stock market crash of 1987 even those central banks which adhered to a money growth rule lended freely to the financial system regardless of the consequences for their monetary targets.
the 40% coverage the Reichsbank, rather than acting as lender of last resort, resorted to quantitative credit restrictions in the midst of a major financial crisis.\textsuperscript{554} Such a policy, however, could only serve to further undermine the confidence in the German financial system. The result was a run on the banks which forced the government to announce a banking holiday, on July 14 1931, which was to last, with different degrees of severity to September 5, 1931. The banking crisis then eventually forced Germany to break with two elements of the gold Standard regime, namely the principle of free cross border capital flows and the fixed minimum coverage of the note issues. On the initiative of president Hoover, a one year moratorium on reparations payments was reached on July 7, 1931. In August a host of standstill agreements was negotiated concerning foreign commercial debts. Starting on July 15, transaction of foreign currencies, and later: also in assets denominated in foreign currencies, were centralised at the Reichsbank. From now on all such transactions required the explicit permission of the Reichsbank. Moreover, in order not to drive the whole banking system into ruin, the Reichsbank was forced to abolish its credit restrictions. By December 31, 1931 the gold and exchange coverage of the note issue had dropped to 24.2\%.\textsuperscript{555}

But abandoning the Gold Standard was not tantamount to establishing a new regime. The absence of an external constraint by itself obviously could not force governments to abandon a restrictive regime in which monetary policies were conducted with the sole aim of preventing inflation. In the initial months after September 21, 1931 it seemed indeed that the floating of the currencies would not give rise to a new monetary policy. Rather authorities feared the resurgence of inflation. In early September 1931 MacDonald had still actively conjured up the memory of the German hyper-inflation in order to quell demands for a change in monetary policy.\textsuperscript{556} The same day the Pound was floated, the BoE increased the Bank Rate sharply from 4.5 to 6\% in order to counteract the expected inflation. The BoE asked banks not to provide funds for speculation as it was feared that a flight out of Sterling would lead to domestic inflationary pressures.\textsuperscript{557} And although it was clear to the government from the outset that the old parity would not be established, the initial impression created was that the floating of the Pound was a temporary expedient which within

\textsuperscript{555} Source: Irmler 1976, p. 292.
\textsuperscript{556} See Boyce 1988, p. 359.
\textsuperscript{557} Sayers 1976, p. 418.
reasonable time would give way to a return to gold, albeit at a lower parity. As Sayers pointed out: "Most people in authority were anxious to emphasise that there was no intention to break with the Gold Standard policy: the step now taken was a reluctant interruption".558

In Germany macroeconomic policies would not take a more expansionary course until roughly one year after the banking crisis. Despite the fact that the banking crisis had forced the Reichsbank to break with some principles of the Gold Standard, the fear of inflation and the desire to get rid of reparations stood in the way of a clear break with the old regime. Most important, Germany decided not to follow the British example when the Pound was devalued in September. In the eyes of German policy-makers, remaining on gold had the advantage of lessening the burden of Germany's foreign debt. According to Luther (1964, p.211) the devaluation of the Pound and the Dollar resulted in a reduction of Germany's foreign debt by about RM 1,5 bn. Moreover, despite the increasingly tight exchange controls, maintaining the gold parity still was seen as a safeguard against inflation.559 Staying on gold, however, implied the need for renewed domestic deflation in order not to undermine the competitiveness of Germany.

After the Krona was forced off gold in September 1931 finance minister Felix Hamrin declared that the new goal for monetary policy was "to safeguard the domestic purchasing power of the Swedish Krona".560 It would be tempting to interpret this declaration as a decisive break with the policy of deflation. In actual fact the proclamation was intended to signal that the Riksbank would not tolerate any inflation. Despite the fact that the government since 1930 had actively been supporting efforts to halt the fall in prices in specific product markets, the gold parity of the Krona was still seen as the safeguard against runaway inflation. The government, the Riksbank and the SAP, therefore, initially held the threat of inflation to be a very real one after September 27, 1931. Accordingly, the proclamation of the goal of domestic price stability was accompanied by a significant increase in the discount rate from 6 to 8%, while the Riksbank asked commercial banks to exert caution in their lending policies. At the same time the Ministry of Finance declared that the Krona would return to gold as soon as foreign conditions permitted.561 After September 27

558 Sayers 1976, p. 413.
559 In his memoirs Brüning (1970, p. 221) argued that, as of late October 1930 he had a secret agreement with Reichsbankpresident Luther to devalue the Reichsmark by 20% after two conditions had been met: (1) The cancellation of reparations (2) The receipt of a foreign loan of RM 2 bn to be used for a currency intervention fund. Brüning apparently feared that without a sufficiently large intervention fund devaluation could not be contained to 20%. According to him only with such a fund "inflation could be durably prevented."
561 See Kjellstrom 1934, p. 53.
Norges Bank similarly declared domestic price stability to be the main concern at the moment, and as in other countries this was based on the fear of inflation. Norges Bank hence followed the Riksbank in raising the discount rate to 8%.

As the spectre of inflation failed to show while the Great Depression raged, governments gradually came to reorient monetary policies in a more expansionary direction. If abandoning gold did not produce inflation, then a relaxation of interest rates might perhaps contribute to mitigating the depression. In short, as inflation did not materialize governments found the courage to abandon the dear money policy to which so many had objected in the twenties.

 Clearest was this change in Sweden. After inflation failed to materialize while the crisis progressed further, deflation came to be seen as the crucial problem. Accordingly the Riksdag and the government, during the first months of 1932 moved to change the goals of monetary policy from a stabilisation of the domestic price level to bringing about a moderate reflation of wholesale prices while consumer prices were to be maintained stable.\textsuperscript{562} The need for reflation so as to stimulate the economy was first proposed by the minister of finance in January 1932, but the matter was delegated to the parliament’s banking committee (Bankoutskott).\textsuperscript{563} The committee’s report, which was submitted to the Riksdag in early May, contained the same, and unanimous, recommendation of a moderate reflation of the wholesale price level. Moreover the committee stated explicitly that deflation should be combated as vigorously as inflation. In a complete reversal of the Gold Standard policy, it was now argued that the exchange rate should adjust to the desired development of the domestic price level. While Social Democrats like Karleby and Wigforss during the inflation of the early twenties had argued that deflation would actually benefit the working class now they agreed with the need for a moderate reflation. In an article in the Social Democratic newspaper \textit{Social Demokraten}, Wigforss argued in November 1931 that a return to the old gold parity would be unacceptable because it would require deflating the domestic price level and hence would lead to more unemployment, a weaker trade union and lower wages.\textsuperscript{564} Five months later, right before the Riksdag debate about the banking committee’s proposals on May 6 and 7, Wigforss argued in the same newspaper that, in view of the on-going deflation, the programme of moderately increasing the wholesale price level was also in the interests of the working class because it would help the economy recover without leading to a noticeable rise in consumer prices and, therefore, without

\textsuperscript{562} See Jonung 1992.
\textsuperscript{563} See Kjellstrom 1934, p. 60.
\textsuperscript{564} See Wigforss 1980b, p. 387/88.
causing real wage losses.\textsuperscript{565} Given the unanimous support in the banking committee, it was not surprising that the Riksdag debate of early may 1932 ended in a recommendation to the Riksbank to reflate the wholesale price level. Different parties may have had different reasons to agree with this programme. For Trygger of the conservative party, the only remedy against the crisis was a reduction in wages.\textsuperscript{566} Despite the fact that the banking committee recommended a stable consumer prices level, Trygger may still have hoped to reduce wages through reflation. Möller, replied that the SAP and the working class rejected a policy of price increases and wage reduction but at the same time argued that the banking committee’s proposed policy would be useful for the country as it would help the economy recover without significantly affecting consumer prices.\textsuperscript{567} Similarly in the second chamber, Wigforss, in response to suggestions that the policy of reflation would be a way of reducing wages argued that such would not be the case by pointing out that wholesale prices had fallen considerably faster than consumer prices and that, therefore, there was a considerable margin within which reflation of the first would not affect the latter.\textsuperscript{568}

While wholesale prices did indeed stop falling from June 1932 onward, a new price fall set in during the first six months of 1933.\textsuperscript{569} In the spring of 1932 the SAP government named a committee to look again at how monetary policy was best conducted. The committee reconfirmed the expansionary policy aimed at reflation. Gustav Cassel, one of Sweden’s most famous economists and an advocate of deflation in the early twenties, now even suggested to help raise the price level by having the Riksbank finance the Social Democrats’ public works programme.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|l|}
\hline
Date & From(\%) & To(\%) & Remarks \\
\hline
February 6 1931 & 3.5 & 3 & To curb inflows of capital \\
July 31, 1931 & 3 & 4 & To curb outflows \\
September 21 1931 & 4 & 5 & idem \\
September 25 1931 & 5 & 6 & idem \\
September 28 & 6 & 8 & To quell expectations of inflation \\
October 8 1931 & 8 & 7 & \\
October 1931 & 7 & 6 & 
\hline
February 19, 1932 & 6 & 5 & Stimulate activity, increase prices. \\
March 3, 1931 & 5 & 5 & \\
May 17, 1932 & 5 & 4.5 & \\
June 3, 1932 & 4.5 & 4 & \\
August 31, 1932 & 4 & 3.5 & \\
\hline
\end{tabular}
\caption{Changes in the Riksbank’s Bank Rate}
\end{table}

\textsuperscript{565} See Wigforss 1980A. \\
\textsuperscript{566} See Riksdagens Protokoll, Första Kammaren, Vol. 3, nr. 33, p. 19. \\
\textsuperscript{567} See Riksdagens Protokoll, Första Kammaren, Vol. 3, nr. 33, p. 29-30. \\
\textsuperscript{568} See Riksdagens protokoll, Andra Kammaren, Vol. 4, nr. 42, p. 16-18. \\
\textsuperscript{569} See Kjellstrom 1934, p. 72.
In one sense the reorientation of monetary policies in Norway can be dated to the week between the devaluation of the Pound and the devaluation of the Krone. Immediately following the devaluation of the Pound, Norges Bank conducted talks with representatives from government, parliament and business. Amongst all these groups there was a strong feeling that the Krone should follow the Pound in abandoning gold. Also the Norwegian association of bankers (Bankforeningen) shared this view. After the disastrous experience of the policies of the twenties, a renewed policy of depressing the domestic price level, now in order to maintain competitiveness and the gold parity, was politically impossible for Rygg. Unlike Colijn, who was confident that Britain would experience inflation and that the Netherlands would be able to depress their domestic price level, Norwegian policy-makers could not contemplate such a course. After having argued for one decade that a policy of appreciation which returned the Krone to gold was the precondition for economic stability, Nicolai Rygg, in his communication to the press after the devaluation now argued that staying on gold would have a strongly negative effect on the real economy. Norges Bank lowered the discount rate on October 8 from 8 to 7%, and subsequently to 4%. Yet initially Norges Bank tried to limit devaluation. During the month of October it intervened in foreign exchange markets so as to maintain a revaluation relative to Sterling. In the face of opposition from a.o. business, this policy was abandoned by the end of the month. By the end of the year the Krone had devalued 10% relative to Sterling. Until June 1933, when the Krone, together with the Krona, was tied to Sterling, Norges Bank did not attempt to stabilise the exchange rate. When DNA PM Johan Nygaardsvold, in his inaugural declaration in 1935 promised that the government would "as long as it stands in its power defend the economic life in the country from swings in the value of money" it was the danger of deflation which was primarily on his mind. One year later, the discussion about how monetary policy could more effectively support the economy, started in 1932, led the Social Democratic government to award Norges Bank the right to conduct open market operations. At the same time the upper limit on Norges Bank note issue was raised by 30% from NOK 250 m to NOK 325 m. According to Hodne (1983, p. 95) the latter decision contributed more to the recovery from the Depression than the alleged Keynesian deficit spending.

570 See Nordvik 1990.  
572 Nygaardsvold's inaugural declaration is reproduced in TFAH 1/1986, p. 65.
That restrictive monetary policies might depress economic activity rather than merely have effects on the price level was a concept well-know to British policy-makers even under the Gold Standard. As mentioned above, Ralph Hawtrey of the Treasury believed that cheap money was the best cure for a recession. Ever since the resurrection of the Gold Standard, the conflict between the domestic and international requirements on monetary policies stood out clearly to policy-makers.\textsuperscript{573} Winston Churchill, Chancellor of the Exchequer in the second Baldwin government, protested, sometimes vigourously, against every increase of the Bank Rate. He considered interest rate policy to have had unsatisfactory result for everyone but the narrow financial circles around the BoE.\textsuperscript{574} Snowden equally was convinced of the detrimental effects of high interest rates. An important motive for his emphasis on balanced budgets was, of course, to avoid pressures on the Pound which would have required higher domestic interest rates.\textsuperscript{575} Reginald McKenna, a former chancellor of the Exchequer, chairman of the Midland Bank and a kindred spirit of Keynes, attributed the dismal performance of the UK economy in the twenties, as compared to the USA, to the BoE’s unresponsiveness to the needs of industry.\textsuperscript{576} At the Mond-Turner conference of March 1928, employers and trade unions could agree that by causing deflation the return to the Gold Standard had given rise to "grave social and industrial ills."\textsuperscript{577}

Yet as long as the consequences of cutting the Pound loose from gold were considered potentially more disastrous, opposition to the deflationary policies of the BoE could not become politically effective. But after the Pound was floated and the threat of inflation failed to materialise, British Conservatives acted decisively to implement a regime of cheap money in which exchange rate and monetary policies came to be judged primarily with respect to their effects on domestic growth and employment, and in which the responsibility for such policies reverted to the government instead of the BoE.\textsuperscript{578}

\textsuperscript{573} See Kunz 1987, p. 16-18.

\textsuperscript{574} "To sum up, the financial policy of Great Britain since the war has been directed by the Governor of the Bank of England and distinguished Treasury permanent officials who, amid the repeated changes of Government and of Chancellors, have pursued inflexibly a strict, rigid, highly particularistic line of action, entirely satisfactory when judged from within the sphere in which they move and for which they are responsible, and almost entirely unsatisfactory in its reactions upon the wider social, industrial and political spheres." Churchill in a letter to Otto Niemeyer of the Treasury, May 9, 1927. Quoted in Boyce 1987, p. 408.

\textsuperscript{575} Conversely for Norman the widespread opposition against increases of the Bank Rate led him to place more emphasis on sound fiscal policies.

\textsuperscript{576} For example, at the annual shareholders meeting of the Midland Bank in 1927. But also McKenna did not unequivocally advocate abandoning gold. See Boyce 1987, p. 137.

\textsuperscript{577} Quoted in Boyce 1988, p. 156.

\textsuperscript{578} See also Cairncross & Eichengreen 1983, p. 88-89.
Whereas Sterling had been weak after September 21, flight money soon returned and by early 1932 the Pound was under strong upward pressure. The desire to prevent a strong appreciation of the Pound prompted the creation in mid 1932 of the Exchange Equalization Account (EEA), a treasury-directed fund for managing the exchange rate. Although the BoE performed the interventions the EEA signified a clear break with previous monetary policies as it was now established that (1) the exchange rate had to be managed in view of the requirements of the domestic economy, and (2) exchange rate policy was the responsibility of the government. But as exchange rate management formed the core of monetary management in general, formation of the EEA effectively meant that interest rate management now also became the domain of the government. Despite the reluctance of Norman, who as of February 1932 would have preferred an appreciation of Sterling, the government pushed for and obtained a low bank rate. Between February and June 1932 the Bank Rate was lowered from 6% to 2% and it would remain there until 1939.

With the Pound freed from gold, the government now also set out to bring about a reflation of the domestic price level. By March 1932 the Treasury was advocating a rise in wholesale prices and low interest rates. Raising the price level, in the view of the Treasury required both that the exchange rate be managed so as to prevent deflationary policy and that money remained cheap and plentiful. Low interest rates, moreover, would have the benefit of reducing the debt burden on the budget.

The logic of deflation implied that also in Germany the contradiction between Brüning’s policy of deflation and his agricultural price stabilisation measures could not be solved in favour of consistent deflation but had to be solved along the lines of consistent prices stabilisation and expansionary monetary policies. Politically the inconsistency in Brüning’s policy led to continuous conflicts between agrarian and industrial interests. Since the policy of deflation could not solve but rather aggravated the crisis, the conflict between capital and labour also became more intense. While industry demanded, and frequently was awarded, further cost reductions and subsidies, labour desperately tried to prevent having to shoulder all the burdens of the crisis. Yet, starting with the collapse of the Banking system in the summer of 1931, representatives of industry increasingly voiced doubts about Brüning’s policy course. And despite the considerable amount of support it received, agricultural was highly dissatisfied. As the policy of deflation implied a radical collapse

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579 See Howson 1975, p. 86.
580 See Howson 1975, p. 86.
581 By the late twenties interest payments constituted 40% of the budget. See Booth 1987, p. 503.
in domestic demand, and hence in demand for agricultural products, even Brüning’s Osthilfe was not sufficient to halt the falling prices and to stabilise the economic position of agriculture. In the summer of 1932 the increasing dissatisfaction of industry and agriculture led to Brüning’s fall, as Reichspreisident von Hindenburg refused to sign an new emergency decree. His short lived successors, in stages turned around economic policies from deflation to expansion. Yet time had run out to prevent the advent of the Nazi regime. In the end, the outcome of Brüning’s deflationary policies was not only to terminate reparations and the neutrality of money postulate, but also democracy in Germany.

Chancellor von Papen, who replaced Brüning in June 1932, undertook the first tentative steps towards a regime change in economic policies. Brüning’s fiscal retrenchment was replaced by moderate expansion as von Papen implemented the Rm 135 m works creation programme which the Brüning government had drafted in its last days. In the so-called von Papen programme, announced on 4-5 September 1932, an additional Rm 170 m were provided for works creation policies. Of more importance than the public works programme was that the von Papen programme also provided for a more relaxed monetary policy. The banking crisis of the summer of 1931 certainly impressed upon the Reichsbank the disastrous consequences of a policy of deflating the economy in order to maintain the legal gold and exchange coverage of the currency in circulation above 40%.582 Faced with a banking collapse the Reichsbank had no choice but to provide liquidity. Luther (1964, p. 251-3) even claimed that the Reichsbank already had started to pursue an expansionary course under Brüning. But to extend liquidity in an effort to prevent a collapse of the financial system is something else than expansionary policies. Yet after July 1931, any further policies of monetary contraction were out of the question. When reparations had effectively been ended at the Lausanne conference on July 8 1932, the second argument in favour of restrictive monetary policies had disappeared.583 And although Luther did not admit it had any influence on his decision, the Reichsbank was under political pressure. Whereas the Reichsbank had gained its political independence under pressure from the allies during the hyper-inflation, the termination of reparations might easily lead to a change in Luther’s position. In opposition to Luther’s wishes, von Papen refused, for example, to include a guarantee of the independence of the Reichsbank in his speech on the end of reparations.584 After the fall of Brüning, conservative newspapers were

582 See Luther 1964, p. 253-4.
583 See Luther 1964, p. 250, 255.
584 See Luther 1964, p. 268.
openly speculating about the need to replace Luther with someone who was willing to pursue a more relaxed policy. As a result, the Reichsbank under president Luther now became willing to cooperate with Papen’s more expansionary policies.

Von Papen’s main aim was to restore private investment. To that end the government issued a total of Rm 1.5 bn in tax coupons which business could use to pay taxes in the years 1934-38. In fact the tax coupons constituted a form of liquidity as they could be deposited at banks and were rediscountable at the Reichsbank. In combination with increased liquidity von Papen sought reduce the burden on business by lowering wage costs. Although he did not, like Brüning, attempt to lower wages by decree, he granted business the right to pay wages below the level agreed in collective agreements as long as the total wage sum of the firms remained the same. In this von Papen tried to directly couple lower wages with more employment. Moreover those firms which did employ additional labour were granted additional tax coupons. In addition the level of unemployment benefits was further reduced and employee contributions increased.

ADGB and SPD, not surprisingly, considered von Papen’s policy an attempt to shift the burden from business to labour. For the SPD, recovery did not require subsidising employers but increasing consumption. Tarnow argued that encouraging employers to lower wages would not lead to more employment because this did not increase the overall level of demand. As an alternative to von Papen’s policies, they resubmitted their public works programmes of May 1932.

In November 1932 von Papen in turn was replaced by general Kurt von Schleicher. In contrast to von Papen, von Schleicher actively sought the support of the ADGB. The main point in his economic policy programme was works creation, and to that end a separate agency was created on December 15, 1932. The public works programme, which the short-lived government started with support of the Reichsbank, amounted to Rm. 550 m. More important was that von Schleicher replaced von Papen’s hated decree of 4-5 September which encouraged employers to reduce wages. In principle Schleicher then had stumbled upon the basic recipe along which social accommodation was being brought about in other countries; stabilisation of prices, including wages, and cheap money supported by some fiscal expansion. Yet politically it was impossible for the ADGB to support an authoritarian regime which stood in sharp opposition to the SPD, and which had clear

585 See Luther 1964, p. 262.
sympathies to the Strasser wing of the NSDAP. Without the necessary political legitimacy to exploit and develop the new regime the Schleicher government had to be short lived. Within two months Adolf Hitler would take over the Chancellorship.

Despite von Papen’s policy of tax coupons the decisive regime transformation in the Reichsbank took place shortly after the change in political regime. The NSDAP regime replaced Luther with former Reichsbank president Schacht. In 1932 Schacht, in his book, "Principles of German Economic Policy (Grundsätze deutscher Wirtschaftspolitik) had pointedly worded the credo of the twenties: "We don’t lack monetary means of circulation in Germany but we lack capital. Capital, however, can not be printed by a paper press. Capital has to be created by savings and work." By 1933 the Reichsbank had apparently abandoned classical theory. Reflecting on the Reichsbank’s role in the Nazi recovery Schacht (1950, p.57, 60) argued: "Money is not capital but it can be transformed into capital at any time. ... The whole automatism of the banknote system laid down by classical economists was found to be in contradiction to the real process of economic evolution. One simply could not leave a whole economy without financial and currency supply, merely because a previous currency theory had contrived such an 'automatism'. That is why the Reichsbank disregarded traditional theory and spurred on production, by generating credit in the form of newly created money, in a broadminded way. Its success proved that it was right. There was no question of any inflationary effect, for the quantity of goods increased so rapidly that it was equivalent to the increased volume of money put into circulation." And while Luther still had complained bitterly about the budget deficit under von Papen which might require the Reichsbank to extend loans to the government, the Reichsbank now did not have any such qualms. More important perhaps, in contrast to the twenties the Reichsbank lost its autonomy with the coming of the new regime. Although Schacht for some time lived in the illusion that he might control Hitler, the latter was not willing to let his policies be hampered by a Reichsbank president. As Schacht towards the late thirties increasingly called for more restrictive policies to counter the inflationary pressures in a full-employment economy, he was replaced by a more cooperative president.

590 Luther 1964, p. 264.
591 The most important instrument for monetary expansion in the early period of the NSDAP regime were the so-called MEFO bills. See Kindleberger 1987 p. 393.
In sum the deflation of the Great Depression cleared the way for a radical, but gradual, reinterpretation of the responsibilities of macroeconomic policies. In a bout of political amnesia, most political parties, between now and the late forties came to forget that, a decade ago, they had clamoured for a strong central bank to tie their hand to the mast in order to restore discipline to an inflationary economy. If the absence of the Gold Standard did not mean inflation, then the policy of defending gold apparently had unnecessarily depressed the economy. In many cases central bankers now came to be considered the culprits who had sacrificed the prosperity of the economy in order to serve the idol of gold. As a result of the change in policy, Central Bankers lost much of their independence. Whether legally independent or not, the absolute priority given to the maintenance of a fixed parity meant that Central Banks necessarily enjoyed a high degree of power and independence. The floating of the currencies hence automatically implied that much of the political initiative in monetary policy had to return to the government. More importantly, however, the changing interpretation of monetary policies required less independent central Banks. As the economies slowly recovered from the cataclysm of the Great Depression, monetary policies now came to be seen again to exert a powerful influence over growth and employment. If monetary policies, however, implied trade offs between growth and inflation, then such decisions had to be taken by governments instead of independent central bankers. Accordingly independent central banks came to be considered as a foreign element in a democratic polity. As an expression of this new conviction Norges Bank, the Bank of England and the Nederlandsche Bank were nationalized.

While, the twenties were anything but a laissez-faire period in economic policies, the proponents of the Gold Standard were now defeated by reference to their own rhetoric. It did not help that many liberal politicians during the Great Depression exclaimed that it was a misunderstanding to claim that they had advocated a total withdrawal of government from policies and that they had always recognized areas where governments needed to correct market outcomes. The rediscovery of the macroeconomic responsibility of governments put liberal views in an untenable position. Yet, in picturing its victory in terms of market versus intervention, the defendants of the new regime would set up a false dichotomy for which they would have to pay the price as the next serious inflationary crisis would develop.

592 See also Goodhart 1994, p. 1427.
4.6 Cementing the New Regime II: Post World War II.

Unlike the First World War, the Second War did not lead to a change in macropolicy regime. The principle that money is not neutral but that a policy of cheap money is a crucial instrument in fostering growth had already been established in the thirties. Likewise the principle of state interference in wage bargaining and price setting had become accepted. The abandonment of the Gold Standard meant that governments no longer considered exchange rates sacrosanct. Instead exchange rate adjustments now came to be seen as preferable to adjustment of the domestic price level. Along with the new views on exchange rate management and monetary policy came also the recognition that placing restrictions on international capital flows was an acceptable policy instrument. The war, hence, did not lead economic policy management on a fundamentally different course but rather speeded up tendencies which had been born during the cataclysm of the Great Depression.

At the end of the War, the economic policy objectives of governments were rather similar to what they had been after the First World War and for largely similar reasons. Just as in 1918 also in 1945, stimulating production would enjoy the utmost priority for Western governments. If anything the larger scale of destruction made this goals more urgent now. Moreover, with the experience of the early twenties and the Great Depression fresh in mind, governments were determined not to let the soldiers return to the prospect of unemployment and economic stagnation, and not to let economic recession threaten political accommodation. Milward (1984, p. 446) summarized it succinctly: "High and increasing output, increasing foreign trade, full employment, industrialization and modernization had become in different countries, as a result of the experience of the 1930s and the war, inescapable policy choices, because governments could find no other basis for political consensus."

As has been argued already in section 4.2, economic policy strategies after the War were not based on Keynesian concepts of deficit spending. Rather the core conviction was that, in order to promote growth, interest rates should be kept low. Instead of following a Keynesian policy of promoting consumption in order to increase demand, consumption rather was to be kept down so as to provide more means for the reconstruction and expansion of the capital stock. Especially given the scarcity of convertible currencies - primarily US Dollars - governments wanted to make sure that imports of consumption goods were curtailed to the benefit of investment goods. The determination to keep interest rates low was primarily motivated by the disastrous experience of the Gold Standard. But similar to 1918 the large stock of government debt militated strongly against
high interest rates. Moreover, the experience of the early twenties had led many politicians to believe after 1945 that there was a real danger that the postwar restocking boom, after a relatively short period, would be followed by a deep recession. The fear of a renewed slump somewhere in the late forties, then, provided an additional motive for low interest rates.

In Britain the general elections of the summer of 1945 produced a landslide victory as Labour captured 393 seats and the conservatives only 213. For the first time since the MacDonald government had disintegrated over the defense of the Pound in 1931, a Labour government would hold office again, but this time backed by a solid parliamentary majority. In response to the disaster of 1931, Labour had seriously rethought its economic policy positions. While still rejecting deficit spending and envisaging the need for a planned economy to cure capitalism's long term problems, the Annual Congress of 1934 and Labour's Immediate Programme (1937), rejected deflation and the Gold Standard and came to advocate stabilization of wholesale prices. More important for postwar policy was the document Full Employment and Financial Policy (1944), written by Labour's economic spokesman Hugh Dalton. Interest rates were to be kept low permanently so as to facilitate reconstruction and maintain full employment after the initial boom, and in order to do so exchange controls would be required. The National Debt Inquiry Committee of 1945, which was strongly influenced by Keynes also reached the conclusion that interest rates had to be kept low in order to facilitate government debt service as well as to counteract the expected recession.

Despite the monetary overhang Dalton, now Chancellor of the Exchequer, in 1945, therefore, set out to depress nominal interest rates below pre-war level. Except for the last two, the reasons he gave for this cheap money policy were quite similar to those which led Lloyd George to spurn dear money during 1918-9: "to save public expenditure on interest, to improve the distribution of income, to encourage investment and so make sure of full-employment. I wished to help the local authorities to keep down the cost of housing programmes, and thus keep down rents. I wished, most of all, to help the local authorities in the 'blitzed cities', both by special grants and by cheap loans. And I wished to prepare the way for the series of nationalisation bills which, during this parliament, we intended to pass. The higher the national credit, the lower the rate of interest, the less the annual compensation charge corresponding to a given capital value."

593 See Durbin 1988, p. 34.
595 Quoted in Howson 1989, p. 404.
In the Netherlands the Social Democrats were less successful electorally. At the end of the war the Social Democrats had attempted to overcome the 'pillarisation' of the Dutch electorate into four relatively stable segments, a Catholic, a Protestant, a Social Democratic and a Liberal one. In order to create a true peoples-party which could also be attractive for voters with religious backgrounds, the SDAP was dissolved and the PvdA created in 1946. The PvdA in effect constituted a merger of the large SDAP with the Liberal and Protestant splinters VDB and CDU. Yet the effort to break through the traditional barriers largely failed. Although the PvdA captured 29 seats in the 1946 elections to the second chamber as compared to 23 for the SDAP in the last pre-war election of 1937, this was less than the share of votes of the three constituent parties had been. But despite its failure to become a true people's party the PvdA broke out of the political isolation of the pre-war period. Already in 1939 the Catholic party had overcome its resistance against Social Democratic government participation, and after the war a coalition government of these two parties was formed in which the PvdA occupied crucial positions, in particular the ministry of finance and the ministry of economic affairs.

The Dutch Social Democratic minister of finance, Pieter Lieftinck shared Dalton's general outlook with respect to interest rate policy. Given that the Dutch state at the end of the war had a total debt of DFL 22.2 bn, of which DFL 16.4 short term floating debt, he believed that high interest rates would exert unacceptable pressures on the state budget. In addition high interest rates would reduce investment. Moreover Lieftinck argued at a time where the government was pursuing a policy of strict wage moderation, rentiers should not be allowed an increase in income. Accordingly the government tried to keep interest rates within the range of 3-3.5% during the first years after the war. And despite the fact that Lieftinck wished to avoid monetary financing of budget deficits, he held that given, on the one hand the reduced tax base and the disorganisation of the tax collection service, and on the other hand the urgent needs of the country, some monetary financing was inevitable. In sharp contrast to the reigning views on monetary policy under the Gold Standard, he even argued that the monetary financing that did take place contributed to the recovery of the country as it allowed for more imports of capital goods.

Compared to the PvdA, SAP and DNA were more successful electorally. The SAP captured 50% of the second chamber seats, in 1944 although this constituted a setback from the absolute majority it had held as a result of the 1940 election. In Norway the 1945 election gave the DNA

an absolute majority in parliament, albeit a slight one. Despite the fact that Sweden had managed to stay out of the war, stimulating growth and low interest rates policies formed the core of postwar economic policies. The roots of cheap money policies, as has been argued, lie in the thirties. When the SAP published its programme for the postwar period in 1944 (Arbetarrörelsens Efterkrigsprogram) the need for low interest rates so as to promote investment was reconfirmed. In addition low interest rates were considered of crucial importance in connection with the SAP’s housing programme. A radical expansion of affordable housing was a crucial element in the SAP’s strategy to durably extend its electoral appeal beyond the blue collar working class. High interest rates would not only have made mortgages more expensive but it was also expected to lead to an increase in housing rents. Similar to the Dutch targets the Riksbank after 1945 kept the discount rate at 2.5% and the yield on long term government debt at 3%. As parliament decided to keep interest rates unchanged in 1945, an increase in discount rates did not occur until the Korea boom. In contrast to the other countries, Sweden did not have to contend with a huge monetary overhang after the war. With its productive apparatus intact, Swedish industry stood ready to profit from the expected strong upsurge in demand for its exports. Rapidly increasing activity however exerted upward pressure on interest rates. If it were to keep interest rates low the Riksbank hence would have to insert liquidity into the economy, and it did so by pursuing state debt. Between 1946 and 1948 its holdings of state debt increased from SEK 1 bn to SEK 3 bn. This policy, however, led to a conflict between Ivar Rooth, the Governor of the Riksbank, and the Government. According to Rooth inflationary pressures should be combated by cuts in public spending and higher interest rates. The SAP government, however, refused to give in and Rooth stepped down in December 1948.

Also the postwar DNA governments considered low interest rates crucial. In line with other governments, a low level of interest was considered necessary to promote investment and full-employment. And like the SAP, DNA stressed low interest rates as an important instrument for bringing about more income equality. Low interest rates would mean low income for rentiers

598 See Lewin 167, p. 220.
599 See, for example, Rooth 1988, p. 68.
601 See Rooth 1988, p. 67-70, and appendix.
and would also keep housing rents low. In 1945 Norwegian authorities then decided to lower the yield on state bonds to 2.5%. Norges Bank discount rate was set at the same level and stayed there for the next five years.

Given the determination to pursue cheap money policies, it would seem plausible to expect a repetition of the experience of the years after 1918. The widely expected restocking boom could easily lead to a situation of relatively tight labour markets and buoyant demand so as to spark off an inflationary spiral. The monetary overhang looming over the economy, especially in countries which had been under German occupation, at the end of the war assured that sufficient fuel for this inflation would be available. Moreover, the desire to maintain low interest rates might force central banks to provide further fuel for inflation. Massive current account deficits in combination with low interest rates might easily provoke exchange depreciation, thereby adding one more source of inflation. In addition, even without a wage-price spiral under way, the sudden freeing of purchasing could easily contribute to widespread speculation and price rises. And even if escalating inflation could somehow be avoided the low interest rate policy might be compromised by excessive capital outflows if other countries would pursue more restrictive policies.

If governments had been confronted with a cumulative inflationary dynamic, policy choices which might have seemed inescapable in order to achieve political consensus might have to be reversed, just as they were in the early twenties. And with the resulting stabilization crisis and high unemployment the postwar consensus would soon have disintegrated. In such a case social scientists, with the quantity theory in mind, no doubt would have explained that the strong will to growth and expansion can not overcome the harsh economic realities of low growth, but only produces inflation. In retrospect the Labour movement, no doubt, would have lamented the failure to mobilize sufficient political resources, the betrayal of its leaders or the inevitability of crises under capitalism. To the right of the political spectrum, no doubt would have explained that it was the radicalism of the labour movement which had caused inflationary mayhem. Yet, despite a determined cheap money policy, nothing of the sort happened after 1945.

In principle four different strategies could be pursued to avoid a repetition of the post World War I inflation: (1) The central banks could adopt a restrictive policy so as to reduce the money supply and stimulate holding liquidity. (2) Governments could try to stimulate the production of goods in order for an increasing GDP to absorb the excess liquidity. (3) The existing currency could be declared invalid and replaced by a new one. (4) Or production and consumption and financial
transactions could be subjected to rigid controls so as to prevent a runaway inflation. Rather than installing new controls this strategy implied maintaining and even extending much of the wartime control apparatus.

The first option, obviously was excluded by the governments’ strong conviction that high interest policies would create an unacceptable economic recession. As Dutch finance minister Pieter Lieftinck (1987, p. 162), for example, argued: "The stricter these instruments are applied, the deeper the economic recession will be which is thus created." The second option was excluded due to the experience of the Post World War I period, where such a strategy had failed to lead to the expected gradual reduction of inflation rates. In occupied Germany the allies pursued the third option as the Reichsmark was replaced in 1948 by the Deutsche Mark (DM). Although currency reform obviated the need for a period of sharply restrictive monetary policies with all its consequences for the real economy, for countries other than Germany such a solution did not seem attractive because it also implied a radical change in the structure of wealth holding in the economy as all accumulated monetary assets were virtually destroyed.

As governments themselves were well aware that the determination to hold interest rates down could easily be compromised by a repetition of the inflationary conditions following World War I, economic policy strategies after World War II embraced the fourth alternative. In contrast to 1919-20, there was no bonfire of controls. To avoid the potential inflationary consequences of a cheap money policy, the Labour Party’s document, Full Employment and Financial Policy argued that subsidies to consumer goods in combination with direct controls on investment, prices, and finance were to be maintained. These proposals were echoed in the governments White Paper on Employment Policy (1944).\(^{602}\) This view corresponded, and indeed was influenced by Keynes views on the problem. As Keynes (JMK, Vol, XVII, p. 185-6) wrote on January 7, 1942, evaluating the lessons of 1921; "The main one [lesson] seems to be that all controls - rationing control, raw material control, new issue control, bank credit control and high taxation control - must be retained in principle for a period of at least two years and only gradually relaxed as and when consumer goods become available in greater quantities. If the vast bulk of purchasing power which must necessarily exist at the end of the war, is released in psychological conditions necessarily surrounding the end of the war, the result cannot be different from what it was in 1919 to 1921."

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While for Keynes the need to maintain regulations was clearly framed in terms of preventing inflationary pressures, the fear of a repetition of the recession of the early twenties provided an additional motive. The SAP did interpret the recession of 1920s not as the result of a restrictive policy but rather more as the inevitable result of the petering out of a postwar restocking boom. Even after the inflationary dangers of the restocking boom had passed, regulations were to be kept in place to prevent crisis and unemployment. The SAP committee on economic policies in the postwar period concluded already in 1943 that public regulation of prices, imports and foreign exchange had to be maintained so as to prevent speculative inflationary pressures after the war.\textsuperscript{603} Instead of abolishing price controls after the war they were even extended in 1947 in response to the build-up of inflationary pressures. In Norway, the new generation of economists, who would have a decisive impact on DNA’s policy, were strongly convinced that the best way to avoid an inflationary spiral was to maintain extensive regulations.\textsuperscript{604} Similarly in the Netherlands, both the Social Democrats and Catholics in 1945 were convinced that a relaxation of the wartime controls would inevitably lead to inflation.

Although there were cross-national differences, the direct regulations which governments imposed after the war in order to prevent inflation basically pertained to four areas. First, the comprehensive price controls which had emerged during the war were to be maintained. In Norway, for example, the law of May 8, 1945 instituted a so called ‘price directorate’ which was to have far-reaching competences not only with respect to prices but also concerning production. In occupied West Germany the allies decreed a general price stop at the end of the war. Control over prices was facilitated because, at least for consumer goods, post-war rationing systems were also kept in place. In addition many governments resorted to subsidisation of basic consumption goods so as to prevent a wage price spiral. Secondly, strict licensing of investment was to prevent excessive demand for investment goods. In the UK prospective investors required permits from the Capital Issues Committee, the public administration or central or local government. Thirdly, in contrast to the post 1918 period when governments had let the currency float down in order to solve trade balance problems, European governments after the war generally felt that devaluation was not likely to solve the balance of payments problem, but rather would create an additional source of inflation. Sweden, Norway and the Netherlands maintained their exchange rate with the Pound, whereas the Pound was remained stable with respect to the dollar. Instead strict rationing of imports was used

\textsuperscript{603} See Lewin 1967, p. 218.  
\textsuperscript{604} See Lie 1994.
to contain trade balance problems. And in order to avoid disruptive capital flows European currencies were protected by a tight wall of exchange controls. Apart from the abortive attempt with Sterling in 1948, currencies, in effect, did not become fully convertible until the late fifties. Sweden, which due to its intact productive apparatus did not suffer from trade balance problems, even decided to revalue the currency in the summer of 1946 in order to combat inflation.

Finally, efforts to moderate nominal wage increases constituted a central element in the policy of preventing a postwar inflationary crisis. Formal incomes policies after the war would only be pursued in the Netherlands and Norway. After the experience of the NSDAP regime both German unions and employers strongly rejected any form of state intervention in the bargaining process. In Britain and Sweden the TUC and SAP considered government directed wage bargaining a threat to their role and their internal cohesion. Yet despite the absence of formal tripartite incomes policies, in the climate of the immediate postwar years, governments could count on the support of the trade unions.

In the UK the Attlee government initially relied on exhortion to convince the TUC that a policy of wage moderation was of crucial importance. In the spring of 1946 the National Joint Advisory Council, a war-time tripartite body, was revived as a discussion forum for wage development. Foreshadowing the corporatist exchange logic which was to become of crucial importance in wage policy in many countries during the next decades, the TUC in the fall of 1947 agreed with the government’s suggestion of a voluntary wage freeze. The wage freeze was to be complemented by a freeze on incomes from profit and rent. In addition the government increased food subsidies and imposed a levy on investment income above £2000 per year. To further strengthen the element of equality, the government pressed the British business association (FBI) to accept a voluntary limit on dividends. Finally, the TUC suggested exemption for the lowest wages groups and for wage increase which would restore established wage differentials.605

In contrast to Sweden, Germany and the UK, in the Netherlands the state would come to occupy the dominant position in wage bargaining during the first two postwar decades. The so-called guided wage policy which was instituted in 1945, basically implied that wages were set by the minister of social affairs after having consulted the tripartite SER. In 1945 wages were set at 115% of their 1941 level and subsequently frozen until 1948 when an increase was granted in order to, partly, compensate for price increases.

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605 See Jones 1987, p. 37.
In Norway wages were frozen by the government for the duration of one year after the cessation of hostilities. In the 1946 wage bargaining round, the DNA, and in particular finance minister Brofoss pressured LO to moderate wages so as not to jeopardize economic recovery. In view of increasing inflation and balance of payments problems the government in the summer of 1947 suggested a wage stop, and the LO agreed.\textsuperscript{606} Wage bargaining up to 1952 took place at the national level between LO and NAF. In addition all agreements were subject to permanent compulsory arbitration (tvungen lønnsnemd) by the wage arbitration board (lønnsnemda), an independent body of experts appointed by the government.\textsuperscript{607}

Politically the maintenance of widespread controls for a transitional period after the war enjoyed consensus. The experience of 1918, when rapid deregulation had undermined rather than promoted recovery, informed the outlook not just of Social Democrats but of Liberal and Conservatives just as well. And while the latter may have pushed for a more rapid deregulation than Social Democratic governments were willing to undertake, the need for extensive controls was not contested.\textsuperscript{608} And while trade unions in 1918 generally pushed for an abolition of war-time wage controls, after 1945 they too were convinced of the need for extensive regulations. Obviously, the fact that Social Democrats were the governing party in most countries greatly facilitated a policy of voluntary wage restraint. Coming from a government which represented the interest of labour, appeals for nominal wage restraint carried much more weight. In Scandinavia this relation was most pronounced. Here Social Democrats had come to power in the thirties and pursued policies which were partly inspired by the trade unions and had directly benefited their bargaining position. When DNA and SAP after the war appealed for wage moderation both to promote recovery and assure the success of Social Democratic governments, unions were sympathetic. Given that Colijn remained in power until the late thirties Dutch unions had a more reserved attitude towards the government also after the law on collective bargaining of 1937. This law not only gave the government the power to declare collective agreements binding, it also contained the provision that, if the need should arise the government could annul collective agreements reached between business and labour. Although in the economic conditions of the thirties this provision was not going to be

\textsuperscript{606} See Leiserson 1959, p. 45-52.

\textsuperscript{607} See Cappelen 1981.

\textsuperscript{608} In Britain the manifesto of the liberal party, for example, argued: "This war has forced us to accept controls which cannot be suddenly relaxed without incurring the dangers of soaring prices and inflation." The Conservative Manifesto maintained that: "As long as shortage of food remains, rationing must obviously be accepted: the dangers of inflation also must be guarded against." Quoted in Cairncross 1985, p. 300. For Norway see Bergh 1989, p. 33-44.
used, the unions objected to it. Yet, by intervening in the labour market in a way beneficial to unions the Colijn government made a decisive contribution to change the unions attitudes towards state intervention and thereby lay the groundwork for the guided wage policies of the postwar catholic - social democratic coalitions.

Here then lay the major difference between the post World War I and II period. As the widespread use of wage and price controls and selective monetary policies successfully prevented an inflationary spiral, a regime change which gave priority to low inflation to the detriment of growth and unemployment was avoided. Yet, as controls effectively prevented the turn to a restrictive macroeconomic regime a different dilemma emerged. At the end of the war governments had recognized that wartime controls could not be prolonged indefinitely. However, as the postwar boom was generally expected to peter out within two to three years, this problem received fairly little attention. After the initial inflationary pressures the main problem was expected to become how to prevent deflation. As governments maintained low interest rates in order to mitigate the expected recession and as the inflationary problem was tackled without restrictive monetary policies, the postwar recession failed to materialize. Instead the defining problem for policy strategies since the fifties became how to simultaneously maintain low inflation and full-employment. Rather than during the immediate post war years, the crucial test for the new policy regime came in the late forties and early fifties. Would it be possible to combine high employment and low inflation in an economy without extensive physical controls, or would inflationary pressures again have to be broken by means of a restrictive macro regime which maintained a high level of unemployment?

Instead of giving rise to a new policy regime, the pressures of the late forties and early fifties led to three adaptations which would allow governments for the next decades to successfully combine moderate inflation with high employment. First, as war time controls were gradually abolished, bi- or tripartite incomes policy became the central pillar of a policy of moderating inflation. In the Netherlands, the system of guided wage policy was maintained until the mid sixties when it was replaced by a more corporatist pattern of wage bargaining in which unions gained a more equal position as compared to the previous system. In Norway such a corporatist system of wage bargaining was already established in the forties. In Sweden wage and price moderation through centralised bipartite agreement became the dominating pattern for the next decades. And although the government did not directly intervene until the seventies, the crucial importance of containing nominal wage growth so as to contain inflation strongly informed both bargaining

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partners. Wage bargaining was less centralised in Britain, yet voluntary or statutory wage moderation would be a constant element in British economic policy for the next decades. The exception to this pattern was Germany. In Germany tight labour markets would not emerge until the sixties. Yet this constellation was not due to a different macro regime which contained inflation by means of maintaining slack labour markets. Instead the massive inflow of refugees from Eastern Europe until the erection of the Berlin wall meant that in Germany above average growth would coincide with slack labour markets.

But despite the Unions’ willingness to carry a major share of the responsibility for keeping inflation down, the regime could not be stabilised by relying entirely on income moderation. A policy of continued wage moderation under tight labour markets posed a threat to the internal cohesion of trade unions. If labour markets were so tight as to induce individual employers to offer wage increases in an effort to attract labour, adherence to wage moderation would undermine the legitimacy of the unions leadership. Sweden had experienced such a situation already in 1947 as wages increased rapidly despite the fact that both LO and SAF made urgent appeals for moderation. In Norway tight labour markets and wage drift increasingly put pressure on the system of centralised LO-NAF bargaining and permanent compulsory arbitration. From 1952 onward bargaining became more decentralised and the permanent compulsory arbitration was abolished, although compulsory arbitration has been used from time to time up to the present. If nominal wage moderation was to be able to carry the main responsibility for keeping inflation down it would have to be supported by economic policies which prevented labour markets from becoming so tight that the ability of both labour market partners to maintain internal cohesion disintegrated.

Secondly, the deregulation of the late forties increased the importance of fiscal policies. But rather than using deficit spending in order to stimulate demand, fiscal policies became a tool for reducing inflationary demand pressures in an economy running at full speed. In Sweden such a use of fiscal policy was advocated by L.O economists Rehn & Meidner. In the UK this pattern emerged in 1947. The 1947 budget was the first postwar budget in which restrictive fiscal policies were explicitly conceived as a means to reduce inflationary pressures and thereby to lessen the reliance on direct controls. In the Netherlands inflationary pressures and current account deficits which emerged in the wake of the Korea boom saw the first application of restrictive fiscal policies.

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611 See Knoester 1989, p. 95-8.
Thirdly, continuous demand pressures prompted an adaptation of monetary policies. The rapid growth after the war and the consequent threat of inflationary overheating meant that the commitment to a rigidly low interest rate had to be abandoned. In response to the Korea boom the DNB for example, for the first time since the war increased its discount rate from 2.5% to 3% in September 1950 and again from 3% to 4% in April 1951. But, given the optimistic expectations about future demands and profits, Central Banks frequently found out that their traditional policy instruments were not effective. Starting from a low level in relation to expected profits moderate increases in the discount rate would do nothing to deter lending to industry. At the same time open market policies, by which the Central Bank would sell state debt to the public so as to reduce liquidity, would be difficult to pursue because the public generally held investment in industry to be more attractive.

In this constellation governments basically had two options to prevent an inflationary overheating of the economy. First, Central Banks could be allowed to raise interest rates radically so as to break the investment boom. Economically such a strategy carried the risk that it would create a major recession rather than just a relaxation of labour market conditions. Politically the strong preference for low interest rates stood in the way of such a strategy. With the option of a monetary stabilisation crisis barred, central banks resorted to a policy which, instead of reducing the willingness to invest sought to curtail the ability of the financial system to finance investment by means of credit rationing. Credit rationing implied that the government imposed a ceiling on the amount of lending the financial system was to undertake. For the commercial banks this meant that they might be directed to invest in state debt which then would allow the state to freeze the liquidity it received. Alternatively the central bank might simply decree a limit on the amount of lending commercial banks were allowed to undertake. In the equity market a rationing of credit could be achieved by restricting new emissions of share. In the Netherlands quantitative credit controls were used as a temporary emergency measure by the central bank in 1950. One year later the law on the credit system (Wet Toezicht Kredietwezen) codified the use of such instruments. In the same years also the Swedish Riksdag passed a law which gave the Riksbank the right to use measures of credit rationing. In Norway credit rationing was introduced in 1955 in the form of an agreement between the state and financial institutions. In the UK limits on bank advances to industry

612 For Sweden see Jonung 1993, p. 317. For the UK see Dow 1964, p. 236.
were used as an element of monetary policy since the late forties. Similar to the initial phase of credit rationing in Norway, restrictions on bank advances were brought about by informal pressure from the side of the government rather than by formal measures.613

In sum during the early fifties countries moved into a policy pattern which was to become typical for the next decades. When tight labour market conditions would threaten to put too much tension on the peak unions ability to enforce a policy of wage moderation, macroeconomic policies would resort to brief periods of restriction by means of fiscal and/or monetary policies so as to ease labour market pressures.614 Given the macroeconomic authorities’ long term commitment to growth and full employment and in a constellation where functioning incomes policies could be relied on to support a macroeconomic growth orientation in the long run, this brief periods of macroeconomic restriction would be interpreted as justifiable, rather than as a regime changes. Accordingly they could be employed without negatively affecting the engine of private sector growth; positive expectations about future growth prospects. With that, the adaptation of the new policy regime to a situation of inflationary rather than deflationary pressures had been completed.

5 The Breakdown of the Social Democratic Consensus

"The only reason we have unemployment is that governments are using it to contain, or to reduce, inflation." (Richard Layard 1986, p. 29)

"Es ist nicht möglich den tiefsitzenden Charakter der Depression in den industrialisierten Marktwirtschaften seit Mitte der 70er Jahre anders als durch die Notwendigkeit einer Inflationsbekämpfung zu erklären." (Hajo Riese 1987, p. 45)

5.1 Introduction

In essence the viability of the growth regime during the post war era depended on the ability to contain inflation through microeconomic means. In practice this meant increasing reliance on incomes policies because the price and quantity controls of the immediate postwar period could not be continued indefinitely. Despite their primary orientation to growth, macroeconomic policies did provide some assistance to the microeconomic efforts at containing inflationary pressures. In an international system where virtually all countries were committed to growth, adherence to the fixed

613 See Dow 1964, p. 235-42.
614 In Britain this policy is generally known as stop and go. British stop and go policies commonly are interpreted in a negative light. Yet in terms of growth and employment this was one of the most successful periods in British economic history. For a description of the short term policy cycles in Sweden see Martin 1985 and Swenson 1989, p. 144-7.
exchange rate regime of Bretton Woods did not function as an external constraint on domestic expansionary policies like the Gold Standard had done. Rather fixed exchange rates could serve as an anchor for the domestic price system, thereby assisting incomes policies in their effort to contain inflation. One important way in which this anchor operated was that firms had only a limited room for price increases. More important, when domestic demand conditions became too tight, brief periods of macroeconomic contraction could be employed to temporarily ease labour market pressures and thereby reduce the strain on incomes policies. Moreover in a constellation where functioning incomes policies could be relied on to support a macroeconomic growth orientation in the long run, these brief periods of macroeconomic restriction would be interpreted as just that, rather than as a regime change. Accordingly they could be employed without negatively affecting the engine of private sector growth: positive expectations about future growth prospects. As Tobin (1980, p. 19) argued: "As Keynes also knew, protracted underproduction and under-utilization severely damages the marginal efficiency of capital. In mild and short-lived recessions investment is buoyed by the belief that high employment and prosperity are the long term norm. Once this confidence is destroyed, as contemporary events again demonstrate, it is terribly difficult to revive it. The practical moral is that active policy, along with market response, is part of the social mechanism for maintenance or restoration of equilibrium."

Fig. 5.1: Private Consumption Deflators

![Percentage Change from Previous Period](chart.png)

Source: OECD Economic Outlook

- GER
- UK
- NL
- NOR
- SWE

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Yet, relying on incomes policies always is a precarious strategy. Ultimately trade unions are organisations designed to benefit their members in wage bargaining and not to function as an additional instrument in macroeconomic policies. As became clear during the late sixties the strategy of relying on microeconomic policies to contain inflation increasingly came into conflict with the organisational logic of the trade unions, especially so because many countries experienced a further reduction in unemployment rates during that decade. The oil price shocks in 1973 and 1979 further exacerbated inflationary problems (See figure 5.1). While some countries had fully embarked on a new regime already before 1978, in the wake of the second oil price shock restrictive macroeconomic policies in order to break inflation would become the general pattern in almost all European countries. Yet it would be incorrect to consider the oil-price shocks as the cause of the regime change. By itself the increase in oil prices only implied a once and for all increase in the price level of western countries. Even the Bundesbank recognized, in the form of its concept of an 'unavoidable rate of inflation', that such price increases were inevitable and should be accommodated. What governments rather reacted to were the increasing problems in the field of incomes policies which spelled the danger, not merely of a once and for all increase in prices but of an inflationary spiral. The replacement of the growth regime by a disinflationary regime during the last two decades hence is primarily a story about the disintegration of the ability to contain inflation by microeconomic means. And as a result of the regime change, mass unemployment again became a characteristic feature of West European economies (see Table 5.1)

While the regime changes in both the 1920s and 1930s took place within the span of four to five years, the transition to a new regime in the seventies and eighties took almost 18 years to be accomplished, from the Bundesbank’s turn to restrictive policies in the summer of 1973 to the pegging of the Swedish Krona to the ECU on May 17, 1991. In the late teens European countries were subjected, to a common shock - the upheaval of the First World War - which elicited, as we have seen, a common policy response. During the Great Depression the commitment to gold meant that policy shocks in the major countries were rapidly transmitted throughout the system. In the seventies and eighties, however, a common shock was not present. Nor were countries initially

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615 Moreover, it seems not correct to understand the oil price shocks as completely exogenous events. During the fifties and sixties oil prices had been quite stable although the price level in western countries generally rose. As a result real oil prices in fact deteriorated. The low but continuous price rises in Western countries lead many trade unions to include price compensation clauses in collective agreements. The oil price shocks can be likewise interpreted as a price compensation measure by the OPEC countries. In other words, while being a cause of part of the price increases in the seventies they were also partly a result of the previous inflationary tendencies in the West.

616 The turnaround in German monetary policies had taken place already before the advent of the first oil price shock.
willing to adjust their economic policies to the defense of a fixed exchange rate. Rather the Bretton Woods system broke apart as policy preferences came to diverge more sharply between countries which displayed a very low tolerance for inflation and countries where inflation was more easily tolerated in order not to jeopardize the commitment to full-employment. In addition institutional differences were more pronounced in the last two decades than during the two previous regime changes. The disparity between the highly centralised Swedish system of wage bargaining and the competing crafts and industrial unions in Britain, for example, did not have a counterpart in the twenties or the thirties. Yet in the end the differences in policy preferences and institutional setup only accounted for differences in timing, but did not allow for the durable coexistence of different policy regimes.

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<td>As a percentage of the total labour force</td>
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Note: German figures for 1991-3 refer to Western Germany
Source: OECD Economic Outlook, Several Issues.

The first countries to switch to a regime of macroeconomic disinflation, with its ensuing mass-unemployment, were Germany and the Netherlands, not because they were confronted with the most serious inflationary pressures, but because the political commitment to a growth regime was most precarious there.617 Due to the tradition of Tarifautonomie, Germany lacked an important policy instrument. The Social Democratic government of the late sixties did attempt to institutionalize tripartite consultations on wage prices and policies. The so-called 'concerted action' (konzertierte Aktion), a tripartite discussion forum, was created as part of Karl Schiller's Keynesian-inspired 'Stabilisation Law' (Stabilitätsförderungsgesetz) of 1967 and met for the first time on February 14, 1967. But, as Scharpf notes, the Concerted Action soon degenerated into a mass-meeting at which the leaders of the participating groups read prepared statements to the press.618 In addition the extreme hesitation in revaluing the DM in the sixties, and the drying up of immigration from the East, in particular after the construction of the Berlin Wall, put increased

617 See also Therborn 1985.
strains on the labour market. The humiliating defeat of the Government in the 1974 bargaining round with the public sector union (ÖTV), strengthened the Bundesbank in its resolve to combat inflation by means of radically restrictive monetary policies. The policy of announcing monetary targets, which was introduced by the Bundesbank in 1974, incidentally had the full support of SPD chancellor Schmidt.

Some of the smaller German neighbours, like Belgium and the Netherlands from the start placed overriding priority on a fixed exchange rate with the German Mark and hence also accepted German policy preferences. In the Netherlands the decision to follow Germany in a severe monetary contraction was mainly informed by the government’s (incorrect) perception that it could not rely on incomes policies to hold down inflation. The Netherlands, however, had travelled a quite different route than Germany to arrive at a similar fork in the road. The system of incomes policies which developed in the Netherlands after the war was the most rigid of any country. Rather than being based on bi- or tripartite negotiations, the state, in the person of the minister of social affairs, unilaterally decided how wages were to change from year to year. Trade unions in this system were effectively reduced to the task of gaining their members acceptance of state decisions. Politically this system rested on the tradition of pillarisation in which the leaders of the respective pillars could commonly elicit absolute loyalty from their base. However, especially in a very tight labour market in which wages were substantially below those in neighbouring Germany and Belgium, such an absolute obedience to the state sooner or later had to develop into a threat to the internal cohesion of trade unions. Moreover, after having reached its peak in the early fifties, the internal cohesion of the pillars, and the whole system of pillarisation itself was subjected to rapid decline.\textsuperscript{619} Both developments lead trade unions, since the late sixties, to require a ’corporatist’ system of political exchange in which actual bi-partite negotiations would take place and in which the state, following the corporatist exchange logic, would offer concession in economic policy in exchange for concession in wage bargaining.\textsuperscript{620} Being used to absolute loyalty, relying on wage bargaining in such a system was too precarious in the eyes of the Dutch policy-makers.

But while in the interwar period Germany (until 1933) and the Netherlands (until 1936) were fighting a losing battle by clinging to restrictive policies, in the seventies they were the pioneers of a regime which would come to be generally accepted in the next decade. Initially both larger countries, like the U.K., and smaller countries like Sweden and Norway, whose politically dominant

\textsuperscript{619} For an excellent analysis of the decline of Dutch corporatism see Hemerijck, 1992.

\textsuperscript{620} See Zimmerman 1986.
Social Democracy was unwilling to accept the consequences of a disinflation strategy in terms of lower growth and higher unemployment, opted for a more expansionary macroeconomic course. Yet, having the political will to continue the old regime was not a sufficient condition if the institutional apparatus to implement such policies was progressively disintegrating. Hence the first set of countries to follow the German and Dutch lead were those, like the UK, the USA, France, Denmark and Belgium, which did display a political desire to continue a macroeconomic growth regime but who lacked the microeconomic means for doing so. Especially Britain with its decentralised trade unions and exposed currency was institutionally ill equipped. By 1978 the British policy of a corporatist 'Social Contract' had ended in rampant industrial unrest and escalating inflation.

Yet, even after the Second Oil Price crisis Norway and Sweden maintained their course of giving priority to full employment. Here not only the political will for full employment was more pronounced, but also the institutional preconditions seemed ideally suited for such a strategy. Ever since the mid-thirties Norwegian and Social Democrats had presented themselves as the guarantor of employment and prosperity. Given the political and ideological hegemony of Social Democracy, full employment also became the highest priority for non Social Democratic parties. The combination of a hegemonic Social Democracy and strong and centralised trade unions implied that the ability and willingness to use (tri- or bipartite) price and incomes policies was rather pronounced. Furthermore, since central banks were tightly controlled by the governments, monetary policies could be conducted in line with the overall policy strategy. In line with most other countries, also Norway and Sweden had implemented far-reaching exchange controls in the run-up to the Second World War. In the postwar period, however, the policy of controlling cross-border financial flows was further extended and refined with the result that by the mid-seventies the isolation of domestic financial markets from developments abroad was probably stronger there than in any other developed industrial nation. In particular the system of credit rationing, by which the government tried to control the amount of credit flowing to (specific sectors of) trict economy without relying

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621 For example, not having to preside over a substantial rise in unemployment was the most urgent policy concern for the "bourgeois" coalitions which governed Sweden from 1976 to 1982.

622 This financial isolation stood in stark contrast to the openness in terms of trade and outgoing direct investments. Together with the Netherlands, Sweden, after the Second World War, developed the highest concentration of large multinational firms of any OECD economy.
on interest rate changes, dictated that a high degree of isolation of domestic financial markets be maintained. In terms of the microeconomic ability to contain inflation both countries also compared favourably to most OECD economies.

This institutional setup allowed for a macroeconomic policy assignment which rested on the shared responsibilities of the government and the trade unions. While fiscal and monetary policies were mainly geared to the defense of full-employment, the responsibility for price stability could largely be delegated to the wage bargaining process. In addition active labour market policies, especially in Sweden, were used to reduce frictional unemployment resulting from rapid structural change. Yet, in the second part of the eighties, also their adherence to full employment policies was abandoned. Eventually also Scandinavian Social Democrats had to discover that in the longer run it is not possible to give policy priority to full-employment instead of price stability. Despite their higher institutional capacity for incomes policies, the strong emphasis on employment caused Swedish and Norwegian inflation rates to be continuously above those in countries like Germany and the Netherlands. In addition, from the mid seventies to the mid eighties real interest rates after tax ex post frequently proved to be negative. But while most countries decisively moved to break inflationary expectations between the late seventies and early eighties, Sweden gave a major boost to its economy by means of a massive devaluation in 1982. For Norway the oil price increase itself meant a big boost in demand. As in the late teens, though less dramatic and sudden, quite optimistic expectations about the future plus expectations of continuous inflation strongly reduced the liquidity preference. And although this initially provided for an additional stimulus to the economy, soon widespread financial speculation emerged. Confronted with acute labour scarcity, escalating nominal wages and rampant financial speculation, also Scandinavian Social Democrats had no other alternative than to stabilize their price levels by means of macroeconomic restriction and at the costs of high unemployment.

To some extent the political dynamics of the regime change was somewhat similar to the change in the thirties as those parties who initiated the new regime generally were not able to profit from it electorally. Rather, the U-turns, many Social Democratic governments took seemed to signal the correctness of the Neo-Liberal critique that the Social Democratic policy model was fundamentally flawed. In Britain the change started in 1975 under Healey and Callaghan, but it was left to Margaret Thatcher to fully develop the new regime. Also in Germany the SPD could not thrive under a regime of high unemployment and it found itself in opposition from 1982 onward. Except for a brief interruption in 1981, the PvdA sat on the opposition benches between 1977 and 1989. Only Scandinavian Social Democrats fared better in electoral terms. Mainly due to

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disagreements amongst the bourgeois parties, the DNA remained the 'natural' governing party. The SAP did lose government tenure after it initiated the new regime, but here the rapid rise in unemployment worked in its favour and it could return to government in 1994.

In a complete reversal of the regulatory optimism of the post Great Depression era, state intervention since the seventies widely came to be interpreted as the cause of, rather than the remedy for, economic instability. Quite similar to the developments of the early twenties, the increasing intractability of inflationary problems caused the doctrine of the neutrality of money to return to the political stage. While Milton Friedman had been quite outside mainstream economics during the fifties and sixties, since the early seventies more and more governments converted to monetarism. But as in the 1920s, conversion to monetarism in no way implied the advent of non-discretionary or rule-bound monetary policies; quite the contrary. And also in this period the prediction that monetary contraction would only have short-term effects failed to come true. When it failed to disappear after the stabilization crises, durable mass unemployment again became interpreted in microeconomic terms, in particular as the result of the a failure of, especially trade unions to allow market forces to operate so as to clear the labour market. As a consequences supply side economics followed on the heels of monetarism, attributing the enduring recession to (policy induced) market distortions.

Yet, because of the long duration of the policy transition the change in orthodoxies was much more drawn out than in the twenties. At some point during the late seventies and early eighties it seemed that rather than to converge, economic policy strategies were diverging between more expansionary Social Democratic policies and restrictive Neo-Liberal regimes.623 Initially, therefore, the end of the Bretton Woods system seemed to reconfirm one of the basic principles of the growth regime, namely that governments were more willing to adjust the exchange rate than to sacrifice their domestic policy preferences.

Keynesians sought to explain this divergence in national policy strategies by incorporating the concept of corporatism into their analysis.624 While macroeconomic policies were still held to be effective, governments could only maintain full employment if trade unions would exert nominal wage moderation so as to prevent high inflation. Such a policy assignment however, could only be executed under a corporatist policy pattern of tripartite negotiations between the government

623 See, for example, Goldthorpe 1984.
624 The literature on corporatism is vast. See for example, Blaas & Guger, 1985; Cameron, 1984; Cawson 1986; Hall, 1986; Keman, 1984; Pekkarinen et al, 1992; Schmidt 1982, and Schmitter 1979.
and highly centralised trade unions and employers associations.\textsuperscript{625} But as even the corporatist show-cases of Austria, Norway and Sweden submitted to high unemployment and restrictive policies, such an interpretation became untenable. At this point the argument that restrictive policies had been forced on reluctant Social Democratic governments by external constraints, in particular by internationally mobile financial capital, became well neigh irresistible for Keynesians. This argument allowed them to maintain that macro policies were still effective - thereby not having to admit to a theoretical error- while the restrictive policies pursued could be attributed to force majeure - thereby not having to admit policy mistakes on the part of the Social Democrats. At the same time this view allowed them to arrive at the same policy conclusions as their academic counterparts, namely that expansionary macroeconomic policies were unavailable and that the key to renewed prosperity had to be sought on the micro level.\textsuperscript{626}

Yet also the interpretation that Social Democrats were overwhelmed by international financial markets is not tenable.\textsuperscript{627} Given the lessons policy makers drew from the Great Depression, one might have expected a proliferation of exchange controls and more active exchange rate policies, especially since, in contrast to the Great Depression, restrictive policies abroad and international capital flows now seemed to pose an acute threat to an expansionary policy regime. Instead, tighter policy convergence based on fixed exchange rates within the EMS became the norm in Europe. And while a tightening of exchange controls could indeed be observed during the late sixties and early seventies both by deficit countries in order to prevent excessive capital outflows and by surplus countries like Germany and the Netherlands to prevent excessive capital inflows,\textsuperscript{628} this development was soon to give way to widespread deregulation.

Given the dominance of domestic inflationary problems, the advent of policies which actively sought to increase external constraints was, however, not very surprising. Letting the currency float downwards in order to pursue a more expansionary policy in a restrictive environment did not seem

\textsuperscript{625} Subsequently the concept of corporatism changed meaning so as to adjust to the new economic orthodoxy. In a mixed form Garrett & Lange (1986) would attribute employment success both to Keynesian policies in the corporatist countries, and to neoclassical real wage flexibility in non corporatist countries. Theoretically more consistent Calmfors and Driffil (1988) came to interpret policy success in corporatist countries also in a neoclassical manner as centralised trade unions were assumed to pursue a wage policy which simulated the outcomes of a neoclassical labour market because they, unlike decentralised unions could not externalize the negative employment consequences of a rigid real wage policy. Katzenstein (1985), finally, provided the supply side interpretation as corporatism now came to signify a superior ability for microeconomic adjustment.

\textsuperscript{626} See, for example, Garrett & Lange 1991.

\textsuperscript{627} See chapter 6.

\textsuperscript{628} See Szász 1974.
a good alternative for governments who were preoccupied with domestic inflation. Rather exchange rate discipline became a welcome instrument to help implementing the new regime. Moreover, those governments who had switched to a macroeconomic disinflation strategy had no use any longer for an instrument like exchange controls which was designed to isolate the domestic economy from a more restrictive international environment.\textsuperscript{629} Rather exchange controls would now come to be considered a source of microeconomic inefficiency and an impediment to the international competitiveness of domestic financial institutions. In addition, promoting free capital flows could help stabilise the new regime as (the threat of) capital outflows could serve as a powerful - political and economic - hindrance to more expansionary policies.

Irrespective of whether it was seen to be caused by the inherent deficiencies of Keynesian deficit spending or the power of international finance, the new regime came to be interpreted as a redirection of attention from the demand to the supply side. Yet, the interpretation according to which policies had simply switched their instruments from macro to more micro-oriented policies in the face of the advent of a structural crisis and on the basis of unchanged policy preferences is not justified. A changing attention to promoting investment instead of consumption cannot be equated with a change of policy instruments from macro to micro. Instead the stimulation of investment, in the aggregate, is incompatible with a policy of high interest rates and a macroeconomic policy regime which is based on a willingness to increase interest rates whenever a threat to external balances appears. As Keynes himself had argued, investment depends on the difference between expected interest rates and expected profit rates, and accordingly a successful supply side policy aimed at stimulating growth will necessarily have to contain a macroeconomic element which encourages investment. The new regime, therefore, is more aptly characterized not as a switch from demand to supply side policies but as a change from growth policies to anti-inflation policies. As Tobin (1980, p. 30) noted: "...the behaviour of business investors and other economic agents was quite different in the mid-1960s when they thought that active macro policy would keep the economy at high employment and steady real growth from what it was before, and for that matter, from what it is now when they perceive that anti-inflation objectives have taken priority."

\textsuperscript{629} Strictly speaking, embracing monetarist policies provides an incentive for maintaining exchange restrictions because, as Kaldor (1983, p. 66) points out with respect to the British deregulation of 1979, the volume of money is more difficult to control in a deregulated system. If one interprets the new regime as being primarily informed by the goal to stop inflation by means of restrictive macroeconomic policies, rather than rigidly enforcing a money growth rule, Thatcher's decision is perfectly sensible. See also Lawson 1993, p. 38-42, 82.
Although the disinflationary regime was not less interventionist as compared with the previous one the common association of restrictive regimes with liberal policy and of the growth regime with interventionism is not entirely coincidental. Under the new disinflationary regime incomes and price policies were largely replaced by reliance on unemployment to produce nominal wage moderation. Seen in isolation the withdrawal of government from price and incomes policies and the reliance on unemployment might easily be interpreted as a return to market forces. Yet because such a policy takes place within the framework of a macro regime in which interventionist policies make sure that the appropriate labour market conditions exist to prevent a resurgence of inflationary pressures, such an interpretation is incorrect. Rather than as a return to reliance on market forces, the change to a disinflationary regime is better understood as the reassertion of the dominance of the state over civil society in economic policies.

5.2 Germany and The Netherlands

While many countries were already pursuing restrictive policies in response to domestic overheating, the oil price shock of late 1973 simultaneously imparted a massive inflationary plus an additional restrictive impulse to oil importing economies. According to OECD estimates the reduction in demand was approximately $16 bn. The upturn in unemployment rates, which resulted from these two restrictive impulses, provoked what in fact may be considered the first widespread use of Keynesian deficit spending. International bodies like the OECD strongly urged a Keynesian response because they feared that governments might be tempted to redress their current account problems by means of restrictive policies, thereby pushing the world economy further into recession.

Whereas Britain did not practice Keynesianism in the interwar period or the fifties and sixties, it did decide to do so in response to the first oil price crisis. British fiscal policies had already become expansionary in 1972 in response to high unemployment. In reaction to the oil price crisis the Labour government took further expansionary measures, although the budget had already been in deficit during 1973 (See Table 5.1). Especially because many other countries did not do so, a sizeable current account deficit developed. Germany instead improved its current account surplus during the oil price crisis. Yet this was not the result of domestic austerity but

630 See Matthews 1968.
631 See, for example, Healey 1989, p. 393.
mainly due to increased spending on German goods from the newly rich oil countries. Like the Labour Party, also the SPD/FDP coalition embarked on a programme of deficit spending. As a result the budget turned around from a surplus of 1.2% in 1973 to a deficit of 5.6% in 1975.

<table>
<thead>
<tr>
<th>Table 5.2 General Government Financial Balances</th>
<th>Surplus (+) or deficit (-) as a percentage of nominal GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>-------</td>
<td>-------</td>
</tr>
<tr>
<td>Germany</td>
<td>1.2</td>
</tr>
<tr>
<td>Norway</td>
<td>5.7</td>
</tr>
<tr>
<td>NL</td>
<td>0.6</td>
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<td>Sweden</td>
<td>4.1</td>
</tr>
<tr>
<td>U.K.</td>
<td>-2.7</td>
</tr>
</tbody>
</table>


In the Netherlands the 1973 elections had led to the formation of a government which could be considered the most leftist in the history of the country, just a few months before the oil crisis. The PvdA was the largest party in the cabinet with seven out of sixteen ministers. Since the rightist CHU did not take part, the Christian Democratic party of the cabinet also showed a relatively leftist tendency. Furthermore the Radical Party (PPR)\(^{632}\) and the left-liberals (D’66) were represented in the cabinet. The new Dutch cabinet, not surprisingly, attached a high priority to full-employment. Expansionary fiscal measures of the Den Uyl government until 1976 totalled more than 10 billion guilders. The bulk of additional spending was used for stimulating construction activity. But apart from the traditional instruments of tax reductions and increases of public investment, also less common measures, like wage subsidies and increases in social-welfare benefits, were part of the package. Although less dramatically than in Germany, also here the budget turned around from a surplus if 1973 to a deficit in the following years.

<table>
<thead>
<tr>
<th>Table 5.3: Dutch Governments 1973-1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>CDA</td>
</tr>
<tr>
<td>-----</td>
</tr>
<tr>
<td>1973-77</td>
</tr>
<tr>
<td>1977-81</td>
</tr>
<tr>
<td>1981-82</td>
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<td>1982-86</td>
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<td>1986-89</td>
</tr>
<tr>
<td>1989-93</td>
</tr>
<tr>
<td>1994</td>
</tr>
</tbody>
</table>

**Notes:** See table 3.3.

\(^{632}\) The PPR had split off from the KVP in 1968.
In 1973 European governments were determined not to repeat the mistake of the Great Depression by aggravating an economic downturn through restrictive policies. The Keynesian experiment, however, was of short duration. Confronted with massive budget deficits, runaway inflation and a run on the Pound in 1976, the British Labour government was forced to abandon its expansionary policies. In a widely noted speech at the 1976 Labour Party conference in Blackpool PM James Callaghan declared Keynesianism a failure: "We used to think that you could spend your way out of a recession and increase employment by cutting taxes and increasing government spending. I tell you in all candour that that option no longer exists, and that insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment in the next step."\footnote{633} In the Netherlands, likewise the year 1976 saw a change in fiscal policy orientation. In view of continuously high unemployment and an emerging current account deficit, the Social Democratic coalition government came to emphasise the need for budget consolidation instead of pump priming. In Germany, Keynesian policies experienced a brief flurry as a result of the internationally coordinated reflation packages agreed at the Bonn summit of 1978. The international recession of the late seventies, however, also terminated these policies.

An important reason for the failure of expansionary policies to produce the hoped-for effects in Germany and the Netherlands was that fiscal and monetary policy were uncoordinated. While the SPD embarked on expansionary fiscal policies in 1974 the Bundesbank had pursued a tightly restrictive policy since the end of 1973 in order to bring domestic inflation under control. While monetary policies were relaxed somewhat in the mid seventies, the highly restrictive policies of the Federal Reserve since the late seventies brought renewed restriction. In response to tight US monetary policies and an international recession, countries like Japan (1979) and Sweden (1982) devalued their currencies by a significant amount, thereby avoiding much of the recession. But since the Bundesbank was not willing to let also the D-Mark float down, sharply restrictive monetary policies were unavoidable. Dutch governments, in turn, were not willing to let the Guilder depreciate with respect to the D-Mark which implied that the Dutch Central Bank (DNB) had to closely match the policies of the Bundesbank.

The conflict between expansionary fiscal and restrictive monetary policies in 1974/75 and the failure of Germany to pursue a Swedish or Japanese style devaluation strategy in response to restrictive US monetary policies in the early eighties might easily seem to be the result of an

\footnote{633 Quoted in Callaghan 1987, p. 426.}
institutional peculiarity, namely the political independence of the Bundesbank. Legally the independence of the Bundesbank rests primarily on §§ 3 and 12 of the Bundesbank law (BbkG). § 3 BbkG states that the Bundesbank shall regulate the supply of money and credit to the economy with the goal of safeguarding the currency. The indirect channels of influence which the Federal Government can use are quite limited as it can only appoint 10 out of 21 member of the central bank council (ZBR, Zentralbankrat). Furthermore these members are appointed for a fixed (renewable) term of eight years. The only more immediate means of influence at the disposal of the Federal Government is the right to postpone decisions of the Zentralbankrat for a period of up to two weeks. Unlike the other countries examined in this essay the goals of monetary policy hence seem to be beyond the purview of the Government.

The Bundesbank’s predecessor, the Bank deutscher Länder (BdL) was founded on March 1, 1948 by the Western Allies and hence predated the foundation of the Federal Republic itself. The statutes of the BdL provided that the bank should conduct monetary policy independent from any directives by German political authorities. The allied banking commission, however, did have the right to issue directives to the bank. Whether this subjection to political authority should be maintained in the newly founded FRG, or whether the central bank should remain independent of German authorities also after the allied banking commission had ceased to exist was a highly controversial issue. Finance minister Schäffer argued that the future Bundesbank should be subjected to government directives because the federal government should not have its economic policies dictated by the central bank council. Chancellor Adenauer initially supported and independent bank, but after 1950 came to advocate more government control. In a famous speech at the annual conference of the Federation of German Industry (BDI) in Köln-Gürzenich on May

634 "Die Deutsche Bundesbank regelt mit Hilfe der währungspolitischen Befugnisse, die ihr nach diesem Gesetz zustehen, den Geldumlauf und die Kreditversorgung der Wirtschaft mit dem Ziel, die Währung zu sichern, und sorgt für die bankmäßige Abwicklung des Zahlungsverkehrs im Inland und mit dem Ausland." § 3, BbkG.

635 "Die Deutsche Bundesbank ist verpflichtet, unter Wahrung ihrer Aufgabe die allgemeine Wirtschaftspolitik der Bundesregierung zu unterstützen. Sie ist bei der Ausübung der Befugnisse die ihr nach diesem Gesetz zustehen, von Weisungen der Bundesregierung unabhängig." § 12 BbkG.

636 "Die Mitglieder der Bundesregierung haben das Recht, an den Bereitungen des Zentralbankrates teilzunehmen. Sie haben kein Stimmrecht, können aber Anträge stellen. Auf ihr Verlangen ist die Beschlußfassung bis zu zwei Wochen auszusetzen." § 13, art 2, BbkG.

1923, 1956 Adenauer openly condemned the BdL’s decision to increase the discount rate from 4.5 to 5.5%. Whereas this position had the wholehearted agreement of BDI president Fritz Berg, Adenauer did not enjoy the full support of his cabinet. Economics and finance ministers Erhard and Schäffer had participated at the ZBR meeting on 18 May 1956 and expressed support for the BdL’s decision. As far as the question of the political independence of the future Bundesbank was concerned, Erhard was, together with the BdL itself, Schäffer’s most determined opponent. Erhard argued that the Federal government should be able to influence monetary policies, but that such influence should not take the form of directives but should rather be exerted through the government’s right to nominate members of the bank and by means of suasion. By the time the BbkG was finally ratified by the Bundestag on July 4 1957 Erhard had managed to build a broad political consensus, including the SPD, in favour of his views. Also the Bundesbank was to remain independent from direct intervention by the government, yet some indirect channels of influence were strengthened.

Given a politically independent Central Bank whose sole priority is to contain inflation, a regime which delegates the concern for price stability mainly to labour market institutions would seem institutionally impossible. As Scharpf (1987) has shown in a game theoretical analysis, for a Central Bank whose prime concern is low inflation the optimal strategy is to pursue restrictive policies which will maintain a sufficiently high level of unemployment rather than to rely on the cooperation of the trade unions and thereby risking a failure to achieve its goal. Yet, it would be incorrect to argue that the new policy regime was imposed upon the German government by the Bundesbank.

Even from a purely legal point of view, the independence of the Bundesbank is not as watertight as it may seem at first sight. First, despite the absence of a right to give directives to the Central bank, the decision-making process on monetary policy is legally a matter for both the government and the bank, since the government has the right to decide on exchange rate arrangements. At several points in its history, the Bundesbank has found the Governments decisions on exchange

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638 See Hentschel 1998a,b.
640 The government, for example, received the right to postpone a ZBR decisions for up to two weeks.
641 The only exception to the is Sweden where Sveriges Riksbank and not the government has the prerogative to decide on matters of exchange rate arrangements. As one Riksbank official remarked in an interview with the author, the statutory autonomy of the Bundesbank does not mean all that much as long as the government has the right to determine what exchange rate policies the Bank shall pursue.
rates to act as a infringement on its policy autonomy. Secondly, since § 3 BbkG does not distinguish between external and internal stability of the currency, it is legally not entirely clear whether this § does indeed unambiguously direct the Bundesbank to give absolute priority to low inflation. With respect to a similar formulation which parliament had asked him to insert in the 1948 law on the DNB, Dutch finance minister Pieter Lieftinck (1989, p. 166) remarked: "The currency has both an internal value, expressed in the domestic price level, as well as an external value, expressed in the exchange rates. Frequently stabilisation of one value excludes stabilisation of the other. The formulation desired by parliament, in my eyes, was, therefore, rather inconsequential (nietszeggend)." Thirdly, the independence of the Bundesbank is not anchored in the constitution; a simple parliamentary majority is sufficient to alter the BbkG.

Fig. 5.2: Private Consumption Deflators

642 The present president of the Bundesbank, Hans Tietmeyer, while discussing the desirable legal structure for a European central bank, shies away from the logical point that the ECB should have full control over exchange rate decision in order to be truly independent, but he does recognize the presence of an unprotected flank and hence advocates: "dass dem EZBS ein hinreichendes Mitwirkungsrecht über die äussere Währungspolitik eingeräumt wird. (Tietmeyer 1990, p. 307–8).

643 Indeed the formulation of § 3 BbkG was left vague on purpose because a concrete definition of what "safeguarding the currency" meant might have entailed the risk of legal action against the bank in case it failed to reach its goal. See Hentschel 1988b, p. 104.

644 § 73, art. 4 of the Basic Law (Grundgesetz) states that monetary affairs are the exclusive prerogative of the federal authorities while § 88 simply states that the federal authorities create a central bank. Tarifautonomie, in contrast, is guaranteed by the Basic Law (§ 9).
One important reason why the legislators eventually decided to grant also the Bundesbank independence from German authorities was the favourable experiences with the conduct of monetary policies by the BdL. Except for the, in fact rather minor, collision between Chancellor Adenauer and the BdL in 1956, a conflict between growth oriented economic policies and a central bank intent on keeping a stable price level at all costs did not materialize. Although inflation rates were lower in Germany already than in most other countries during the 1950s, the BdL certainly did not pursue a policy of absolute price stability (See figure 5.2). More important, the large influx of labour from Eastern Europe meant that a growth oriented monetary policy during the 1950s did not have to confront the problem of inflationary pressures arising from tight labour markets. Nor did the BdL share the monetarist position which the Bundesbank was to embrace in the early seventies. Erhard’s draft of a Bundesbank law of October 25, 1995 contained the provision that the Bank should be allowed to increase the currency in circulation only up to a maximum of DM 1 bn at the time. Moreover, the bank would only be allowed to do so if the government agreed. The BdL, however, opposed this provision on the grounds that increases of the amount of currency in circulation were the symptom rather than the cause of inflationary developments.

From its foundation in 1957 until the early seventies also the Bundesbank pursued a growth oriented policy out of its own accord and not primarily because it had no choice under the Bretton Woods regime. As former Bundesbank President Emminger (1987) remarked, during the fifties and sixties the Bank did not yet recognise the existence of a possible contradiction between the requirements of external exchange rate stability and domestic price stability. During the fifties such a constellation did indeed not exist as the slack labour market situation would have made it quite difficult for a serious inflation to develop. In 1960 the unemployment rate, however, dropped below 1% and stayed there for the rest of the decade with the exception of the years 1967-68 (See Table 5.4). Yet even under tight labour markets the Bundesbank did not call for a regime change in monetary policy. During this period the Bundesbank, like most other central banks, apparently felt strongly that the growth of industry, and export industry in particular, was the key to economic success, rather than low inflation, as it came to argue starting in the seventies. In response to the

646 The population of West Germany increased from 43 m in 1939 to 54.3 m in 1958. Source: Schlesinger 1976, p. 556, 559.
647 See Hentschel 1988b, p. 92.
648 In his inaugural speech in 1980 new Bundesbank president Karl-Otto Pöhl, for example, argued that tight money and economic growth are not contradictory. See Balkhausen 1992, p. 139.
tightening labour market pressures and mounting inflation, the Bundesbank did initially decide to steer a more restrictive course. In June 1960 the ZBR decided in favour of a restrictive package consisting mainly of a 1% increase of both the discount and Lombard rates, a reduction of the commercial banks’ discount facilities and an increase of the reserves they were require to hold at the Bundesbank (Mindestreserven), plus a prohibition to pay interest on deposits by non-residents. One week after these measures, however, the Federal Reserve decided to lower its interest rates with the result of a massive inflow of foreign funds into Germany. The threat to the restrictive monetary policies this entailed might have been easily solved by letting the DM appreciate. Yet, at a meeting with the Federal Chancellor on August 4 1960 such a solution was rejected. As Emminger (1987, p. 111) reports Bundesbank president Karl Blessing fully supported this decision. Instead the Bank called upon the Federal Government to increase capital outflows, for example in the form of development aid, so as the reduce the upward pressure on the DM. In this Blessing was in full agreement also with German industry. In the fall of 1960, for example, Hugo Rupf, the president of the German association of machine tools manufacturers (Maschinenbauverband) organised a DM 1.5 bn loan from German industry for development aid purposes.

<table>
<thead>
<tr>
<th>Year</th>
<th>Germany</th>
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<th>Sweden</th>
<th>Britain</th>
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Source: Maddison 1982

649 See also Strange 1980, p. 51-52.
650 See Emminger 1987, p. 112.
The basic growth orientation of the Bundesbank, also under tight labour markets, became even more apparent in 1961 in connection with the discussions about a possible revaluation of the DM. Shortly after the DM had become convertible with respect to the Dollar in 1959, the massive trade surplus indicated that it was seriously undervalued. Partly in response to international pressures, the government began considering a revaluation, but the Bundesbank, strongly supported by the CSU minister of economics Franz-Josef Strauß, was adamantly opposed. Bundesbank president Blessing even threatened to resign, although he eventually decided not to carry out his threat when the government gave in to pressures and revalued nevertheless.651

<table>
<thead>
<tr>
<th>Date of Investiture</th>
<th>Chancellor</th>
<th>SPD</th>
<th>CDU</th>
<th>CSU</th>
<th>FDP</th>
<th>DP</th>
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<td>R</td>
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<td>R</td>
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</tbody>
</table>

Notes: See table 3.3.

The Bundesbank, admittedly, did support SPD economics minister Karl Schiller when he, against the wishes of the CDU/CSU cabinet majority, proposed to revalue the DM in 1968. Yet, this episode did not mark a decisive change in Bundesbank thinking. Three years later, Schiller and Bundesbank president Klasen found themselves in opposite camps. In accordance with the views held by the majority of banking and industry, Klasen strongly opposed Schiller's decision to temporarily float the DM, and proposed exchange controls instead.652 According to Emminger (1987, p. 230) the ZBR itself was split on the issue. Whereas the majority supported Klasen, a minority of seven members advocated floating. One year later (1972) the same debate was repeated.

651 See also the Bundesbank's annual report for 1960 (which was published after the revaluation of March 7 1961), in which it strongly warns against further revaluations because of the damage to exports.
652 See Balkhausen 1992, p. 103.

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but this time Klasen prevailed. Rather than constituting an obstacle, the policy of the Bundesbank contributed to a policy regime in which the responsibility for low inflation increasingly was placed on the shoulders of labour market institutions. Indeed, the reason why Schiller proposed revaluation in 1968\(^{653}\) and floated the DM in 1971 was that he feared the tight labour market would threaten the DGB’s ability to maintain its policy of wage moderation.

The definitive change in policy orientation at the Bundesbank apparently came between Klasen’s resistance against floating in 1972 and the US decision to devalue the Dollar by 10% on the 12th of February 1973. Although the devaluation of the Dollar, combined with an upward float of the Yen, did manage to calm down exchange markets, the relief was only of short duration. In the beginning of March a new wave of speculation against the Dollar broke loose. On March 1, the Bundesbank alone bought $2.7 bn in order to defend the parity. Confronted with this renewed onslaught, the government and the Bundesbank, on March 2 1973, decided to float the currency; a decision soon followed by other European countries. The Bundesbank used the floating of the DM to administer a severe monetary restriction. The bank now came to consider nominal revaluation as a means to promote domestic price stability, both directly because of the pressure exerted on domestic prices and indirectly by alleviating the need for the Bundesbank to maintain the parity by means of expansionary policies. Yet this new policy orientation did not mark a rift between the Bank and the government. The change to restrictive policies after the D-Mark had begun to float relative to the Dollar in 1973 as well as the switch to monetary targeting in 1974 were clearly supported by the government. Although there is some dispute as to where exactly the idea of monetary targeting originated in Germany - within the Zentralbankrat, the Sachverständigenrat, or from Helmut Schmidt - it is clear that the SPD government did not object to this new type of policy.\(^{654}\) After the escalating wage bargaining round in 1974, and especially after the embarrassing defeat of the government in the negotiations with the public sector trade union ÖTV, monetary targeting to chancellor Schmidt was a welcome device which could restore discipline in the labour market.\(^{655}\)

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653 He succeeded in 1969.
655 The perception that the labour market needed more discipline was probably also strengthened by the fact that the D-Mark was now floating and world-market prices accordingly could not necessarily be counted any more to perform that function.
The Bundesbank and the government remained in agreement about monetary policies until early 1979. After it had brought about an increase in unemployment rates and had clearly signalled the change in regime, the Bundesbank assumed a more relaxed stance from late 1974 until late 1978. When Chancellor Schmidt agreed at the Bonn Summit in 1978 that Germany become the 'locomotive' which was to pull the world economy out of the recession, the Bundesbank ended up supporting the government course, although president Emminger had been initially reluctant. The tighter policies of the Bundesbank as of early 1979 (See Table 5.6) did, however, prompt an open conflict between the Bank and Chancellor Schmidt. However, as the immediately following period showed, it is quite doubtful that Schmidt was calling for a regime change whereby the fight against inflation should again be delegated to the Labour market institutions so that the Bundesbank could concentrate on stimulating the economy.

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<th>Table 5.6: Central Bank Money Stock. Targets and Outcomes</th>
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As a result of Paul Volcker's turn to extremely restrictive monetary policies on October 6, 1979, the D-Mark came under strong downward pressure. In 1980 a veritable crisis of confidence in the D-Mark erupted. At first the Bundesbank tried to stem the outflow of funds by a combination of intervention on the currency markets and increasing the discount rate. After it lost about one quarter of its reserves between October 1979 and April 1980, the Bundesbank decided to move to a fully restrictive policy. Monetary policy was progressively tightened over the next year, especially in February 1981, and a more relaxed stance was only assumed from mid 1982 when downward pressures on the DM had abated.

The Bundesbank admitted that from the viewpoint of the domestic economy the restrictive policy could not be justified, but argued that such policies had to be pursued due to external pressures, i.e. the Federal Reserve's policy. Yet there would have been another alternative at this point than to follow the Fed's lead. In response to high US interest rates, the Japanese government let the Yen float downward by more than 20%. As a result the Yen now became considered undervalued which caused expectations of a revaluation. By means of such a policy the Japanese government in fact

656 Scharpf 1987, p. 189.
de-coupled itself from US policies, both because devaluation obviated the need for domestic restriction and because the expectations of revaluation allowed for lower domestic interest rates. As will shall see in the next section, the SAP government under finance minister Feldt pursued a similar strategy in 1982.

The Bundesbank council would never have agreed to such a strategy because it implied abandoning the priority of low inflation in monetary policy and a delegation of this task back to the labour market. Yet also Chancellor Schmidt and the rest of the government did not advocate such a strategy. As Schmidt argued in late 1979: "We were also the first (government) to understand that you cannot cure the world's economic structural crisis by printing money. We'll not give up our conviction in that field. Others are on the verge of giving it up, some don't have the strength to do it although they understand its being necessary. No, we will not accept wrongly so-called Keynesian recipes for a totally non-Keynesian situation." It is true, Helmut Schmidt complained bitterly about unnecessarily high interest rates in 1981. Yet he agreed that the DM should not be allowed to devalue like the Yen, he merely believed that the exchange rate could be stabilised also at somewhat lower interest rates. Whether Schmidt was right or not is difficult to say, but it is clear in any case that as long as it was accepted that the Bundesbank should follow the Federal Reserve's policies, economic developments would not have been much different in Germany even if Schmidt had had his way in 1981. In Germany a Japanese or Swedish style strategy, was only advocated by a minority. Hans-Jürgen Krupp, former President of the German Institute for Economic Research and main economic adviser of the SPD, was one of them. Similarly Alois Pfeiffer of the DGB board suggested that the Bundesbank let the DM devalue, and he assured that the trade unions would exert moderation in order not to increase inflationary pressures.

Ironically the change in US policies was partly brought about by the Bundesbank itself. As strong downward pressures on the Dollar emerged by mid-1979, American officials urged the Bundesbank to lower its discount rates so as to relieve pressures. Instead the Bundesbank matched the FED's discount rate increases and decided to aim for the lower band of the monetary target. This decision, which was widely criticized throughout Europe and the U.S., is seen by Spahn as the centre-piece of a risky strategy that intended to put the Dollar under pressure in order to force

657 Helmut Schmidt, Interview with The Economist, September and October 1979, reprinted in Hanrieder 1982, p. 211.
the Federal Reserve on a restrictive course. Yet this episode does not allow for the conclusion that the Bundesbank must indirectly be held responsible for the change in US monetary policies and for the international recession which followed. As the policies of 1985 and the spring of 1995 show, the Federal Reserve at times has taken an attitude of benign neglect with respect to a massive downward slide of the Dollar. Yet, in 1979 the main concern of the Federal Reserve was domestic inflation, and under those circumstances a massive devaluation was intolerable. Monetary policy in the U.S. had become more restrictive since the fall of 1978. Despite this restrictive policy, monetary growth remained strong as inflationary expectations contributed to a rise in velocity. The Federal Reserve had apparently lost control over monetary aggregates and could only hope to regain it by wielding the big stick of a monetary shock therapy. It was only in such a constellation of domestic inflationary pressures that the Bundesbank could exert effective pressure on the Federal Reserve by not supporting the Dollar.

In the Netherlands the DNB, ever since the breakup of Bretton Woods had given priority to maintaining a fixed exchange rate with the DM. In the eyes of the DNB such a policy was necessary in order to contain inflation. As the DNB decided to maintain a fixed parity with the DM, the pattern of monetary policy was largely similar to Germany. Also here restrictive monetary policies counteracted more expansionary fiscal policies in 1974 but the conflict eased in the second part of 1974 as the Guilder was strong on international markets. From March 1976 the guilder came under downward pressures which abated during the summer but again reemerged strongly during August. In reaction to the capital outflows the Bank tightened monetary policy in order to defend the exchange rate. Money market rates were raised and the contraction of liquidity was not sterilized. At the same time the Bundesbank intervened heavily on the foreign exchange market in favour of the Guilder and allowed its monetary target to be exceeded. Pressures abated in August, but nevertheless realignment of parities within the Srake, the first in three years, was agreed upon in October. The Dutch Guilder was devalued 2% percent with respect to the DM. And also here the change in Federal Reserve policy led to strongly restrictive monetary policies. In 1979, for example, the DNB reintroduced quantitative credit restrictions, in addition to higher interest rates, in order to reduce the liquidity position of the economy.

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659 See Spahn 1988A, p. 94 and 1988B p. 19. According to Emminger (1986 p. 455), however, the switch to more restrictive policies was only made after it had become clear that the Dollar had begun to recover.

As in Germany, conflicts between the (Social Democratic) government and the Bank have been few. The most serious conflict during the last four decades occurred under a Christian-Liberal coalition on 18 December 1980, when the Board of the DNB took the unprecedented step of writing a letter to the minister of finance in which it argued that the budget deficit was undermining the efforts of monetary policy to maintain the parity and contain inflation. If the budget deficit would not be reduced, the DNB threatened even tighter monetary policies. During, and shortly after the Social Democratic/Christian coalition of 1973-77 some critique was voiced with respect to the exchange rate policy of the DNB. As the policy of maintaining the parity with the DM especially during 1977 and 78 implied a revaluation with respect to many other countries, some Social Democratic politicians and economist argued that the DNB was counteracting the policy of improving competitiveness by means of wage moderation, and thereby was in fact preventing a reduction in unemployment. In an interview, given years after he left office the Minister of Social affairs in the PvdA/Christian coalition complained that it was frustrating to urge workers to moderate wage in order to increase employment while the Bank was revaluing at the same time. Wim Kok - Chairman of the FNV trade Union under the PvdA Christian coalition, minister of finance from 1989-93 and presently prime minister - even argued that the differences in monetary policy was one of the crucial reasons why Sweden could pursue a successful policy of full-employment whereas the Netherlands could not. "Sweden has created itself space in monetary policy which, in a not unimportant way, made it possible to give priority to employment instead of to reducing inflation and maintaining the value of the currency." In response to criticism of its exchange rate policies in the seventies, the DNB, however argued that devaluations merely would promote a cumulative wage price spiral.

Legally Dutch governments are in a much stronger position with respect to their German colleagues. In 1948 the DNB was nationalised and the new Central Bank law explicitly gave the minister of finance the right to issue directives to the DNB. As Wellink & Halberstadt 1985 (p.191) point out: "Whether in the case of a real clash (between the government and the DNB) the government would come out on top depends on the prevailing political situation, as the Minister of

661 See van Straaten 1989, p.306.
662 See Visser & Wijnhoven 1989, p. 91.
664 See, for example, Brugmans 1983, de Jong 1960, Schotsman 1987.
Finance could always resort to direct financing of the budget deficit abroad or put in practice section 26 of the Bank Act, giving directions for the Bank’s policy 'to be properly coordinated with Government’s monetary and financial policies.'

Yet despite, Kok’s remarks of 1989, there are no indications that the PvdA, or any other of the major parties, ever seriously advocated a Swedish strategy of flexible exchange rate so as to be able to prioritise full-employment in a restrictive international environment. In a parliamentary debate about exchange rate policies on April 13, 1978 PvdA MP Wöltgens did suggest that the DNB should take a more independent position from the Bundesbank, yet he was not wiling to draw the logical conclusion and advocate devaluation. In a similar debate on 24 September 1979, PvdA MP Kombrink encountered a similar problem with his arguments. He argued that the policy of the DNB neutralized the positive effects of wage moderation. In response to critique from the government he, however, explained that he did not advocate devaluation, but thought that the Guilder should not appreciate. But as the DNB pointed out, that was a contradictory position, because given the depreciation of the Dollar during the previous years a policy of maintaining the real exchange rate would have required devaluations within the EMS framework.665

Why then did Dutch and German Social Democrats not advocate a Swedish or Japanese type of strategy in the late seventies? Why did they adhere to a restrictive regime even after the wage price spirals of the early seventies had disappeared, instead of advocating a regime which delegated responsibility for inflation again to labour market institutions? One possible answer would seem to be that such a strategy was not politically viable and that, therefore, it was useless to advocate it. In Germany such a policy would have faltered on the resistance of the Bundesbank. The DNB would also have been adamantly opposed and the PvdA would most likely not have found a majority amongst the 'bourgeois' parties. Yet, if Social Democrats had perceived a possible alternative which could have reduced unemployment, they would certainly have advocated it, even if, from a political point of view, it was not immediately feasible. Moreover, given the high capacity for wage moderation which both Dutch and German trade unions again displayed since the mid seventies, such a strategy would not have to falter on the inability of the trade unions to cooperate. Yet, the answer seems to be that both parties in the late seventies, were not really convinced that their central bank presidents were wrong when they argued that a devaluation strategy might provoke a renewed price wage spiral. At this point in time, the outlook of both parties was still to a substantial degree shaped by the historical failures in incomes policies which they both experienced in the sixties and

early seventies. For Germany, in addition the strong tradition of Tarifautonomie, meant that there was no framework for the unions and the government within which to discuss such a strategy. In the Netherlands, however, virtually all parties and even the trade unions, did not really perceive the need for such a strategy, as incomes policies were interpreted mainly in terms of real incomes policies. The task of incomes policies in this framework was to reduce unemployment by means of increasing export competitiveness. And as long as the central bank did not pursue an aggressive revaluation policy, restrictive monetary policies only by very few were considered the main obstacle to full-employment.

After the experience of the Weimar Republic and the Third Reich, the German trade unions came to consider the principle of government abstinence from wage bargaining (Tarifautonomie) as one of their most sacred achievements. While the Dutch form of wage policy meant that the DNB could successfully rely on low wage increases in the fifties, the abundant supply of labour achieved the same result in Germany.\textsuperscript{666} Despite unprecedented growth rates and strong employment growth, the massive influx of labour, first from eastern and afterwards from southern Europe, kept unemployment at a fairly high level throughout the 1950s. With the erection of the Berlin Wall the supply of labour from the east dried up, and although German industry started to recruit foreign workers from southern Europe, the unemployment rate dropped rapidly. Hence from now on the threat of wage inflation became an increasing concern for monetary policy.

With increasingly tight labour markets since the early sixties, the state came to question the concept of Tarifautonomie. In particular it came to perceive an increasing need to influence wage bargaining as a way of containing inflation.\textsuperscript{667} For chancellor Erhard the solution was to be found in a stronger control of the state over organised economic interests. Erhard, partly in response to Adenauer’s close relationship with the BDI,\textsuperscript{668} was quite hostile with respect to giving organised interest groups access to the centres of political decision-making. For Erhard, the competing demands organised interest made on the state were detrimental to the economy.\textsuperscript{669} Yet under the conditions of the sixties, this aversion against organised economic interests could not give rise to a ‘liberal’ style of policy-making in which organised interests were kept at a distance from the

\textsuperscript{666} Cf Emminger 1987, p. 29, Jacobi et al 1992, p. 220.

\textsuperscript{667} The scientific advisory council of the economics ministry (Wissenschaftlicher Beirat beim Bundeswirtschaftsministerium) already pleaded for the introduction of incomes policies in 1956. See Cassel 1972.

\textsuperscript{668} Erhard, for example, thought that Adenauer’s close relationship with the BDI prevented the Chancellor from acting more energetically against price increases. See, for example, Erhard’s letter to Adenauer of January 30, 1956, quoted in Koerfer 1987, p. 88.

\textsuperscript{669} See Abromeit 1994, p. 163.
government. Such policy-making style would only be possible, though not necessary, in a regime of high unemployment. As long as German economic policy authorities were not willing to rely on mass-unemployment, the state had to seek closer relationship with organised economic interests. Somewhat similar to Britain, where Conservative PM Edward Heath in the early seventies was forced to make a U-turn form Neo-Liberalism back to corporatism, Erhard’s objections to interest group involvement were not translated into weakening the state’s relations with civil society but rather into a call for a stronger direct influence of the state over the organisations of civil society. As distributional struggles intensified, Erhard argued, the Liberal stage, inaugurated by him as minister of economics, should now make way for a more structured polity. The concept of the Formierte Gesellschaft, which Erhard presented in his inaugural speech as federal chancellor to the Bundestag on November 10, 1965, envisaged the formation of a corporatist society in which the state would dominate organised interest groups and use them as instruments of economic policy.

In response Karl Schiller of the SPD advocated a corporatist solution, in which interest groups and the state were to interact on a more equal footing than envisaged by Erhard. Schiller’s Konzertierte Aktion, a tripartite meeting for the purpose of coordinating economic policies, was part of the introduction of Keynesian concepts of discretionary fiscal policy aimed at influencing short-term demand conditions (Globalsteuerung). In response to the inflationary pressures resulting from tight labour markets in a booming economy, German economic policies were hence converging towards the pattern of its West-European neighbours.

In what might have been the beginning of the 'stop-go' policies pursued in other countries, the Bundesbank tightened monetary conditions in 1967 so as to create a recession. In response to the recession Schiller’s new concepts of Keynesian policies were first put into practice as he convinced the unions to show moderation while embarking on fiscal expansion. Yet both the trade unions and the Government would look back with bad memories to this period of informal incomes policies. The boom, which already started in the Summer of 1967, was unexpectedly strong, as were productivity increases in industry. In the first 1967 sessions of the Concerted Action the DGB had agreed to wage increases of 4-5% but productivity in industry increased by 8.6% in 1968. As profits exploded while the union leadership pursued wage moderation Germany experienced a

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670 See Beer 1982, p. 84-87.
671 See, for example, Hildebrand 1984, p. 160-70.
wave of wildcat strikes in 1969, which was followed by a 'wage explosion' in the bargaining rounds of 1970-72. In the summer of 1973 another wave of wildcat strikes occurred, albeit less widespread than in the fall of 1969, as workers tried to obtain compensation for high inflation rates. The culmination came in 1974 in the form of a humiliating defeat for government in the wage bargaining round with the ÖTV, public sector trade union. In the previous year the ÖTV had accepted the government's demand for a "stability sacrifice" (Stabilitätsopfer). Yet as prices rose much faster than expected the rank and file grew restless, which forced the ÖTV leadership to take quite an aggressive stance in the 1974 round. It was mainly this experience which convinced Helmut Schmidt of the correctness of a regime which delegated the concern for low inflation to monetary policy.

Government dominated wage setting formed the cornerstone of the Dutch strategy from the end of the war until the sixties. Although some flexibility was provided for, the so-called "directed wage policy" meant that the minister of social affairs would unilaterally determine wages, while the main task of the trade unions consisted in securing their member's acceptance of the ordained wage level.

While having similar growth rates, the Netherlands could not benefit from an extensive influx of labour and the peculiar Dutch brand of Catholicism and Calvinism prevented tapping the domestic female labour supply to an extent comparable to other European countries. Inevitably, therefore, the attempt to pursue a state directed wage policy under tight labour markets was to come in conflict with the organisational logic of the trade unions. The beginning of the end came in 1963 when, in one of the most absurd episodes of wage bargaining, trade union negotiators with all their might tried to prevent the electronics giant Philips from offering wage increases in excess of those laid down by the ministry of social affairs.

With the 1960s breakdown of incomes policies in mind, the Dutch trade unions in the early seventies were strongly opposed to government interference in the wage bargaining process. But they still accepted that they had an important responsibility for the macroeconomic situation. When, by means of a special law (Machtigingswet, January 1974) the Den Uyl government was granted far-reaching - though only temporary -powers in the field of incomes policies in order to deal with the inflationary pressures from the oil-price shock, the statist wage policy of the 1950s and early sixties seemed to have reappeared. In contrast to their bitter resistance against state interference in wage setting during the early 1970s, the unions - under the impression of the rapidly deteriorating economic situation - now were willing to accept the guidelines of a wage policy. As the economy further deteriorated, the unions agreed to a standstill in real wages for the year 1976.
In contrast to the fifties and sixties, however, the Unions were not satisfied any more with the role of ensuring the implementation of government policies. Instead trade unions now demanded an exchange for their cooperation in incomes policy, as happened, for example, during the 1972-73 wage bargaining round. A larger degree of income equality, protection of the social security system and more expansionary fiscal policies in order to stimulate employment ranked highest on their list of priorities. The Netherlands, in short, had moved to a corporatist pattern of conflict mediation.\textsuperscript{674}

In political terms the adherence to a restrictive monetary regime proved to be quite costly for Dutch and German Social Democrats. Unlike the SAP which pursued a soft currency policy and thereby effectively defended full-employment, the continued mass-unemployment served to undermine the economic policy credibility of both parties. Moreover, in a stagnating economy and under restrictive monetary policies the need for budget cuts would become ever more urgent. Without macro stimulation business would quite naturally come to see reduction in taxes and social security benefits as the road to improve its position. In addition the need for budget cuts jeopardized the blue collar-middle class alliance from which Social Democrats drew much of their strength. The last two factors were decisive in the fall of the SPD government in 1982, when the FDP withdrew from the coalition because the SPD, not entirely unlike the Müller government in 1930, felt that it no longer could go along with a policy which would have implied cuts to labour market programmes and unemployment benefits while business was to receive tax breaks.

In the Netherlands, the logic of a restrictive regime implied first of all a strengthening of the right wing of the CDA relative to the trade union wing. Because it had proven impossible from the end of the first world war until 1994 to form a government without participation of the Christian Democrats, the power relations within that party rather than election outcomes were decisive in terms of what government was going to be formed.

The year 1976 marked the turning point in the PvdA's fiscal policies from Keynesian stimulation to budget consolidation. Confronted with higher budget deficits, rising unemployment and a weak Guilder, PvdA minister of finance Duisenberg - later to become president of the DNB - initiated the so-called 1% operation, which aimed to reduce the growth of the collective sector.\textsuperscript{675} Public expenditures now came to be seen increasingly as a factor contributing to the crisis than a factor alleviating it. The very generous social welfare system, it was argued, contributed to a loss

\textsuperscript{674} Zimmerman 1986

\textsuperscript{675} I.e. transfer system plus state expenditure.
in competitiveness through the high burden it placed on total labour costs\textsuperscript{676}. Moreover, in a highly open economy like the Dutch, fiscal spending was seen to lead to current account deficits rather than domestic employment. The high budget deficits that would result from maintaining the system at the present level would furthermore lead to an ever greater financing need and thereby would contribute to monetary instability. The DNB feared that the failure to subordinate fiscal and incomes policies to the requirements of the Guilder might lead to a "Danish scenario" in which high budget deficits and a current account deficit required constantly high interest rates in order to defend the parity, and eventually led to the repeated devaluations.

Once the solution to the crisis was identified in terms of increasing export competitiveness by means of lowering costs, the left wing of the CDA was necessarily placed on the defensive, as were the Social Democrats. For the right wing, on the other hand, it seemed more attractive to form a government with the Liberals, since that party was not as attached to the welfare state as the Social Democrats. This then was the main reason why the PvdA, despite substantial gains in the elections of 1977 did not return as a government party. The PvdA did manage briefly to return to the government benches in the wake of the Second Oil Price crisis, when, in response to a dramatic increase in unemployment rates the CDA decided to include it in the coalition. However, the unwillingness of the CDA to tolerate, higher budget deficits in order to fight unemployment led to the rapid break-up of the coalition. The Social Democrats remained in opposition until 1989, when they again joined the Christian Democrats as junior partner in a coalition government. Yet, the economic policy constellation was basically unchanged. While in opposition, the Social Democrats had called for less severe welfare cuts, but while in government they found that such a policy would have unacceptable consequences of the budget. For the PvdA this turnaround provoked a rapid decline of its popularity, starting in the early nineties.

In addition to Social Democratic government participation, the second victim of the restrictive regime was Dutch corporatism. During the first two decades after the war Dutch wage policies had primarily been interpreted as real wage policies, i.e. policies aimed at increasing growth by keeping wages below those in competing countries. These policies were widely credited for the rapid growth after the war, although their main effect probably was to saddle the country with a larger low-technology sector. Unlike in Germany, where the advent of a regime which relied on high

\textsuperscript{676} The most influential proponent of these view was the Central Planning Office (CPB).
unemployment to contain inflation ended the need for incomes policies, the Dutch governments perceived a clear need for incomes policies after the mid seventies. Between 1976 and 1982 the government intervened almost continuously in wage setting.

Quite in keeping with its long term traditions, the Dutch trade unions did not have a fundamentally different view concerning the need to combat unemployment by means of improving international competitiveness. Although they stressed the need for more active employment policies, they were also convinced that in order to increase investment first of all profits would have to rise and, therefore, real wages would have to decline. Already during the 1975 negotiations they offered to keep wage growth below productivity and their willingness for moderation increased in stages with the deepening of the crisis from the demand to price compensation only, to demand for price compensation only for the lower incomes, to the acceptance of general real wage reductions for everybody. In short, the Dutch wage policy from 1977 onward increasingly moved towards a strategy of real devaluation within the framework of fixed nominal exchange rates.

Yet, unlike the postwar decades Unions now had to be offered a quid pro quo for wage moderation. The government repeatedly offered an increase in its contributions to the social welfare system as well as reductions in direct taxes in order to compensate for the fall in wages. If a real devaluation strategy had been successful in increasing growth rates, such a pattern of corporatist bargaining might have been feasible. Under the reigning monetary regime this was not the case, however. As a result corporatist bargaining proved to be an increasing strain on the budget.

It took the recession of 1980-82 to break the domestic stalemate. Although, the Christian/Liberal Lubbers government, which took office in September 1982, did not resort to rule by decree in order to break the corporatist stalemate and implement a macroeconomic policy that ignored demands of labour like the Martens V government in Belgium for example, its policy style likewise had a strongly authoritarian character. "The new government used its methods of strong rule to implement essentially Neo-Liberal policies. It abandoned the approach of corporatist policy making with respect to industrial relations and simply bypassed the corporatist advisory channels (including the Social and Economic Council). Moreover, in cases where advice was legally mandatory it turned this requirement into a joke." 677 The main goals of the new government were a reduction in the budget deficit through a major overhaul of the social welfare system and reduction in public employment and, improvement of private sector profits through tax and social-welfare reductions, and deregulation and redistribution of labour.

677 Scholten 1987, p. 121.
In the field of wage policies the government withdrew from intervention altogether. The withdrawal of government from wage setting became possible because of three related developments. First, the government threatened to unilaterally impose wage controls if the outcome of negotiations would be considered unsatisfactory. 

Second, the link between private sector wages on the one hand and transfer payments and public sector wages on the other had been severed so that the outcome of free negotiations would have no direct effect on government expenditures any more. Third, and most important, the Unions had been severely weakened. Since the end of the seventies all unions were losing members rapidly. As the decline of the unions accelerated and unemployment increased it became increasingly unnecessary for the government to even threaten with intervention.

5.3 The Disintegration of Scandinavian Social Democracy

"...if we fail and push inflation up again we ourselves must bear the consequences - a lower standard of living, less employment and less space for an active reform policy. In that case we might have to start to travel the same dark road as many other countries in Europe." (Kjell-Olof Feldt 1986. Quoted in Feldt 1991, p. 295)\textsuperscript{679}

While in the deflationary constellation of the Great Depression, Germany (until 1993) and the Netherlands (until 1936) were fighting a losing battle by clinging to a restrictive policies, in the seventies they became the pioneers of a regime which would come to be generally accepted in the next decade. Yet, the German and Dutch strategy to pursue a restrictive monetary regime and tolerate high unemployment might have been expected to remain an isolated phenomenon in a West European economy where most other countries would pursue macroeconomic policies for growth and employment. As long as other countries were willing to let the D-Mark (and the Guilder) revalue, emulation of the German policy regime, in principle, was not unavoidable. By means of a more flexible exchange rate management it would be possible for countries with different national macroeconomic strategies and different wage setting dynamics to coexist in an open world economy. Once Germany had embarked on a restrictive monetary regime, maintaining a fixed exchange rate with the DM for other countries became tantamount to importing restrictive policies. On the trade

\textsuperscript{678} "In fact, the leader of the Christian Labour Union, Harm Vermeulen, stated on 10 March 1983 that he had been so afraid of the possible invocation of decree laws by the new government that this was the reason why he supported the 'social agreement' in the Foundation of Labour (19 November 1982). Schollen 1987, p.146.

\textsuperscript{679} My translation.
balance side restrictive policies abroad would result in a current account deficit, and expansionary domestic policies would further serve to aggravate the problem. As long as devaluation was be ruled out such problems would eventually have to be corrected by means of restrictive domestic demand management policies. Furthermore, maintaining a fixed exchange rate implied that nominal wages had to be kept in line with those in competing countries if export competitiveness was not to be undermined via a real appreciation. Since the institutional structure of German and Dutch labour markets by itself displayed a high capacity for wage moderation, the German decision to tolerate high unemployment, implied that it would be virtually impossible for other countries to match the low German inflation rate.

In short, it would seem plausible to expect that the regime change in Germany and the Netherlands would prompt other European countries to make more frequent use of devaluations in order to prevent having to adjust both policy preferences and wage bargaining outcomes to the German pattern. In the extreme case a decision to maintain an expansionary macroeconomic policy course might even have served to change the German policy regime. A country which single-handedly pursues restrictive monetary policies in an otherwise expansionary world is most likely to experience a strong appreciation of its currency. In 1976, for example, the Swiss National Bank had to abort the policy of pursuing more restrictive policies than Germany because the credibility of its policy commitment led to an excessive appreciation which threatened to ruin the export sectors. Given the economic and political importance of the export industry in Germany, such a development might easily have undermined political support for a restrictive regime. Moreover, the demonstration effect of neighbouring countries pursuing successful policies for growth and employment might have served the same purpose. In other words, Germany and the Netherlands might have suffered a fate similar to the one of the Gold Bloc countries after 1931.

Yet there was a crucial difference between the Great Depression and the Seventies: during the thirties countries suffered from deflationary problems while already since the sixties containing inflation had become a crucial problem for governments. Because the exchange rate provides the link between domestic and foreign prices, exchange rate policies cannot be analyzed solely with respect to their effects on external trade and payments. Put differently, the nature of the exchange rate precludes analyzing states as unitary actors who are solely involved in an inter-national game. The most crucial internal function of the exchange rate is to provide a nominal anchor for the price system and an anchor for economic policies. In wage bargaining, the potential threat to export

680 See also chapter 6.
competitiveness resulting from a nominal wage increase which exceeds those in competing countries is a powerful argument for moderation. Moreover, a failure to maintain wage increases in line with those of foreign competitors should trigger an automatic corrective mechanism in the form of rising unemployment. Without a fixed exchange rate constraint the price level becomes indeterminate in the sense that any price level is compatible with competitiveness. The decision to pursue a soft-currency policy in order to safeguard full-employment however, does imply that the purely institutional, as opposed to economic ability of trade unions to maintain nominal wage moderation attain greater importance. In a constellation where the domestic labour market institutions lack the ability for nominal wage moderation, a soft currency policy will mean a further weakening of the constraints on inflation.\textsuperscript{681} Hence those countries which lacked the institutional ability to moderate nominal wages under the conditions of the seventies would in fact be structurally unable to continue pursuing a soft-currency policy in order to prevent importing restrictive policies. And that was exactly the problem which terminated the old policy regime in Britain already under the Labour government in 1976.

Quite in keeping with the principle of the growth regime, monetary policy was subordinated to the overall policy orientation.\textsuperscript{682} Already the Conservative Chancellor of the Exchequer Barber had indicated in 1972 that he would be willing to let the Pound float downwards in order not to compromise his fiscal stimulation package. Under expansionary fiscal and monetary policies containing inflation, therefore, had to rest on price and incomes policies, but due to the general outlook of the trade unions as well as their high degree of decentralisation, conditions were very unfavourable for such a policy.\textsuperscript{683} The decentralisation and militancy of British trade unions already had become a major problem for the Labour government of PM Wilson (1964-70), during the later years of its tenure. Wilson felt that wildcat strikes at the local level were a major cause of the high wage drift which was undermining his statutory incomes policies. In order to remedy the situation, the white paper \textit{In Place of Strife} (1969), proposed that the Government be given the right to impose a 28 day cooling off period in case of wildcat strikes. As Jones (1987, p. 78) notes: "It was hoped these measures would help to tip the balance of power in collective bargaining more in favour of the employer." In face of massive opposition from the TUC and within the Labour party, Wilson was forced to abandon his plans. Also largely in response to trade union opposition Wilson de facto

\textsuperscript{681} Cf Schager 1991.

\textsuperscript{682} See Dimsdale 1991, p. 125.

\textsuperscript{683} See Scharpf 1987, Ch. 5.
abandoned incomes policies. The result was a wage explosion. In 1970 nominal wages increased by about 14% despite rising unemployment. The Conservative government under PM Heath which succeeded Wilson in 1970 was even less successful. Similar to PM Thatcher in 1979, one of Heath’s central campaign pledges had been not to resort to incomes policies. Instead Heath hoped to reduce inflationary wage pressure by means of industrial relations legislation. But as the Thatcher strategy showed, a credible renunciation of incomes policies could only be made on the basis of the political willingness to rely on high unemployment as the main instrument for holding inflation in check. This, however, Heath was not willing or able to do. Accordingly, his strategy soon proved to be ineffective and in 1972 a statutory wage policy was introduced despite his campaign pledge not to do so. At the same time price controls were strengthened. The government fell in early 1974 when the mineworkers called a strike in protest against wage policies.

After a wage explosion in 1974-1975, the impression made by the crisis and the desire to maintain a Labour government in office, the new Wilson Government was able to enlist the cooperation of the trade unions in 1975. Wilson placed its hopes on voluntary wages restraint, the so-called Social Contract. In essence the Social Contract was a corporatist policy which sought to achieve wage moderation in exchange for improvements in social welfare and tax cuts. In addition, Wilson promised a 'new industrial strategy' which in essence was a meso- and micro-level corporatist policy aimed at promoting modernisation and investment in private industry. Although very successful in bringing inflation rates down, the wage policies of 1975-76 had also led to a reduction in real wages. Unable to reach an agreement with the Unions on voluntary restraint Wilson introduced statutory policies for the 1977-78 bargaining round. Such policies, however, were highly unpopular with the rank and file and union leadership. The left of the Labour party saw Chancellor Healey’s incomes policies as a capitalist measures which increased profits and held back wages. By late 1978 wage moderation completely collapsed as the fragile centralization which the TUC had achieved under the voluntary incomes policies on 1975-77 and a wave of strikes washed over the country in the notorious 'winter of discontent' of 1978. Also here the public sector union (NUPE) played a crucial role in the break-down. NUPE members overwhelmingly came form the bottom end of the pay scale, and in comparison even to other British unions, the NUPE leadership had fairly little control over the grassroots. According to Healey (1989, p. 467): "The winter of discontent was not caused by the frustration of ordinary workers after a long period of

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684 Source: Jones 1987, p. 79.
685 On Heath’s U-turn see Beer 1982, p. 84-87.
wage restraint. It was caused by institutional pressures from local trade union activists who had found their roles severely limited by three years of incomes policies agreed by their national leaders, .."

In a last desperate attempt to stem the tide, the government convinced the TUC to sign a joint declaration, published in mid-February 1979, in which the latter accepted the objective of reducing inflation to below 5% within three years. The TUC also agreed to a so-called national economic assessment, one of the functions of which was to determine the available room for pay increases. At the same time the TUC issued guide-lines concerning industrial disputes which were aimed at reducing secondary picketing, keeping up essential services and which called for a ballot to precede every strike. Yet by this time the influence of the TUC over its grassroots was apparently rather limited and strikes continued to escalate. As a direct result of its inability to handle the industrial relations crisis, PM Callaghan’s government fell over a vote of no-confidence on March 28, 1979.

<table>
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<tr>
<th>Date of Investiture</th>
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</tr>
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<tbody>
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<tr>
<td>1950</td>
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<td>1963</td>
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<td>X</td>
</tr>
<tr>
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<td>Harold Wilson</td>
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<td>1966</td>
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<td>1970</td>
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<td>X</td>
</tr>
<tr>
<td>1974</td>
<td>Harold Wilson</td>
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<td></td>
</tr>
<tr>
<td>1976</td>
<td>James Callaghan</td>
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</tr>
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<td>1979</td>
<td>Margaret Thatcher</td>
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<td>1983</td>
<td>Margaret Thatcher</td>
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<td>1987</td>
<td>Margaret Thatcher</td>
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<tr>
<td>1990</td>
<td>John Major</td>
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Notes: See table 3.3.

Domestic inability to control inflation could only serve to undermine the confidence in the Pound, especially so since, despite having lost its dominance to the Dollar, the Yen and the DM, Sterling was still widely held internationally. In this constellation both Chancellor Healey and the BoE saw no alternative than to initiate a switch to ‘monetarist’ policies. Since December 1976 the Labour government published money growth targets (for £M3). And although Chancellor Healey held that a low Sterling exchange rate was good for British industry, he allowed the Pound to float upwards after the crisis of confidence had passed in order not to compromise the restrictive monetary policy which he held necessary to combat inflation. As witnessed by Callaghan’s 1979 Labour Party Conference speech, the government now abandoned its Keynesian conviction of being able
to achieve low inflation and full employment and instead gave overriding priority to reducing inflation. As Gordon Richardson (1978, p. 34), Governor of the BoE, argued: "In times past other features of the economic system, such as a fixed exchange rate or Gladstonian budgetary principles, were thought to provide some guarantee of stability. These restraints have now gone. The main rôie, therefore, that I see for monetary targets is to provide the framework of stability within which other policy objectives can be more easily achieved." While the basic shifts in policy assignments had already taken place before 1979, Labour, due to the high costs in terms of unemployment, remained reluctantly 'monetarist'. And even despite Richardson’s emphasis on monetary targets as an anchor to economic policies, he was far from being a convinced monetarist. In the same speech Richardson (1978, p. 34) argued that monetary policy should not "be left to fight inflation singlehanded", and that Britain, in his view, was destined to continue the incomes policy efforts. It was left to Margaret Thatcher to fully develop the new regime.

As is well known the Thatcher government in 1979 embarked on a ferocious policy of high interest rates and fiscal cutbacks. At the same time exchange controls were abandoned and, also partly due to the North Sea oil, the Pound started to appreciate rapidly. As a result Britain experienced its worst economic crisis since the war. The mas-unemployment which resulted from her early policies did not lead PM Thatcher to doubt that restrictive macroeconomic policies would have long term depressive effects on the economy, nor did it allow Labour to regain the initiative. Edward Heath’s U-turn of 1972 away from Neo-Liberalism and towards Corporatism, and his subsequent fall over conflicts with the trade unions, had become somewhat of a trauma for the Conservative Party. PM Thatcher was determined not to repeat Heath’s mistakes. More important, however, the extent of the economic policy debacle of 1974-79, and the fact that the last Labour government had seen no choice but to reorient policies in a Thatcherite direction, enormously strengthened the Conservative’s hold on government. Because Labour had demonstrated that it lacked any feasible alternative, the massive recession and the durable mass-unemployment initiated by Thatcher offered no opportunities for an improvement of Labour’s electoral fate.

The extent of the crisis after 1979, which also might have come as a surprise to PM Thatcher instead of bringing about a change in macro-policies caused her to focus on micro-level problems. At the 1981 Conservative Party conference she remarked: "Today’s unemployment is partly due

686 See also Hall 1992, p. 100.
687 See also Thatcher 1993, chapter 5.
688 See also Gamble 1992, p. 62.
to the sharp increase in oil prices; it absorbed money that might otherwise have gone to increased investment or to buying the things which British factories produce. But that is not all. Too much of our present unemployment is due to enormous past wage increases unmatched by higher output, to union restrictive practices, to overmanaging, to strikes, to indifferent management, and to the basic belief that, come what may, the government would always step in to bail out companies in difficulty. No policy can succeed that shirks those basic issues." But far from believing that high domestic costs were the only obstacle to prosperity and full-employment, PM Thatcher held, in line with what would become the general conviction of most policy-makers during the eighties, that the central problem was the insufficient productivity of industry. "In spite of what might seem the more immediate and pressing problems of strikes, price competitiveness and international recession, the root of Britain's industrial problem was low productivity." In short, with the Thatcher government the regime change had been completed in Britain. Macroeconomic policies were now considered responsible for keeping inflation low while unemployment and sluggish growth was interpreted as a microeconomic phenomenon.

Yet Sweden and Norway did not suffer from a decentralised and militant labour movement, nor from the unwillingness to coordinate monetary and fiscal policies in pursuit of the goals of growth and full employment. Instead both countries at the onset of the depression in the early 1970s could dispose of a set of institutional arrangements which were almost ideally suited to effectively combine full-employment with price stability. Unlike, Germany, monetary policy decisions have been closely coordinated with the government's overall policy strategy. Ever since both countries abandoned the Gold Standard in 1931 the ministry of finance in both countries came to play the dominant role in monetary policy-making. The centralization of macroeconomic policy-making in the hands of the government is supplemented by a wage setting system which is highly conducive to policy concertation.

While the Bundesbank's decision to use monetary targets constituted the core element of the shift to a disinflationary policy regime, Norway and Sweden, due to their high preference for full employment and their confidence in domestic institutions, did not follow that course. Yet initially both countries decided in favour of membership in the so-called 'Snake' European exchange rate arrangement. In Norway the potential conflict between membership in the Snake and the commitment to full employment was not expected. After the unprecedented growth period during

689 Quoted in Thatcher 1993, p. 155.
690 Thatcher 1993, p. 92.
the Bretton Woods system, the move to more flexible exchange rates was rather interpreted as a threat to international trade and growth rather than a possibility to continue pursuing domestic objectives in a changed environment. The Norwegian government considered the doubling of the bandwidth of the Smithsonian versus the Bretton Woods agreement to contribute to uncertainty and it welcomed the so called 'Snake in the tunnel'. Initially participation in the Snake rather seemed to pose a threat to the ability to pursue restrictive policies domestically. With low unemployment, high price and wage increases, and the North Sea oil wells expected to come on line in the mid 70s, large current account surpluses and strong domestic demand were expected. Against the majority of business and the Valutarådet, but with the support of the LO, the government on November 15, 1973 hence decided to revalue the Krone by 5%. The single most important factor in this decision was the desire to dampen domestic inflation.\footnote{See Doblou 1993, p. 53-4.} Furthermore since EC membership was envisaged at this point, Snake membership seemed only logical.

<table>
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<th>Sp</th>
<th>V</th>
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<tr>
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Source: Furre 1992, p. 504-5. Notes: * 40% before 1977 election. See also table 3.3.

While both countries felt the effects on the oil price crisis somewhat later, also here fiscal policies turned expansionary in an attempt to bridge over what was expected to be a temporary shortfall in international demand. Like in the Netherlands and Britain, wage bargaining assumed a decidedly tripartite character in the seventies. In contrast to the pattern of the fifties and sixties, when the state influenced bargaining by means of (in)formal consultations with the unions and employer associations, it now entered the arena as a third partner, offering tax cuts, subsidies and social security improvements in exchange for moderation of nominal wages and prices.
The intensification of public involvement in wage bargaining took place against the background of three related developments. First, actual bargaining outcomes frequently deviated significantly from the intentions labour market partners expressed in bi- or tripartite consultations. Tripartite bargaining for the state hence constituted an attempt to gain more control over actual outcomes. Secondly, the sixties had generally given rise to increased ambitions in employment policies. After more than a decade of boom conditions, governments' confidence in their own ability to fine-tune the economy had grown significantly. Even lower unemployment rates, frequently coupled with higher participation rates, naturally implied stronger wage and price pressures. Thirdly, the economic constellation after 1973 implied the need to rely to a greater extent on incomes policies, at least for those countries who were not wiling to sacrifice the full-employment target. Whereas strong inflationary pressures in the fifties and sixties generally coincided with tight labour markets which allowed for brief periods of macroeconomic restriction, the oil price crisis simultaneously increased inflationary pressures while reducing demand. The policies of countries like Germany further contributed to restrictive demand impulses. In a constellation where fiscal and monetary policies needed to be expansionary in order to avert the threat to full-employment, incomes policies necessarily had to play an even greater role in bringing inflation rates down.

In Sweden such policies were initiated with the so called Haga settlements of 1974-76 when tax cuts and increased transfer payments were offered in exchange for wage moderation. Tripartite bargaining was introduced in Norway under the bourgeois government of Lars Korpvald in 1973. In the bargaining round on the revision of the two-year agreement reached in 1972, the unions agreed to settle for compensation of only 45% of price increases in exchange for policies aimed at reducing inflation; i.e. price subsidies, a revaluation of the currency and a price stop for certain goods and services. From the point of view of the LO the wage moderation in 1971 and 1972 and the tripartite agreement of 1973 were not a success as, due to higher than expected inflation, real wages decreased in 1972 and only marginally increased in 1971 and 1973 while the economy was booming and profits were high. Accordingly resistance against centralised tripartite bargaining also grew visibly within LO in 1974. Opposition against incomes policies was further fanned by

692 See also Armingeon 1985, p. 36-9.
693 The policy of bridging over the international recession in the second part of the seventies, in fact was the first serious attempt at Keynesian deficit spending by a Swedish government this century. See Jonung 1994, p. 236.
694 Inflation also had an indirect negative effects as real wages as it moved wage earners into higher tax brackets. See Per Kleppe, St. forh. 1973-74, 7b, p. 2724.
the increasing popularity of the Socialist Left Party (SV, *Sosialistisk Venstreparti*) amongst LO members. In the eyes of SV incomes policy basically was an attempt to rob workers of wage increases. As many other West European countries, also Norway in the late sixties experienced a strengthening of the radical left, mainly fuelled by the dissatisfaction of middle class intellectuals, but also attracting some support from blue collar dissatisfaction with centralised wage bargaining. In the early seventies, moreover, SV could draw much strength from its anti-EEC position. Whereas the leadership of both DNA and LO and the DNA government of PM Bratteli, in a rather autocratic way, had come out strongly in favour of joining the EEC, the referendum held in September 1972 showed that not only a majority of the Norwegian electorate but also a majority of DNA and LO members were opposed to membership. As a result the position of both the LO and DNA leadership with respect to its membership was weakened after 1972. And as several large member unions rejected centralised bargaining, the LO leadership, in December 1973, for the first time since 1961 reluctantly decided in favour of industry level bargaining. In Norway the negative effects of the first oil price crisis on demand and employment were not felt until 1975. For Norwegian industry 1974 was still very much a boom year. Tight labour markets, high profits, stagnating real wages during 1970-73, a strong leftist opposition within LO and high (expected) inflation, all contributed to a veritable wage explosion. In industry nominal wages rose by over 25%, 17,2 being due to contractual increases and the rest to wage drift, which meant an average increase of real disposable incomes of 6%. Yet also in this case LO and NAF got government assistance in order to help them reach an agreement. After a request from the LO, MOF Per Kleppe on March 29, 1973 presented a package of subsidies, tax reductions, and increased social welfare. This package was presented several days before the members of the crucial Metall union were to vote on the agreement their negotiators had reached with the employers. The main reason for Kleppe to present this package was to prevent *Jern & Metall* from rejecting the agreement, and the outbreak of industrial actions which would have followed.

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695 The foremost SV spokesman on these matters was Fin Gustavsen, a member of the Metall union (*Jern & Metall*). With his background Gustavsen, however, was somewhat of an outsider in a party dominated by middle class intellectuals.  
696 See, for example, SV MP Berge Furre, St. forh. 1973-74, 7c, p. 2931. For the academic version of this argument see Panitch 1979.  
698 See Per Kleppe, St. forh. 1973-74, 7b, p. 2722-2727.  
In response to the wage explosion of 1974 and the international economic crisis, which now was also making itself felt in Norway, MOF Per Kleppe, pushed for tripartite bargaining in 1975. The main concern for the government was to reduce inflation. The high increases of 1974 had contributed to a rapid rise in inflation, which again was likely to contribute to higher nominal demands in the 1975 revision. In addition the government feared that the agreement reached with the agricultural sector in 1975 would prompt LO to demand extra wage increases. Based on a Storting decision already made in 1965, the average income in agriculture was to be raised to the average income of industrial workers. In 1975 the government agreed that this goal should be reached in three years.

One of the reasons the government argued in 1975 - and the argument has been frequently repeated since - that inflation had to be brought down was that it undermined Norwegian competitiveness. Whereas Norwegian inflation had been amongst the lowest in 1973-74, the 1974 wage round lifted it above OECD average with an ensuing loss of competitiveness and market shares. Lower inflation in this view would hence not be a goal in itself but only an end to prevent the undermining of the unemployment goal. Yet, such an argument would seem hardly convincing. A loss of competitiveness due to high domestic inflation only results if the central bank is instructed to defend the nominal instead of real exchange rate, and, therefore, it is the outcome of a policy choice rather than of wage bargaining. If inflation only were a problem in relation to competitiveness, than the simplest solution, instead of engaging in costly tripartite bargaining, would be to instruct the Central Bank to adjust the nominal exchange rate to the outcome of wage bargaining so as to stabilise the real exchange rate. Yet, as has been argued, ignoring inflation in the longer run would be impossible as it would lead to a complete disintegration of the economy. Although using somewhat different arguments, the government in fact made a similar point, and these arguments, rather than the argument that inflation undermined competitiveness, must be considered decisive.

In St. M. 82, 1974-75, which argued in favour of concerted bargaining, the government pointed out that inflation reduced the government’s control over the economy. Moreover, inflation was primarily seen to benefit those with high debts, i.e. the higher income groups, and thereby counteracted the government’s aim at a greater degree of income equalisation. Yet the realization that inflation in itself had negative effects was not new, and hence was not sufficient to prompt the government to call for tripartite bargaining. In the previous decades escalating inflation had been dealt with partially by tightening credit restriction so as to cool down the labour market. In the

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700 See Per Kleppe, 6 October 1975, St. forh 1975-76, 7a, p. 22.
constellation of 1975, however, the government, along with the OECD, had come to the conclusion that the international recession was best countered by expansionary macroeconomic policies. Given its weakened position after the EC referendum debacle, the DNA leadership, moreover, was less willing to tolerate a temporary rise in unemployment, than it would have been before 1972. If inflation had to be brought down and if this could not be done by means of monetary restriction, than indeed wage bargaining had to be the main instrument. And since, moreover, increasing budget deficits were considered to be desirable given weak international demand, the logical, and indeed the only, solution left was for the state to aim for a bargaining pattern which coupled expansionary policies with wage moderation. As Per Kleppe argued: "The government does not wish to combat price and cost increases at home with methods which will exacerbate the employment problem. It has, on the contrary, maintained domestic demand. In such a situation, however, domestic cost increases can lead to weakened competitiveness relative to foreign firms and thereby endanger jobs in the longer run. Partly because of this background there was a need for untraditional solutions with the index-settlement in the fall."\textsuperscript{701}

The prospect of becoming a major oil exporter in the near future certainly influenced the extent to which the government was willing to shoulder the costs of a moderate LO-NAF agreement. The prospects of oil income simultaneously increased the willingness to incur deficits and the ability of Norway to borrow. Yet, as shown also by the Swedish case, the policy strategy started in 1975 was by no means predicated by the prospects of oil wealth, but was a result of the policy goals (low inflation and full employment) and the international economic constellation (recession in the OECD area). As MOF Kleppe argued: "Even without prospects of oil incomes Norway, like Sweden, should have pursued the same general policy, namely to maintain activity and employment despite recession abroad."\textsuperscript{702}

The employers’ association shared the government’s view on the desirability of tripartite bargaining. After the extremely high increases in 1974, a return to centralised bargaining held the promise of more moderate agreements. Furthermore state participation implied that the NAF would have to shoulder less of the burden of any agreement reached. Support amongst LO was more tenuous. One the one hand the leadership realized that a repetition of the 1974 wage explosion would have negative consequences for employment and the economy in general. On the other hand, the LO leadership had to heed the internal opposition, especially from the higher paid unions and

\textsuperscript{701} Per Kleppe, 6 October 1975, St. forh 1975-76, 7a, p. 22.
\textsuperscript{702} Per Kleppe, 6 October 1975, St. forh 1975-76, 7a, p. 22.
SV sympathisers, which saw centralised bargaining as an undue restriction on their market power. That the LO leadership could eventually agree to tripartite bargaining without provoking serious opposition was mainly due to the facts that (1) the government in 1975 before the start of negotiations guaranteed a real wage increase of 3%, and (2) that no provisions on limitations to wage drift were included. For the next three years then (1975-77), wage bargaining in Norway took place on a tripartite level with the stateshouldering about 50% of the costs of the LO-NAF agreements.\(^{703}\)

As the international economy failed to recover, the competitiveness of Norwegian industry deteriorated rapidly and the current account deficit grew to unprecedented heights, the government gradually came to realize that the continuation of the bridge-building policy was impossible. MOF Per Kleppe early on called for a turn to austerity but he failed to convince the government until after the 1977 elections. In December 1977, however, the government proposed fiscal and monetary restriction, the latter in the form of higher interest rates and reduced lending by state banks. The following month an agreement was reached with commercial banks to reduce lending for consumption purposes. In February 1978 the Krona was devalued by 8% which was coupled with a price stop. In addition general subsidies to business were to be abandoned in exchange for supporting only those with a good chance of survival.

The year 1978 also marked the breakdown of tripartite corporatist wage bargaining which had been initiated in 1973/1975. Because the government thought it urgent that the budget deficit be reduced it was no longer willing to enter into costly tripartite agreements. More important than budgetary concerns, perhaps was the realisation that tripartite agreements increasingly failed to perform their function of keeping down nominal wage increases. Whereas tripartite bargaining gave the government greater control over the policies of the peak associations, it simultaneously had the effect of weakening the hold of the peak organisations over their membership. In 1977-78 wage drift reached record proportions as it accounted for more than double the contractual wage increases (See table 5.12). As tripartite bargaining had obviously failed, one alternative open to the government was to reduce inflation by driving unemployment up. Yet, at the time such a solution was unacceptable to the DNA, especially since it was still suffering from the after effects of its 1973 EEC defeat. As a consequence the government resorted to a price and wage stop, which was to last from September 1978 to January 1 1980. The government had reached agreement with LO and NAF beforehand, and in effect the price and wage freeze temporarily solved an internal coordination problem within LO. Whereas the leadership and the low paid unions realised that wage drift had

\(^{703}\) See Dahl 1989, p. 10.
become unacceptable, agreement on limitations to wage drift would have put too much strain on the internal cohesion of the LO. A government proclaimed wage freeze, however, although not popular amongst many LO members either, could be more easily accepted.

Despite concerted efforts at wage moderation neither country managed to bring inflation rates down to the German level. The higher domestic inflation rate combined with participation in the Snake, therefore, implied a real appreciation of the Norwegian Krone. Also in Sweden the non-membership of some of its important trading partners and the higher inflation rate as compared to Germany meant that the Krona effectively underwent a real appreciation during its membership in the Snake. In terms of a trade weighted exchange basket the Krona revalued about 11% between 1974 and 1976.\textsuperscript{704}

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</tr>
<tr>
<td>08/10/1982</td>
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</table>

Source: Jonung 1993, p. 290

Unwilling to adjust their economic policies in a restrictive direction, both countries left the 'Snake' and neither country joined the EMS. Instead they defended their commitment to full-employment by resorting more frequently to devaluations.\textsuperscript{705} In Norway, for example, the debate about EMS membership in November 1978, initiated by the DNA produced a majority against. The main arguments were that EMS membership would mean that economic policies would be dominated by Germany, that it would lead to an appreciation of the currency and that it would imply a move towards EC membership. And also Norges Bank voted against EMS membership. On December 11, then, Norwegian PM Nordli announced that the Krone would not join the EMS. The bourgeois coalition which had come to power in Sweden in 1976 had left the Snake already in August 1977, on the ground that fixed exchange rates were not compatible with Swedish economic

\textsuperscript{704} Figures from Lybeck 1982, p. 92.
\textsuperscript{705} See Mjøsset, ed, 1986.
policies. In total the bourgeois governments implemented four devaluations between October 1976 and September 1981 (See Table 5.9). The Norwegian Krone was devalued both in April and August of 1977. And in the period 1978-86, five more devaluations took place.

The start of a more flexible exchange rate policy in Norway and Sweden during the 1970s has often been interpreted as the start of a new regime in which domestic goals gained dominance over the maintenance of the external constraint. Yet, as a regime can only be sensibly defined in terms of its overarching goals this was not a regime change but an adaptation of policies to changed external circumstances. As a result of those policies both countries recorded substantially lower unemployment rates by the beginning of the 1980s than most other OECD countries. In 1981 the unemployment rate in Norway and Sweden stood at 2% and 2.5% respectively. Germany still fared relatively well with a rate of 4.2% but in Britain and the Netherlands open unemployment stood at 9.8% and 8.5% respectively.

One decade later, however, the economic policy picture looked radically different. By 1991 the political commitment to full-employment had been repudiated in favour of policies aimed at reducing inflation and maintaining a stable exchange rate. The Social Democratic government which took office in Norway in 1986 embarked on a so-called 'turning operation' in the wake of which the commitment to full-employment was de facto abandoned.\textsuperscript{706} After 1986 the commitment to a fixed exchange rate became the first policy priority. While domestic financial markets had been largely deregulated during the first half of the decade\textsuperscript{707}, the commitment to fixed exchange rates was backed up by the dismantling all of its foreign exchange controls. By July 1, 1990 the remaining controls had been abolished\textsuperscript{708} and on October 19, 1990 the Krone was pegged to the ECU.\textsuperscript{709} As a result of the ensuing high interest rate policy aimed at reducing inflation and creating confidence in the Krone the unemployment rate shot up from 2.1% in 1987 to 6% in 1993, while the banking sector experienced a major crisis due to debt default. Meanwhile, nearly fifteen years after the conversion of the Bundesbank, Norges Bank came to espouse the same view on the

\textsuperscript{706} Fagerberg, Capellen, Mjøset and Skarstein, 1990.
\textsuperscript{708} Kari Olsen, 1990.
\textsuperscript{709} See Christiansen, 1990.
responsibility of monetary policy for unemployment. According to the governor of Norges Bank "...the only way to achieve a sustainable high employment level is to enhance labour market flexibility, and to put wages onto a path more beneficial to product markets."\textsuperscript{710}

After the turning operation the exchange rate policy no longer was considered an instrument for stimulating the economy in Norway.\textsuperscript{711} The two committees which the government initiated in order to draft proposals for economic policy strategies were explicitly instructed to assume a fixed exchange rate policy.\textsuperscript{712} Again, in keeping with the general logic of a restrictive regime, improving export competitiveness now became the main strategy for reducing unemployment. The cornerstone of the national strategy for increased employment, on which both unions and employers have agreed, is the so-called 'solidarity alternative' which aims to keep Norwegian wage growth below that of its competitors so as to increase external price competitiveness over the next five years by 10%. As Norges Bank correctly pointed out in its annual letter to the Minister of Finance, such a strategy may place rather high demands on the Norwegian labour markets partners as: "One must expect that also other countries with significantly higher unemployment than us, also will try to bring about low wage growth in order to reduce their employment problems."\textsuperscript{713} Yet far from rejecting such a strategy Norges Bank considered it the most promising alternative, also because a surplus on the current account was considered necessary to maintain confidence in the fixed exchange rate of the Krone.\textsuperscript{714} In contrast to other countries, however, the large oil incomes leave substantial room for fiscal expansion.

Sweden went through a similar policy sequence. In 1990 the Riksbank was freed from the concern for employment levels and was assigned the sole task of maintaining a fixed exchange rate with the ECU. Fiscal policies supported this policy orientation. While unemployment had been rising sharply since 1990 the budget for 1991 held that: "In the long run it is not possible to safeguard employment in an economy which has a higher inflation rate than the surrounding world. In order to protect employment and prosperity, economic policies during the next few years with all strength will have to aim for a permanent reduction in inflation. This task must take priority over all other

\textsuperscript{710} Norges Bank 1991, p. 3. In the same speech Skånland argued that "The notion that the state is responsible for employment, which appears more deep-rooted in Norway than in other countries, is a threat to employment since it undermines an understanding of the responsibility of the social partners." Ibid, p. 4.

\textsuperscript{711} "Det er nok først siden 1986 at valutakursen er satt opp som et mål i seg selv. Tidligere ble den sett på mer som et middel, mens renten var målet (alltså den lave renten som aldri lot seg oppnå)." Dammann 1991, p. 60.


\textsuperscript{714} See Skånland & Skjæveland 1992, p. 248.
ambitions and demands." Meanw[hile also Sweden had largely deregulated domestic financial markets. And also here the priority of fixed exchange rates and low inflation was backed up by the dismantling of foreign exchange controls. By September 21, 1989 this process was completed and on May 17, 1991 the Krona was pegged to the ECU. As in Norway, the switch to a policy of price stabilization was accompanied by the deepest recession and the highest unemployment rates in post World War II history. Within the space of three years the unemployment rate shot up from 1.5% (1990) to 8.2% (1993). And also in Sweden the new policy regime has caused a major crisis in the banking sector.

But why would even countries like Norway and Sweden, where Social Democratic parties retained control of government and labour played a central role, be willing to commit themselves to a German type macroeconomic policy strategy? In essence Scandinavian Social Democrats stumbled over the same problem that had caused the Branting government to resign in 1920. As Feldt (1991, 303-4) argued in retrospect, the policy of stimulating growth and defending full-employment had been too successful: "We had speeded up Sweden to such an extent that both firms and households became too optimistic, too confident in the future. Because of that wages and prices were increased too strongly and people consumed too much and saved too little. Moreover, the fight against unemployment had been so successful that we now suffered from a serious labour scarcity in several areas." A policy aimed at promoting growth even if it meant neglecting inflation eventually set in train a process which made governments lose control over the economy, and eventually left no choice but to abandon the regime. The main mechanism of the process of disintegration are detailed in figure 5.1.

The policy of bridging over the recession by means of fiscal spending involved the typical Keynesian m[i]stake of treating private investment activity as an exogenous cyclical factor rather than an endogenous factor critically determined by the nature of the policy regime. The international downturn of the seventies, and in particular the recession of 1979-82 was not the reflection of a cyclical, i.e. temporary, downturn in investment demand but the result of the decision of the majority of OECD countries to stamp out inflation. Accordingly the expected international ups[wing did not take place and, therefore, also the bridge building policy had to fail in the medium term. Although

716 My translation.
successful in terms of preventing open unemployment, a policy which created jobs in the public sector while private sector activity remained slack eventually had to shipwreck on the rocks of simultaneous current account and budget deficits.

In Sweden the growing budget and current account deficits prompted the conservative government to take a restrictive fiscal policy stance in the early eighties. The cutbacks caused a major confrontation with the trade unions. In the spring of 1980 Sweden experienced the most dramatic labour conflict since the war as a wave of strike and lockouts virtually paralysed the whole economy. Being unable to follow through with a more restrictive course, the government resorted to a devaluation of the Krona by 10%, and simultaneously reduced taxes in the hope to reduce inflationary effects and to moderate nominal wage increases.

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(1) The failure to check the growth of credit to the economy contributes to labour scarcity and high profits which in turn increase the incentives of local wage earners as well as employers to defect from centrally negotiated wage bargains. Furthermore the emergence of a "speculation economy" with high profits and wages in the financial sector makes, especially blue-collar, trade unions, less willing to support wage moderation

(2) Inflation due to high wage settlements in tight labour markets increases the overall demand for and supply of debt and increasingly makes both the credit rationing system as well as more market based monetary policy instruments ineffective.

(3) Labour scarcity and high wage increases in the private sector make it difficult to contain wage demands in the public sector and thereby lead to increased public spending.

(4) Strong monetary growth makes it increasingly difficult to find political support for fiscal retrenchment. Particularly public sector unions are increasingly reluctant to support cuts in public spending at a time when high incomes are earned in the "speculation economy".

(5) The failure to check fiscal spending contributes to labour scarcity and high profits which in turn increase the incentives of local wage earners as well as employers to defect from centrally negotiated wage bargains.

(6) The failure to contain fiscal spending increase the government's borrowing requirement, adds to the liquidity position of the economy and thereby counteracts the efforts of the Central Bank to control the volume of money. Furthermore, buoyant demand in the economy overall as well as inflation increases the overall demand for debt and increasingly makes both the credit rationing system as well as more market based monetary policy instrument ineffective.

Despite the initial success of the Norwegian wage freeze, both countries recorded quite high inflation rates by the beginning of the eighties. In 1981, for example, the numbers were 13.4 and 12.4 for Norway and Sweden respectively, while Germany recorded an inflation rate of 6.4%. The high inflation rate was a major motive behind the restrictive fiscal policies of the new Norwegian conservative government in 1981. Combined with the restrictive policies in the rest of Europe the result was that unemployment increased to over 3% in 1983. For a moment then it might have looked as if the commitment to full-employment had been abandoned, yet this feat had to wait until the Social Democratic government of the late 1980s. The proposed restrictive policies of the government at times of increasing unemployment caused vigorous opposition. During the budget debate in the fall of 1982 LO organized a political protest strike in which 650,000 members are said to have participated. LO also advocated a more expansionary monetary policy. In early 1983 LO chairman Tor Halvorsen suggested a substantial reduction in interest rates in order to stimulate investment. The DNA had a similar view, interest rates for investment should be reduced but private consumption should not be stimulated.

By the early 1980s it had become clear that a change in course was unavoidable. In principle two options existed. Both countries might decide to follow the example of Danish PM Poul Schlüter and prescribe a "potato diet" to the population. By means of a combination of a hard currency policy and fiscal retrenchment the Schlüter government managed to reduce inflation as well as the current account and budget deficits. The unpleasant effect of such a strategy was the emergence of durable mass-unemployment. Alternatively, one might attempt to stimulate private investment rather than to compensate for the lack of private investment by means of public sector expansion. Successful expansion of the private sector would not only mean higher tax receipts but would also allow for cuts in fiscal spending without jeopardizing full employment. Given the policies of the rest of the OECD countries, such a strategy would also imply giving domestic industry a decisive advantage, both in order to prevent the restrictive conditions in the international environment from dragging down the domestic economy and to reduce current account deficits. Both countries chose the latter course.

In 1982 the newly elected SAP government under the direction of minister of finance Kjell-Olof Feldt embarked on a new strategy labelled the 'Third Way'. The centre-piece of this strategy consisted of a massive devaluation by 16%, announced on the government's first day in

718 Fagerberg et al, 1990, p. 78.
office. The devaluation was intended to give a major boost to the private sector. At the same time the extensive subsidies to industry, which had been introduced under the previous government were abolished. Despite its declared intentions to stimulate the most promising private sector ventures and to let laggards fall by the wayside, most of the radically increased funds for industrial policy under Sweden’s bourgeois coalitions, as indeed was the case in most other countries, went to support large ailing firms in traditional sectors. Apart form the internal tensions within the trade unions a selective industrial policy was apt to create, a strategy of supporting the laggards did not seem very promising to the new SAP government. In contrast to the policy of the Conservatives, the strategy of the "Third Way" successfully combined devaluation, fiscal consolidation and wage moderation. While the devaluation remedied the current account deficit, the budget deficit was tackled by means of increased revenues and reduced spending. In order to prevent devaluation from merely leading to more inflation, the government proclaimed a wage stop. More important, the government reached an agreement with the unions not to seek compensation for price increases in the next bargaining round.

In the medium term the results of this strategy were impressive. While the budget deficit was around 6% of GDP in 1982, by 1988 the budget showed a 2% surplus. At the same time unemployment decreased from 2.6% to 1.6%. Apparently the combined effects of devaluation, wage moderation, accommodating monetary policies and an upturn in the world economy had increased private activity enough to overcompensate for the restrictive fiscal policy stance.\textsuperscript{720} Moreover, the devaluation apparently restored confidence in the Krona. The Krona had already been under pressures in the since August 1982, but after the SAP victory capital outflows had increased dramatically to about SEK 1 bn per day.\textsuperscript{721} After the devaluation, however, capital flowed back again.

The bourgeois governments in Norway were not forced to take as dramatic measures. While, in the wake of the second oil price shock, restrictive policies abroad clearly had negative consequences for the domestic economy, the rise in oil prices itself implied a strong improvement in export earnings and government revenues. According to calculations of the Norwegian Statistical

\textsuperscript{720} Increased private sector growth, in turn, also implied that less fiscal austerity would be needed in order to restore budget balance.

\textsuperscript{721} Feldt 1991, p. 57-8, 60.
Office, the growth rate of GDP would have been considerably lower without higher oil prices during 78-80. In 1983, the opposition to rising unemployment led to the formation of a new - though still conservative - coalition which turned to highly expansionary policies.

The explicit choice for continuing the employment oriented regime after the early eighties, and the boost given to the economy by means of the Swedish devaluation and the rapid increase in oil incomes, meant that market participants not only could be confident about high demand in the future, but also that they could expect relatively high inflation rates to continue. As a result loan financed real estate seemed the best way to safeguard and increase wealth.\footnote{Cf. Feldt 1991, p. 121.}

Research about centralised wage bargaining has recognised that, while centralization of wage bargaining might indeed considerably improve the inflation-unemployment trade-off, the capacity of centralised unions to direct wage bargaining only exists within a specific range of labour market constellations.\footnote{See, for example, Martin 1985, Sabel 1981, Swenson 1989.} Once labour markets become so tight as to induce local employers to offer wages considerably in excess of the central agreements, centralised bargaining will effectively break down. A similar conclusion holds if unemployment rises to such levels that local employees are willing to accept lower wages in order to secure their job.

What has been less well recognized, however, is that the Central Bank too can be considered a peak association which can only effectively control the supply of credit to the economy if its policies are not in strong contradiction to the incentives its constituents\footnote{See, for example, Dow 1988.} - commercial banks and wealth-holders in general - face. As SAP board member Sköld warned quite correctly during the Great Depression, it would be of little use to place the banking system under the control of the state because that would not allow it to control the behaviour of depositors who ultimately determine monetary developments.\footnote{See Tingsten 1941, Vol. p. 340-1.} In contrast to the trade unions, the disintegration of the steering capacity of Central Banks, however, is not marked by excessive unemployment or labour scarcity, but by the presence of widespread expectation of deflation or inflation.

While being relatively successful in implementing exchange controls, both countries proved unable to retain control of their domestic financial markets. The regulation of the financial system had functioned relatively satisfactorily during most of the postwar period. However, the combination of low interest rates and credit rationing in an environment of high and volatile inflation
rates made existing controls rapidly ineffective. As the demand for debt increased as households adjusted to continuous inflation, the combination of low interest rates and credit rationing became increasingly unworkable. In Norway, the process was set under way in 1978 as the Central Bank tightened quantitative restrictions on bank lending in order to slow down credit supply while avoiding a sharp rise in interest rates.\textsuperscript{726} Given the strong demand for credit, this prompted the rise of a so-called grey market of non-bank financial institutions.\textsuperscript{727} The first impulse of the authorities was to extend regulations but this proved only partially effective as it fanned circumvention. The following four years saw an accelerating process of increasingly strict and detailed controls and new ways of circumventing them. "The extent of regulation reached a peak in 1983, when virtually the entire controllable credit market was subject to direct regulation. The regulations were not effective, however, since the credit market showed great inventiveness in channelling credit so as to meet the underlying demand. ... The leakages to the unregulated credit market reached a peak in 1982-83. The result of the policy of control was, therefore, that it contributed neither to efficient allocation of resources nor to effective control of aggregate demand for goods and services. By the start of 1984 it was, therefore, clear that the policy of control had had its day."\textsuperscript{728} Except for the first year of extended controls, the overrun of the credit supply targets increased rather than decreased (See table 5.10).

By 1984 the general mood had changed very much in favour of deregulating the domestic credit markets. However, this was not only due to the futility of controls but also to mounting political pressures. Not only was the financial community adamantly opposed, but at a time when large speculative gains could be made the credit restrictions were also unpopular with a wider audience. The Social Democrats had already been confronted with the political realignments wrought by inflation in the late seventies as the owners of cooperative houses rebelled against the policy of keeping prices artificially low, which prevented them from realizing inflation gains. The issue of deregulation was an important point in the election campaign of 1981, and it doubtless benefited the Conservatives. For the Conservatives deregulation held the promise of breaking up traditional bases of Social Democratic support. The miscalculation was that, without a strongly restrictive monetary policy to break the underlying demand for credit, deregulation could only spell further chaos. Between 1984 and 1987 Norges Bank virtually lost control over the economy. In

\textsuperscript{726} See Holli, 1978.

\textsuperscript{727} Stenius 1987, p 109.

\textsuperscript{728} Gonn,1985, p. 220, 223.
the last three years credit overruns exceeded 100% (Table 5.10) The households saving ratio was negative in 1985 and 1986. Moreover, real estate prices had risen almost 2.5 fold between 1980 and 1987 and the demand for mortgages simultaneously expanded rapidly. During the same period the Oslo Stock Exchange Index almost septupled. In short, the economy moved into a speculative frenzy.

| Table 5.10 Credit Targets and Actual Supply. Norway 1974-87 Billion Norwegian Krone |
|-------|----------|----------|
| Target | Actual Supply | Percentage Overrun |
| 1974   | 12.7      | 12.8      | 0.7          |
| 1975   | 17.3      | 18.2      | 5.4          |
| 1976   | 19.5      | 22.4      | 14.7         |
| 1977   | 22.7      | 25.4      | 12.4         |
| 1978   | 23.9      | 22.0      | -8.0         |
| 1979   | 22.0      | 24.4      | 10.8         |
| 1980   | 25.2      | 30.2      | 19.5         |
| 1981   | 30.0      | 39.1      | 30.3         |
| 1982   | 33.9      | 42.1      | 24.1         |
| 1983   | 38.8      | 47.7      | 22.8         |
| 1984   | 41.3      | 62.3      | 50.8         |
| 1985   | 48.5      | 97.8      | 101.6        |
| 1986   | 47.3      | 112.8     | 138.5        |
| 1987   | 53.4      | 122.8     | 130.0        |


The boom had initially been fuelled by large short term capital inflows which had become possible after the deregulations of 1982-84. In 1986 sentiments turned against the Krone as the fall in oil prices led to a dramatic worsening of the current account. With the inverted oil price crisis of 1986 the DNA government which took office on May 9 found itself in a position similar to the SAP in 1982. The reduction in oil revenues meant that also Norway would have to confront the problem of a twin deficit. But in order not to jeopardize full-employment despite the need for fiscal retrenchment a big devaluation might seem the solution. Financial markets had apparently come to this conclusions also, as the shift from the Willoch to the second Brundtland government was accompanied by heavy pressure on the Krone. On May 11 the government did indeed announce a 12% devaluation. As was the case with the 16% devaluation of the Krona in 1982, 12% was larger than expected by many. Monetary policies meanwhile remained accommodating although a largely unsuccessful effort was made to reregulate parts of the domestic credit market. Also in accordance

\(^{729}\) See Damman 1992.
with the policies of the Third Way, fiscal policies became more restrictive. Having played the main role in bringing the Willoch government down by voting against his proposal for fiscal cutbacks, Prime Minister Brundtland now presented a rather similar package.

Yet even the negative oil-price shock failed to cool down the economy, and in the course of 1986 inflation rates started to edge upwards again. In early 1987 the Social Democrats felt that a radical change in expectation was needed to put the economy on an even keel again. Both fiscal and monetary policies were considerably tightened and the Central Bank was de facto freed from its commitment to full-employment. The government stressed strongly that the May devaluation was to be the last one and backed up its claims with a rapid dismantling of exchange controls. The 'Turning-Operation' of the Social Democratic government, in short, signalled a decisive change from a policy regime of flexible exchange rates and domestic stimulation to a regime of a fixed external constraint and domestic restrictiveness.

Although less pronounced, Sweden has experienced a similar sequence of events since the mid eighties. Like Norway, Sweden saw a strong growth of unregulated credit markets. While finance houses (finansbolag) had been established in Sweden already during the fifties, they lay largely dormant until the mid seventies. In 1975 lending by finance houses accounted for approximately 7% of non-priority lending, but by 1984 this figure had more than tripled to 23-24%. The rapid growth of an unregulated market increasingly emasculated the Riksbank's controls, and as a result finance houses were subjected to increasingly strict regulation from 1980 onwards. In 1980 lending regulations were extended to finance houses and from 1981 to 1984 increasingly tight ceilings were set, but in the first three years the targets were substantially exceeded. Although most finance houses obeyed the regulations, the lending overruns were due to a large increase in the number of newly established finance houses. Only in 1984 regulations finally seemed to have the desired effect, as the overall lending stayed within the ceiling. Yet this success was more apparent than real since the increasing strictness of controls led credits from finance houses to flow to other sectors. Moreover, the strong growth of the unregulated market disturbed the de facto cartel of Swedish banks and thereby put additional pressures for deregulation on the Riksbank.

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730 Non-priority lending is lending for all purposes other than priority housing construction.
By 1985, then, the mood at the Riksbank also had very much changed in favour of deregulation. "Regulations induce the creation of new channels for credit. The on-going development is rendering them less and less effective. The intended restrictions on the credit market are not achieved, at the same time as the structure of the market is distorted when lending regulations are implemented for any length of time. Under these circumstances the Riksbank has resolved to rescind the current recommendations and instructions concerning ceilings on lending by banks, housing credit institutions and finance houses." As in Norway, the increased regulations were also becoming unpopular with both industry and consumers. Apart from providing an additional credit channel, finance houses offered several services, like leasing and hire-purchase, which were not available from banks.

On November 21, 1985, the Riksbank abolished all lending ceilings. Although policy makers were aware of the danger that deregulation might further contribute to an overheating of the economy, the Riksbank assured the finance minister that it would be able to prevent a credit explosion of the Norwegian type by means of tighter policies. In line with what Norges Bank would later come to see as the main mistake of the government, the Riksbank saw the Norwegian credit explosion as the result of an inconsistent policy which on the one hand wanted to rely on so-called market-based instruments by deregulating the domestic credit market while on the other hand was not willing to accept a market-determined interest rate. The continued effort by the Norwegian governments to keep interest rates low during 1986 led commercial banks to make massive use of Norges Bank rediscout facility. Instead in 1986 the Riksbank introduced a so called interest rate stair (Räntetrappe) which made the interest rate at which each individual commercial bank could have recourse to the Central Bank dependent on its debt position at the Bank. In principle not unlike the IMF tranche system, the Räntetrappe gave the Riksbank the ability to apply different rates to different borrowers while the average discount rate would increase automatically in case the commercial banks would expand their amount of rediscouing overall. Yet, this system still did not imply a complete abandonment of low interest rate policies as the "staircase" did not lead upwards endlessly but had a maximum rate. Those policies did not seem to have an effect, however.

"The massive borrowing by households on the organized credit market has coincided with a steep rise in real interest rates after tax. ... Instead of being appreciably curbed by the positive real rate

733 Sveriges Riksbank 1985, p. 15.
of interest, the borrowing propensity of households seems to have been influenced by earlier experience of markedly negative real rates after tax and this experience may continue to dominate for some years.  

Under the type of boom which developed both in Norway and Sweden, wage moderation eventually had to collapse. In a time where large gains could be made on the stock market and by speculating with real estate, wage moderation became unacceptable for many members. But even the developing labour scarcity by itself would probably have been sufficient to provoke a breakdown in wage moderation. By placing the trade unions in direct opposition to market forces, even the most centralised ones will become overburdened. Being situated within rather than above the market, trade unions can provide no substitute for a consistent macroeconomic policy. Rather unions can only heed their macroeconomic responsibilities and preserve their institutional cohesion if their policies affect expectations in the same way as macroeconomic policies. In the eighties, the attempt to obtain a stabilization of the price level from unions in a situation of general labour scarcity, inflationary expectations and a basically accommodating monetary policy was doomed from the beginning. Any effort to moderate wage growth by means of central agreements below the level the employers were willing to offer could only result in strong centrifugal tendencies.  

Whereas the conservative governments in Sweden had experienced major problems in enlisting the support of the trade unions, one of the main reasons why the SAP in 1982 felt it would be able to pursue more effective policies was that it thought it could count on policy concertation. However, the first breakdown in centralised bargaining already occurred in the first wage round after the devaluation, when the metal employers, confronted with a radical increase in profitability and difficulties in attracting labour, wanted to offer higher wages. In contrast to Swedish traditions, this initial breakdown prompted increased government intervention in the wage bargaining process in an effort to maintain centralization. In addition both peak organisations repeatedly tried to discipline their members. In a situation where business enjoyed exceedingly good profits and unemployment dropped below 2% such appeals were increasingly futile. 

In a last desperate attempt to restore some degree of moderation and centralization to the labour market, the government, in February 1990, proposed a general ban on wage and price increases as well as a ban on strikes. Although the leadership of both the LO and SAF originally supported the proposed measures, opposition from their members rapidly made their position

735 Nilson 1988, p. 25.
736 See Martin 1991.
untenable. Moreover, the measures failed to secure a majority in the Riksdag. It was only after the onset of a severe recession during 1990 that it was possible to restore some degree of centralization and moderation in the labour market. Yet, the fact that this re-centralization had to take place outside of the traditional channels of negotiations between the LO and SAF leadership testifies to the severity of the disruption of relations between the peak association’s leadership and their constituents.

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<td>2.8</td>
<td>6.7</td>
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<td>1.5</td>
</tr>
</tbody>
</table>

Source: The Swedish Economy, Several Issues.

Eventually, then, the scarcity in the labour market posed a more serious problem to the cohesion of the LO than the much debated structural shift in the composition of the labour force which led to a blurring of the boundaries between white and blue collar workers. The latter development made only the effort to reduce overall wage differential increasingly unworkable and the LO has de facto largely given up on this goal already since the mid-eighties. The labour market scarcity however disintegrated the LO’s capacity for overall wage moderation.

The conservative governments in Norway during the first half of the 1980s largely refrained from formal incomes policies but they issued frequent appeals for wage moderation. Under the centralised Norwegian labour market system it could count on a substantial degree of wage moderation. But also in Norway tight labour markets rapidly undermined the ability of peak

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organisations to enforce agreements. Wildcat strikes increased substantially in the first part of the decade as compared to the seventies. As a result central unions themselves felt the need to bargain for higher wage increases. In the 1986 bargaining round the LO, for the first time in several years, was not satisfied with protection of the existing real wage but demanded an increase plus a reduction of the workweek from 40 to 37.5 hours. Not willing to agree, the employers side called a large scale lockout. Calling a large lockout in fairly tight labour market conditions soon turned out to be a mistake. Support for the lockout soon disintegrated within the employers’ camp and the NHO had to make a humiliating retreat. As a result, contractual wages in industry during virtually exploded in 1986-87, despite the fact that wage drift even increased with respect to the previous year.

But why the did both governments allow the boom to continue for so long instead of using restrictive fiscal and or monetary policies to slow down the economy? In both countries the Central Banks had attributed part of the blame for the boom to excessive fiscal spending. For MOF Feldt himself it was unforgivable that fiscal policy actually became stimulating after the mid eighties. Politically, strong fiscal restriction would have been quite difficult for both the bourgeois government in Norway and the SAP government in Sweden, especially because they were in a minority position. The high oil income in Norway and the growing economy meant that it would have been very difficult to explain the need for restriction. As mentioned above, the DNA itself voted against spending cuts proposed by the Willoch government even as late as 1986. In Sweden the strategy of fiscal moderation was opposed from the beginning by what may be called the Keynesian wing in the SAP and LO. During its time in opposition the SAP had criticized the government for its cuts in public sector spending. Former finance minister Gunnar Sträng was not thrilled by Feldt’s calls for fiscal moderation. As Keynesian policies could supposedly increase employment without the increase in private sector profits Feldt called for, this view quite naturally held a greater appeal to the LO. On several previous occasions the emergence of high profits had undermined the member’s acceptance of LO’s wage moderation. And irrespective of the question of private sector profits the Keynesian strategy was obviously inherently more attractive to the public sector unions. The ferocity of the international crisis of 1979-82 and the escalating budget deficit helped the SAP to overcome these objections. Yet, as the success of the Third Way materialized, pressures for increased fiscal spending intensified.

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738 See, for example, Bergström 1987, 1991 on the SAP 1981 congress.
Table 5.12: Yearly increase in wages in Norwegian manufacturing of adult males, by contractual increase and wage drift. In %

<table>
<thead>
<tr>
<th>Period</th>
<th>Total Increases in Wages</th>
<th>Contractual Increase</th>
<th>Wage Drift</th>
<th>Wage Drift as share of Contractual</th>
<th>Unemployment Rate (%)</th>
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<td>1971:1-1972:1</td>
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Yet, fiscal policies could be made responsible to contributing to the boom only in a very restrictive sense. Swedish budget deficits declined rapidly after 1982, and during the late eighties the budget was in surplus. As a budget surplus implies that demand is drained from the economy, it would hardly be appropriate to label fiscal policies expansionary. If fiscal policies are to be blamed for the overheating this could only be true in the sense that they were not restrictive enough to prevent overheating given the buoyant demand in the private sector. Accordingly, the criticism of fiscal policies can not be subsumed under the new neoclassical policy orthodoxy in which ill-advised fiscal policies are held to be the cause of disturbances in the real sector. At best fiscal management can be accused of a "Unterlassungsstünde", i.e. a failure to appropriately counteract the dynamism of the private sector. However, it is highly debatable whether even the latter accusation can be leveled justifiably. When the Keynesian policy orthodoxy disintegrated in the seventies and it became fashionable to blame governments for all the ills besetting the economy, the concept of crowding out enjoyed a renaissance. It has hardly ever been pointed out that, what may be called "crowding in" is a possibility as well. A further increase in the budget surplus would only have produced a proportionate decrease in aggregate demand on the assumption that the private sector was in equilibrium. But all the indicators pointed to the incorrectness of this assumption.
But even if fiscal policies could not be made sufficiently restrictive, more restrictive monetary policies and a revaluation could have been used to curb overheating. Using exchange rate and/or monetary policy would also have had the political advantage that such a policy did not require a majority of the Riksdag or the Storting. Rather a majority in the Central Bank board would have been sufficient. Although Riksbank governor Dennis continuously pushed for more restrictive fiscal policies, he argued that there was no possibility of more restrictive monetary policies. As long as the Krona was to be maintained at its parity with the currency basket, no room for increased interest rates was said to exist. A revaluation, it was argued, would have not been credible on international financial markets. But even within the theoretical framework used by the Riksbank, Dennis’ justification can hardly be considered convincing. If a revaluation had indeed not been credible, higher interest rates would have been required to maintain the new parity. Accordingly the lack of credibility would have allowed the Riksbank to exceed international interest rates levels and hence would have strengthened rather than weakened the dampening effects.\textsuperscript{739}

Although it is difficult to document the exact decision making process within the Riksbank, it is plausible that Governor Dennis shared Feldt’s main conviction that the private sector was too small and the public sector too big. From that perspective a revaluation would have been quite perverse as it would have had a significant effect on the exposed sector while leaving the sheltered sector unscathed.

Here then reappeared the basic dilemma, which had already frustrated the SAP’s efforts in economic policies during the late teens and early twenties. In order to promote growth and full employment investment activity had to be stimulated at all costs, yet without the ability to effectively curb inflationary expectations, investment would gradually acquire the character of a flight out a money and into highly speculative transactions. In short, in order to regain the stability of the monetary economy Social Democrats had to discourage investment and use the unemployment rate in order to compensate for the disruption of the trade unions ability to moderate wages. Social Democrats, not surprisingly attempted to avoid this choice as long as possible and increasingly had to resort to desperate measures. Eventually the dilemma could only be 'solved' by embracing a theory which reintroduced the dichotomy between the real and monetary sector, so typical of the standard view of the twenties, and in which the simultaneous presence of a restrictive macroeconomic regime and microeconomic policies to promote risk-capital and investment are not considered contradictory any more.

\textsuperscript{739} See also Wohlin 1991, p. 382. "En rörlig växelkurs hade gjort det möjligt för riksbanken att driva upp ränteläget väsentligt högre redan 1986 -1988."
III Conclusion
6 The Feasibility of Social Democracy in an Internationalized Economy

"The experience of the years before the war has led most of us, though some of us late in the day, to certain firm conclusions. Three, in particular are highly relevant to this discussion. We are determined that, in future, the external value of sterling shall conform to its internal value, as set by our own domestic policies, and not the other way round. Secondly, we intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements, or flights of hot money. Thirdly, whilst we intend to prevent inflation at home, we will not accept deflation as the dictate of influences from outside. In other words, we abjure the instruments of the Bank rate and credit contraction operating through the increase in unemployment as means of forcing our domestic economy into line with external factors." (JMK XXVI, p. 16)

"In my opinion, free movements of capital appear desirable from the standpoint of stabilisation policy. A stabilisation policy that accommodates domestic inflationary disturbances becomes untenable if it rapidly results in capital outflows that threaten the foreign exchange reserves. As a result, greater discipline is imposed on both monetary and fiscal policy; accordingly fundamental imbalances need not arise.

Thus, currency flows should function as a clear signal that policies need to be changed." Lars Calmfors 1985, quoted in Glynn 1992, p. 110.740

6.1 Introduction

Starting with the crusades, the history of Western Europe, in a sense, is a history of the internationalization of political and economic relations.741 Hence there can be little doubt that the economic and political conditions in European nations during the last three hundred years have been strongly influenced by external factors. Discoveries and subsequent colonization of vast new territories gave rise to the first truly global trading network; the discovery of gold in South America and later in North America fuelled inflation in Europe; the decline of transportation costs led to inflows of cheap Russian and American agricultural goods and contributed to the Great Depression of the 19th century; international finance started with the Fuggers in Augsburg and was developed to great heights in Venice, Amsterdam and London; the first transatlantic telegraph in 1866 linked financial markets closer together than ever before; the spread of the Gold Standard since the 1860s implied closer policy coordination between participating nations. Moreover, in a system

740 Swedish; Calmfors 1985, p. 89.
741 See, for example, Wallerstein 1974.
characterised by extensive international trade the macroeconomic policies of, especially, the large countries was bound to have strong impacts on the smaller countries. The decision of the USA and Britain to return to gold in the early twenties obviously had a depressing effect on Norway, Sweden and the Netherlands. Similarly the start of restrictive policies in Germany in 1973 and the US turn to monetarism in 1978 strongly affected smaller nations.

One might be content to conclude, therefore, that "international factors matter" and there would be no difficulty supporting this with some detailed case studies. Yet the mere fact that countries are affected by their environment is obvious and, therefore, rather uninteresting. This chapter will address a more precise question: To what extent can the three changes in economic policy regimes which can be observed in Western Europe since the end of the First World War be attributed to international forces beyond the control of domestic governments? Did the turn to restrictive policies in large economies leave smaller nations no choice but to also embrace such policies? And did large countries themselves have a choice in a world of free capital mobility? More precisely, is a Social Democratic policy for growth and full-employment possible in an internationalised economy or does the economic viability of Social Democracy depend on the absence of free cross-border capital flows?

Two years before his death, Keynes argued in a speech to the British House of Lords, that the toleration of free international capital movements would indeed seriously compromise the ability of the government to pursue full-employment policies. Keynes' determination to "retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements or flights of hot money" was widely shared at the time. The recognition that international capital flows needed to be strictly controlled both in the interest of international financial stability and domestic policy autonomy entered prominently into the institutions and policies of the Bretton Woods era.

The first three decades after the Second World War seemed to brilliantly confirm Keynes' views; international capital mobility was at an historic low and the world economy boomed. The Keynesian belief in the manageability of the economy, however, would not survive the seventies and eighties when mass-unemployment again became a constant and seemingly intractable problem.

743 The articles of the International Monetary Fund (IMF) in particular.
in western economies. After the first oil price crisis, but especially during the recession of 1979-82 most developed countries experienced a substantial rise in unemployment. And by the early 1990s even the Social Democratic holdouts of Norway and Sweden had to report mass-unemployment.

Simultaneously with the reemergence of mass-unemployment, international capital mobility revived strongly. The exchange rate crises of the late sixties and early seventies, which eventually brought down the Bretton Woods system of fixed exchange rates, were only the prelude to even more extensive and volatile capital movements in the following decades. The amount of cross border financial transactions virtually exploded since the late sixties. As Helleiner (1994, p. 1.) notes, daily foreign exchange trading in the early 1990s had reached a level of about $1 trillion, which is roughly forty times the size of daily international trade. As many Central Banks have repeatedly experienced, the amount of short term speculative capital flows dwarfs the resources they can muster for exchange rate defence. 744 In addition the explosive growth of so-called Euromarkets meant that a substantial part of international financial transaction took place at a remove from national regulators.

The almost simultaneous appearance of these two phenomena has led many politicians and scholars to conclude that the reemergence of international finance undermined the Keynesian world in which governments could guarantee full employment by means of macroeconomic policies. 745 In theoretical terms the 'external constraints' view can be interpreted as an adaptation of the Keynesian position to the events of the last 25 years. 746 In contrast to the newly popular neoclassical interpretation, the external constraints view holds that macroeconomic policies in principle can be effective in durably influencing the economy, but that national governments have lost control over economic policy instruments. By maintaining, on the one hand, that macroeconomic policies do affect the economy in the long run, the external constraints view does seem to provide an explanation for the neoclassical puzzle of why growth and employment failed to recover after the disinflation

744 See, for example, Langli 1993.

745 See, for example, Garrett & Lange 1991 p. 542-3, who argue that during the fifties and sixties "..leftist governments were able to pursue the interventionist policies of the full-employment welfare state - epitomized by countercyclical fiscal and monetary policies - without fear of undermining macroeconomic performance. ... Thus, even if today there are still strong domestic incentives for governments to pursue distinctive partisan strategies (...), these interdependence arguments suggest that such incentives are now overwhelmed by international constraints." Huber & Stephens 1992, p. 6: "National sovereignty over economic and social policy was lost due to the internationalization of capital markets." Also Stewart 1983, Scharpf 1987, Ci.: 11.

746 External constraints are not a important topic in neoclassical economics because macroeconomic policies even in a (hypothetical) closed economy are considered unable to durably affect growth and employment. Rather free capital flows are considered desirable as a protection against domestic inflationary policies. See, for example, Calmfors 1985.
of the seventies and eighties. On the other hand, the view that restrictive policies are forced upon reluctant governments by external forces seems to explain why macroeconomic policies are restrictive in a time of high unemployment.

Surveying the last two decades, the external constraints view seems able to draw from a rich reservoir of evidence. In a study of changes in economic policies in eleven countries, the Organization for Economic Cooperation and Development (OECD, 1988, p. 16), for example, concluded: "In almost all the episodes considered, it was exchange-rate pressure that brought matters to a head and determined the timing of the introduction of comprehensive policy measures."\(^{747}\) The example of Mitterand's U-turn of 1982 features prominently in many accounts of external constraints on macroeconomic policies. In the US the shift to restrictive monetary and fiscal policies was preceded by a period of continuous capital outflows and a depreciating dollar. In Britain the turn to monetarism was effectively prepared under the Labour government when strong downward pressures on Sterling in 1976 led the government to take the humiliating step of applying for IMF assistance. Even the Bundesbank was not impervious to external pressures: Chancellor Schmidt's expansionary policies of the early eighties led to massive capital outflows, which prompted the Bundesbank into drastic interest rate increases in February 1981. More recently, Bundesbank president Schlesinger deflected part of the political pressure to lower interest rates in the wake of unification by pointing out that interest rate reductions in Germany are constrained by the need not to destabilise exchange and credit markets.\(^{748}\)

For smaller countries, not surprisingly, many more examples can be found. In Austria the demise of the successful policy of full-employment started in 1979 when the attempt to pursue a more expansionary monetary policy had to be abandoned in the face of massive capital outflows.\(^{749}\) In Denmark two attempts - by Social Democratic governments - in the mid and late seventies to pursue expansionary policies floundered on a current account deficit and downward pressure on the currency.\(^{750}\) In Norway the Social Democrats' turn to restrictive policies in 1986, which was followed by the highest unemployment since the thirties, was preceded by massive downward pressure on the Krone.\(^{751}\)

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\(^{747}\) Emphasis in the original.

\(^{748}\) In an interview with the *International Herald Tribune* on Tuesday April 27, 1993.

\(^{749}\) See, for example, Scharpf 1987, p. 91 and Unger 1990.

\(^{750}\) See, for example, Thygesen 1982 and Mjøset, ed., 1986.

\(^{751}\) See, for example, Qvigstad & Skjøveland 1994.
But even though it has become commonplace to attribute the decline of the full employment regime to insurmountable external constraints, the argument is both theoretically and historically flawed. Neither is the reemergence of high international capital mobility since the late sixties an inevitable trend based on technological advances, nor does the presence of high capital mobility preclude alternative macroeconomic policies. Especially when looking at the conduct of economic policies in a longer perspective, the claim that the emergence of global finance terminated the successful pursuit of growth and full-employment policies is not very convincing for five reasons. First, today’s high level of international capital mobility is not without historical precedent, nor is the widespread belief that international capital mobility leaves countries no other option than to pursue restrictive policies. Second, as the experience of the Great Depression shows, the historical record does not provide strong evidence that the presence of extensive cross-border financial flows requires countries to pursue restrictive macroeconomic policies. Also in more recent times several countries have been able to pursue a more expansionary policy course despite high capital mobility. While many European countries were complaining that Paul Volcker’s restrictive policies forced them to do the same, Japan defended a more expansionary policy orientation by means of an aggressive devaluation. In Europe, the Social Democratic governments in Sweden and Norway for a long time defended their commitment to full-employment by staying outside the European Monetary System (EMS). Moreover, after the breakdown of the narrow EMS band in late 1992, it has again become difficult to argue that the effect of increased capital mobility is to require fixed exchange rate policies in order to maintain the confidence of financial markets. It is noteworthy that the Swedish Riksbank felt it necessary to charge an interest rate of 500% - from September 16 to 21, 1992 - when it was desperately trying to defend a fixed exchange rate, and not after it had let the Krona float downward.

Third, it would also appear rather surprising that at a time when governments are allegedly under increasing pressures from international capital flows, economic policies seem to aim at increasing the international financial exposure of domestic economies rather than reducing them. Whereas the massive capital flows of the interwar period led many governments, during the thirties and after the War, to impose exchange controls, governments in the seventies and eighties have been abolishing restrictions on cross border capital flows. At present even moderate proposals to limit international financial speculation, like the so-called Tobin tax\textsuperscript{752}, fail to arouse an interest in most countries.

\textsuperscript{752} Tobin (1978) proposed an "internationally uniform tax on spot transactions across currencies".
Fourth, it is somewhat peculiar that the conviction that full-employment policies have fallen victim to external constraints historically tends to gain political popularity exactly when many governments hold that expansionary macroeconomic policies are in fact undesirable because they merely lead to higher inflation,\(^{53}\) and that external constraints hence constitute a welcome obstacle to inflationary domestic policies.\(^{54}\) The Bundesbank’s turn to restrictive policies since 1974 was, obviously, not prompted by external constraints but by the desire to quell domestic inflation. Nor was Margaret Thatcher forced by external constraints to pursue restrictive policies.

Fifth, while it is correct that the successful pursuit of growth and full-employment since the late thirties was closely linked to the macroeconomic policy stance, a countercyclical Keynesian policy pattern was, as has been argued, a rare case indeed which had been mainly confined to textbooks. But if neither the recovery from the Great Depression nor the postwar growth can be attributed to Keynesian policies, the alleged emasculation of such policies due to international capital mobility cannot serve as an explanation for the termination of full employment. In sum, because the present level of international capital mobility is not historically unprecedented and because countries have managed to steer an alternative course despite high capital mobility, it is not very convincing to argue that no room for policy choice exists due to external constraints.

Instead, the turn to restrictive policies in both the early twenties and the last two decades was primarily driven by domestic rather than international factors. Both the reemergence of the Gold Standard as well as the popularity of the EMS and exchange deregulation in the eighties are a reflection of a domestic institutional failure to contain inflation rather than an inevitable outcome dictated by the imperatives of internationally mobile capital. It was the runaway inflation in a constellation of vigorous restocking boom and an uncontrolled monetary overhang which made post World War I governments deem the reconstruction of the Gold Standard necessary. And again during the last two decades the failure even of corporatist institutions to contain inflation, has made

\(^{53}\) As David Andrews (1994, p. 439) notes: "... fundamental modifications in the causal beliefs of monetary authorities about the long-term trade-off between inflation and unemployment have taken place, with the result that many governments have become less tolerant of inflation. This shift in the internal preferences of European governments coincided with the changes in external constraints they face (..). Under such circumstances, the decision of most Western-European governments to adopt the so-called 'strong currency option vis à vis the deutsche mark is, if anything, overdetermined." Emphasis in the original.

\(^{54}\) See, for example, James Callaghan’s famous pronouncement at the 1976 Labour Party conference: "We used to think that you could spend your way out of a recession and increase employment by cutting taxes and increasing government spending. I tell you in all candour that that option no longer exists, and that insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment in the next step." Quoted in Callaghan 1987, p. 426.
the imposition of external constraints desirable.\textsuperscript{755} Under the mounting difficulties with containing inflation by means of incomes and price policies, external constraints represented a welcome alternative means to help enforce price stability.

6.2 A Secular Increase in Financial Integration?

Not unlike the widespread belief that somewhere between the mid thirties and early fifties a 'Keynesian revolution' in policy making took place, the view that the present period is characterised by a historically unprecedented level of international financial integration, with the result of a dramatic reduction in national policy autonomy, threatens to become an article of faith which requires no further investigation. While international capital mobility has certainly increased dramatically during the last 25 years it is by no means clear that the present situation is historically unique. Free flow of capital across borders constituted one of the main pillars of the classical Gold Standard system and accordingly the pre-1914 period was marked by very high capital mobility.\textsuperscript{756} Not unlike the seventies and eighties, the monetary history of the twenties and thirties is rife with examples of large speculative capital movements. Especially during the late twenties and early thirties hot money flows connected to suspected exchange rate changes frequently reached such proportions that they overwhelmed the resources of central banks.\textsuperscript{757} Reviewing the period 1920-70, Carlo Zacchia (1977, p. 584), for example notes: "Short-term capital movements did not reach, in the post-war period, the dimensions of the twenties, neither did they produce such disruptive effects." Robert Zevin, examining the empirical evidence on financial openness comes to the conclusions that "every available descriptor of financial markets in the late nineteenth and early twentieth centuries suggests that they were more fully integrated than they were before or have been since."\textsuperscript{758}

\textsuperscript{755} See also Zevin 1992, p. 73: ".. much of the observed international financial market cohesion in the 1980s reflects a genuine convergence of policies. I believe this convergence can be explained by common responses to the inflation and perceived policy errors of the 1970s."

\textsuperscript{756} In his Theory of Money and Credit, first published in German in 1912, Ludwig von Mises (1980, p. 413), for example, argued: "The mobility of capital goods, which nowadays is but little restricted by legislative provisions such as customs duties, or by other obstacles, has led to the formation of a homogeneous world capital market. In the loan markets of the countries that take part in international trade, the net rate of interest is no longer determined according to national, but according to international, considerations. Its level is settled, not by the natural rate of interest in the country, but by the natural rate of interest anywhere. Emphasis in the original.

\textsuperscript{757} See, for example, Brown 1987, Chapter 1.

\textsuperscript{758} Zevin 1992, p. 51-2.
Although the advances in telecommunication and information technology of the last two decades have been quite spectacular indeed, the technological means for moving large sums of money quickly across borders have been available ever since the establishment of international telegraph and telephone services in the final decades of the 19th century. While computers, fibre optic cables and satellites do process information much swifter than the old telephone and telegraph lines the few minutes gained by using modern technology to transfer funds are not policy relevant.\footnote{See Zevin 1992, p. 51-3.}

As the history of the demise of the Gold Standard shows, the occurrence of massive international speculative capital flows was not a phenomenon which had to await the coming of these innovations. And despite continuous technological advances since the 1930s, cross-border financial flows subsided strongly since the second part of the thirties and revived only in the late sixties. Moreover, the technological determinism implicit in some versions of the external constraints view ignores the Janus-faced nature of all technological advances. For governments so willing, modern technology provides the means to monitor the activities of citizens to an extent unparalleled in history. There is no reason why such technology could not be used to actually tighten control over cross-border transaction, especially so since "the reality is that such electronic transfers leave more traces than traditional currency transactions." (Block 1987, p. 216)\footnote{See also Block, 1987, p. 184: "The point is that the degree to which the international economic order regulates and restricts international capital flows is itself a matter of political choice, and the efficiency arguments for complete freedom of capital movement are deeply flawed." Also Stewart 1983, p. 26.}

Nor does the history of economic policy-making seem to provide strong evidence that the presence of extensive cross-border financial flows requires countries to pursue restrictive macroeconomic policies. If it was possible to establish a regime which gave preference to internal balance and growth during a period of relatively strong financial integration, it cannot be argued that the "Keynesian capacity" of national states was inevitably doomed once capital mobility increased again from its post World War II low. If it is the degree of financial integration which accounts for the present spread of restrictive policies, no policy change during the Great Depression should have been possible to start with. Instead, in the thirties highly international speculative capital constituted a bigger problem for governments who clung to the Gold Standard than for those embarking on inflationary policies.

The rapid reemergence of (short-term) international capital flows since the sixties has no doubt made the life of central bankers more difficult. Given the massive financial flows which may occur as soon as suspicion with respect to the maintainibility of a given exchange rate level arises,
it is easy to understand how central bankers, especially those in small countries, may come to feel that they possess only very little autonomy. Yet, the fact that the defense of a given exchange rate has become more difficult in no way implies that domestic economic policies have to be adjusted to the exchange rate rather than the other way round. In fact one might just as well argue that increased capital mobility facilitates more expansionary policies as it increases the costs of defending an overvalued currency. By making an overvalued exchange rate untenable, increased capital mobility could be seen to have the effect of improving the coordination between exchange rate policy and the general orientation of the policy regime.

Table 6.1: Descriptive Statistics of Real Interest Rates, the G11 Countries, 1881-1990.

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Standard Deviation</td>
<td>Mean</td>
<td>Standard Deviation</td>
<td>Mean</td>
<td>Standard Deviation</td>
</tr>
<tr>
<td><strong>Real Short-Term Interest Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>4.8</td>
<td>2.0</td>
<td>3.8</td>
<td>6.7</td>
<td>0.3</td>
<td>3.9</td>
</tr>
<tr>
<td>Britain</td>
<td>2.9</td>
<td>2.3</td>
<td>4.2</td>
<td>7.1</td>
<td>-0.1</td>
<td>3.4</td>
</tr>
<tr>
<td>Germany</td>
<td>2.4</td>
<td>2.3</td>
<td>5.1</td>
<td>5.2</td>
<td>2.2</td>
<td>2.6</td>
</tr>
<tr>
<td>France</td>
<td>2.8</td>
<td>6.4</td>
<td>1.2</td>
<td>14.7</td>
<td>-0.9</td>
<td>5.2</td>
</tr>
<tr>
<td>Japan</td>
<td>-1.5</td>
<td>5.5</td>
<td>1.4</td>
<td>8.8</td>
<td>1.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Canada</td>
<td>n.a.</td>
<td>n.a</td>
<td>n.a.</td>
<td>n.a</td>
<td>n.a.</td>
<td>n.a</td>
</tr>
<tr>
<td>Italy</td>
<td>n.a.</td>
<td>n.a</td>
<td>n.a.</td>
<td>n.a</td>
<td>n.a.</td>
<td>n.a</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.8</td>
<td>4.8</td>
<td>0.6</td>
<td>9.6</td>
<td>0.4</td>
<td>3.8</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.2</td>
<td>2.8</td>
<td>4.3</td>
<td>5.8</td>
<td>-1.7</td>
<td>3.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>n.a.</td>
<td>n.a</td>
<td>1.8</td>
<td>1.5</td>
<td>1.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Switzerland</td>
<td>n.a.</td>
<td>4.4</td>
<td>5.3</td>
<td>-0.1</td>
<td>1.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Mean</td>
<td>2.3</td>
<td>3.7</td>
<td>2.7</td>
<td>7.2</td>
<td>0.4</td>
<td>3.2</td>
</tr>
<tr>
<td>Convergence</td>
<td>1.1</td>
<td>1.6</td>
<td>1.9</td>
<td>2.6</td>
<td>1.0</td>
<td>0.8</td>
</tr>
</tbody>
</table>

| **Real Long-Term Interest Rate** |
| USA                  | 3.7  | 2.2            | 4.6  | 6.8            | 0.8  | 3.6           | -0.7 | 4.4            | 2.5  | 0.7           | 3.9  | 3.8           |
| Britain              | 3.0  | 2.3            | 5.4  | 7.1            | 1.1  | 2.8           | -0.8 | 2.6            | 3.2  | 1.0           | 2.2  | 3.7           |
| Germany              | 2.9  | 2.4            | 6.9  | 6.0            | 4.3  | 2.8           | 4.3  | 4.4            | 4.3  | 0.9           | 4.4  | 0.9           |
| France               | 3.5  | 6.5            | 1.0  | 15.1           | 0.4  | 4.4           | -1.2 | 6.2            | 1.8  | 1.1           | 1.8  | 1.2           |
| Japan                | n.a. | n.a            | 1.7  | 1.3            | n.a. | n.a           | n.a. | n.a            | n.a. | n.a           | n.a. | n.a           |
| Canada               | 2.9  | 4.1            | 5.4  | 6.5            | 1.3  | 3.8           | -0.7 | 4.4            | 3.4  | 0.7           | 3.8  | 3.1           |
| Italy                | 4.2  | 2.4            | 3.4  | 9.3            | 0.3  | 9.4           | -1.5 | 12.9           | 2.3  | 2.2           | 1.4  | 4.8           |
| Belgium              | 5.2  | 5.0            | 1.8  | 9.8            | 2.7  | 3.4           | 1.8  | 4.6            | 3.5  | 1.1           | 4.1  | 3.3           |
| Netherlands          | 2.4  | 2.6            | 5.8  | 5.6            | 0.1  | 3.1           | -1.3 | 3.5            | 1.6  | 1.7           | 4.2  | 2.4           |
| Sweden               | 3.4  | 3.3            | 6.1  | 7.0            | 0.5  | 3.3           | -0.9 | 3.9            | 2.0  | 1.4           | 2.8  | 3.0           |
| Switzerland          | n.a. | 6.6            | 5.5  | 1.0            | 1.7  | 1.7           | 1.8  | 1.8            | 1.1  | 1.4           | 1.3  | 1.6           |
| Mean                 | 3.3  | 3.4            | 4.7  | 7.9            | 1.3  | 3.6           | 0.1  | 4.9            | 2.5  | 1.2           | 3.3  | 3.1           |
| Convergence          | 1.1  | 1.2            | 1.5  | 1.9            | 0.9  | 1.2           | 1.4  | 1.6            | 0.8  | 0.4           | 0.9  | 0.8           |

*Note: Real interest rates calculated as the nominal interest rate minus the annual rate of change of the CPI.*

*Source: Bordo & Jonung, p. 49-51.*

Moreover, while central banks predominantly operate in the markets for (very) short term funds, it is not necessarily true that the international considerations also decisively affect long term real and nominal interest rates. But especially for a policy regime which prioritises growth and full-employment, the development of real long term interest rates rather than short term rates should
be of crucial importance. The available empirical evidence, however, does not suggest that periods of high capital mobility are necessarily characterized by international convergence of real long term interest rates.

In an impressive empirical study of monetary regimes from 1881 to 1990 Bordo & Jonung (1994), for example, found that such was not the case. Table 6.1 summarizes some of Bordo & Jonung’s findings. The first column for each respective period shows the mean of short- and long-term real interest rates, as well as the grand mean. The degree of convergence was calculated by taking the mean of the absolute differences between each country’s descriptive statistic and the grand means of the group of countries.\textsuperscript{761}

The figures for short-term rates indeed seem to confirm increasing integration. Convergence around the mean is stronger in the most recent period than during any previous time. But it should be noted that there is no historical trend towards convergence. Convergence decreased during the Interwar period and increased again during the Bretton Woods period as a whole. Moreover the increase in convergence during the seventies and eighties as compared to the sixties is minimal. The figures of long-term rates, however, show a different picture. The most recent period does not appear as a time of historically unique financial market integration. In fact convergence for the seventies and eighties is the same as for the Bretton Woods period. And although convergence increased during the sixties, it has decreased again, albeit minimally.

<table>
<thead>
<tr>
<th>Year</th>
<th>USA</th>
<th>Canada</th>
<th>Japan</th>
<th>Britain</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Belgium</th>
<th>Switzerland</th>
<th>Sweden</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965-69</td>
<td>1.8</td>
<td>2.6</td>
<td>2.1</td>
<td>3.1</td>
<td>4.7</td>
<td>3.2</td>
<td>3.2</td>
<td>3.2</td>
<td>1</td>
<td>2.4</td>
<td>3.7</td>
</tr>
<tr>
<td>1970-74</td>
<td>0.7</td>
<td>1.8</td>
<td>-3.4</td>
<td>1</td>
<td>3.2</td>
<td>1.3</td>
<td>0.7</td>
<td>1</td>
<td>-1.3</td>
<td>0.2</td>
<td>6.6</td>
</tr>
<tr>
<td>1975-79</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
<td>-2.2</td>
<td>3</td>
<td>0.5</td>
<td>-3.2</td>
<td>1.3</td>
<td>1.6</td>
<td>-0.1</td>
<td>6.2</td>
</tr>
<tr>
<td>1980-84</td>
<td>4.9</td>
<td>4.6</td>
<td>4.1</td>
<td>2.9</td>
<td>4.2</td>
<td>3.6</td>
<td>1.1</td>
<td>5.2</td>
<td>0.3</td>
<td>2.8</td>
<td>4.9</td>
</tr>
<tr>
<td>1983</td>
<td>8.1</td>
<td>5.9</td>
<td>5.6</td>
<td>6.2</td>
<td>4.6</td>
<td>4.9</td>
<td>2.9</td>
<td>4.1</td>
<td>1.2</td>
<td>3.5</td>
<td>6.9</td>
</tr>
<tr>
<td>1984</td>
<td>8.2</td>
<td>8.4</td>
<td>4.5</td>
<td>5.8</td>
<td>5.4</td>
<td>5.7</td>
<td>4.2</td>
<td>5.6</td>
<td>1.6</td>
<td>5.6</td>
<td>6.6</td>
</tr>
</tbody>
</table>

*Note:* The estimates are based on the yield on (long-term) industrial bonds at the close of every month, subtracted by the percentage change in the respective consumer price index during the immediately preceding twelve -month period. The column furthest to the right shows the range, i.e. the difference between the highest and lowest real interest rate for each period.

*Source:* Oexlheim 1990, p. 244.

In a book-length study on the financial integration of the Swedish economy, Oexlheim (1990) failed to find evidence of a dramatic increase during the last two decades. On the contrary, surveying the differentials of real long-term interest rates between Sweden and a host of other countries, total

\textsuperscript{761} See Bordo & Jonung 1994, p. 19.
financial integration\textsuperscript{762} rather seemed to have decreased in the early eighties (See Table 6.2). "Whatever perspective we adopt in relation to real interest rate developments, the conclusion is that during the first half of the 1980s total financial integration decreased compared with the immediately preceding period\textsuperscript{763} (Oxelheim 1990, p. 344). For Norway, Damman (1991, p. 54-56) has shown that both the real and the nominal interest rates for Norwegian and US state bonds moved very closely up to roughly 1980. After 1980, however, large interest rate differentials appeared.\textsuperscript{764}

6.3 Some Views About the Importance of External Constraints

Not surprisingly the political and academic debate about the impact of external constraints on domestic policies closely follows the distinction between neoclassical and Keynesian interpretations (See Table 6.3). While Social Democrats generally tend to hold policy autonomy to be desirable, neoclassically inspired views frequently arrive at the opposite conclusion. The neoclassical argument for the undesirability of domestic policy autonomy, as reflected in the advocacy of a return to the Gold Standard and of maintaining fixed exchange rates in the EMS is ultimately based on the assumption of the neutrality of money. As shown in chapter 2 neutrality of money implies that expansionary monetary policies will merely cause inflation while expansionary fiscal policies tend to expand the public sector at the expense of the private sector. Since it is also commonly assumed in these views that governments, for electoral reasons are continuously tempted to pursue expansionary macroeconomic policies, the policy constraint arising from a fixed exchange rate, in conjunction with or as an alternative to an independent central bank, are seen as a device which will protect the domestic economy from the inherent myopia of the political system. Keynesians, in contrast, hold that macroeconomic policies are crucial in determining the level of unemployment. Moreover, they do not share the neoclassical skepticism with respect to the state, but rather hold that the conduct of economic policies will be informed by the desire to maximise the performance of the economy.

\textsuperscript{762} A situation of total financial integration would be characterised by cross-national equality of real interest rates. For this condition to obtain not only financial markets but also goods markets have to be fully integrated. An observed reduction in total financial integration can hence be due to either reduced financial and/or reduced goods market integration.

\textsuperscript{763} Zevin (1992, p. 53-4) also argues that financial integration has been less in the eighties than in the seventies.

\textsuperscript{764} For Sweden see Gottfries et al 1992: p. 25.
Yet, the assumption that macroeconomic policies cannot affect real variables is not a necessary one in order to arrive at the conclusion that domestic policy autonomy is undesirable, as the case of Hegemonic Stability Theory (HST) shows. The core concept of this view is one of a potentially anarchic international system which is continuously plagued by problems of free-riding and non-cooperation. In this view Adam Smith's invisible hand most definitely does not extend its reach to the international economy. Instead the perennial threat to a stable international system of mutually beneficial relations arises from individual countries' efforts to maximise their own short-term benefits thereby destroying the wellsprings of common welfare. International prosperity, therefore, comes to depend upon the presence of a benevolent hegemon who will let the concern for the maintenance of a mutually beneficial system of international relations prevail over the short term maximisation of his own interests. The mayhem of the Great Depression, in this perspective, can be interpreted as a relapse into "beggar-your-neighbour" policies due to the absence of such benevolent leadership.

Table 6.3: Some Views on Macroeconomic Policy Autonomy

<table>
<thead>
<tr>
<th>Is policy autonomy possible?</th>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard Keynesianism</td>
<td>Neoclassical Views</td>
</tr>
<tr>
<td></td>
<td>This Study</td>
<td>Hegemonic Stability Theory</td>
</tr>
<tr>
<td></td>
<td>External Constraints Views</td>
<td>--</td>
</tr>
</tbody>
</table>

The characterization of the catastrophe of the Great Depression as a vicious cycle of competitive depreciation and tariff increases received strong support by Ragnar Nurkse's influential League of Nations Study. The most sophisticated and most influential version, however, is Kindleberger's (1973). For Kindleberger the Great Depression came about because the USA

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765 See also Gilpin 1987, p. 147, and Oye 1992, p. 211: "The vast majority of academics and policy makers in advanced industrial states ... see the transcendence of dilemmas of collective action as the central problem in contemporary international political economy."

766 The economic disturbances since of the last decades might similarly be related to an alleged weakening of US hegemony and the lack of a successor. Yet, the last two decades have posed more problems to the advocates of Hegemonic Stability theory than the Great Depression because the counterpart to what is alleged to have been a series of competitive devaluations in the thirties seems to be lacking at present.

767 Kindleberger preferred the term responsibility to hegemony (Kindleberger 1986, p.289). The label HST has been placed on his views by other scholars.
was unwilling and the UK unable to provide the necessary leadership to stabilise the system. As a result, the absence of countercyclical lending and an international lender of last resort; the failure to maintain open trade market and stable exchange rates; and the lack of international policy coordination conspired to produce one of the severest economic recessions in history.\textsuperscript{768} "When every country turned to protect its private national interest, the world public interest went down the drain, and with it the private interest of all."\textsuperscript{769}

Given the weight they have recently come to place upon the effects of international capital mobility it may be surprising to note that Keynesians have no good theoretical base for arguing that international capital mobility severely restricts domestic policy autonomy. Rather, introducing perfect capital mobility, in the sense that the domestic interest rate can no longer deviate from the international interest rate, into the standard Keynesian model for an open economy leads to an optimistic conclusion. The so-called Flemming-Mundell model\textsuperscript{770} reaches the conclusion that not only exchange rate management, but also fiscal policy under fixed exchange rates can be used very effectively in a constellation of perfect capital mobility.

| Table 6.4: Available Policy Instruments According to the Standard Flemming-Mundell Model |
|-----------------------------------------------|-----------------------------------------------|
| No Capital Mobility                          | Perfect Capital Mobility                      |
| Fixed Exchange Rates                         | Fixed Exchange Rates                          |
| Flexible Exchange Rates                      | Flexible Exchange Rates                       |
| None                                          | Fiscal Policy                                 |
| Monetary Policy                              | Monetary Policy |

The results are fairly straightforward (See Table 6.4). Under conditions of no international capital mobility the decision to adhere to a fixed exchange rate also implies a decision to abandon fiscal and monetary policy autonomy. More expansionary policies in such a case will namely lead to a current account deficit due to a higher domestic GDP. Under fixed rates, however, the only

\textsuperscript{768} See Kindleberger 1986, Ch. 14.

\textsuperscript{769} Kindleberger 1986, p. 291. See also Munthe 1991, p.25. Some authors have also applied the HST to the present crisis. At first sight this would seem a promising strategy as the decline of the Bretton Woods regime of fixed exchange rate was closely followed by the advent of mass unemployment and international depression. For the present Gilpin (1987, p. 142.), on the basis of HST arrives at a conclusion which echoes the neoclassical argument that lack of external discipline creates instability. "The abandonment of Bretton Woods and the system of fixed exchange rates meant the loss of international financial discipline. .... Without fixed exchange rates, there were no longer external constraints on national behavior. As a result the world monetary and financial system became increasingly unstable, and the threat of a collapse of this system became a major concern for the international political economy."

\textsuperscript{770} The Flemming-Mundell model is simply an IS-LM model with international capital flows added onto it. For a useful discussion see Argy 1981 Ch. 22 and Dornbusch 1980, Chs. 10-11.
redy for a current account deficit is to reduce the level of GDP. If governments, however, in the absence of capital mobility, decide to pursue a more active exchange rate policy, fiscal and monetary policies now also become available because in this case the current account deficit resulting from more expansionary demand management policies can be remedied by means of a devaluation. Under conditions of (perfect) international capital mobility, however, the decision to adhere to a fixed exchange rate does not imply the emasculation of all remaining policy instruments. Rather fiscal policy can be used very effectively in such a constellation. An increase in domestic demand will, given an initially unchanged volume of money, increase domestic interest rates and thereby provoke capital inflows until domestic rates have come down to the international level again. Monetary policies hence must necessarily accommodate the stance of fiscal policy. Given the decision to use a more flexible exchange rate policy, monetary policy becomes very effective. Lower domestic interest rates will now lead to a devaluation which provides an additional stimulation to effective demand by means of higher exports and lower imports.

International capital mobility, according to the Flemming-Mundell model, does pose some constraints on the usage of instruments in the sense that if it is decided to maintain a fixed exchange rate, monetary policy will not be effective while under flexible rates fiscal policy will be. Yet, in the Keynesian view, international capital mobility does not constitute any obstacle to reach the level of GDP the government prefers. On the contrary, according to standard Keynesian views, with perfect capital mobility there will now also be an effective policy instrument even under fixed rates (See table 6.4).

While in the HST interpretation economic prosperity appears as a public good which is always under threat from the incentive individual nations have to free-ride, the view which has come to occupy a prominent place during the eighties pictures the international system as a powerful constraint which prevents government from pursuing policies for growth and full-employment,

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771 Since monetary policy does not need to accommodate fiscal policy in the absence of international capital flows because the higher interest rate per definition does not provoke capital inflows, fiscal policy, therefore, loses some of its effectiveness since the increase in public demand is somewhat counteracted by higher interest rates and hence lower investment.

772 Again the results are quite straightforward: monetary expansion under fixed rates will lead to lower interest rates and hence to capital outflows until the original rate of interest and volume of money are restored. Fiscal expansion under flexible rates will lead to higher domestic interest rates and cause a revaluation until the original level of GDP and the original interest rate are restored.

773 If the Keynesian model does conclude that international capital mobility does not pose an obstacle to discretionary demand management, then the often heard argument that the core problem with Keynesianism is that it was devised for a closed economy (For example, Healey 1989, p. 379) must be wrong. Instead one would have to argue that the Keynesian treatment of international economic relations is wrong.
thereby harming not only their domestic economy but the prosperity of the international economy as a whole. In contrast to the HST interpretation in which a dysfunctional organisation of the international polity comes to be held responsible for the economic mayhem of the Great Depression, the 'External Constraints’ view holds that a disfunctional organisation of the international economy has had far-reaching political consequences. The core concept here is one of states trying to pursue a policy of growth, full employment and an extensive welfare state, which is suspiciously eyed by the world of business and finance.\(^{774}\) In political terms this position is commonly associated with a Social Democratic interpretation according to which policies for full-employment and social welfare are potentially against the interests of business. To the extent that business becomes internationally mobile, it gains an exit option thereby frustrating domestic economic policies. International direct investment constitutes such an exit option. More important, however, is that the international mobility of financial capital will allow for an immediate and massive response to any (plans for) policies considered to be unsympathetic to the business community. In a world with no restrictions on the international movement of capital, governments, it is argued, must necessarily let the interest of the business community prevail.

The external constraints view consists of two sub-versions. In the first version a hierarchy among states is assumed plus a preference for restrictive macroeconomic policies in the dominant country(ies).\(^{775}\) In Europe this dominant role is frequently attributed to Germany, who is seen to have a high preference for restrictive policies due to its historical experience of hyper-inflation and/or the independence of its central bank. On a world-wide scale the restrictive policies the Federal Reserve pursued after its turn to monetarist policies in October 1979 is widely seen to have forced similarly restrictive policies on other countries.\(^{776}\) In the second version restrictive policies do not originate from the political preferences of dominant countries any more, but from the inherent preferences of internationally mobile capital. Internationally mobile capital, in this view, is seen to have a pronounced preference for countries pursuing 'sound' policies of high interest rates, low inflation and budget balance. Countries attempting - or even suspected to be about to attempt - a

\(^{774}\) See, for example, Stewart 1983, p. 52: “Thus just as contractionary policies in one country tend to be validated and reinforced by the responses of the world financial community, expansionary policies tend to be invalidated and aborted.”

\(^{775}\) See, for example, Scharpf 1987, Ch. 11, Streeck & Schmitter 1991. Cornwall 1989, 1990 attributes restrictive policies in the larger countries to the lack of adequate labour market institutions which could have contained inflation without recourse to unemployment. Given the policies of the larger countries the smaller countries are seen to have no choice.

\(^{776}\) Even the Bundesbank felt forced by concern for the external balance to pursue policies which were unduly restrictive given domestic conditions. See, for example, Scharpf 1987, p. 187-93. Also Kennedy 1990. p. 47.
more expansionary policy will be punished by capital outflows. While in the first version political preferences, in the dominant countries at least, still have a role to play, politics, in the second version, primarily consist in adapting to the anonymous pressures of international capital. Both versions have in common that the massive increase in international capital flows since the late sixties is seen as a process beyond politics, determined instead by structural/technological factors. Accordingly the widespread deregulation of exchange controls is interpreted as a set of measures which de jure recognised a situation which de facto had already come into existence.

In theoretical terms, the route through which Keynesians, and many others, have recently arrived at the conclusion that external constraints emasculate macroeconomic policies, and that domestic policies thus have to be adjusted to the exchange rate rather than vice versa, is by postulating the primacy of market over politics. In this view devaluations can easily become cumulative under capital mobility because wealth-holders interpret a devaluation as a commitment to unsound policies and hence will come to expect further devaluations. The result is a flight out of the domestic currency which can only be stopped by a turn to restrictive policies. Yet, confidence is easily lost, but gained only with great difficulty. Countries with a history of devaluations and expansionary policies will be suspect in the eyes of wealth holders, and the latter’s distrust will need to be compensated for by higher interest rates in order to convince them to hold the domestic currency. But it is not only a history of actual devaluations which may damage a country’s reputation. Already the mere suspicion that countries might be willing to pursue policies which eventually might become incompatible with fixed exchange rate might have same effect. To the extent that international financial markets interpret budget deficits as an indication of waning adherence to fixed exchange rates, a failure to balance the budget, irrespective of actual devaluations may prompt capital outflows. In the extreme case even domestic political opposition to the policies pursued may argue to damage the interests of the country as it undermines the credibility of the government’s exchange rate commitment. In short, if devaluations and expansionary policies inevitably lead to exchange crises and higher interest rates for a long time to come, then the best service a government can perform

\[777\] For an early analysis along these lines see Stewart 1983. Also Huber & Stephens 1992, p. 6, Webb 1991. Also see Cornwall 1989, p. 113-4. See also the references in Helleiner, 1994, Ch. 1.

\[778\] In more formal terms: While the equilibrium condition for financial markets in the original FM Model is \( I = I^f \), the equilibrium condition now becomes \( I = I^f + \Delta e^d \), where \( e^f = f(\Delta e_{t-1}, \ldots, \Delta e_{t-n}) \). Where \( I \) is the international interest rate \( I^f \) the domestic interest rate, and \( \Delta e^f \) the expected change in the exchange rate.
to the economy in the macroeconomic field is to give absolute priority to a fixed exchange rate and institutionalise this priority in such a way that wealth holders will have no reason whatsoever to suspect a rekindling of expansionary policy experiments.\footnote{779}

Historically the HST view has primarily enjoyed popularity as an explanation of the Great Depression\footnote{780} while the emergence of overpowering external constraints is widely treated as an explanation for the economic policies of the last two decades. The popularity of the HST as an explanation for the Great Depression and the external constraints view as an explanation of our present predicament is quite in line with a widespread tendency in political economy to attribute the catastrophe of the thirties to political factors while postulating the dominance of structural economic factors during the last decades. The emergence of this peculiar dichotomy probably is due to a combination of hindsight and lack of historical detachment. Given the policy regimes which emerged in response to the Great Depression it is impossible to argue that no macroeconomic alternatives existed at the time. Accordingly it becomes almost inevitable to attribute the Great Depression to a deficiency in the political system which led to the pursuit of erroneous policies. While for Friedman the blundering of the Federal Reserve, and for the Keynesians the stubborn ignorance of the argument that restrictive policies during a recession could only aggravate matters, must take the blame, for Kindleberger it is the political inability of the USA to fill the vacuum left by the UK.\footnote{781} Given the lessons of the interwar period most academics would be reluctant to argue that history at present repeats itself. For those who still believe in the effectiveness of macroeconomic policies some versions of the external constraints view which postulates that governments had to pursue restrictive policies against their will, must almost inevitably seem the only plausible conclusion.

\footnote{779} Susan Strange (1986, Ch. 1) provides another interpretation of the dynamics of international capital flows as she depicts modern finance as a casino. But this interpretation per definition cannot be used to argue in favour of insurmountable pressures for restrictive macroeconomic policies because in a true casino the numbers at the roulette tables should be randomly distributed rather than to display a quite distinctive trend.

\footnote{780} Some authors have applied HST to the present period. In this view the international economic crises would be the result of the American abdication from its hegemonic responsibilities under the Bretton Woods system. According to Gilpin (1987, p. 141) the end of the Bretton Woods system meant that "Domestic autonomy had triumphed over international rules; nations disengaged from the requirements of a fixed-exchange system in order to pursue one or another national objectives such as expanding exports, stimulating economic activities, or preventing inflationary pressure." Yet the application of HST to the present period has been less successful, and less popular, as a repetition of the beggar my neighbour policies which allegedly took place during the thirties did not occur despite the absence of a responsible hegemon. For a similar point see Helleiner 1989, p. 21.

\footnote{781} See, for example, Kindleberger 1973, p. 314.
Yet, this peculiar alteration between the dominance of political and economic factors is neither theoretically nor historically convincing. Analytically the core error of both the HST and external constraint views on the impact of external forces lies in the failure to correctly analyse the domestic motives of external economic policies. Together with neoclassical views, the HST shares the widespread prejudice that the real and not monetary variables are the principal target of economic policies. But as it fails to recognize that influencing nominal variables is foremost in economic policy, it also misunderstands the true character of regime changes. The external constraints view suffers from a similar neglect of domestic dynamics as it can recognize disruptive financial flows and speculation only in the form of cross-border transaction and not in their domestic manifestation of an ex- or im-plosion of the financial system. While the argument that maintaining the confidence in the currency constitutes the main constraint facing economic policies does contain a core of truth, the absolute distinction between domestic and international financial flows employed in the external constraints view precludes its protagonists from a fuller understanding of the nature of the confidence problem and thereby leads to a failure to understand cumulative exchange rate crises as a manifestation of a disruption of the confidence in the currency based on a domestic inflationary constellation.

In contrast to HST, neoclassical views have the analytical advantage of pointing out that the state’s ability to pursue a beggar my neighbour policy of competitive devaluations rests on the willingness of wage earners to accept a lower real wage. However, as argued in chapter 2, the presence of a monetary economy implies the inherent policy priority of price stability. Accordingly neither the neo-classical assumption that free markets will tend towards Pareto optimum nor the Keynesian assumption that maintaining growth and full-employment can be delegated to the state are correct. Rather the history of external economic policies confirms the dominance of the goal of price stability. And it is only on the basis of this assumption that the historical paradoxes which present itself to both the HST and the 'external constraints view can be solved.

6.4 Free Riding as the Core Threat to International Prosperity?

Interpreting international economic interaction in public good terms, the main threat to economic prosperity would seem to come from the incentive individual nations face to improve their position by resorting to devaluations. Episodes of competitive devaluation, however, have been absent since 1918, even in the absence of a hegemon who could prevent nations from resorting

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782 I.e. exchange rate management, exchange controls and tariffs.
to such policies. Most countries let their currency float after the 1918. But similar to the devaluations of 1949 this mainly implied a devaluation of European currencies relative to the Dollar, while the inter-European rates changed little. The Reichsmark did devalue much more than other currencies, and thereby did provoke some retaliation, although this did not take the form of competing devaluation but of surcharges on German imports. Instead of following the Reichsmark, Germany’s most important competitors, like Britain, Sweden and the Netherlands, embarked on a policy of revaluing their currencies relative to gold, and, therefore, relative to the Reichsmark, as of mid 1920. More important, the economic effects ran quite contrary to what HS theories would predict. The period of floating at the same time was a period of economic boom, whereas the recessions started with the policy of revaluation.

But also the Great Depression, the paradigmatic case of HST, cannot be understood as a case of predatory policies. The initial devaluations did give some currencies a trade advantage, but the second round of devaluations, from the Dollar devaluation in 1933 to the end of the Gold Bloc in 1936, basically restored the relation of exchange rates to what they had been before September 1931. As Irmler (1976, p. 303) pointed out, the alleged competitive devaluations did not amount to much more than an increase of the price of gold.783

The breakdown of the Bretton Woods system superficially seemed to confirm the fears of HST: countries abandoned their commitment to a fixed exchange rates system and the world economy moved into recession. Yet the Breakdown of Bretton Woods, did obviously not lead to competitive devaluations. Germany, did not abandon the Bretton Woods system in order to be able to devalue but rather in order to avoid restrictive monetary policies from being compromised by the need to counteract pressures for revaluation. Rather than giving rise to mutually incompatible devaluation strategies, the more flexible exchange rate management after the breakup of Bretton Woods allowed for the coexistence of different national policy preferences.

Under fixed exchange rates no possibility existed to durably deviate from the policies of the majority of countries in the system because more expansionary or depressed domestic conditions would lead to pressures for de-or revaluation. For Germany in the late sixties and early seventies this meant that a consistently restrictive monetary policy to stamp out domestic inflation was impossible because the threatening revaluation of the currency would require more expansionary monetary policies. Conversely countries with more expansionary preferences would have to abandon their course as devaluation threatened. Under flexible rates, however, such policies could

783 See also Hirsch & Oppenheimer 1977, p. 620.
coexist as the more restrictive countries revalued relative to more expansionary ones. In Europe, however, this period of floating was of a relatively brief duration. The growth of the European Monetary System (EMS) since the late seventies fixed exchange rates ever more tightly and accordingly left less and less room for national policy divergence.

From the HST perspective the willingness of other countries to link their currency to the DM by entering the EMS must seem rather perverse. While many European governments already seemed to be under pressure from the restrictive policies of the Bundesbank, linking the currency to the DM mark implied foregoing an important source of policy autonomy. What were the motives of the countries to join the German model? The German government had a clear incentive to link other countries to its policy strategy. Pursuing a more restrictive policy than almost all other countries might easily lead to an excessive revaluation of the DM and hence cause serious problems for the export industry. Given the importance of this sector, such an outcome might undermine the political support for the anti-inflation course. But as other countries linked their currency to the DM, Germany was frequently able to combine restrictive monetary policies with a real devaluation, i.e. given Germany’s lower inflation rate, fixed nominal exchange rates with some of its most important trading partners improved German export competitiveness. From this perspective it is clear why Bundesbank president Pöhl should object to Feldt’s devaluation of 1992. From an HST perspective, however it is not clear at all why not all countries followed the Swedish example of 1982 but instead committed themselves to a restrictive course which also implied the risk of a loss of competitiveness. The problem for the world economy of the eighties rather seemed to be that an increasing number of countries was willing to pursue restrictive policies in order to quell growth and inflation, rather than to devalue in order to avoid having to pursue restrictive policies.

The inability of public goods theories of international economic interaction to explain the absence of destructive strategies of competitive devaluation must be attributed primarily to two theoretical shortcomings. (1) Sharing an assumption common to most research in International Political Economy, HS theories treat states as unitary actors; accordingly they fail to analyse the domestic preconditions for such policies. (2) Sharing the preoccupation of standard economics with real variables and static redistribution effects, HS theories tend to consider exchange rate changes which only achieve nominal effects as irrelevant, while real devaluations are characterised as beggar your neighbour policies. In actual fact something akin to the opposite holds: exchange rate

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784 See, for example, Hankel 1980, p. 27-29.
management historically must primarily be interpreted as a policy to influence domestic nominal wage and price formation. Moreover, the threat of beggar your neighbour policies looms larger under restrictive fixed exchange rate regimes than under flexible regimes.

When looking at its domestic effects, it is hardly befitting to characterise a real devaluation as a policy of 'help yourself and beggar your neighbour' as it suggests that all the benefits accrue to the domestic country while all the costs are borne by the rest of the world. A devaluation implies higher import prices, and therefore, at a given nominal wage will lead to a lower real wage. Only if wage earners accept a reduction in real wage can a real devaluation be maintained. If nominal wages increases so as to recover the old real wage, also the old relative prices in external trade are restored and the attempt at real devaluation will accordingly have failed. Its only effect in this case will have been a higher domestic price level. In actual fact a real devaluation, therefore, is just one of the mechanisms through which domestic wage earners can exchange lower real wage for more employment.

As will be recalled the recent resurgence of neoclassical macroeconomic analysis, spearheaded by Friedman, argued that a reduction in unemployment by means of Keynesian policies is impossible since wage earners cannot be assumed to suffer from 'money illusion'. If wage earners will not mistake a mere rise in nominal wages for a rise in real wages then, it is argued, the price rise caused by expansionary Keynesian policies will not result in a lower real wage but in higher nominal wages and hence will not create more employment but more inflation.\textsuperscript{785} Therefore neoclassical should arrive at a conclusion quite opposite to the HST, namely that competitive devaluations are impossible.\textsuperscript{786}

Yet, as even many neoclassical economists would admit nowadays the assumption that real wages are uniquely determined in the market and that hence no room for incomes policies exist is too strong.\textsuperscript{787} Rather the ability to implement a real devaluation seems to depend on the state's ability to reach an agreement with the trade unions concerning a policy strategy aimed at increasing employment in the export sector by reducing real wages. Countries who, like in the early twenties and during the last two decades, already suffered from a domestic inability to contain inflation by means of wage- and incomes policies will only aggravate their domestic inflationary problems by devaluing their currency. Not only do devaluations have a direct effect on the price level by

\textsuperscript{785} For a useful summary of the neoclassical theory of voluntary unemployment see Stadermann 1987, Ch. 24.

\textsuperscript{786} CF Schager 1991, p. 182.

\textsuperscript{787} See, for example, Calmfors 1993.
increasing import prices, they also prevent higher domestic nominal wage increases from negatively affecting external competitiveness. With that they not only remove one of the motives of both labour market partners to exercise wage moderation.\textsuperscript{788} If domestic institutions fail to contain inflation at high employment the possibility of pursuing a policy which maintains a high level of demand and employment hence becomes irrelevant. Rather restrictive policies will be required to increase unemployment and thereby reduce inflation. In such a constellation adhering to a fixed exchange rate can constitute a crucial element in creating and maintaining a restrictive macro regime as it provides the invaluable function of providing a rigid constraint on both domestic policy and prices. In Britain during the mid seventies, for example, a devaluation strategy was not possible. In fact, one of the main reasons for the breakdown of incomes policies during that period was that the devaluation of Sterling turned what was supposed to be a policy of nominal wage moderation into a policy of real wage reduction. Margaret Thatcher in an attempt to reduce inflation accordingly embarked on a policy of real revaluation instead of a policy of devaluation.

Corporatist economies, in contrast, did have institutional and political preconditions more suitable for such a strategy. The best example, of course, is the SAP’s devaluation of 1982, which was backed up by the LO so as to assure an improvement in competitiveness. But also here a soft currency strategy was only feasible as long as domestic incomes policies could be relied on to contain inflation.

Given that the majority of OECD countries had embarked on a regime which attempted to reduce inflation by means of restrictive macroeconomic policies, countries which did pursue real devaluations in the context of the seventies and eighties’ hence did not have to fear setting off a devaluation spiral, despite the disintegration of the Bretton Woods system and the weakening of US hegemony. Since those countries which switched to a restrictive regime apparently were trying to reduce domestic demand, the reduction in exports which they would experience due to real devaluation in other countries does not counteract but reinforce the policy goals of the former. Rather than causing a change of course, the revaluation of the currency\textsuperscript{789} can and historically has been an important instrument in addition to restrictive fiscal and monetary policies for pursuing

\textsuperscript{788} Especially in neoclassical rational expectations models it has become standard to assume that a credible commitment to a fixed exchange rate will lead labour market partners to adjust their wage bargaining as to prevent any negative effects on unemployment. However, the (public goods) dynamics of wage bargaining is such that, especially under tight labour markets, expectations about a nonaccommodating policy cannot effectively prevent an escalation of nominal wages. As history shows, higher unemployment and not a mere policy announcement by the authorities is required to bring down inflation.

\textsuperscript{789} Which is analytically the same, of course, as the devaluation of the currency of those countries wishing to maintain a more expansionary course.
restrictive policies. Germany, of course, broke out of the fixed exchange rate arrangement in 1973 because it needed to be able to revalue in order to pursue its anti-inflation policy. Similarly Britain in the early years of the Thatcher government willingly accepted a massive revaluation of the currency as a way to curtail domestic demand.

Apparently with the standard interpretation of the thirties in mind, IMF chairman De Larosière feared that the Swedish devaluation of 1982 would lead to a chain reaction. But although Bundesbank president Pöhl objected to the Swedish move, Germany clearly was not going to retaliate by devaluing the DM just because Sweden had decided to do so. Feldt’s and Dennis’ Nordic colleagues also voiced strong displeasure with respect to the Swedish plans but as Feldt pointed out correctly the alternative for Sweden was a strongly restrictive Swedish monetary and fiscal policy which would have had long term negative consequences for them. Moreover, Denmark’s Poul Schlüter would have been in no position to put his new strategy of fighting inflation by means of a hard currency policy in question by following the Krona. And in Norway the budget and current account situation after the oil price increase did not mandate a devaluation while the domestic inflationary problems did not seem to make this a wise choice.

It is this dominance of domestic problems which explains why European countries since the breakdown of Bretton Woods did not durably resort to a system of flexible exchange rates in order to accommodate different national preferences in term of the inflation/unemployment trade-off. Plans for a monetary union had already been developed in the form of the so-called Werner Plan of 1970. The Bundesbank’s turn to monetary targeting, however, marked the emergence of divergent national policy preferences. As long as some countries felt that they could contain inflation without copying the German strategy, progress towards more fixed exchange rate arrangements in Europe was impossible. The Snake arrangement, which replaced the Bretton Woods system by 1976/77 only covered Germany and some of its small neighbours with similar policy preferences, as countries like France, the UK, Norway and Sweden were unwilling to reorient their macroeconomic policies in such a way as to make them compatible with maintaining a fixed exchange rate with the DM. Tighter linking of exchange rates within the EMS and eventually the resurrection of the plans for a monetary union only became possible after the initially more expansionary countries had come to perceive the need for macroeconomic restriction in order to control their own inflationary

790 See Feldt 1991 p. 77, 84.
792 Feldt 1991, p. 73, 83.
problems. In other words, while the interwar Gold Standard gradually crumbled as the domestic consequences of the priority of external balance became too disruptive, European monetary relations developed from the limited membership in the European Snake to the virtually encompassing EMS as the domestic consequences of policy autonomy became intolerable. French support for Monetary Union, for example, came forth only after Mitterand had realised that his expansionary macroeconomic policies were infeasible. As Andrew Moravcsik (1991, p. 51) noted: "Mitterand's decision to remain in the EMS, announced on 21 March 1983, 'marked a turning point not only in French domestic politics but also in French policy toward the EC."

Paradoxical as it may seem, the threat of cycles of competitive devaluations has historically been more present under restrictive fixed exchange rate regimes than under flexible rate regimes. The Gold Standard and the EMS emerged not as the result of a successful attempt by a benevolent hegemon to prevent myopic policies but as an attempt to supplement a domestic policy of combating inflation by the imposition of an external nominal anchor for domestic wage and price formation. Historically, the switch to restrictive policies in both these periods, also meant that unemployment came to be interpreted as a microeconomic phenomenon. As we know since Keynes, a general reduction in real wages by means of a general downward adjustment of nominal wages is rather difficult in a closed market economy. Since wages are variable costs, general nominal wage reductions will rather lead to a lower price level and deflation. In an open economy it is of course possible to lower real wages with respect to competitors abroad by means of a general domestic reduction in nominal wages. Analytically reducing domestic wages relative to those in competing countries under fixed nominal exchange rates is exactly the same as a real devaluation, and the label 'internal devaluation' hence is befitting for such a strategy. And although a strategy which attempts to improve export competitiveness by means of increased productivity might not require real wage cuts but can rely on keeping real wage increases below productivity increases, analytically this must also be considered a beggar your neighbour strategy. Competitiveness is a relative term of course, and strategies to improve employment through improved competitiveness hence can only succeed to the extent that they are not successfully pursued by other countries. Of course, no open economy can afford to neglect keeping its cost and productivity level in line with those of competitors, especially under restrictive regimes where macroeconomic policies are not available for

794 See Steinher 1990, p. 60-1
795 See Keynes 1973, Ch. 19.
employment creation. Yet exactly because no individual country can afford to neglect competitiveness, those policies generally display the dynamics commonly attributed to competitive devaluation policies.

But the combination of adherence to restrictive macroeconomic policies and fixed nominal exchange rates, and the conviction that unemployment can only be decreased through lowering real wages or increasing competitiveness yields the worst of all possible worlds. In such periods restrictive policies which discourage growth become a general feature of the international system and are combined with attempts to pursue competitive real devaluations by means of (relative) real wage reductions. It is not surprising, therefore, that historically those periods in which microeconomic policies were assigned to growth and unemployment and macroeconomic policies to low inflation constitute the most depressed episodes in the world economy irrespective of whether individual countries were willing to adhere to a (hegemonic) exchange rate regime. In sum, it would have been desirable that those who fear the emergence of beggar your neighbour policies would have paid more attention to policies which attempt to improve competitiveness under fixed exchange rates than to the threat of competitive devaluations which supposedly emerges in the wake of the breakup of fixed exchange rate regimes.

Because theories of International Political economy interpret exchange rate policies as aimed at bringing about changes in the balance of trade, it tends to consider exchange rate changes which do not lead to changes in the real terms of trade as irrelevant. Such episodes, from the perspective of the domestic country, would rather appear as a failed policy. Yet, through their effects on prices and domestic macroeconomic policies, such exchange rate changes do have important real effects. Historically two types of nominal devaluation policies can be identified.

(A) The devaluations which led to the breakup of the Gold Standard mainly served the purpose of allowing a stabilization of the domestic price level and enabling states to pursue more expansionary monetary policies. Rather than being due to the absence of a benevolent hegemon, the Great Depression was primarily the outcome of governments' desperate attachment to the gold Standard for fear of repeating the inflation of the early twenties. In a sense the Great Depression was due to governments continuing to fight the battles of the last inflationary war even during times of deflation. Yet just as continued inflation can not fail to lead to a collapse of the financial system, continued deflation has the same effect. Ultimately at the point when the financial systems started to collapse under the burden of debt default, governments were forced to admit that the self-imposed external constraint of the Gold Standard had to be removed. The breakup of the Gold Standard in September 1931 simply marked the unwillingness to tolerate the domestic fall in prices which
continued adherence to a fixed exchange rate required. Far from being inspired by a desire to beggar their neighbours the devaluations and tariffs of the thirties must be understood as two crucial measures in a broader policy aimed reflating the economy.

The spectacle of countries hurting their domestic economies by pursuing severely restrictive policies in order to maintain a fixed parity and abandoning the Gold Standard only when forced to do so by massive capital flows, should have aroused the suspicion of those analysing state behaviour in terms of myopic maximization of domestic welfare.\footnote{The only exception was the USA which decided out of its own will to abandon gold rather than being forced of by capital flows.} Moreover, analysts might have noticed that the occurrence of widespread efforts to halt or even reverse deflation is rather inexplicable if governments were trying to help themselves and beggar their neighbours by pursuing competitive devaluations. If a devaluation is to have effects on the trade balance it must be prevented that domestic prices rises undo the competitive advantage. To combine devaluation with a policy of domestic reflation hence must seem contradictorily from the point of view of increasing competitiveness. It makes perfect sense, however, if devaluation is understood in the context of combating deflation. Devaluations and tariffs during the Great Depression were employed in order to halt the process of deflation by importing a price rise,\footnote{As President Roosevelt argued on April 19, 1933, the decision to abandon the Gold Standard was a decision to defend the internal price level instead of the external value of the currency. See Brown 1987, p. 35.} allowing for more expansionary monetary policies, and preventing import from undermining domestic price stabilization arrangements. The devaluation of the Dollar in 1933 was specifically inspired by the desire to increase the domestic price level by means of increasing the price of domestic goods. In Britain, Sweden and Norway, as we have seen, devaluation was initially forced upon governments, yet they used the room which had now become available to stabilize prices and pursue of policy of cheap money.

Because governments themselves did not understand the devaluations of the thirties as beggar your neighbour policies, it becomes understandable why they would not retaliate against the second wave of devaluations in 1935-6. As, for example, the signing of the tripartite agreement in 1936 showed, devaluations generally were not interpreted by other countries as a hostile act towards them but understood as a measure of domestic reflation which might benefit international trade as a whole by bringing about economic recovery of the devaluing country.\footnote{Sec, for example, Oye 1992, p. 128, who notes with respect to the three powers partaking in the tripartite agreement: "All three monetary powers saw further deterioration in the French economic position as undesirable, and saw devaluation of the franc as a necessary condition for French economic recovery."} Similarly the Bretton Woods system of fixed exchange rates was accepted by European countries not because they had finally
learned that competitive devaluations are destructive, or because they were pressured to do so by the USA, but because the Bretton Woods system did not constitute a threat to the new, expansionary, policy regimes.

And because the breakup of the Gold Standard ended deflation and allowed for more expansionary policies, devaluation in this period had profound positive effects on the international economy as a whole, even though real exchange rates returned to their 1931 level in 1936. The reason is simple, if all countries pursue devaluations in order to avoid restrictive demand management policies the end result will be a higher overall growth rate as compared to generalized regime of restrictive policies. As Eichengreen & Sachs (1990, p. 238) argued: "We do not present a blanket endorsement of the competitive devaluations of the 1930s. Though it is indisputable that currency depreciation conferred macroeconomic benefits on the initiating country, because of accompanying policies the depreciations of the thirties had beggar-thy-neighbour effects. Though it is likely that currency depreciation (had it been even more widely adopted) would have worked to the benefit of the world as a whole, the sporadic and uncoordinated approach taken to exchange-rate policy in the 1930s tended, other things being equal to reduce the magnitude of the benefits." In short, the popular view that no one can profit once devaluation strategies become widespread seems to be an example of the well known fallacy of composition. A benevolent Hegemon who would have enforced adherence to the Gold Standard during the Great Depression hence would rather have aggravated than mitigated the problems of the international economy.

(B) The second type of nominal devaluations aims to compensate for higher domestic inflation rates. This type of devaluation recognizes that different countries have different labour market institutions and different preferences for full-employment and inflation. Those countries which because of lower unemployment rates and/or less institutional capacity for nominal wage moderation have above average inflation rates, will have to adjust their exchange rates in order to avoid a real

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799 See also Temin (1989, p. 87): "Every effort was made in 1931 to preserve the gold value of the mark, pound and dollar. Britain has been roundly criticized, then and now, for losing that battle. But we would all have been better off if the leaders had thrown in the towel, either in the summer of 1931 or by following Britain's example in the fall."

800 For example, Scharpf 1987, p.330.

801 See Temin 1989, p. 35-6, 87. Also Oye 1992, p. 213. Eichengreen (1992, p 100) notes that the recession of 1920-21 was not as general as the Great Depression because several countries were not pursuing restrictive policies at that point. In Germany, for example, boom conditions were maintained until mid 1923 and this somewhat counteracted the restrictive effects the policies of the US and Britain had on the world economy.
Devaluations of this type hence are purely aimed at nominal effects and are defensive in character. They do not try to create a competitive advantage towards other countries by lowering the relative price of domestic goods, and with domestic real wages, but they simply try to prevent a revaluation and a rise in domestic real wages due to higher domestic inflation rates. Historically such strategies have been pursued by the Scandinavian countries from the mid-seventies until the late eighties and by Britain at several instances. In the aggregate also such strategies must be considered beneficial to the international economy as a whole because they prevent a turn to restrictive macroeconomic policies in these countries and hence contribute to overall demand.

Finally once exchange rate changes are considered as policy measures which, under specific circumstances may preclude the need for to turn to restrictive macroeconomic policies, it is not clear any more whether even real devaluations like the Swedish one of 1982 can be considered to be of a beggary my neighbour character. The advent of restrictive policies abroad implied that for any given level of domestic demand there would be less demand for exports. Apart from devaluing the only other option Swedish policy makers faced in 1982 was to pursue restrictive domestic policies so as to redress the trade balance deficit which had emerged largely as a result of restrictive policies abroad. But an economic recession in Sweden would only have further aggravated, though probably only slightly, the recession in the world economy. Put differently, to reject the Swedish devaluation of 1982 on the basis that economic mayhem would result if all countries would try to pursue such policies is beside the point. This policy was a a response to the policies of the majority of OECD countries to reduce their domestic level of demand. If other countries had had the same policy preferences as Sweden in 1982, the devaluation would not have been necessary to start with.

Furthermore, as Korkman has argued quite plausibly, devaluations may be a effective means of solving a coordination problem of the central trade unions in systems characterised by intense inter union rivalry. If inter-union rivalry leads to absolute wage increase consider excessive by the labour market partners, devaluation can provide a correction without the need for renewed decentralised negotiations. "Devaluation is a way of reducing the average level of real wages without interfering with the wage relativities that union rivalry is all about." (Korkman 1988, p. 21)

See also Korkman (1988) who, correctly, argues that, even if devaluations do not reduce real wages in the long run they may have an important role to play in stabilizing business expectations in highly open economies.

Cornwall (1989, 1990) quite correctly argues that larger economies during the last decades switched to restrictive policies because they lacked a corporatist framework for containing inflation under full-employment. But he then continues that, given restrictive policies in the larger countries, smaller corporatist economies had no possibility any more of pursuing expansionary policies because: (1) The changing character of trade towards less price sensitive and more quality oriented products implies that the volume response to a given devaluation has become smaller. (2) Increased real wage resistance makes real devaluations very difficult even for corporatist economies since the rise in import prices will be passed on to wages. (3) Expansionary policies are likely to provoke capital outflows. But, lower foreign trade elasticities only mean that in order to achieve the same volume effect the devaluation has to be larger. If corporatist economies indeed have a high institutional capacity to exchange wage moderation against full-employment then there is no reason to assume that they should not be able to do so if the wage moderation takes the form of not adjusting nominal wages (fully) to the increase in import prices. And as will be shown below the third reason is incorrect also.
In sum, the assumption that the international economy is best analyzed in terms of a public good or zero-sum game rests on an erroneous understanding of the motives of economic policy-making. The habit of much of international political economy to analyze states as unitary actors prevents the recognition that in monetary economies governments must primarily address a potential control problem with respect to their domestic economy and hence must give priority to containing inflationary and deflationary pressures. In periods of domestic inflationary pressures, states cannot, even if they wish, engage in predatory macroeconomic policies because both tariffs and devaluations will rather aggravate these problems with the consequent risks of hyper-inflation and a collapse of the financial system. It is these domestic deflationary and inflationary forces which were the driving force behind the historically observed changes in exchange rate regimes.

6.5 External Constraints or External Anchor?

At first sight it might appear that the view that macroeconomic policies are primarily dictated by the wishes of internationally mobile capital can solve some of the historical paradoxes which present itself to HST. First the 'external constraints' view realizes that maintenance of a fixed exchange rate regime is not necessarily beneficial as such a system, built on the basis of restrictive policies, may actually be detrimental in terms of growth and employment both for individual countries and the international economy as a whole. Secondly the tenacity with which countries during the interwar Gold Standard and in the EMS were willing to depress domestic economic conditions in order to maintain a fixed parity may be interpreted as a policy dictated to them against their wishes by internationally mobile capital. Chancellor of the exchequer Philip Snowden, for example, argued on January 14, 1931 that one of the reasons why budgets needed to be balanced was to appease international holders of Sterling and thereby avoid economic mayhem. "There are disquieting indications that the national finances, and especially the continuously increasing load of debt upon the Unemployment Insurance Fund, are being watched and criticized abroad. ... It is believed that there is a steady trickle of money being transferred from this country abroad. We cannot afford to let this movement increase. ... Any flight from the pound would be fraught with the most disastrous consequences—not merely to the money market but to the whole economic organisation of the country." Similarly it could be argued that the increase in international capital mobility since the eighties has evaporated national policy autonomy. Under a more flexible

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805 See also Oye 1992, p. 116-8.
806 Quoted in Howson 1975, p. 70.
management of exchange rates, in principle even small countries could always mitigate the effects of a restrictive international environment by devaluation. But if the effect of international capital mobility is to make such devaluations cumulative, such an option would no longer exist. Joining the EMS and constructing an EMU would not mean a reduction in policy autonomy, but rather might allow the EC as a whole to recover some of the autonomy in monetary policy all members states as such had lost.\textsuperscript{807} Kjell-Olof Feldt, former SAP minister of finance and presently chairman of the broad of directors of the Riksbank, for example, recently argued that in view of the speculative pressures to which the Krona is subjected in a system with high international capital mobility, joining the EMU would have positive effects for Sweden.\textsuperscript{808}

By itself, however, the emergence of perfect international capital mobility (i.e. the assumption that $i^* = i$\textsuperscript{809} must necessarily always hold), is not sufficient to conclude neither that macroeconomic policies must converge internationally nor that they must become restrictive. As was shown above, traditional Keynesian analysis holds that the introduction of perfect capital mobility does not reduce national policy autonomy but simply requires relying more on fiscal or exchange rate policy than on monetary policy. In practice this Keynesian interpretation has proved to be of little value. If the defense of the external flank indeed requires high interest rates and thereby discourages investment, it is doubtful whether fiscal policy can function as an adequate alternative. To increase public spending while discouraging private investment is rather likely to lead to a growing public sector and continuing budget deficits than to overall growth. Historically therefore, governments in the twenties and during the last two decades, who pursued restrictive monetary policies in order to maintain a fixed exchange rate generally had to confront the need to reduce public spending.

Yet, even under the assumption that monetary policies do play a crucial role in economic policy strategies, it is not clear why the introduction of perfect capital mobility should lead to policy convergence around a restrictive rather than an expansionary regime. One country pursuing single-handed expansionary policies in a generally restrictive environment will indeed most likely be confronted with the choice of either abandoning its reflatory course or accepting a strong

\textsuperscript{807} Webb (1991) provides an analytical link between hegemonic stability theory and the external constraints view along those lines. Decline of American hegemony does not lead to beggar your neigbour exchange rate policies because capital mobility makes such policies extremely costly.

\textsuperscript{808} "Skynda på med monetär union", Dagens Nyheter, March 10. 1995.

\textsuperscript{809} Where $i^*$ is the domestic interest rate and $i$ the international interest rate.
devaluation of its currency. However, in theory an open international system might just as well give rise to a mirror situation in which those countries pursuing a more restrictive course come under strong pressure to choose between excessive revaluation or abandoning their policy.

During the sixties and the early part of the seventies the increasing internationalization of money and finance was primarily argued to make combating the inflationary pressures emanating from the US' expansionary policies almost impossible as domestic monetary restriction would be neutralized by capital inflows in response to higher interest rates. And if policy preferences of the majority of OECD countries during the last two decades were indeed correctly characterized as giving priority to growth and full-employment, then the reemergence of capital mobility might just as plausibly have led one to expect a repetition of the scenario of the mid thirties when countries like France, Switzerland and the Netherlands who attempted to maintain a restrictive course were confronted with highly erratic capital flows and a further deepening of the recession. Given the allegedly unique preference of the Bundesbank for restrictive policies, why should Germany not have been confronted with a rapidly revaluing currency and a consequent collapse of export industries? Assuming that Germany had a considerably stronger preference for restrictive policies than most of its neighbours, should not the reemergence of capital mobility have led to massive speculations on continuing revaluation of the D-Mark, economic recession and massive political opposition against restrictive monetary policies? Why is it that the Bundesbank's preference for restrictive policies should allow it to dominate monetary policy in Europe rather than being forced to pursue more expansionary policies in response to excessive revaluation?

Clearly the restrictive policy bias which the 'external constraints view' holds to be characteristic of the present situation, does not arise from the emergence of international capital mobility per se, but from imputing a specific set of preferences to internationally mobile wealth.

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810 The abrogation of the Mitterand experiment during 1982/3 is probably the best-know example of this.

811 See, for example, Block 1977, p. 206 and Gilpin 1987, p. 144. The theoretical and political discussion of the relation between capital mobility and inflation has apparently made an 180 degree turn since the late sixties; from the conviction that capital mobility makes anti-inflationary policies under fixed exchange rates impossible and hence requires a switch to flexible rates, to the argument that capital mobility makes a policy of low inflation and fixed rates inevitable. This analytical salto mortale simply reflects the policy priority of low inflation. When states, under fixed exchange rates are confronted with serious inflationary problems which cannot be handled by incomes policies any more they will tend to discover their policy autonomy, if they face domestic inflationary pressures under flexible rates they are prone to proclaim their policy impotence in the face of capital mobility.

812 The Swiss experience of 1976 when the SNB (Schweizerische Nationalbank) abandoned its more restrictive policy in favour of a closer link to the DM in response to an explosive revaluation of the Franken which threatened to ruin the export sector is a recent example of expansionary impulses emanating from an international system with high capital mobility.
holders, namely their abhorrence of policies for growth and employment. Only under this assumption will it be impossible for individual countries to maintain a more expansionary policy course in a restrictive environment by means of a soft currency policy.

Yet, the external constraints view suffers from the same inability to correctly understand the dynamics of domestic policy-making as HS theories and hence arrives at a rather erroneous view concerning the impact of international finance. Analytically the position that a devaluation will create expectations of further devaluations is quite peculiar as it says that someone who seeks a cure for his illness will thereby increase expectations that his health will get worse. Financial markets do continuously monitor economic policies and may frequently arrive at the conclusion that a country’s policies are incompatible with its exchange rate level. But this in no way implies that financial markets enjoy primacy over politics. Instead politics might exert its primacy by adjusting the exchange rate level to current policies rather than to adjust policies to the current exchange rate. Indeed in economics it is quite standard to argue that even in a world of high capital mobility exchange rate adjustments are an effective means of remedying balance of payments problems. Take the hypothetical case of a country with a strong political preference for full-employment in a restrictive international environment. Given the difference between domestic and international policy preferences financial markets may very well come to the conclusion that the present exchange rate is unrealistic. Defence of the exchange rate by means of restrictive policies may very well further disrupt the confidence of the financial markets as it moves the country further away from its goal of full employment and hence cannot fail to increase political opposition. Devaluing the currency to a level which is deemed compatible with the goal of full-employment in this case will restore rather than disrupt financial markets’ confidence in the currency.

813 IMF staff member Mussa argues along similar lines when he points out that US commitment to a fixed exchange rate would be viewed with distrust by financial markets because the latter realise that there is insufficient political support in the US for a policy which depresses domestic growth for the sake of the exchange rate. Mussa 1994, p. 399.

814 See, for example, Dornbusch 1980, Ch. 13.

815 It is quite interesting to note that in the neoclassical ‘model seemingly so popular with central banks at present the equally popular argument that expectations of devaluation lead to higher domestic interest rates and hence should be avoided by domestic policies is not admissible. If Id-I=dee and if de=dw=dp, which as will be remembered in the neoclassical view must be assumed in order to arrive at the conclusion that Keynesian policies are ineffective, then dpe=dee. But since I=I-n-dpe, and when assuming for simplicity that the rate of inflation abroad is 0, I*r=I*n it also follows that I*r=Id,n + dee -dee=Id.r. Again this inconsistency reflects that monetary and exchange rate policies are not based on policy-makers belief in neoclassical argument but in a reluctance to embark on policies which might increase inflationary pressures or might make the containment of inflationary pressures a shared responsibility between central banks and labour market institutions.
Analytically the external constraints views suffers from the problem of being unable to recognize disruptive capital movements unless in connection with cross-border flows, while ignoring the preconditions for domestic financial stability. The introduction of the potential unwillingness of domestic wealth holders to hold the national currency as a device to explain the necessity of restrictive policies must remain theoretically unsatisfactory as long as it remains unrecognized that wealth can be allocated in many ways even in a closed economy. The presence of international financial relations is neither a necessary nor a sufficient condition for the occurrence of disruptive financial transactions. Transferring financial and monetary assets into a foreign currency by no means is the only option open to wealth holders who have lost confidence in the domestic currency. Even if wealth holders are completely barred from international transactions they are in no way forced to maintain their portfolio, but always have the option to acquire (speculative) real assets and/or debt. If continued inflation has disrupted the confidence in the currency, closing the loophole of capital outflows will not dispose of but rather aggravate the problems as it leads to a domestic flight out of the currency and the accompanying explosion of the financial system. Even a closed economy, hence, cannot avoid to address its inflationary problems. In other words, it is theoretically inadmissible to invoke the internationalization of finance as the decisive factor in terminating the Social Democratic policy regime since it predates the possibility of a market reaction on the existence of a plurality of polities and hence ultimately collapse the distinct categories of state and market into one.

It is certainly correct that the history of the interwar period provides many examples of erratic short term capital movements which seemed induced by mere rumours rather than any fundamental factors. In addition it seems also correct that the occurrence of these capital flows disappointed both the Keynesian (F-M) belief that international capital mobility would prove to be no constraint on economic policies and the neoclassical conviction that exchange rates in a system of free floating would adjust to reflect inflation differentials and hence would allow each individual country to choose its own preferred rate of inflation.\textsuperscript{816} Rather the advent of flexible rates by itself promoted speculation as it implied an increase uncertainty about future exchange rate levels. Yet, these short term capital movements by themselves cannot furnish an explanation for regime changes as they do not spark off cumulative price movements. Moreover, governments can and have frequently used exchange controls to contain erratic short term capital flows.

\textsuperscript{816} See also Piore & Sabri 1984, p. 172-4.
Instead the reasons why devaluations may give rise to cumulative outflows is primarily related to problems of containing domestic inflation rather than to the presence of international capital movements per se.817 In a regime which tolerates high and variable inflation, the long term value of financial wealth is already being eroded and this by itself will cause wealth holders to shift into foreign currency.818 Pursuing an accommodating exchange rate policy in this constellation can only be interpreted as a political refusal to combat inflation and hence necessarily must aggravate the flight out of the domestic money. Under these circumstances a devaluation thus does create the conditions for expecting further devaluations and on this basis short term speculation might become seriously destabilising. Especially reserve currency countries like the US and the UK have been confronted with this problem during the seventies and eighties.819

The dominant domestic constellation of deflation in the early thirties, in contrast, is not one which undermines wealth holders confidence in the value of money. Rather continued deflation tends to make holding money so attractive that lending activity is radically reduced and both the financial system and the real economy are threatened with collapse. While for wealth holders the value of domestic money is secured, the political and economic effects of deflation make the continued adherence to a fixed exchange rates seem less and less feasible. In this constellation the game on international financial markets rather is not to be caught holding a currency which devalues against gold. As a result international financial markets became extremely fickle during the Great Depression; reacting massively to even very remote indications that devaluation might be forthcoming. Yet countries which clung to gold did further destroy rather than improve the confidence in their currencies as these policies implied worsening domestic economic and political problems. Devaluation, especially when combined with a credible end to restrictive policies, instead did not create expectation of further devaluations but rather removed the expectations of deflation and hence set the stage for an abatement of domestic political conflicts, an end to hoarding and a recovery of lending and hence investment.820 In the end even a staunch advocate of the Gold Standard

817 See Riese 1986, Ch. 6.
818 The problem is particularly urgent for countries whose currencies is widely held internationally.
820 The surprise about the actual possibility of living without a rigid external constraint was perhaps most poignantly expressed in Labour MP Tom Johnson’s famous remark after the Pound was forced off gold in September: "They never told us we could do that." (Quoted in Kindleberger, 1984, p. 332.) The remark has also been attributed to Sidney Webb. See Temin (1989, p. 112).
like Hendricus Colijn, who initially expected the British devaluations of September 1931 to lead to inflation there and a loss of confidence in the Pound, eventually had to realize that a relaxation of the external constraint was inevitable.

Peter Temin’s (1989, p. 71-72) remark with respect to German policies has general validity for the Great Depression: "The argument that devaluation would increase capital flight confuses the cure with the disease. Capital was fleeing because people holding Reichsmarks were afraid the currency would lose its value. Once devaluation had taken place, only the expectation of further devaluation would have led to flight. In any case further flight would only lower the price of the mark, leading other people to want to buy it. Devaluation, therefore, would have reduced capital flight and its effects, not increased it." In the thirties, accordingly, speculative capital movements rather constituted a problem for conservative governments who clung to the Gold Standard than for Social Democratic governments embarking on inflationary policies.

In sum, to attribute the advent of restrictive policy regimes to international capital flows is to hold the messenger responsible for the bad news. The advent of massive capital flows and exchange crises is simply the manifestation of a desire to change portfolio allocation to less inflation-prone assets, which would have taken place in other form if the option of acquiring assets denominated in foreign currencies had been effectively barred. In a (financially) closed economy such a constellation rather is manifested by a flight into debt and real estate and an explosion of financial markets. It is, therefore, a fundamental misconception of the political left to single out the international capital market as the major scapegoat which prevents the implementation of policies for growth and full-employment. Financial markets do not have a built-in bias against such policies but rather indiscriminately undermine any policy regime which fails to prevent cumulative changes in the price level. And the latter feat has been successfully accomplished by governments of a leftist as well as rightist hue.

Historically the correctness of the position that the presence of international capital mobility is not a factor which fundamentally changes the options and constraints on macro policy, is shown both by the fact that countries which have effectively isolated their domestic financial markets have not been absolved from combating inflation by contractionary policies while countries without serious domestic inflationary problems have managed to pursue expansionary policies without being undermined by international capital flows, and by the possibility of establishing an expansionary regime in the open financial environment of the early thirties.
The breakdown of the interwar Gold Standard provides, perhaps, the most spectacular illustration that international capital mobility does not preclude and sometimes even may promote a switch to more expansionary policies. Yet, with episodes in mind like the short-lived Hornsrud government and the fall of the second Labour government, Social Democrats concluded that international capital mobility was inimical to their policy goals. Christian Hornsrud, who had taken office on January 27, 1928 as PM of the first DNA (minority) government, and who had declared in his inaugural speech that the government would be guided in all its actions by the desire to prepare the transformation to a socialist society,\textsuperscript{821} was immediately confronted with massive capital outflows. Within two weeks the government was brought down as the leader of the Liberal Party, Mowinckle, upon advice of the governor of Norges Bank, Nicolai Rygg, decided to call for a vote of no confidence. Edvard Bull, foreign minister in Hornsrud’s government, expressed the general feeling of the DNA when he said that the government’s fall had been a dictate from financial capital ("Bankkapitalens Diktat"). In Britain the Labour Party claimed that the second Labour government had been brought down by a "Bankers' Ramp", meaning that financial circles had engineered the crisis of the Pound in order to topple the government and achieve a cut in spending, in particular on unemployment benefits.\textsuperscript{822} Apart from Norman’s continuous demands for budget cuts, this view could derive support from New York’s J.P. Morgan & Co’s insistence, that budget cuts were a precondition for a loan to defend the Pound. The trauma of Snowden’s defense of the Pound prompted the Labour party’s decision to make exchange controls an integral part of monetary policy. Superficially the analysis may have seemed quite plausible. After all, Snowden’s budget cuts constituted an effort to appease wealth holders and thereby stem the speculation against the Pound. If a future Labour government could successfully employ exchange controls it might avoid speculative outflows without having to bow to the 'dictate of finance'.

Yet neither episode can be read as evidence that Social Democracy and free capital mobility are incompatible. While in opposition DNA, and the Farmers Party, had strongly opposed Norges Bank’s policy of pushing the Krone up to its pre war gold parity. Because DNA and BP had polled 36.8% and 14.9% respectively in the 1927 elections a devaluation might reasonably be expected. Capital outflows had already started before the government was formed and could not be stemmed by declarations from Hornsrud, as well as the BP that the Krone was not to be devalued. The

\textsuperscript{821} Hornsrud’s inaugural speech is reproduced in Maurseth 1987, p. 445.

\textsuperscript{822} The DNA also interpreted the British crisis in such terms. See for example, Arbeiderbladet 21 September 1931, p. 6 "It is haute finance which governs England. After the details of the English government crisis became known, it turned at that all of it had been a manoeuvre of haute finance to get rid of the labour government." My translation.
massive withdrawals, however, acutely threatened the solidity of a banking system already weakened by Norges Bank's deflationary policies, yet the government rejected Ryggs proposal for a bank insurance fund.\textsuperscript{823} Using an argument quite reminiscent of present day liberal views on subsidies to industry, the government held that, while a bank insurance fund may be helpful, it is in principle not correct that the state should give a guarantee for deposits (inskudd), and that the state should not keep banks alive whose soundness, due to their own policies, had become doubtful.\textsuperscript{824} DNA and AFL had interpreted the deflationary policies as being mainly inspired by the interest of creditors, and the latter were taken to be represented by the banks. Similarly the postwar inflation was attributed to financial speculation. In the view of the labour movement, to cancel the debts which many had incurred during inflation and which had become a heavy burden under deflation would merely mean to present the bill to those responsible; the banks. As a result of this interpretation the DNA showed a great reluctance to support banks in difficulties, interpreting it as a subsidy to the wealthiest and most powerful capitalists. But while it may have its merits, not to subsidise industrial firms who have not been able to survive on the market, in a monetary economy such a neglect of the state for the solidity of the financial system is potentially disastrous. In fact Rygg was quite right to advice Mowinckle to topple the government because the combination of massive capital outflows and no guarantee for bank deposits could only lead to disaster. Yet the lesson to be learned here was not that financial capital dictates policies. Rather than trying to soothe financial markets by issuing declarations that he would not put into practice the policies he had advocated while in opposition, Hornsrud should have started his term in office with a substantial devaluation of the Krone. As subsequent experience from later countries would show such a policy would have most likely stemmed capital outflows. Quite paradoxically therefore, the Hornsrud government did not fail because its Marxist leanings led it to attempt to increase state control over the economy, but because it did not dare to assume control over the exchange rate and because it failed to guarantee enough state control over the financial system.

Labour's analysis suffered from similar shortcomings. As postwar experience would show, exchange controls can only provide temporary and partial relief if the confidence in the current exchange rate is fundamentally disrupted. Consequently they do not suffice to prevent a change in policy if a change in the exchange rate is to be avoided. Secondly, and more important, Labour was incorrect to interpret the downward pressure on the Pound as a vote of no confidence of wealth

\textsuperscript{823} See Keilhau 1950.
\textsuperscript{824} See Odelsting Med. nr 5 (1928) and Rygg 1949, p. 499.
holders against Social Democratic policies. Given the mounting opposition against deflationary policies and the state of the current account and budget deficits, even a wealth holder with strong Labour sympathies may have easily come to the conclusion that if the exchange rate was to be maintained more energetic restriction would be required. Yet, such a constellation allows for two courses of action to restore confidence in the exchange rate: either macropolicies can indeed be made more restrictive or the currency is devalued to a more realistic exchange rate.

The speculation against the British Pound during the late twenties and early thirties was not inspired by the fear of expansionary policies per se but by a general belief that the Pound had been reestablished at too high a parity and that British society was less and less likely to be willing to bear the costs of such a commitment. Even the fall of the Second Labour government and the presentation of a balanced budget by the National Government under MacDonald on September 10, 1931 failed to calm financial markets. Instead a relatively harmless protest of Navy sailors against pay cuts, somewhat exaggeratedly known as the "mutiny at Invergordon" on September 14 and 15, 1931, caused sheer panic on exchange markets. Fearful of a massive downward slide of the Pound, the Bank of England increased the discount rate from 4.5% to 6% on the same day the Gold Standard was abandoned. Yet, after the decision to cut the Pound lose from gold on September 21, 1931, no cumulative downward run on the Pound developed. The announced twilight of Britain did not take place, instead the British economy started its slow ascent towards recovery. Especially during November and December there was considerable downward pressure on the Pound and on December 3 it reached a low point of $3.24. While the Bank of England, partly because of lack of funds, stayed aloof, downward pressure on Sterling abated. From March 1932 onward Sterling came under strong upward pressure. Ironically therefore, Labour might have harboured a less pessimistic view about the inherent political preferences of internationally mobile capital, if it had considered the gold parity less sacrosanct in 1931.

After the devaluation of the Pound both Sweden and Norway experienced large outflows of capital as financial markets apparently perceived their commitment to stay on gold to have become incredible in the face of the British action. The initial reaction of both Norges Bank and the Riksbank was to defend the old parity. Being unable to procure foreign currency loans, devaluations became inevitable within one week of the British decision. Again, after devaluation speculation against

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825 Sayers 1976, p. 422. Interestingly the decision of the DNB to shed its Sterling reserves contributed significantly to this fall. The Dutch central bank apparently did expect a further downfall and decided to cut its losses but this was evidently not a general feeling shared by holders of Sterling.

826 For Sweden see Larsson 1991, p.91.
both currencies largely abated. No flight out of the Swedish Krona occurred after the SAP had come to power in 1932 on the basis of an explicitly reflationary programme. Nor did Norway experience an exchange rate crisis when the Social Democratic Nygaardsvold government took office in 1935.

In the Netherlands, on the other hand, the British devaluation did not seem to evoke a crisis of credibility. Gold stocks rather remained high in both countries throughout the whole period. After the British devaluation speculation against the Guilder was fairly subdued and subsequently the Netherlands actually experienced an inflow of capital. Gold and foreign currency reserves of the DNB increased from Fl. 931 million in September 1931\textsuperscript{827} to Fl. 1,106 million in January 1933. Yet, the initial credibility of the exchange rate target waned as more and more countries devalued and the depressing effects of deflationary policies to neutralize the overvaluation of exchange rate became more pronounced. Especially from 1933 to 1936 the DNB continuously had to ward off speculation against the Guilder. Large outflows occurred in response to the devaluation of the Yen\textsuperscript{828} (December 31, 1931), the devaluation of the Dollar (March 1933), Germany’s announcement of a transfer payments moratorium (June 1933), the devaluation of the Belga, and in May 1936 after the victory of the Popular Front in France. But also whenever a change in the domestic political situation seemed to imply a weakening of the support for the gold parity capital flowed out. When it seemed in September 1935, for example, that the government did not have a majority for the proposed budget cuts, speculation against the Guilder was massive and calmed down only after the proposal were approved.\textsuperscript{829} But also pronouncements from outside political circles could cause capital flows. Deterding’s advocacy of abandoning gold, for example, was partly responsible for the weakness of the Guilder in late June 1933.\textsuperscript{830} The mutiny on the Navy ship "Zeven Provincieën" in early February 1933 off the coast of Indonesia, which like the mutiny at Invergordon was inspired by a cut in sailor’s wages, similarly provoked capital outflows.

As was the case in Britain, the depreciation of the Guilder in 1936 rather restored than destroyed confidence in the currency. Quite contrary to the expectations of the government and the DNB, who feared that a serious crisis of confidence in the Guilder would follow on the heels

\textsuperscript{827} Figures from Griffiths 1987, p. 169.

\textsuperscript{828} Because of the threat to the competitive position of Indonesia, the Guilder seems to have been more affected by the Yen devaluation as other gold bloc currencies.


\textsuperscript{830} See Brown 1987, p. 40.
of depreciation,\textsuperscript{831} the Dutch EEA soon was confronted with the task of preventing excessive appreciation instead of depreciation.\textsuperscript{832} After devaluation exchange markets calmed down and the DNB could lower its discount rate in (December 1936) and end the ban on long-term foreign lending and the export of private gold (mid-1937).\textsuperscript{833} Equally in contrast to the government's expectations, government bonds rallied strongly in response to the depreciation of September 26 1936.\textsuperscript{834}

Similarly the economic policy developments after 1973 must be read as evidence that Social Democracy cannot thrive in a world where inflationary pressures have to be combated by means of restrictive macroeconomic policies, rather than as evidence that Social Democracy and international capital mobility are incompatible. Governments who felt they did not have an acute inflationary problem could be more sanguine with respect to downward pressures on the currency, or could even pursue a deliberate soft currency policy in order to aggressively defend full-employment. In the seventies and eighties, for example, devaluations within the EMS have been possible without creating expectations of further devaluations. Whereas it became popular since the late seventies to argue that the actions of the Federal Reserve and the Bundesbank\textsuperscript{835} provided an insurmountable hurdle to employment oriented policies, the Riksbank pointed out that an alternative did in fact exist. As Riksbank governor Lars Wohlin, argued on September 14, 1981: "The answer to the American interest rate policy is to devalue and thereby give industry the possibility to expand despite high interest rates."\textsuperscript{836} The Swedish devaluation of 1982 obviously did not lead to cumulative pressures but rather restored confidence in the currency. Moreover both Norway and Sweden could choose to adjust their exchange rate in order to prevent higher domestic inflation rates from undermining external competitiveness. The regime change came only at the point where the institutions designed to contain domestic inflationary pressures became unable to perform their function.

\textsuperscript{831} See Vlak 1967, p. 38.
\textsuperscript{832} See Vlak 1967, ch. 3.
\textsuperscript{833} The sensitivity of exchange markets to rumours of a Dutch devaluation eventually even came into conflict with the right of free speech. In 1933 one of the directors of the DNB enquired whether it was legally possible to take action against those speaking out publicly in favour of devaluation. The minister of finance - possibly even to his dismay - replied that such action was not possible under Dutch law. See Griffiths 1987, p. 170.
\textsuperscript{834} Vlak 1967, p. 42.
\textsuperscript{835} For Marsh (1992) it is clearly the Bundesbank which decides the course of European economic policies: "the Bundesbank now effectively runs monetary policy" (p. 1). "In 1960, Britain could still relish the taste of hard-won victory in the Second World War. No one in London realised that the next battle for Europe was already under way: and that it would be decided not by force of arms, but by the power of German money." (p. 10) "The Bundesbank has replaced the Wehrmacht as Germany's best known and best-feared institution." (p. 10).
\textsuperscript{836} Quoted in Jonung 1993, p. 308. My translation.
Up to this date Japanese policy-makers still have not found it necessary to maintain a high level of unemployment in order to keep inflation under control. As the example of Norway and Sweden shows, one major problem for even very centralised western labour markets has been that labour scarcity provokes escalating nominal wages as employers try to attract labour and unions try to maximise their incomes. Japan, however, has a rather different labour market structure which makes the occurrence of this mechanism much more difficult. In a system in which the individual worker’s pay depends primarily on the time he/she has spent with the company, it becomes very difficult for firms to raid other firms labour force as well as for workers to switch company. In addition to these institutional mechanisms there is an 'ideological' mechanism to the extent that switching jobs merely because another employer offered a bit more is generally considered to violate the loyalty a worker is supposed to show his company. Whereas most western countries hence argued that the restrictive American and German interest rate policies of the late seventies left them no choice but to pursue a restrictive policy themselves, Japanese policy-makers responded with a significant deviation.

The successful Japanese and Swedish policies of the late seventies and early eighties also imply that president Mitterand’s famous U-turn in macroeconomic policies of 1982/3 cannot, as is generally assumed, be treated as an illustration that expansionary policies are impossible in a world of international capital mobility. Rather the French episode merely shows that it is not possible to pursue two mutually incompatible goals at the same time. Since France was not willing, for reasons related to domestic inflation as well as foreign policy, to give up its commitment to the EMS, the experiment of pursuing more expansionary policies than Germany necessarily had to fail.

In the USA the rapid depreciation of the Dollar in 1978/9 was one reason for the radical change in monetary policies. Yet, this was also a period with high domestic inflation. As the Federal Reserve could not treat the depreciating Dollar with benign neglect because of its effects on domestic inflationary pressures, the Bundesbank could exert effective pressure for a change in American policies by refusing to prop up the dollar with lower interest rates. Instead the Bundesbank matched US discount rate increase thereby keeping up the pressure on the Dollar. In 1985 and in the spring of 1995, however, The Federal Reserve could and did take a much more benign attitude to depreciation because serious domestic inflationary pressures were absent. In this constellation it was the Bundesbank which felt obliged to follow: reducing German interest rates in order to counteract an excessive appreciation of the DM.

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837 See Emminger 1986.
And although politicians like Feldt argue otherwise, the break up of the EMS in a wave of international speculation during late 1992 does not prove that there are no policy alternatives. On the contrary. Apparently international capital mobility does not imply that fixed exchange rates and internal policy adjustment are the only policy options. Rather financial markets seemed to hold that given insufficient convergence in domestic policies the plans for monetary union were not credible. Whereas some currencies, like the Guilder and the Krone have continued to shadow the German mark, those that have not did not experienced the dire consequences predicted by the external constraints view. As argued above, Britain has used the breakup of the EMS in order to lower domestic interest rates. And although it may be too early to tell, such a policy seems to have had beneficial effects on the economy as Britain now ranks amongst the fastest growers in Europe. In Sweden the effect of the EMS breakup was that financial markets, against the determined policy of the Riksbank, imparted a significant expansionary impulse to the export sector by pushing the Krona down.

At the same time the episode of December 1992 confirmed another lesson, which might have been learned already under the Gold Standard, namely that a fixed exchange rate is not a necessary safeguard against inflation. In Sweden, a devaluation in 1991 when inflation was high, the domestic economy over-heated and the banking system exploding would only have created further mayhem. When however, in late 1992 under conditions of a severe domestic recession, the currency was forced to devalue by about 20% the inflation which policy makers generally feared to follow did not occur. Indeed with a financial system which has become extremely conservative in its lending practices due to the recent experience of massive debt default and with a very slack labour market, it is well-nigh impossible to start an inflationary process.

6.5.1 Capital Flows and Exchange controls

That the three policy regime changes of this century were not forced upon reluctant governments by the forces of internationally mobile capital, but primarily constituted a reaction to problems in controlling domestic nominal prices is further confirmed by the policies states have pursued with respect to restrictions on the free flow of capital across borders. If it were indeed correct that governments at all times prioritise growth and employment and that unhindered international capital flows preclude such policies, then all three regime changes should have been characterised by an intensification of exchange controls. Though the diagnosis would have to be that such efforts were successful only at one historical instant, namely during the Great Depression. In order not to be forced to pursue undesirable policies, the turn to a restrictive regime in the early
twenties and at present times should have been preceded by (desperate) attempts to place restrictions on international capital flows. Similarly the decision to reorient macroeconomic policies from the defense of the gold parity towards stimulation of the economy, and in particular the decision to pursue cheap money policies in the early to mid thirties would have to be preceded by a successful attempt to reduce international financial integration. In actual fact, however, governments’ attitude to exchange controls displayed a quite different pattern.

On the basis of the assumption that free capital flows inhibit macropolicies aimed at growth and employment, governments during the twenties and the last two decades must seem to have behaved in a rather perverse manner. Instead of battling to defend an expansionary policy orientation by means of exchange controls, the restrictions placed in the way of international capital flows at the outbreak of war were removed after 1918. Many controls fell victim during the bonfire of controls in the immediate postwar years. The prohibition on the export of gold, obviously, had to remain in force as long as the currency was not brought back to parity. But by 1925 international capital flows in the developed world found few obstacles in their way. More important perhaps, also the last two decades have been characterised by a dismantling of exchange controls rather than by an attempt to strengthen them. The Thatcher government set the tone, as one of its first measures after assuming office in 1979 was to abolish all exchange controls. And by the end of the decade also the Scandinavian Social Democrats had liberated capital flows. The emergence of a new and expansionary policy regime in the thirties was not preceded by the imposition of decisive hurdles to the international flow of funds. With the exception of Germany, the Great Depression saw few attempts to install exchange controls. Instead it was the threat of war which lead to a rapid proliferation of exchange controls in the late thirties.

Once it is realised, however, that governments at all three historical junctures were battling cumulative domestic price movements rather than the forces of international finance, a diagnosis of perverse policy behaviour is no longer necessary. Exchange controls can and have been used successfully to contain short term flows of funds and hence may allow for a smoother and more orderly adjustment of exchange rates. Even in the eighties, for example, exchange controls have been used in the EMS framework to limit short term speculative flows related to exchange rate realignments.838 If, however, capital outflows are a reflection of a long-term distrust in the solidity of the domestic currency rather than just the manifestation of expectations of a change in exchange rates, exchange controls, even if implemented successfully, are of not much use because purchasing

838 See Giavazzi & Giovannini, 1989. Also Artis 1987, Ch. 7. p. 179.
(debt denominated in) foreign currency is not the only exit option available to wealth holders. Rather, in a constellation of ingrained inflationary expectations, effective exchange controls may very well be counterproductive as they contribute to a domestic financial "greenhouse" climate.\(^{839}\) If inflation has seriously undermined the attractiveness of holding the domestic currency and hence increased wealth holders' desired holdings of foreign currency, closing off the avenue of capital exports will not restore confidence but is rather likely to rechannel the flight out of the domestic money into speculative real assets rather than foreign currency. The Reichsbank, for example, used exchange controls during hyper-inflation\(^{840}\) to prevent additional price impulses through devaluation, but as long as the domestic causes of inflation were not removed such controls did nothing to solve the basic problem. Accordingly periods in which domestic inflationary pressures became the dominant problem for policy-makers have been characterised by relaxation of exchange controls. Conversely in the deflationary constellation of the Great Depression there was no urgent need for exchange controls. The core problem then was that ingrained expectations of deflation caused a radical increase in the willingness to hold money and a consequent unwillingness to finance investment. Whether it was possible to transfer funds abroad or not was quite irrelevant to this problem. The solution rather had to consist in a policy which credibly abandoned deflation and hence increased the willingness to finance productive undertakings again.

That there is something wrong with the view that free international capital flows pose an insurmountable obstacle to expansionary policies should have become clear already during the thirties when a fundamental reorientation of the policy regime took place without decisive restrictions on capital flows. After abandoning the Gold Standard, many countries feared that a loss of confidence in the currency would lead to a strong increase in international hot money flows. In line with arguments presently popular again, most governments interpreted the highly erratic capital flows which they experienced in the late twenties an early thirties as the reflection of international finance's general distrust of expansionary policies rather than as a distrust in the political and economic feasibility of the Gold Standard parities. Accordingly it was expected that the switch to more expansionary monetary policies, which generally took place after devaluation, would have to be protected by means of restrictions on cross-border capital flows. In September

\(^{839}\) Swedish commercial banker Wallenberg (1985, p. 72) outlined another mechanism by which Swedish exchange controls in the eighties contributed to domestic overheating. Because Swedish exchange regulations forbid premature repayment of foreign debt in order to prevent speculation against the Krona the excess liquidity many firms had during the eighties could not be channelled abroad but had to remain in the domestic economy.

\(^{840}\) For example, the Law Against Capital Flight and Capital Flight Abroad, of September 8, 1919.
1931 the BoE introduced capital controls, but relaxed these restrictions already the same year and abolished them altogether in March 1932.\textsuperscript{841} Foreign issues in the London capital market, however, were maintained under informal control also after 1932 as the BoE tried to discourage foreign lending.\textsuperscript{842} The National Government apparently did not perceive relatively unhindered capital flows as an obstacle to its cheap money policy as also in Britain far-reaching exchange controls were only imposed in response to the threat of war. The Riksbank introduced some foreign exchange restrictions in the autumn of 1931, and the Swedish ministry of finance drafted a law on exchange controls during 1932.\textsuperscript{843} In addition the SAP came to hold that part of the unemployment in the twenties had been due to capital export from Sweden.\textsuperscript{844} But because the feared erratic hot money flows and the flight of investors from the country failed to materialise, also after the SAP had come to power the Swedish draft proposal for a foreign exchange law was never presented to parliament\textsuperscript{845}.

Germany was an exception to this general pattern as the Reichsmark in effect ceased to be a convertible currency after July 15, 1931.\textsuperscript{846} The bank holiday declared in response to the German credit crisis meant that until August 5 1931 foreign transaction had ceased. In the mean time the emergency exchange decree of July 15, 1931 centralised all transactions in foreign currency in the hands of the Reichsbank and abolished the forward market for foreign exchange. Three days later an additional emergency decree required that all holdings of foreign currency and paper denominated in foreign currency be presented to the Reichsbank. Violation of this decree was punishable with imprisonment of up to ten years. One of the implications of the new rules was that all imports now effectively required permission from the central bank. After the summer of 1931 exchange controls were tightened in successive stages and maintained until the end of the war. But not even the German case implies that exchange controls were required to pursue expansionary policies. The massive outflows before the summer of 1931 were primarily inspired by expectations of a devaluation of the Reichsmark and the fear of a collapse of the banking system, and hence were a

\textsuperscript{841} See Oye 1992, p. 113-4 and Helleiner 1994, p. 32.
\textsuperscript{842} See Cairncross & Eichengreen 1983, p. 94.
\textsuperscript{843} See, for example, Thomas 1936, p. 195. Other examples include the USA where exchange controls were introduced during the banking crisis on March 6, 1933. Belgium introduced temporary controls on the day it went off gold (March 19, 1935).
\textsuperscript{844} See Unga 1976, p. 173.
\textsuperscript{845} Cf Kock 1961, p. 203.
\textsuperscript{846} For a description of German exchange controls since the summer of 1931 see Luther 1964, Ch. 11.
reaction to restrictive rather than expansionary policies. But since Germany, also after the turn to more expansionary policies in late 1932, did not wish to devalue the Reichsmark, the dilemma between these mutually incompatible goals had to be solved by maintaining tight exchange controls.

In the majority of countries, then, it was the threat of a new war rather than the regime change during the Great Depression which provided the decisive impetus for exchange controls. In Sweden, for example, far-reaching exchange controls were only introduced by the Foreign Exchange Law of 1939 and the Foreign Exchange Decree of 1940.

After the war, exchange regulations were kept in force or even tightened. Maintaining exchange controls generally was based on three motives. First, the extreme scarcity of hard currency created the need to limit imports to goods essential for reconstruction. Second, the measures taken to control the monetary overhang and the advent of credit rationing required that the loophole of capital imports and exports be closed. In the Netherlands, for example, where credit restrictions (rationing) were not conceived as a permanent feature but were only to be used in times of excessive domestic credit growth in order to allow the DNB to reduce credit to the economy, exchange restrictions were used intermittently in combination with domestic credit rationing. Third, exchange restrictions by many governments now came to be seen as a necessary measure to defend a cheap money policy.

As the problems of postwar reconstruction were gradually overcome in the fifties, a general phase of liberalisation set in which culminated in the convertibility of European currencies in 1959. By the beginning of the sixties countries had either abolished many of the restrictions on cross border capital flows or were applying such measures only very sparingly while keeping them on the books. Yet this phase of increasing liberalisation was of short duration. The exchange rate crisis of the late sixties saw a renewed intensification of exchange controls both in an effort to stem capital outflows and to stem capital inflows (as, for example, in Germany and the Netherlands).

Both Sweden and Norway, to some extent did not join in the liberalisation trend of the fifties and sixties. Foreign exchange transactions relating to trade were generally liberalized, as in other countries, but the restrictions applying to non-trade related transactions remained tighter than elsewhere. The core of the exchange controls prevented residents from acquiring foreign assets as well as non residents from dealing in domestic assets. Outgoing direct investment was generally not impeded by restrictions. Both countries joined the OECD's code on the liberalisation of capital transactions in 1961, and this generally implied liberalisation of direct investment. Outgoing direct

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investment did require permission of the authorities but such permission was generally given. In response to the balance of payments problems of the early seventies, Swedish rules required as of 1974 that outgoing direct investment be financed by foreign currency loans. In both countries the problems of the early seventies gave rise to some changes in exchange regulations with the aim of promoting inflows while limiting outflows. In 1974 Sweden abolished the general prohibition of borrowing abroad although the provision was made that foreign loans should have a maturity of at least five years. The same provision was applied by Norwegian authorities.

Maintaining more extensive exchange controls in large part was a necessary result of both countries’ more extensive reliance on credit rationing. If domestic borrowers had had the ability to borrow abroad, the rationing of credit, which came to play a central role in both central bank’s monetary policies since the fifties, could easily be circumvented. Therefore, exchange regulation during the fifties and sixties did not have the function of defending a more expansionary policy from restrictive foreign influences. Indeed, with a booming world economy and a general commitment to growth policies there was no serious external threat to the Scandinavian Social Democrats’ goal of full employment.

But as policy regimes changed abroad since the mid seventies and the world economy moved into recession, it would seem that exchange controls now had to become a necessary tool in order to allow Scandinavian Social Democrats to continue pursuing more expansionary policies. Instead of tightening exchange controls, both countries followed Margaret Thatcher’s early lead and abolished all controls in the late eighties.

In Sweden foreign exchange controls were lifted in the period 1986-1989 by the SAP government. In 1988 the forward exchange market was liberalized. By January 1989 all restrictions concerning the purchase and sale of Swedish and foreign shares, and direct investment were lifted. In June 1989 most of the remaining restrictions were lifted. As a result Swedish residents were now free to borrow and lend abroad and trade with domestic and foreign assets irrespective of purpose or maturity.848 In Norway most of the remaining exchange controls were abolished on July 1 1990. The deregulation measures of July 1990 mainly affected the household sector as most restrictions on foreign exchange dealings concerning the corporate sector had already been lifted.849

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849 See Olsen 1990.
But why then would even Scandinavian Social Democrats abolish exchange controls in an increasingly restrictive international environment? The most obvious answer would seem to be that they had no choice as the internationalization of financial markets rendered the existing controls ineffective and made isolation of domestic financial markets excessively costly. Yet such arguments do not seem convincing.

First, as argued above, it would be fallacious to conclude that specific social and economic consequences are necessarily imbedded in new telecommunications and data-processing technologies. A second view argues that the impossibility of exchange controls arises because of a problem of transition. While exchange controls might technically be feasible and have beneficial effects, the mere announcement of stricter regulations will create massive outflows and hence will create exactly the economic disorder they intended to prevent.\textsuperscript{850} Although this can indeed be a major obstacle, it does not explain why countries like Norway and Sweden, which already had an extensive system of capital controls in place before the first oil price crisis, decided to dismantle rather than to strengthen them.

Thirdly, it is argued that domestic financial firms will be at a disadvantage in international competition. Yet the British experience seems to suggest that this is not necessarily true. Britain maintained exchange controls up to 1979 and even tightened them during the seventies. Yet London remained one of the leading financial centres. British exchange controls served to limit the integration of domestic financial markets with the international environment, but they placed no obstacles in the way of a thriving financial sector specialised in channelling funds from foreign lenders to foreign borrowers. But even if exchange controls disadvantage the international competitiveness of domestic financial firms, this could hardly have been a decisive arguments for Social Democratic governments believing that exchange controls were necessary in order to maintain the commitment to full employment policies.

Moreover, the process of dismantling exchange controls in both Sweden and Norway does not confirm the view that this constituted simply a legalization of already existing practices.\textsuperscript{851} Although there were sizeable loopholes both related to foreign trade credits and to companies with foreign branches, and although the early liberalization of (short term) forward exchange markets tended to keep short term nominal interest rates in line with international rates, both countries have

\textsuperscript{850} Stewart 1983, p. 86, Scharpf 1987, p. 306, argues this point for the United Kingdom.

been fairly successful in precluding foreigners from trading in Krone(a) assets as well as preventing residents from trading non-Krone(a) assets. This is shown by the fact that after deregulation a very sizeable increase in transactions took place. According to a study by Lindenius, private sector borrowing in foreign currency, purchases of Swedish interest bearing assets by non residents and purchases of foreign shares by resident all increased rapidly in response to the deregulation in Sweden. She argues that: "The abolition of exchange control has clearly been followed by extensive portfolio adjustments, Investors have adapted to the new opportunities provided by free capital movements." (Lindenius 1990, p. 19)

Yet that Scandinavian Social Democrats would abolish exchange controls in a time of recession abroad becomes less puzzling once it is realised that by the mid eighties they did not believe any more that exchange restrictions were crucial to safeguard the commitment to full employment. As argued in the previous chapter, while the majority of OECD economies during the eighties suffered from mass-unemployment, Norwegian and Swedish governments were confronted with a overheated economy and labour scarcity. Even before the Liberalisation of exchange controls both countries had taken measures to increase the pressure of external constraints on the domestic economy.

The most conspicuous of these measures was the imposition of a ban on borrowing abroad by public authorities. In Sweden public foreign borrowing had been introduced by the bourgeois government in 1976. The downward pressures on the Krona in that period seemed to call for an increase in domestic interest rates, yet the government feared that this would have a negative effect on investment. Public borrowing abroad, in this constellation served as a way to improve the balance of payments by increasing capital inflows without an increase in domestic interest rates. During the period 1975-79, when the trade balance was in deficit, Norwegian governments had applied the same technique.

The imposition of a ban on public borrowing in Sweden in 1984 was an attempt to reduce demand pressures in the economy by increasing external constraints on fiscal policies. As Swedish deputy minister of finance Erik Åsbrink (SAP) argued, the purpose of this policy was to increase constraints on the domestic economy. "There are many indications that [the policy of public foreign

852 See Wihlborg 1993, p. 250.
853 Calmfors (1985, p. 89) is, therefore, certainly correct to point out that it is somewhat of a contradiction to argue that foreign official borrowing should be halted in order too prevent macropolicies from becoming too accommodating while at the same time arguing that exchange controls are required in order to be able to pursue a more independent policy.
borrowing] has tempted, in a longer perspective, a too expansionary fiscal policy. Due to the state's foreign borrowing it has been possible to have a deficit on the current account year after year without the negative effects becoming sufficiently clear. When the state started to borrow abroad in 1977 to cover the current account deficit, a natural corrective mechanism was abolished. In 1986 also the Norwegian government decided to ban public official borrowing, even though a renewed deficit on the trade balance emerged in that year. And also here the arguments was that public official borrowing might hinder the necessary fiscal moderation.855

Banning public foreign borrowing thus must be considered an effort to re-orient monetary policies from internal to external balance in order to reduce the inflation rate.856 The reduction of tax deductibility of interest payments was another clear sign that both governments were concerned with slowing down the economy rather than with defending an expansionary policy orientation against restrictive influences from abroad. Even on the assumption that international capital mobility equalizes interest rates, domestic real interest rates could still be made to deviate, for example, by tax deductibility of interest payments. Thus the national tax system can be used both as a selective tool to direct financial flows and to stimulate investment overall. Yet both governments have argued that the tax deductibility contributed to the credit explosion and have moved to reduce this tax deductibility.

In contrast to Sweden, Norway developed an extensive system of interest rate subsidisation in the postwar period by making credit available through state banks at rates below those in the commercial market. In line with the general policy of trying to cool down the domestic economy, the credit share of state banks dropped dramatically in the eighties.

As the escalating inflation prompted a regime change in Norway in 1987 with the result that adherence to a fixed external constraint and tight money now came to be considered essential to contain domestic inflation, exchange controls as a way to pursue more expansionary policies in a restrictive environment lost their rationale. The Kleppe committee, for example, which was appointed in order to propose ways to reduce unemployment, was instructed to operate on the

854 Åsbrink & Heikensten 1986, p. 27. My translation. See also Hanson & Lindberg 1989, p. 20: "The foreign exchange norm was introduced in the knowledge that the rate of price increases in the Seventies and early Eighties had proved incompatible with a fixed exchange rate. There had been a number of devaluations and an appreciable risk existed that future wage settlements would be based on expectations of recurrent devaluations if competitiveness weakened once more. There was thus a need for further commitments to ensure that the direction of economic policy would be consistent with a given exchange rate."


856 In terms of the capability of coordinating fiscal and monetary policies a ban on public external borrowing is hence equivalent to a larger degree of autonomy for the central bank.
assumption of a fixed exchange rate policy. Accordingly interest rate policies necessarily had to be tied to the defense of the parity.\textsuperscript{857} A reduction in interest rates now was seen to depend on increasing the credibility of the exchange rate commitment by pursuing domestic macroeconomic policies consistent with such a goal. Given the unwillingness to employ the most crucial instrument which would allow for some domestic policy autonomy, the usefulness of exchange controls was no longer considered in its relation to an expansionary monetary policies. Instead exchange controls now came to be seen as a set of regulations which lead to microeconomic distortions and placed Norwegian firms, industria\textsuperscript{\textprime} as well as financial at a disadvantage in international competition.\textsuperscript{858} Both for the government and the central bank the microeconomic effects were the main reason to deregulate. Moreover, the need to adjust to EC regulations now also was introduced as an argument in favour of deregulation. But again, such considerations could only become important on the basis of a prior conclusion that a macroeconomic policy which deviated strongly from the EC pattern was no longer desirable.

In Sweden, exchange controls were lifted before the change in policy regime. Although also here the microeconomic efficiency of such controls figured prominently in the debate, the argument that a deregulation of cross border financial transaction would exert a disciplining role on domestic policies was of decisive importance. When the Swedish commission on exchange regulations Valutakommitteen published its report in 1985, the Bourgeois parties took the position that deregulation of exchange controls was indeed desirable in order to impose greater discipline on domestic macroeconomic policies.\textsuperscript{859} The main source of the disturbances besetting Sweden was argued to be a too accommodating economic policy and removing exchange controls would hence increase domestic stability as it would make such policies more difficult to pursue.\textsuperscript{860} The majority of the commission, mainly SAP members, however, held that exchange controls were still desirable in order to shield Sweden from foreign disturbances and maintain some autonomy in macroeconomic policies. Yet the views from majority position suffered from a strange inconsistency, because on

\textsuperscript{857} See NOU 1992:26, p. 42.
\textsuperscript{859} See SOU 1985: 52. Among those supporting the minority position was Anne Wibble, future finance minister in the Bildt government.
\textsuperscript{860} For a similar view see Wallenberg 1988, p. 28.
the one hand they argued that it would be easier to maintain higher interest rates with exchange controls,\textsuperscript{861} while on the other hand it was argued that abolition of exchange controls would lead to more restrictive policies.\textsuperscript{862}

While the SAP members on the Valutakommiteen seem to have been torn between the SAP’s traditional argument for exchange controls and the requirements of the Swedish economy, for both the ministry of finance and the Riksbank, the overheating of the domestic economy was the overriding concern. Governor Dennis of the Riksbank was very much in favour of exchange deregulation. While Dennis argued that exchange controls had become ineffective he also hoped that deregulation of exchange controls would help reduce inflation as it increased the credibility of the exchange rate target by reducing the room of manoeuvre of domestic policies.\textsuperscript{863} Finance Minister Feldt and his deputy Åsbrink also were strongly advocating exchange deregulation. Feldt, however, did not argue that the deregulation of exchange controls was required in order to discipline economic policies, and it would indeed have been difficult for the minister of finance to agree with the opposition. The budget proposal for 1989, in which the abolition of exchange controls was proposed argued that, due to, amongst other things, the internationalization of the economy and the introduction of new financial instruments, exchange controls had become less effective. Past experience also had shown that in times of downward pressure on the currency, confidence could only be restored by means of monetary and fiscal policy measures. Moreover, it was argued that exchange controls had a negative effect on the competitiveness of Swedish firms, in particular small and medium sized firms. Finally it was argued that Sweden should not stay aloof when EC countries liberalised their financial transactions.

The microeconomic motive of improving business competitiveness certainly was of central importance to Feldt. As argued, Feldt’s core conviction was that the public sector should shrink and that the private sector should be stimulated. Yet, it seems quite plausible that increased pressure on domestic policies provided an additional motive.\textsuperscript{864} Exchange deregulation fitted within Feldt’s overall strategy as it might be expected to increase pressures for reduced fiscal spending while reducing interest rates and thereby stimulating business. Given that Sweden had substantially higher nominal interest rates than Germany, deregulation could indeed be expected to lead to lower rates.

\textsuperscript{861} Many businessmen and economists advocated exchange deregulation also because it was expected to lead to lower domestic interest rates. See, for example, Wallenberg 1988, p. 29, and Calmfors 1985.
\textsuperscript{862} See Calmfors 1985, p. 91.
\textsuperscript{863} See Wihlborg 1993, p. 274.
\textsuperscript{864} See also Wihlborg 1993, p. 286.
Reducing the policy autonomy of the Riksbank, furthermore, would strengthen the argument that the reduction in domestic demand would have to be brought about primarily by means of fiscal policy rather than by monetary policies.

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Because policy-makers, quite correctly, believed that the boom of the eighties and the ensuing crisis had to be attributed primarily to domestic factors, continued mass-unemployment and speculation on the currency will not induce them to re-impose exchange regulations. For Norwegian and Swedish policy-makers, as for most of their colleagues abroad, the lessons to be learned from the experience of the eighties was that a strategy which attempts to maintain full-employment by means of a soft currency policy will lead to escalating nominal wages, a burgeoning public sector, financial speculation and inflation rather than to growth of productive investment and productivity. Because macroeconomic strategies apparently only postponed but not solved the problems, the solution now was sought in policies of microlevel adjustment. Despite the fact that policy-makers in recent years have regularly invoked the argument that external constraints stand in the way of a more relaxed monetary policy, imposition of exchange controls or even a conscious devaluation are ruled out. Such measures are feared to signal to both unions and business that micro level adjustment is less urgent and that macroeconomic policies will bail them out instead.

6.6 Conclusion

Historically no clear relationship exists between the political success of Social Democracy and both the extent of international capital mobility and the type of exchange rate regime. Social Democracy has thrived in times of high international capital mobility as well as in times of low,
capital mobility. While the fifties and sixties, a period of low capital mobility, are generally considered the Golden Age of Social Democracy, the Social Democratic model was established in a time of high capital mobility, namely the thirties. And despite a sharp increase in capital mobility Social Democratic policies were successfully pursued in Scandinavia up to the late eighties. Similarly, a fixed exchange rate regime does not necessarily lead to restrictive economic policies and mass-unemployment, nor does flexible exchange rate management necessarily imply an expansionary regime and full-employment. Social Democratic policies experienced their greatest success under the Bretton Woods regime of relatively fixed exchange rates. At the same time the fixed rates of the interwar Gold Standard witnessed the most dismal period for Social Democracy in this century. Also under flexible rates Social Democracy has both thrived and declined. In the seventies and eighties Sweden and Norway protected full-employment by means of more flexible exchange rate management, while the SPD and the Labour party quite dismally failed to maintain full-employment under the more flexible exchange rate policies they pursued after Bretton Woods. Rather than the weight placed upon maintaining a fixed exchange rate, it is the policy goal informing each regime which is decisive in terms of the viability of social democratic policies. Whereas the interwar Gold Standard was primarily constructed as a device to institutionalise restrictive anti-inflation policies, the priority of fostering growth and full-employment figured prominently in the Bretton Woods system.

Whether or not Social Democracy would succeed was determined primarily by domestic politico-institutional factors rather than international economic factors. While exchange rate changes, despite intermittent periods of very high cross-border capital mobility generally do constitute an effective means of mitigating restrictive shocks from the international system, repeated nominal (or real) devaluations will exacerbate domestic control problems in the case of the prevalence of domestic inflationary trends. Unless the resilience of domestic institutions, and in particular wage setting and financial institutions, is such that inflation can be kept in check under the absence of an external anchor in the form of a fixed exchange rate, the priority of external balance, and hence internal adjustment, will have to be reinstated.

Perhaps more so than in other areas, political scientists working in the field of international political economy have been willing to accept newly popular economic theories about the emasculation of domestic policies due to the internationalization of finance. Especially in small

365 Cf Temin 1989, p. 80: "It was not enough to go off gold; the gold-standard mentality had to be excised, the gold-standard policy regime abandoned."
open economies the claim that powerful external constraints force the state to pursue policies which run counter to the interests of labour must seem eminently plausible. Yet, that states should be so eager to pronounce their impotence in the face of markets and add to their troubles by abolishing restrictions which serve to provide some degree of protection from external pressures should have aroused the suspicion of political analysts.

It is no coincidence that the rediscovery of insurmountable external constraints should follow closely on the heels of the neoclassical rediscovery that macroeconomic policies are impotent. The postulate of the inability of monetary policies to affect real variables reflects the legitimatory requirements of a political system which has lost control of price and wage setting and accordingly requires monetary restriction and increased labour market slack in order to regain recovery. Whereas the simultaneous rediscovery of market imperfections on the supply side makes the postulate of the neutrality of money impervious to the failure of its empirical prediction that the increased unemployment in response to monetary restriction would be temporary, the consistent refusal of all central banks to practice the policies prescribed by monetarists testifies to the inadequacy of this economic framework.

In a sense the rediscovery of an insurmountable external constraint allows the left of the political spectrum to pronounce a similar ineffectiveness of macroeconomic policies without having to share the domestic conclusions that union strength is an obstacle and that Keynesian policies must fail, to which monetarist viewpoints inevitably give rise. Similarly the rediscovery of this constraint takes place not at the time of increased international cross border flows, but at a time where domestic institutions fail to contain inflation. And in analogy to the refusal of central banks to practice monetarism, the actual policy patterns rarely confirms the impossibility of devaluations or of a divergent in exchange rate policy. For those Social Democrats not willing to accept the policy ineffectiveness theorem it seems hence more attractive to maintain the view that macro policies affect unemployment but to deny that governments can be held responsible for the occurrence of restrictive policies.

7 Deflation, Inflation and Social Democracy

7.1 Social Democracy in a Monetary Economy

Western economic thought has traditionally been informed by a productivist bias according to which the production of goods and services appeared as the wellspring of prosperity. Indeed for most of the economic doctrines of the last three hundred years the most damning verdict that could
be pronounced on a social class was to label them unproductive. Classical economic theory in the version of Smith and Ricardo argued that aristocracy in fact played a parasitic role in the economy. Marx drew the logical conclusion from a model with labour as the only factor of production and argued that the workers were the only ones to perform productive tasks in society. Monetary and financial transactions, as they did not produce any tangible goods, could never hope to elicit the esteem awarded "honest hard work". Such transactions at best were considered irrelevant to the growth of prosperity, or, in the worst case, were brandished as immoral or criminal. Condemnation of money lending as usury has a long tradition in the West.

The normative position that monetary and financial activities are less respectable and useful than the production of goods was all too easily transformed into a theoretical argument that money performs no essential functions. For Marx a true understanding of the real driving forces of a capitalist economy could only be arrived at by piercing through the veil of monetary (surface) phenomena in order to advance to the 'real' driving forces of a capitalist economy. And whatever their differences, Liberals agreed with him. 866 Ludwig von Mises, the life-long critic of socialism, held (in 1912) that it was no longer necessary for him to criticise the 'fantastic suggestion' that economic problems are primarily connected to the monetary system or that the monetary use of gold and silver is objectionable, because others, of which Marx is recognized as being one, had developed this critique long ago. 867 "All the processes of our economic life appear in a monetary guise and those who do not see beneath the surface of things are only aware of monetary phenomena and remain unconscious of deeper relationships."863

Social Democracy, being rooted in a conflict of interest between (industrial) capital and labour, quite naturally shared this assumption that the productive sector was crucial while monetary and financial matters were epiphenomenal.869 As a result of this theoretical interpretation, Social Democrats would generally surmise that the main obstacle to the implementation of their views would arise from the (systemic) power of (industrial) 'capitalists'. Yet in the last seven decades the developments in the monetary area have been decisive for the political and ideological development of Social Democracy.

866 On the fundamental agreement between Socialists and Liberals in the interwar period see also Polanyi 1957, p. 25.
867 Von Mises 1980, p. 112.
869 The XYZ club for example, which was to help the Labour Party understand monetary and financial matters, was founded in 1932 by Nicholas Davenport and H.V. Berry because they felt that "the Labour Party was woefully short on expert knowledge of the City's financial institutions." Quoted in Pimlott 1977, p. 37.
Ideologically the core conviction of Social Democracy, which sets it apart from Liberalism and Socialism, is that a 'capitalist economy' does not by itself produce acceptable economic outcomes and that markets can and should be manipulated in such a way as to achieve the normative goals full-employment, an extensive welfare state and a fair degree of income equality. Yet this Social Democratic position is partially incompatible with the dynamics of a monetary economy which require that maintenance of relative price stability enjoy policy priority. Just as Liberals historically had to realize that the vision of non-discretionary or automatic policy-making is unfeasible in monetary economies, Social Democrats had to confront the fact that even a political majority and well-developed policy instruments would not necessarily allow them to superimpose their normative policy goals on the economy. Given their core constituency, Social Democrats would perhaps even be more unable than other political movements to consciously embrace a position which held that the state actually might have to provoke a recession and unemployment if no other means were available for halting inflation. Similar to Liberals who adjusted to a conflict between the inherent policy priority of price stability and the political requirements of economic policies by adopting a different theoretical interpretation of the economy which allowed the new policies to be interpreted as a shift in methods rather than goals, also Social Democrats adjusted by means of theoretical reinterpretations of the workings of a capitalist economy and by placing different emphasis on various goals which had been traditionally part of the labour movement like, income equality, firm level democracy or full-employment. In historical perspective then, the ideological development of Social Democracy has to be understood in terms of the tension between the normative preference for full-employment, growth and welfare and the inherent requirements of price stability.

Contrary to what Social Democrats may have thought, the relevant question on the economic policy agenda in the years immediately following 1918 was not how to socialize the economy, but how to halt inflation. While the question of socialisation could be delegated to commissions for further study, the escalating inflation had to be addressed. Yet the constellation of tight labour markets and high inflation, which most countries reached around 1919, was not one which could easily be addressed within a socialist understanding of the economy. Rather than being confronted with an ever growing and ever more wretched 'reserve army of the proletariat' the developing labour market scarcity rather tended to strengthen workers' position relative to capital. Moreover, despite the political tensions between capital and labour at the end of the war, an 'investment strike' or massive capital flight did not develop. Irrespective of the political tensions employers apparently had sufficient confidence in the future to embark upon extended investment projects.
While generally in favour of high wages and full-employment, the labour movement had no 'natural' view with respect to inflation. To take a position on inflation would require a macroeconomic theory about causes and effects of monetary factors, and that was an area which, due to the focus on conflicts of interests between employers and workers, had traditionally been underdeveloped in Social Democratic analysis. If Lenin, as Keynes claimed, did indeed believe that "the best way to destroy the Capitalist System was to debauch the currency"\(^{870}\) those Social Democrats who aspired to a socialist society may have been expected to greet inflation. Following Marx's lead that monetary phenomenon are epiphenomenal to the workings of a capitalist society, one could surmise that Social Democrats would be indifferent with respect to inflation. Given that it undermines the value of real debt, Social Democrats could even have welcomed inflation because it stimulates investment and employment without requiring wage reductions while at the same time undermining the income of the rentiers.\(^{871}\) But to the extent that nominal wages failed to adjust to inflation, Social Democrats would object to inflation as a mechanism of wage reduction. The emergence of widespread financial speculation and the presence of 'inflation profiteers' also constituted a source of irritation for the working class, as some people apparently could get rich easily on the stock exchange while 'hard honest work' was not so rewarded.

As has been argued in chapter 3, Social Democrats generally came to support deflationary policies mainly because inflation undermined real wages, because they thought that the increase in unemployment would be short-lived, and because speculation profits constituted a major irritant. The resulting crisis and the persistent mass-unemployment in turn came to be interpreted not as the outcome of a specific policy regime but as the inevitable manifestations of a capitalist economy or, in a rather more puritanical vein, as the inevitable price to be paid for the excesses of the boom period. As a result, the ideological and practical efforts at reformulating Social Democratic strategy during the twenties share the common trait of implicitly or explicitly excluding the possibility of any viable macroeconomic alternatives to Gold Standard policies. The economic policy requirements of the Gold Standard regime were not recognized as the result of a policy choice made under the highly specific conditions of escalating inflation, but came to figure as the "reality" to which Social Democratic thought and practice would have to adjust. Only in Norway, where it

\(^{870}\) Keynes 1963, p. 77. Kindleberger 1987, p. 332, however notes that "it is impossible to find a statement to that effect in Lenin's writings."

\(^{871}\) Contrasting value-creating industry with a parasitic financial sector, of course has a long tradition in leftist thought.
took Norges Bank eight years to return to the pre-war gold parity, was the argument that the crisis was actually caused by policies advocated more forcefully. But as long as DNA was unwilling to advocate alternatives to the Gold Standard, such a policy had to remain politically impotent.

With the acceptance of the new macropolicy regime which was established in response to the postwar inflations, the range of possible ideological interpretations Social Democrats could give to the situation of the twenties had in fact become rather narrow. In essence ideological adaptation to the new regime had to be defensive and confused. By embracing the need for Gold Standard policies, Social Democrats in fact embraced a regime which institutionalized unemployment and in which the strength of organised labour and welfare arrangements necessarily had to be considered an obstacle to the state's economic policy goals. First, the priority of defending the Gold Standard required domestic downward flexibility of nominal wages and hence stood in conflict with strong trade union organisation. Secondly, because of the unavailability of macroeconomic policies to combat recession and unemployment, cost reductions necessarily came to be seen as a major avenue to improving competitiveness and growth. And also this stood in conflict with a strong labour movement. Although the manifestations of this dilemma would differ from country to country, this was the underlying factor which all Social Democratic parties shared and which blocked ideological and political advance.

The view that unemployment and crisis could only be resolved by micro-level measures, which was an almost inevitable conclusion under a restrictive macro regime, was partly reflected in a stronger Social Democratic emphasis on issues of firm level democracy. In practice Social Democrats often found it difficult to resist the conclusion that lowering (wage) costs would indeed be the best way to improve (export) competitiveness and safeguard jobs in the short term. As, for example, Lewin (1967 p. 52) points out, the SAP would tend to oppose wage cuts when in opposition while accepting them when in government. And also the SDAP admitted that wages were too high. 872

But embracing such a position as its official ideology could, quite understandably, not be an attractive prospect. It would be politically impossible for a Social Democratic party to maintain that unions were their own worst enemy. On the one hand the result of such a constellation was that labour market and welfare policies now primarily were justified defensively as measures which might not necessarily be optimal in terms of economic performance but which were nevertheless

872 See De hen 1980, p. 162.
defensible on social grounds as a way to mitigate the hardships of unemployment. In other words, labour market and welfare policies for Social Democratic parties during the twenties were primarily a part of social policy rather than a part of economic policy.

On the other hand, continued unemployment and the absence of a macroeconomic alternative led Social Democrats to place their hopes on improvements in productivity as an alternative to cost cutting. As compared to the demands to improve competitiveness through cost reductions this strategy was politically far more attractive for Social Democratic parties. The focus on increased productivity through rationalization, adoption of new technologies etc. allowed the role of labour to be redefined from an obstacle in cost adjustment to a crucial partner in productivity. The 'craze for rationalisation', i.e. the view that closer firm level cooperation between capital and labour would promote a more rational and more efficient capitalism, also strongly affected Social Democratic parties and trade unions in the twenties. As against the accusation of betraying socialist concepts of capital-labour antagonism and class struggle, closer firm-level cooperation between capital and labour could be ideologically interpreted as a step towards 'industrial democracy'. Rather than constituting rejection of the class struggle the new emphasis on supply side policies could be presented as an encroachment of labour on what were traditionally considered the prerogatives of capital.

In practice such micro corporatist arrangements failed to live up to their promises. They did not manage to solve the unemployment problem, nor did they give rise to a democratisation of the economy. Moreover, cooperative micro level capital-labour relations would not become the dominant pattern during the twenties. In fact they would largely stay confined to modern, less labour intensive export industries like chemicals and metal working. And even there the pressures exerted by Gold Standard policies would make such cooperation always fragile. Moreover, given the persistent mass-unemployment, labour generally found itself in the weaker position when bargaining with employers on the micro level.

873 Within the ADGB, for example, the discussion about the more micro level concept of industrial democracy set in after the breakdown of the macro corporatism of the ZAG.

874 See also Unga 1976, p. 62 on the SAP in the twenties: "Because for moral reasons they considered the road to wage reduction closed but nevertheless thought it necessary to reduce production costs should cost reductions be accomplished in a completely new way, i.e. by means of rationalisations" My translation, emphasis in the original. See also Kônke (1987, p. 100) who argued that the ADGB's concept of economic democracy initially reflected the increased cooperation between labour and capital made necessary by economic developments.

875 See, for example, Unga 1976, ch. 6 on the SAP and Kônke 1987 ch. 6 on the discussion within the SPD and ADGB.
A perhaps more important ideological effect of the seeming lack of an alternative to Gold Standard policies was the revival of a concept which conformed more closely to a Marxist interpretation of society, namely the concept of an inevitable historical progress of society towards socialism. Paradoxically perhaps, placing stronger ideological emphasis on a Marxist concept of historical inevitability might have been a plausible development which Social Democratic parties could be expected to go through as a step in the process of shedding its socialist ideology, also independent of the reigning policy regime. As Social Democrats who had left the opposition ghetto to take government responsibilities had to come to terms with the problem that socialisation constituted neither a politically nor economically feasible cure to capitalisms’ economic problems, dissociating the goal of socialism from practical policies by relegating it to the long term of historical inevitability would seem an attractive solution for a party which wanted to exploit the opportunities for reform policies yet did not want to increase internal tensions by bringing about a sudden reorientation of policy goals. Yet as labour friendly reforms had to stagnate under the regime of the twenties the reference to historical inevitability had to take on an additional task. To stress more strongly that the advent of a socialist society, in which all demands of labour would be fulfilled, would be the inevitable outcome of the progress of history would have to seem a useful rhetorical device to maintain the spirits of the constituency and not to abandon all its ideals in a period when economic policies threatened the interests of labour and when Social Democrats frequently could not identify alternatives to the reigning policy regime.

Lewin (1989, p. 168) has pointed out that for the SAP in the twenties the reference to the inevitable march of history towards socialism functioned as an effort to maintain a distinct Social Democratic interpretation in spite of the SAP’s lack of alternative to most of the economic policies pursued by the bourgeois parties. The DNA was a reformist party before the war but in 1919 became a member of the Comintern during the wave of revolutionary sentiment after the war, and, in terms of its official ideology remained a revolutionary socialist party all throughout the twenties. But the persistence of the verbal radicalism of the DNA during the twenties may, as, for example, Andersen has pointed out, be seen as a way to maintain internal coherence and defend the movement from outside attacks in a period where no effective policies against the economic crisis seemed to be available. 876 And once an alternative did become available in the thirties, DNA had no problems with fully and rapidly embracing ’reformism’ despite more than a decade of revolutionary rhetoric.

876 See Andersen 1978, p. 84.
In contrast to the SAP and DNA who could go to or remain on the opposition benches as a way of solving the contradiction between the interests of its constituency and the policies which economic ‘reality’ seemed to dictate, the almost continuous threat to the political democracy of the Weimar republic meant that the SPD frequently could not afford this kind of political absenteeism. Due to this double pressure, the official SPD ideology after the end of hyper-inflation was marked by a revival of Kautsky’s historical fatalism.\footnote{Köncke 1978. p. 34} Whereas the Görlitz programme of 1921 had avoided Marxist terminology in order to present the SPD as a broad people’s party, the Heidelberger programme of 1925 again made stronger reference to Marxist concepts.\footnote{See, for example, Schönhoven 1989, p. 102-3.} The concept of Organised Capitalism, which became accepted as the official ideology at the Heidelberg congress of 1925, performed a similar ideological function as Kautsky’s fatalism. According to Hilferding economic development was marked by a secular progress towards socialism as increasing cartelisation and monopolisation would gradually replace the market with planning. On the one hand this programme discerned a clear historical task for a Social Democratic party, namely to eventually take over the instruments of planning which had arisen in the old order so as to place them at the service of society as a whole. On the other hand, such a concept placed little demands on concrete short term policies.

In Britain the leftward shift of Social Democratic ideology in response to the Gold Standard constellation was mainly confined to the ILP fraction of the Labour Party. The ILP was unwilling to support wage cuts but rather supported the introduction of a minimum wage as a means to stimulate domestic demand. Yet because increased domestic wage costs could easily be seen to lead to reduced competitiveness and job losses, the logical solution to this conundrum seemed to be the call for a planned economy in which it would be possible to expand employment and wages.\footnote{On the I.L.P.’s views at this time see, for example, Brand 1973, p. 117.} The ILP, however, failed to have an appreciable impact on the policy position of the Labour party. Rather its leftward swing around the mid twenties meant that it lost two of its most prominent members, Ramsay MacDonald and Phillip Snowden.

Rather than blaming an outdated adherence to some Marxist tenets for the inability of Social Democrats to propose feasible policies to combat unemployment during the twenties and the early phase of the Great Depression, it would seem more accurate to attribute the ideological popularity of some Marxist inspired views to the lack of feasible policy alternatives which resulted from the acceptance of the absolute priority of the Gold Standard. To abstain from a policy of reforms which
might improve the lot of the working class or even to abstain from attempting to block policies which might be unfavourable, never was a viable policy option. Even those parties who held that no serious improvement of the plight of the working class could be obtained within a capitalist system necessarily had to pay attention to short term reforms. Especially if other parties pushed such reforms Labour could hardly refrain from supporting them and advancing similar policies without losing popularity and initiative. Marxist ideology in practice would, therefore, hardly seem an obstacle to reformism. Rather than leading to reformist abstinence, a Marxist interpretation might merely lead Social Democrats to stress that in the end all reformism had to remain insufficient. As has been shown in chapter three for example, even the staunchly Marxist DNA felt obliged to propose short term measures against the crisis of the early twenties.\textsuperscript{880} And whereas the staunchly reformist SAP proposed extensive short term macroeconomic measures to combat unemployment already before the war, this policy tradition had to be abandoned during the twenties.

At the onset of the Great Depression hence also Social Democrats generally interpreted the need to pursue restrictive policies as a requirement imposed by hard economic reality, rather than a requirement arising from a prior political decision to give priority to the Gold Standard. But as the Gold Standard policies lead to a deflationary disaster in the form of the Great Depression, the view of immutable constraints on macroeconomic policies had to give way to a renewed recognition of the existence of policy alternatives. In many cases Conservative and Liberal parties took the initiative by imposing micro level regulations and pursuing a policy of cheap money. In the thirties Social Democratic parties, with the exception of the SPD which had ceased to exit in legality in 1933, came to embrace Keynesian type proposals of increased fiscal spending as a way to combat unemployment. Some, like the SAP would do so already before the Great Depression hit, while others, like the SDAP, would only take this step after the Great Depression had raged for half a decade. Although, as has been argued in chapters 4 and 5, Keynesian policies of deficit spending to combat unemployment did not play a role of importance before the seventies, the concept of an interventionist state which safeguarded full-employment in the face of an unstable market economy did come to play a crucial ideological role for Social Democracy during the fifties and sixties.

The long term (ideological) importance of Keynesian concepts stands in contrast to the Social Democrats own understanding in the thirties and up to the forties. Social Democrats were generally convinced that fiscal expansion would only provide short term relief. Embracing fiscal expansion in the thirties was primarily a result of union pressures for immediate measures to combat

\textsuperscript{880} See, for example, Førsund 1978, p. 31-2 and Ousland 1949, Vol. 3, p. 96.
unemployment. Given that Social Democrats nowhere had a parliamentary majority, this required proposing programmes which could also be acceptable to other political groups. In the longer run, however, Social Democrats were convinced, far-reaching planning would be the only cure for the ailments of capitalism.

Hence, while the fear of a repetition of the post World War I inflationary boom led also the conservative and liberal parties to advocate the initial retention of wartime controls after 1945, Social Democratic parties saw the regulatory changes initiated in the thirties and intensified by the war as the initial stages in the construction of an economy which would accord a substantial role to planning.\(^{881}\) Given the rapid increase in micro level interventionism and the popularity of ideas of planning and regulation across the political spectrum, it was understandable that Social Democrats would interpret the Great Depression as proof of their postulate of the inherent shortcomings of a system of capitalist production. In the postwar years most Social Democratic parties hence saw it as their historical task to bring to its logical conclusion what had started in the thirties, namely to prevent rather than combat economic crises by subjecting production and consumption to far-reaching public planning.\(^{882}\)

In the Netherlands, the interventionist crisis policies of Colijn’s government since the early thirties were instrumental in changing the policy orientation of the SDAP. While the Laissez Faire of the Christian Democrats had been answered by the SDAP with the socialist version of Laissez Faire, which argued that it was futile to try and cure the evils of capitalism within the system, increased activism on the parts of the Christians Democrats shifted the discussion to interventionist policies within the capitalist system.\(^{883}\) In the SDAP the shift in perspective from Socialisation to planning took place between the publication of the pamphlet Socialisatie 1933 and the Plan van de Arbeid in 1935. The former report was basically a revised version of the 1920 socialisation report, and, after the disappointing elections of 1933, came to be seen by the SDAP leadership as lacking concrete proposals for combating the crisis. The Plan van de Arbeid of 1935, which the SDAP launched with a massive propaganda campaign, in contrast contained the idea of planning which was later to develop into Vos’ PBO proposals.\(^{884}\) The Plan van de Arbeid, distinguished clearly

\(^{881}\) According to Hugh Dalton, Chancellor of the Exchequer in the first postwar Labour government, the experience with the war-time regulations showed the utility of the concept of public ownership. See Cavanagh Hodge 1993, p. 18.

\(^{882}\) On the SAP see Lewin 167, p. 219.

\(^{883}\) See Nekkers 1985, p. 39.

between short term (macroeconomic) crisis measures to combat the Great Depression and the transformation to a planned economy as the only long-term solution to the problems of capitalism. In an attempt to merge Social Democratic and Catholic views on planning, Hein Vos, one of the authors of the Plan van de Arbeid and minister of economic affairs from 1945 to 1946, presented a blueprint for a corporatist organisation of the Dutch economy. The economy was to be organised in roughly three dozen vertically integrated tripartite boards, so-called PBO's who were to determine investment, production, prices and wages. The state was to have a decisive influence in these boards as it would have the right to postpone or nullify the decisions of the PBOs. At the national level a tripartite Socio Economic Council (SER) was to advise the government with respect to its social and economic policies.

Included with the ADGB's WTB plan, in the form presented to the Reichstag by the SPD in August-September 1931 was a plan called "Umbau der Wirtschaft" \(^{885}\), which called for increased planning in private industry alongside nationalization of key industries and the expansion of the public sector. The concept of planning in private industry by means of price and quantity regulations clearly reflected the policies increasingly pursued at home, and abroad by (non Social Democratic) governments. Similar to the Dutch proposals, the state was to play the dominant role in the planning process. Given the experience of the NAZI period proposals like the Dutch PBOs for the SPD may have contained too many corporatist overtones. At its first congress in 1946, economic spokesman Victor Agartz explained that the SPD rejected not only: "liberalism in its original form, monopoly capitalism with imperialist tendencies, the Neo-Liberalism currently emerging" and "centralised state capitalism in the form of a marketless economy" but also "the corporate state" \(^{886}\). Yet the SPD's postwar views on the regulation of the economy were in many way reminiscent of the "Umbau der Wirtschaft" plans.\(^{887}\) Also after 1945 the SPD stressed strongly that recovery would only be possible on the basis of a planned economy. However, this did not mean a nationalized economy. Only key industrial sectors were to be nationalised. As in the Umbau programme state led planning in combination with private property was advocated.

\(^{885}\) This programme originated from within the AFA union.

\(^{886}\) Quoted in Miller & Pothoff 1986, p. 155.

\(^{887}\) After the war the SPD did not produce a policy programme. Its views on economic policies had to be distilled from statements by prominent members like Schumacher, Agartz and Veit. See Miller & Pothoff 1986.
Also DNA’s crisis proposals during the Great Depression distinguished clearly between short term macroeconomic measures and long term planning. As already the subtitle of the ‘3 Years Plan’ of 1933, 'The road towards a socialist planned economy in Norway' indicates, it was primarily concerned with a thorough structural reform of the microeconomy than with a reorientation of macroeconomic policies. The plan argued that the solution to the unemployment problem had to consist in increasing the productive potential rather than redistributing income. And because the core weakness of capitalist economies was diagnosed to be its uncoordinated, anarchic character, planning would be necessary to reach this goal. Yet, this view of planning, which became the official party view, was quite different from previous views. Whereas in the twenties socialisation of the economy had been considered the necessary first step towards a planned economy, from the early thirties onward DNA came to understand planning as measures which could also be pursued without necessarily requiring the abolition of private ownership of the means of production. During the war exiled members of the Norwegian trade unions, in a brochure called Femtidens Norge, had drafted a three level structure for future economic planning. In contrast to, for example, the Dutch proposals the national level council was not to have an explicitly tripartite composition but was to be nominated by parliament along lines of party proportionality. In addition to the National Council the plan envisaged sectoral and firm level councils. Building, in part on the views of Colbjørnsen and Sømme, DNA’s 1949 programme clearly saw a planned economy as the best solution for Norway. Already two years earlier the DNA government had instituted the so-called Sjøastad commission which was to write a draft law on the regulation of production.

The debacle of the MacDonald/Snowden government not only caused Labour to rethink its macroeconomic views but also led to reconfirmation of the need for planning. Labour’s 1934 manifesto For Socialism and Peace envisaged “full and rapid Socialist economic planning, under central direction.” In practice the postwar Labour government proposed a regulatory solution similar to, though less far reaching than, the Dutch PBO’s. Tripartite Development Councils (DC)

889 Colbjørnsen & Sømme 1933.
890 Cf, Colbjørnsen & Sømme 1933, p. 12/13; "Vi kan ikke gjennemføre en rasjonell samfundsmessig planøkonomi uten ingripede forandringer i landets økonomiske bygning og hele den økonomiske virksomhet." "Vi må ha effektive kontroll med den private økonomiske virksomhet." (Emphasis in the original).
891 Colbjørnsen & Sømme 1933, p. 12, 20.
892 See Førsum 1978, p. 29.
893 See Bergh 1978.
894 Quoted in Mowat 1955, p. 548.
would take care of reorganising industrial sectors. At the national level, the process of industrial reorganisation was to be coordinated by a Central Economic Planning Staff, created in 1947 and a tripartite Economic Planning Board.

The SAP's views on planning were rather similar. In the understanding of the SAP, the postwar period was to be the harvest time (Skördetiden) for Social Democracy. After, in their own understanding, having successfully conquered the crisis by means of its macroeconomic policy programme, the SAP would now set out to reorganise the economy in such a way so as to prevent a repetition of the Great Depression. The SAP's programme for the postwar period envisaged a tripartite body for the long-term planning on investment, the foundation of a state bank and the socialisation of the insurance industry. In keeping with proposals from the interwar period, the state should establish public firms to compete with private business in those areas where private entrepreneurship was operating inefficiently. The SAP, in line with other Social Democratic parties, was now to take a pragmatic approach to state ownership. State ownership of the means of production was no longer a sine qua non for remedying the deficiencies of capitalism, but was to be applied only in those instances where private ownership produced unsatisfactory results. Looking at the experience of the interwar Socialisation Commission, when the SAP had failed to establish that Social Democrats did have an alternative for running firms in such a way as to avoid the unsatisfactory outcome of private entrepreneurship, it is questionable whether this pragmatic approach contained a viable policy. Fortunately for the SAP it was spared having to attempt to run industries itself as the next decade left few reasons to complain of the outcomes of a privately organised industry.

These proposals for widespread planning which Social Democrats, with the exception of the SPD, tried to put into practice in the late forties may easily seem an adjustment of the methods by which to reach the unchanging goal of political regulation of the anarchic process of capitalist production. While Social Democrats, in their own understanding, initially held that the capitalist

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895 The same view appeared, for example, also in the Plan van de Arbeid. See Pronk 1985, p. 195-7. For the SPD this pragmatic attitude was expressed in the slogan: 'Wettbewerb soweit wie möglich, Planung soweit wie nötig'. See Lehnert 1983. p. 179.

896 In the Görlitzer programme (1921) had already taken such a pragmatic approach, but this trend was reversed with the Heidelberger programme (1925). See Winkler 1982, esp. p. 14.

897 Hemerijck 1992, p. 134-135, for example, argued that the PBO plans contained in the Plan van de Arbeid, marked the completion of the SDAP's conversion to corporatism which is said to have begun with the 'socialisation report' of 1920.
anarchy could only be tamed by means of the socialisation, or nationalization, of the means of production, theoretical work done by, for example, Nils Karleby and J.M. Keynes showed that by means of planning the same goal could be reached without the need to abolish private ownership.

But to interpret the Social Democratic views on the need for planning as a linear progression from earlier socialist beliefs conceals an exogenous (to Social democracy) change in ideological and political circumstances to which these proposals constituted a response. It was not self-evident that the crisis of the Great Depression would lead Social Democrats to include planning as a relevant issue on the policy agenda. The crisis of the early twenties had had the opposite effect as the issue of socialisation became a mere rhetorical device with no relevance for concrete policies. Hilferding's SPD, which found it more difficult than many other parties to live with a large disparity between practice and theory, justified the absence of socialisation from the policy agenda by means of the theory of 'organised capitalism'. In the SDAP, which traditionally was strongly influenced by its German neighbour, similar views enjoyed popularity. The Socialisation Report of 1920, for example, held that 'trusts' provided a living example of how waste and inefficiency can be avoided by means of the conscious organisation of production. The SAP's socialisation commission, as we have seen, failed to produce concrete proposals after more than a decade of deliberations. And even DNA, who had joined the Commintern, presented no concrete plans. The DNA did produce concrete proposal for macropolicy at several instances, but failed to give any concrete content to its demand for socialisation. And also in response to the resurgence of mass-unemployment during the last two decades Social Democrats did not propose a far reaching political regulation of the economy but rather came to accept the need for a fair measure of deregulation.

Given the urgently felt need for crisis measures which could command political support also outside Social Democratic circles, the result of the Great Depression might have been to make proposals for far-reaching political regulation of the economy even more irrelevant for practical policies than they already were. That the opposite happened was in large measure due to the reaction of Conservative and Liberal parties to the Great Depression. Rather than defending the free market and the rights of private property, Liberals and Conservatives came to impose far-reaching regulation

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898 See also Miller & Potthoff (1986, p. 156-7): "Whereas Social Democrats had shrunk from taking any practical steps in this direction [socialisation] in the aftermath of the First World War on the grounds that one could not socialise a heap of rubble, after the collapse of 1945 they saw the very ruin of the economy as their opportunity to erect a radically new system that would be egalitarian in its effect and ensure peace."


900 See, for example, Førsund 1975, p. 1.
on the micro level. Given the rapid spread of price stabilisation arrangements, frequently at the behest of business and agriculture, it seemed to Social Democrats that the issue of planning now had been placed on the political agenda.\textsuperscript{901} As deflation caused serious doubt about the virtue of competition amongst farmers, businessmen, and parties on the centre and right of the political spectrum, it now seemed that views of a planned economy could be given a concrete interpretation, which would be able to build on the short term policies which had emerged during the Great Depression, and that, therefore, the dualism between practical policies and the conviction of the need of a planned economy which had plagued parties all throughout the twenties could be solved. This implied that it would become easier to pacify the leftist opposition within Social Democratic parties which argued that short term crisis measures served to stabilise capitalism and hence would retard the coming of socialism.

In Germany, for example, Hilferding had to admit in the face of the Great Depression that his prediction of an increasingly stable 'organised capitalism' was incorrect. Instead the SPD came to interpret the turn to microeconomic interventionism under the Brüning government as a confirmation of its view that the anarchic character of capitalist production would inevitably lead towards ever more intense state regulation and a suspension of the rights of private property. That the authorities, under Brüning's *Osthilfe*, had acquired the right to, for example, reduce interest rates on outstanding loans to agriculture, postpone their repayment or even reduce the principal, was considered to be "a terrible shock to all the ideological foundations of the capitalist system.\textsuperscript{902}" In response to Brüning's policies, the SPD even went so far as to claim that the increasing political intervention meant that the 'right of the state to interfere in the economy for the benefit of society as a whole had been proclaimed.\textsuperscript{903} In Norway Colbjørnsen argued in December 1932 that the price stabilisation measures introduced by the government like, for example, the *Melkesentrale*, were in fact a step towards socialism.\textsuperscript{904} In the Netherlands SDAP board member Oudegeest concluded that the policy proposal, which the annual congress of 1934 accepted and which mainly consisted of a plea for more planning, actually had already been taken up by the government.\textsuperscript{905}

\textsuperscript{901} In the late thirties Ernst Wigforss, for example, believed that through cooperation with business a step could be made towards a more socialized economy. See Helldén 1989, p. 514.


\textsuperscript{903} My translation. Quoted in Könke 1987, p. 207.

\textsuperscript{904} See Førstund 1978, p. 45 and p. 39-40.

\textsuperscript{905} See Meijer 1977, p. 73.
Yet the micro interventionism of the thirties was in no way a response to an inherent inefficiency and anarchy of a system of capitalist production. In theoretical terms the Social Democratic argument for planning was based on the notion that the uncoordinated character of decisions about prices, production and investment in a market economy would necessarily lead to misallocation and disparities between production and demand. Conscious coordination of economic decisions was seen to be the remedy. However, this argument consisted of an inadmissible application of microeconomic concepts to the macro economy. While individual firms may indeed find out that they have expanded their productive capacity far beyond the market demand for their products, macroeconomically such crises of overproduction - or underconsumption if you will - are logically impossible. As the value of production per definition must equal the sum of incomes, macroeconomically a situation cannot arise in which the available incomes are insufficient to absorb production. This was of course the whole point of Say's law. Problems arise in the economic circulation if the money revenues derived from production are not re-channelled to consumption or investment. If, for example, an increased preference for holding liquid assets prompts a reduction in consumption and financing of investment, the result will be a recession and a shift to a lower level of production. And this was of course the main argument behind Keynes' view.906

In other words, the crisis of the thirties was primarily related to the process of disposition over money and had nothing to do with the uncoordinated character of firm-level decision-making. The Great Depression had shown that a monetary economy required a fair degree of nominal rigidity and that governments could only violate this requirement at great costs. The new macroregime arising in the thirties, however, had found a rather effective answer to the potentially destructive effects of a high liquidity preference, and accordingly the widespread postwar discussion about the need for planning in order to cure an inherently stagnant and crisis-prone capitalism was basically addressing a non-problem. As the next decades would show convincingly, a system in which the planning and execution of production and consumption was largely left to private initiative was economically and politically far superior to any form of centralised planning.

With episodes from the height of the deflation in mind when business was desperately calling for governments to protect it from the anarchy of the market, Social Democrats after 1945 actually were surprised at the resistance of the business community against the postwar plans for control of

906 Keynes, of course, is considered the principal critic of Say's Law. Yet, both views are not incompatible. For even though the value of total income must equal the value of total production, this does not imply, as Say's law is frequently seen to, that the amount of production undertaken is such as to assure full-employment. See, for example, Riese 1988, section II.
investment and production. But as macroeconomic policies credibly abandoned their deflationary stance, the private sector would come to look upon plans for far-reaching planning as an undesirable intrusion of the state rather than a welcome protection against the anarchy of the market. Yet it was not only business which objected. With no crisis in sight, also trade unions could not become enthusiastic about a system which would radically curtail their freedom of action by replacing bargaining by capital and labour with state control. For Social Democrats, widespread planning was not seen as an end in itself but as a means to a prospering economy. As the expected postwar recession failed to materialise and centre and right wing parties, business and labour proved increasingly skeptical with respect to their plans, Social Democrats decided to shelve the construction of a planned economy.

In Sweden, the SAP shelved its proposals for planning definitively, after the 1948 election, which was dominated by this issue. In the preceding three years a heated debate raged between the SAP, on the one hand, and the 'bourgeois' parties and business, on the other. Like most Social Democratic parties the SAP was convinced that the economic outlook for the period after the postwar restocking boom were very bleak indeed. It stressed continuously that it understood planning as a way to avoid the coming crisis. Already in the Efterkrigsprogramm it had been pointed out that if private enterprise would manage to make full use of available resources, i.e. maintain full employment, private property was not to be threatened. The opponents in this debate, in contrast, held quite optimistic views about the economic future. It were these views which proved to be correct, as from 1946/47 onward the acute economic problem was one of overheating instead of recession. And it was this problem which would come to dominate economic policies.

The postwar DNA government did create the institutional framework envisaged in Frentidens Norge, but in practice the impact of these councils remained negligible, mainly due to a lack of enthusiasm on the side of business. The failure of the councils, however, did not mark the end of DNA's planning policy. Instead it was over the planning powers to be given to the state that the most vocal political struggles were fought in the early fifties. That extensive control needed to remain in force during the period of reconstruction was a view generally shared by all political parties. Yet, starting in 1946, the farmer party, the Liberals and in particular Høyre, increasingly started to voice their suspicion that DNA intended these regulations not as temporary measures but as a prelude to a planned economy. Given DNA's 1949 programme and the Sjaastad commission,

these suspicions certainly were not without ground. But although initially greeted enthusiastically by the labour movement, the Sjaastad draft law (rasjonaliseringsloven) "which would have empowered the government to reorganize private industry on the basis of 'social considerations'" was not presented to parliament. As in other countries the main reason for the DNA’s decision to shelve its planning ambitions was a combination of strong political opposition both from business and the 'bourgeois' political parties and a continuous economic boom. Perhaps more so than for other Social Democratic parties, DNA had seen planning as a means to its highest policy priority, promoting growth. When its pessimism about postwar economic development proved unfounded, abandoning planning was no difficult step to take. After 1952 the term "planning" did remain in DNA’s vocabulary, but now it came to stand for management of credit- and budgetary policies so as to prevent inflationary overheating of a rapidly growing economy.

In contrast to postwar Sweden the SDAP required a coalition party, namely the Catholic KVP, in order to muster sufficient parliamentary support for its PBO plans. While Catholic thinking at the time, perhaps even more strongly so than Social Democratic views, was strongly convinced of the need for a corporatist organisation of the economy similar to the plans outlined by Vos, the KVP objected to the strong position the state was to have in the PvdA’s plans. Instead of imposing PBOs from above, the Catholics proposed to form PBOs only on the basis of mutual agreement between the firms and workers concerned and the state. The result of the 1946 election in which the KVP became the biggest party, meant that the PvdA had to accept the Catholic proposal. But also inside the labour movement Vos’ plans did not command uniform consent. The Social Democratic trade union NVV, the biggest trade unions in the country, in line with their Christian colleagues and the employers organisations, rejected the original plans because it considered them a threat to its own position in the economy. As the formation of PBO’s was hence left to the initiative of business, and given the reigning macroeconomic regime, it was no surprise that business showed virtually no interest. As a result the whole PBO plan simply petered out.

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909 Derry 1973, p. 413.
911 Slagstad (1993, esp. p. 49) quite aptly calls the years 1945-53 the period when DNA found itself.
912 After the 1944 elections the SAP held half of the seats in the second chamber. It would only have required the assured support of the Communists to push through its planning proposals.
913 In an unanimous advice from the Stichting van de Arbeid in March 1946.
The British DC’s suffered the same fate. Jim Tomlinson captures the essence of industry’s changing enthusiasm for regulation: “Initially employers were sympathetic to the idea and the intention was that these establishments should be voluntary. However, employers’ attitudes changed, as it became apparent from 1947/8 that the DCs would not be needed as bases for cartels in a slump. Quickly they became viewed rather as instruments of governmental control.”\(^{914}\) And also in Britain, the TUC was rather skeptical with respect to planning. Economic planning would also entail that the state controlled the allocation of labour to firms. Indeed the so called manpower budget was envisaged as the most important element in the Labour Party’s planning concepts. But while the TUC was willing to enter into tripartite voluntary wage restraint agreements, it did strenuously object to a system in which the unions’ role in wage bargaining was to be replaced with administrative decision.\(^{915}\) Nevertheless, the Labour Party officially maintained its commitment to socialisation. Despite the fact that it was attacked several times by Gaitskell and Crosland as being outdated and electorally unpopular, clause IV of the party constitution, which defined public ownership of the economy as the main goal of the party, survived. However, this commitment was largely symbolic, almost from the time it was introduced in 1918. Between 1945 and 1949 Labour nationalised a host of industries which, apart from the Bank of England and civil aviation, consisted either of public utilities like railways, gas and electricity, or ageing industries like coal mining, iron and steel. After this was accomplished, there was no intention to follow clause IV and continue so as to eventually nationalise the whole economy.\(^{916}\)

The SPD’s insistence that economic recovery was only possible on the basis of planning outlived itself as the FRG economy boomed. Gradually the SPD found itself in the unenviable position of a opposition party arguing, quite contrary to real world developments, that economic prosperity could not be achieved if its plans were not adopted. In the Godesberger Programm of 1959 finally the SPD abandoned the remnants of socialist tradition by rejecting the socialisation of even key industrial sectors.\(^{917}\) The delay with which the SPD took this step was mainly due to its peculiar political position in the first two decades of the Federal Republic. The western allies’ commitment to economic reconstruction of West Germany along the lines of a market economy provided the SPD with a scapegoat which allowed it to avoid addressing the inherent deficiencies

\(^{914}\) Tomlinson 1989, p. 17.
\(^{915}\) See Beer 1965, p. 200-08.
\(^{916}\) See Morgan 1985, chapter 3.
\(^{917}\) The DGB took a similar step with its Düsseldorf Programme of 1963.
of the socialisation concept. Moreover, such a position could survive for sometime after the formation of the FRG because the strong electoral showing of the Christian Democrats kept the SPD out of reach of the Bonn government benches.

In sum, despite the rapid spread of micro regulation during the Great Depression, Social Democratic views of planning had to remain politically impotent. Social Democratic thinking, marred by the assumption that the micro level behaviour determined the dynamics of the economic system, came to interpret something which was the outcome of a specific macro policy regime - i.e. deflation and depression - as the inevitable result of anarchic capitalist competition. But planning was not the logical conclusion to the new policies of the thirties. Rather the dynamics of a monetary economy implied that a policy regime which decisively abandoned the need for deflation was the logical solution to the problems which manifested itself in the Great Depression. Rather than institutionalizing planning Social Democratic policies would be dominated in the next two decades by an entirely different problem, namely how to keep inflation low under full employment and rapid growth. And it was this constellation which Social Democratic ideology would have to address.

Despite the failure of their planning proposals, the ideological outcome of the Great Depression was to establish the hegemony of Social Democratic ideas in economic policy. While the need to combat the post 1918 inflation confronted Social Democracy with a fundamental ideological dilemma as the restrictive policy regime left no room for active policy management to reduce unemployment but rather had to define unemployment as the responsibility of the labour market, the deflation of the Great Depression confronted Conservative and Liberals with an ideological dilemma. As they had defined the policy of giving priority to a fixed exchange rate and relegating the responsibility for growth and employment to the micro level as Laissez Faire, they could not embrace the, historically correct, argument that the new regime constituted a change in policy assignments and goals rather than a change from non-interventionism to interventionism. Accordingly the policy changes of the Great Depression had to appear as the bankruptcy of Liberalism. Apparently an 'automatic' monetary policy tied to the defense of the parity was not a precondition for but an obstacle to economic prosperity. More important, perhaps, in the Great Depression the micro level price flexibility, which was supposed to be a precondition for growth and employment seemed to be part of the problem rather than the solution. As Conservatives and Liberals found that they had to heed the call from agriculture and business for price stabilisation agreements, it became rather difficult to differentiate their views from the Social Democratic position

918 See Lewin 1989, p. 208 for a similar discussion.
that a market economy needed political steering in order for prosperity to be achieved. Moreover, once it had become accepted that price stabilisation was a necessity, it became difficult to argue that this principle applied everywhere except in the case of wage bargaining. In the wake of the Great Depression even Conservatives and Liberals, often implicitly only, came to abandon the view that trade unions per se are obstacles to economic prosperity.

And even though Social Democrats did not spearhead the establishment of the new regime and initially interpreted it quite incorrectly as a step towards socialism, the ideological demise of Laissez Faire could not but benefit a political movement which had argued all along that the capitalist system needed to be tamed by political regulation. In 1937 NVV vice chairman, S. de la Bella, for example could present the outcome of the Great Depression as a confirmation of traditional Social Democratic views. He concluded that whereas the view that the economy needed an extensive degree of regulation (ordering) was initially only advocated by the Social Democrats, it now had come to be shared by the Catholic and Protestant parties and even by the Liberals. After the post-1945 debate about planning had died down, Social Democrats hence found themselves in an ideological environment in which the need for a 'managed economy' had come to be accepted across the political spectrum.

As macroeconomic policies rather than cost cutting and labour market flexibility came to be identified as the road to prosperity, it now also became possible for Social Democratic parties to broaden their appeal beyond the traditional industrial working class and present themselves as a true people's party. That Social Democrats would need to extend its appeal beyond the traditional blue collar industrial working class was not realised only since the mid thirties. Its 1911 programme already stated that the SAP would also seek support from non-industrial workers and the so-called Småfolk, i.e. shopkeepers, independent craftsmen, small holders. In its 1921 Görlitzer programme the SPD had tried to present itself as a people's party. Yet under the conditions of the twenties when high labour costs, expenditures on labour market programmes and welfare state spending in general were considered obstacles to economic prosperity, the defense of the interest of its core constituency would stand in the way of presenting Social Democrats as a people's party. In a time when employers pressed for lower wages and each social group struggled not to be affected by cuts in state spending, a strategy which tried to present the workers interest as being consistent with the

interest of broader social circles had to remain impotent. Moreover, being under severe political and economic pressure, the traditional working class would more strongly come to emphasise its separate identity in an effort to strengthen internal cohesion and solidarity. But as the quest for economic prosperity, in the wake of the Great Depression became interpreted as a positive sum game this dilemma could be solved.

Although fairly unimportant in terms of the macroeconomic policies actually pursued up to the early seventies, Keynesianism, was an ideal ideological tool for Social Democracy. On the one hand, the interventionist state now came to be seen as the guardian of economic prosperity, which gave Social Democrats an ideological advantage over political movements which had emphasised more strongly liberal concepts. On the other hand, the macroeconomic character of the Keynesian recipes denied the existence of an inevitable trade-off between high wages, extensive welfare and, growth and employment. Rather than having to defensively justify welfare state arrangements as measures which protected Labour against the social hardship of a market economy, they now could be interpreted as measures which not only contributed to greater social and economic equality but also creased the stability of the economic system due to their effect as automatic stabilisers.

Yet in practice the Keynesian view that discretionary policy management protected society from recession and unemployment was doubly incorrect. First the view that public consumption could compensate for private investment never had been a good guide to policy. At best deficit spending could be successful as one element in a regime aimed at promoting growth. Secondly, the view that economic policies had to be conducted with the priority of promoting growth and employment was only viable as long as inflationary pressures could be contained. As the long period of postwar growth gradually undermined the feasibility of a policy regime which assigned the main responsibility for containing inflationary pressures to micro level arrangements, also Social Democrats would have to abandon the view that the responsibility for full-employment could be assigned to macroeconomic management.

922 Winkler (1982, p. 45) interprets the change from the reformist Görlitzer programme to the more Marxist Heidelberger programme (1925) as the ideological price to be paid for the unification with the USPD. SPD reformists like Bernstein had a dominating influence on the 1921 programme whereas the 1925 programme was heavily influenced by USPD theoreticians like Hilferding. Yet, it seems implausible that the SPD leadership would have accepted this programme without even trying to convince the former USPD members of the importance of a broader political strategy (Winkler 1982, p. 46), if the advent of recession and continuous mass-unemployment after the stabilisation of the Reichsmark had not simultaneously reduced the possibility of reaching agreements in economic policy with conservative parties and increased the need for labour as a social group to strengthen its internal cohesion by emphasising what set it apart from other groups. (See Schönhoven 1989, p. 108 and Winkler 1982, p. 52-3).

923 Hall (1989, p. 365), for example, notes that Keynesian ideas about the instability of the economy played an important role in justifying the expansion of the state.
During the second part of the sixties rank and file discontent with a policy regime which required workers to abstain from fully exploiting their market strength became increasingly acute. Immediately after the war the pronounced feeling of a national emergency, the government tenure of Social Democrats plus the relatively slack labour market in several countries had greatly facilitated a policy of nominal constraint. As the problems of postwar reconstruction were overcome, extension of welfare state arrangements came to play a more important role in maintaining unions’ support for the regime. Yet, such mechanisms increasingly proved to be insufficient, especially so as labour market conditions further tightened during the sixties in most countries.\textsuperscript{924}

On the union level growing dissatisfaction with the regime was manifested in strong pressures for more local autonomy. On the party level such opposition promoted the growth of an internal leftist opposition which called for a "more socialist" Social Democracy. Instead of concentrating on wage moderation, Social Democrats were urged to rediscover their role as representatives of the working class in the struggle with capital. After its eviction from government in 1951, and confronted with successive electoral defeats Labour, less successfully than other parties perhaps, tried to shed its image as a narrow working class party committed to nationalisation.\textsuperscript{925} Under the leadership of Gaitskell, the party, by 1959, had effectively eliminated extension of public ownership from its agenda.\textsuperscript{926} The theoretical justification for this was derived from Crossland (1956), who, following the developments in other Social Democratic parties, argued that creating growth so as to be able to finance extensive welfare state arrangements should be at the heart of Labour policy, and that nationalisation was not a necessary instrument to achieve this. Yet this tendency towards de-radicalisation of the party’s official ideology came to a halt in the late sixties. The increasing need to rely on incomes policies and the increasing dissatisfaction of trade union activists with such policies, resulted in a renewed radicalisation of policy positions, although not of actual policies.\textsuperscript{927}

The response of Social Democrats to the challenge of leftist opposition was threefold.\textsuperscript{928} First the extension of the welfare state was speeded up, but now frequently in the form of an explicit quid pro quo for wage moderation. Secondly, firm level codetermination became an important

\textsuperscript{924} Germany only reached full-employment in the early sixties.
\textsuperscript{925} In the field of actually policy Labour had become decidedly less enthusiastic about nationalisation already in 1947.
\textsuperscript{926} See also Smith 1992, p. 18.
\textsuperscript{927} The 1973 Labour Party programme, for example, spoke of a "fundamental and irreversible shift of the balance of power and wealth to working people and their families." Quoted in Smith 1992, p. 22.
\textsuperscript{928} See also Esping-Andersen 1990, Ch. 7.
issue. Thirdly, Social Democrats sought to reduce excess profits in industry, both as a means to reduce the available room for granting wage increases and, more importantly, as a means to defuse the unions’ impression that income moderation was a one sided affair.

In the Netherlands the PvdA developed plans for funnelling of excess profits during the early/mid sixties. The most sophisticated proposals, however, were developed in Sweden. Although frequently interpreted as a break with reformism and a reorientation towards the old socialist goal of a socialized economy the Swedish proposals for wage earners funds, presented in the Meidner report of 1976, were a logical extension of the Rehn-Meidner model prompted by the increasing problems the LO experienced with fulfilling the task of maintaining moderate nominal wage increases in a period of tight labour markets and high profits. The proposals envisaged a share of excess profits being paid into a union managed fund which would acquire stock in Swedish firms. In this way the labour movement would come to own a gradually increasing share of Swedish industry\(^\text{929}\) while the latter would be provided with relatively cheap credits. To avoid fragmentation these funds were not to be managed on a firm level basis but by the nation level of the LO.\(^\text{930}\)

Certainly the emergence of a left opposition within Social Democratic parties since the late sixties had other sources than the labour market tensions involved in a policy of nominal wage moderation. Leftist opposition to the policies of the fifties and sixties was frequently voiced by a new generation of middle class intellectuals who were entering Social Democratic parties in large numbers. But the agitation of these groups for a more socialist Social Democracy failed to have an appreciable impact on Social Democratic policies. In the end the significance of the revolt of the Juso’s in the SPD and Nieuw Links in the PvdA amounted to not much more than a vehicle for bringing about a generational change in the party leadership.

For some scholars\(^\text{931}\) and more than a few Social Democrats, the renewed emphasis on firm level democracy and proposals like the Swedish wage earner funds meant that Social Democracy was about to resume its journey to a socialist society. Korpi (1978), for example, argued that the new regime of the thirties had been a class compromise as Social Democracy had become strong enough to make employers accept strong trade unions, an extensive welfare state and interventionist policies, but was still too weak to dislodge capital from its position in the economy. Towards the seventies Social Democracy was argued to have accumulated sufficient power resources in order

\(^{929}\) According to the original proposal the funds would own more than half of the stock of Swedish shares after 20 years.

\(^{930}\) See also Ahlén 1985.

\(^{931}\) See Korpi 1978 and Stephens 1986.
to terminate the compromise. But, as has been argued in chapter 4, the new policy regime established in the thirties cannot be understood as a compromise between labour, which allegedly intended to abolish capitalism but lacked the power to do so, and capital, which aimed to destroy organised labour but equally lacked the power to do so. Rather the new regime was based on a common interest in ending deflation. The change in ideological outlook during the late sixties and seventies did not constitute an effort by a greatly strengthened Social Democracy to complete the transformation of economy and society begun in the thirties, but rather reflected growing problems with handling the macro regime. Irrespective of the leftist outlook of a new generation of members, the policy direction Social Democracy would take during the next decades was to be determined by its inability to rely on labour market institutions instead of unemployment to contain inflation. To the extent that the leftist tendencies of the late sixties an early seventies built on worker opposition to the arrangements of the old regime, they were not the harbingers of a new radicalisation but rather announced the decline of Social Democracy and the advent of the ideological dominance of Neo-Liberalism. Similarly the defeats of Social Democracy suffered since the mid seventies were not the outcome of a political strengthening of 'Capital' which allowed the latter to turn back the clock on the 'compromise' reached in the thirties. Rather than being its cause, the relative strengthening of 'Capital' with respect to labour was the outcome of the new policy regime. In a regime which saw no alternative to bringing down inflation than to depress the economy by restrictive macroeconomic policies, 'Capital', on the micro level would inevitably be able to increase its strength relative to labour.

Overlooking the policy changes of the last two decades it is not immediately obvious that the new regime should have come to be interpreted as a shift towards liberalism. As argued in chapter 2, it is not clear why trying to enforce a strict money growth rule or trying to adjust domestic nominal prices to the requirements of a fixed exchange rate within the EMS should be called liberal. Moreover, as mass unemployment endured, also non Social Democratic governments accepted the need for active supply side policies, not simply in the sense of reducing costs buts also as positive policies, to stimulate innovation, new technologies, education etc. Even a prominent conservative politician like Britain’s Nigel Lawson interpreted the essence of the new regime primarily in terms of a different assignment of policy goals to instruments rather than a shift from interventionism to non-interventionism.932 That the new regime nevertheless was presented as a liberal regime was hence not so much related to the changing character of government intervention as to the ideological

needs of a regime which, because its macroeconomic hands were tied by a policy of disinflation, needed to reject responsibility for growth and employment. But since Social Democrats themselves had come to accept that macro stimulation of the economy is not possible, it also becomes difficult to reject the interpretation that a solution to the crisis has to be found in awarding more space for market forces. In ideological terms the outcome of the seventies and eighties hence was opposite in character to the Great Depression and similar to the developments of the early twenties.

By itself the failure of deficit spending in the seventies did not necessarily imply that Social Democracy no longer had an alternative in economic policies and hence would have to embrace some version of the Neo-Liberal orthodoxy. As the SAP’s strategy of the Third Way showed, it was still possible to defend full-employment despite the need for budgets cuts as longs a monetary and exchange rate policies could be employed for that purpose. Feldt’s emphasis on private sector growth did earn him the label Neo-Liberal from the left of his party, but the ability of the Third Way to combine full-employment with, albeit modest, real wage growth and some improvements in social welfare made the SAP’s economic policies virtually unassailable. The Third Way did not disintegrate because the left withdrew its political support for a strategy based on stimulating private sector growth but because of its inability to contain inflation.

Only when also Social Democrats came to accept that there was no alternative to reorienting monetary and exchange rate policies solely towards the goal of combating inflation did Social Democratic concepts necessarily lose their dominance in economic policy. Must important, the new regime implied durable mass unemployment and Social Democrats accordingly lost the reputation, built up since the Great Depression, of having a superior recipe against unemployment as compared to liberals or conservatives. In addition the reorientation of monetary policies implied that also Social Democrats now had to interpret unemployment primarily as a microeconomic phenomenon. Under a restrictive monetary regime any form of fiscal Keynesianism would necessarily shipwreck on the rocks of high budget and current account deficits. And with macro stimulation ruled out, the firm level, and hence the market, necessarily had to become the main focus of attention.

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933 Tony Blair’s enthusiasm for communitarianism, for example, seems to be much less inspired by grass roots objection to a paternalistic welfare state rather than by the financial need of the state to shed some of the responsibilities it acquired during a period of high growth.
Also Social Democrats now had to admit that high cost, and in particular wage costs, were a major obstacle to employment. In Norway, for example, the hopes for a reduction of unemployment in the new regime came to be placed on reducing real wages so as to increase export competitiveness. The main strategy of the SAP government, which came to power in 1994 for reducing unemployment is to reduce wage costs by means of employment subsidies. In the Netherlands, wage moderation has been the main strategy for reducing unemployment since the mid seventies, and the PvdA’s return to government in the late eighties did not change this. Rather PvdA finance minister Kok hopes to reduce unemployment by coupling wage moderation with tax reduction so as to attract foreign investment.

Certainly cost cutting is not Labour’s only remedy to unemployment, nor the one it emphasises most. Similar to the interwar emphasis on rationalization, Social Democratic parties try to distinguish themselves from Neo-Liberal policies by emphasising a left version of supply side policies. As opposed to the liberal version Social Democratic parties identify both a greater need for government intervention and a positive role for trade unions. After the failure of the Third Way Swedish Social Democrats now believe that the best way to improve industrial performance is to join the EC thereby assuring markets as well as increasing pressures to innovate. Moreover, trade unions are seen to play a critical role in promoting industrial innovation.

In Britain, the initial reaction of the Labour Party to its defeat and the emergence of Thatcherism consisted of a sharp turn to the left. Already under the last Labour government the leftist opposition had been greatly strengthened in response to the hated incomes policies and rising unemployment and budget austerity. After 1979 the so-called ‘hard left’ succeeded in controlling the party for several years. Labour’s new economic policy was the so-called Alternative Economic Strategy (AES). Basically the AES was driven by a desire to promote growth and full-employment without having to have recourse to incomes policies, i.e. without having to discipline the trade unions. Since such a strategy would most likely involve higher inflation, a loss of competitiveness and current account deficits, it envisaged strict import controls and the reimposition of tight exchange controls. Since, moreover, it was feared that private business under such a strategy would not be willing to invest sufficiently out of its own account, a large degree of economic planning with a prominent role for trade unions was envisaged. The electorate, quite correctly so one is tempted to add, did not put great faith in the ability of the AES to deliver economic results superior to those of Thatcherism, and Labour suffered a momentous electoral defeat in 1983, being spared the humiliation of becoming only the country’s third largest party only by a narrow margin. The 1983
defeat marked the beginning of the end for the labour left, although it would take until 1987, after yet another defeat in the general elections, for the new leadership under Neil Kinnock to feel sufficiently strong to embark on a radical review of Labour’s policy position, which would result in Labour’s macroeconomic policy views becoming hardly distinguishable from those of the Conservatives. The Labour Party, for example, now also officially came to reject Keynesianism and, joining the general trend, came to see improving the competitiveness of British industry as the solution to low growth and high unemployment, and this was seen to require a more active industrial policy. However, industrial policy for Labour no longer entailed direct intervention, partly through public enterprises. As other parties Labour had learned that the state, even under a Social Democratic government, and especially in times of recession, is not better able to identify promising industrial ventures than private business itself. Industrial policy now came to mean improving the framework conditions under which industry operated. As Andrew Gamble (1992, p. 67) characterised Labour’s new view: "Left to itself, Kinnock asserts, the ‘market’ does not do three essential things which a modern economy needs. It does not invest adequately in education and training, science and technology, and research and development; it cannot ensure adequate provision of health, social services and social security; and it cannot protect the environment."

Yet, despite the fact that the Labour party strongly emphasises the differences between its strategy and the policies of the Conservatives, the need for supply side policies which entail more than cost cutting is clearly recognized by the latter and indeed by virtually all parties to the right of Social Democracy also in the other countries. Moreover, because Social Democrats do also recognize the need for cost reduction, differentiating themselves from the programme of their political opponents becomes more difficult than their emphasis on leftist supply side policies might suggest. Accordingly, also Labour parties can no longer unambiguously reject the argument that unemployment is a result of excessively strong trade unions.

In order to distance itself from the Conservatives, and possible also in order to ease the ideological transition from a radicalised party in the early eighties which thought predominantly in terms of a capital-labour antagonism to a position which argued that creating conditions under which private business could prosper was also in the best interest of Labour, the Policy Review reemphasised the alleged conflict of interests between industry and finance (the City). Conservative policies were interpreted as serving the interest of the City, whereas Labour would put the interests

934 On the Policy Review see, for example, Shaw 1993, 1994 ch. 4.
of industry first. In the field of macroeconomic policies, the Policy review even claimed that macroeconomic policy would be subordinated to the interests of industry. The Policy review, however, failed to explain what type of macroeconomic policies that entailed. Indeed as Gamble (1992, p. 71) argued: "The sections on macroeconomic policy are undoubtedly the weakest and least convincing in the Policy Review." The reasons for this weakness are obvious. Because of the centrality of tight money in the Thatcher strategy and Thatcher’s hostility to Labour, the Labour Party had to distance itself from such policies. Unlike other parties it could not embrace the position that tight money would eventually lead to more jobs in the future by means of bringing down inflation. The political need to reject such policies led Labour, quite correctly, to claim that tight money had done serious damage to Britain’s industrial capacity. Unfortunately for Labour, such a position would inevitable draw the question how it was going to contain inflation of not by means of tight money. To that question, however, Labour could not give an answer, because the obvious answer ‘incomes policies’ was unavailable, not only because trade unions adamantly rejected any such policies, but also because such a policy position would have reminded the electorate, no doubt prodded along by the Conservatives, of what had happened last time Labour had put its eggs in the basket of incomes policies. Rejecting tight money but not having a viable alternative anti-inflation policy, the macroeconomic section necessarily had to remain vague.

As was the case for other Social Democratic parties, the reference to external constraints also helped Labour to openly accept the need for tight money. Initially Labour was handicapped in this respect because it was very clear that Thatcher’s initial policies had not been forced upon her by overwhelming external forces. After all a substantial appreciation of Sterling had been one of the main ways by which the massive recession of the early eighties had been brought about. Yet as the eighties progressed Labour overcame this handicap. With reference to increasing capital mobility and the internationalisation of the economy, and no doubt also inspired by the Conservative’s internal divisions on this issue936, Labour since the late eighties came to advocate participation in the Exchange Rate Mechanism (ERM) of the EMS. Although this was initially made conditional upon coordinated European reflation, this condition was quietly dropped when the Conservatives brought Sterling into the ERM on October 5, 1990.

Having lost a theme which might be exploited to the disadvantage of the Conservatives, Labour subsequently came to advocate EMU. In fact Labour was more in need of ERM participation than the Conservatives. Despite the fact that also for Thatcher and Lawson high interest rates were

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936 See, for example, Lawson 1993, ch 39, 53, 64, 73 and Thatcher 1993, Ch. XXIV.
considered politically damaging\textsuperscript{937}, the Conservative government enjoyed enough autonomy from business and labour not to require the device of external constraints in order to justify tight money. For the Labour Party this might have been different, especially so since it claimed that tight money damaged industry and that it would subject macroeconomic policies to the interests of industry. In retrospect, Labour may be glad that it did not win the general elections of April 1992. Within 5 months of the elections Sterling was pushed out of the ERM in a storm of international financial speculation, and a Labour government in that situation may well have suffered the fate of MacDonald 61 years earlier.

More important perhaps than Social Democracy's inability to develop an alternative and effective policy against unemployment is that, given budget deficits and the need to cut costs, it can no longer expand but has to contract the welfare state. Such policies, however, are likely to drive a wedge between its labour and middle-class supporters and thereby threaten its electoral success as a people's party, and its ability to find coalition partners. In Germany the SPD-FDP coalition broke up in 1982 as the FDP insisted that the efforts to reduce the budget deficits should focus primarily on areas which were dear to the SPD constituency like labour market programmes, unemployment insurance and pensions. The SPD's apparent willingness to do so, however, led to a major conflict with the trade unions. In opposition, the PvdA had mainly sought to distinguish itself from the Christian-Democratic / Liberal government by calling for more protection for low income groups. Given continuous high deficits, such policies, however, would have required more taxes, which the PvdA could not whole-heartedly support, because it also felt that the Dutch cost level needed to be reduced. Moreover, the middle class would not be enthusiastic about tax increases for the benefit of lower income groups in a time of welfare cutbacks. When the PvdA entered government again in 1989, after 12 years absence, it found that it had to reduce rather than increase income protection. Especially the 1991 cuts in benefits for disabled workers\textsuperscript{938} caused a major conflict with the trade unions, similar to the SPD-DGB conflict of 1982.\textsuperscript{939}

The Norwegian Social Democrats, up to now have been able to avoid serious conflicts of this type, mainly because the oil wealth avoided the need for cutbacks. In response to the rapid rise in unemployment in the late eighties, tensions did increase between the unions and the party, but DNA was able to head off a conflict by means of additional fiscal spending. In Sweden the advent of

\textsuperscript{937} See, for example, Thatcher 1993, p. 698-9.

\textsuperscript{938} The disability programme in the Netherlands is extensively used a a reservoir for unemployed workers.

\textsuperscript{939} See van Praag 1994.
recession and mass-unemployment has electorally benefited the SAP. After its dismal performance in the 1991 election, the SAP came close to an absolute majority in 1994. Given its policy history, the Swedish electorate trusted that the SAP would be better able to design remedies against the economic crisis than the bourgeois parties. Yet it is quite unlikely that the SAP can fulfil expectations this time. As the policy experience of other west European countries during the last two decades suggests, a policy which relies on cost reductions, be it in the form of employment subsidies, is unlikely to revive the economy and lead back to full employment. Without a decisive upturn in private sector activity, also the SAP will be increasingly forced to choose between its working class and middle class constituencies. One conflict which is already gaining contours is that middle class voters might support reducing wage protection at the low end of the spectrum as a means to allow for the emergence of a private low wage service sector which might be able to compensate for the reduced level of public services.

7.2 Conclusion

"The causal relationship between inflation and growth must be seen as a problem in political economy, for it is the response of governments to inflation, both actual and predicted, that has and will determined the ultimate impact of inflation on the growth of productivity and output." (Cornwall 1987, p. 839)

Both periods of persistent high unemployment in this century have been the outcome of restrictive macroeconomic policies. Durable mass-unemployment appeared in the early twenties in response to the spread of sharply restrictive macroeconomic policies throughout the international economy. The change in policy regime during the Great Depression was decisive for eliminating mass-unemployment, although, with the exception of Nazi Germany, full-employment was generally not restored until countries seriously started preparing for war. Durable mass-unemployment appeared again during the seventies as more and more countries embarked on restrictive policies in order to break inflationary pressures.

Gøsta Esping-Andersen (1985, p. 193) noted that: "long-run Social Democratic strength will depend on the capacity to control the business cycle." But although major recessions and mass-unemployment must be attributed to economic policies, governments, and not even Social Democratic governments, did not always have an alternative to restrictive policies. The normative assumption generally underlying theories of political economy that the state should aim to maximise growth and employment does not conform to the requirements of a monetary economy. Confronted with a price-wage, wage-price spiral, maintaining accommodating policies aimed at stimulating
investment became unfeasible during the early twenties even for governments who clearly recognized that economic growth held the key to the reconciliation of Capital and Labour. Indeed the hyper-inflation and subsequent collapse of the German economy showed what the consequences would be if the state refused to prioritise price stability instead of growth. Similarly, in the seventies the disintegration of institutional arrangements designed to contain nominal price and wage increases meant that there eventually was no alternative to a policy which provoked recession and unemployment. Certainly some countries like Germany and the Netherlands overreacted to inflationary pressures and inflicted unnecessarily severe recessions on the economy, but the fact that eventually even Scandinavian Social Democrats found it necessary to provoke a recession implied that the policy priority given to inflation versus unemployment ultimately could not be considered to be determined by the relative strength of the political forces supporting the respective goals.

Although governments may not have had an alternative to restrictive macroeconomic policies in times of strong inflationary spirals, what was certainly not inevitable was that such policies should become institutionalised for many years to follow. As was argued in chapter 4, the main reason for the severity of the Great Depression was that governments were willing to pursue sharply restrictive policies in order to maintain the parity for fear of reigniting inflation. Recent Swedish history provides a less dramatic example as the Riksbank in late 1992 went to great lengths to avoid a depreciation of the Krona. The substantial depreciation which nevertheless occurred did not lead to inflation but rather gave export industry a sorely needed boost.

The early twenties and the last two decades, as well as the Great Depression, hence were what in modern terminology are called critical junctures; i.e. brief periods of political and institutional restructuring which were to decisively shape economic policies in the next decades. Modern political research has shown that the institutional structure of the policy-making process can decisively influence policy outcomes.\textsuperscript{940} Yet, institutions can be changed despite their considerable inertia. What ultimately explains the willingness of governments to adhere to a restrictive regime even in times of high unemployment is not the power of habit, nor the high amount of political energy required to change an established regime, but the fear of a resurgence of spiralling inflation. It is not the increase in prices as such which governments fear but the progressive loss of control over

\textsuperscript{940} See, for example, Hall 1986.
the economy they experience in such circumstances, as labour market organisations disintegrate, the central banks lose their ability to fine tune, and, if inflation is tolerated long enough the financial system explodes.

Most economists, and most political economists, would argue that the ideal economy is characterised by full and instantaneous price and wage flexibility. If prices and wages adjust immediately no disequilibrium can occur. The emergence, during the last century of institutions like trade unions and welfare arrangements which served to impede price flexibility would appear in this perspective to be the cause of much of the economic problems of the 20th century. Yet, this view is mistakenly based on the neoclassical habit of analyzing relative prices in a world without money. In the real world economic actors set nominal and not relative prices. If producers and wage earners rapidly adjusted prices and wages to excess supply’ the result would more likely be deflation and the collapse of the financial system than instantaneous equilibrium. The emergence of trade unions and, albeit limited, welfare arrangements in the last century, therefore, did not mark the perversion of the market economy but a necessary element in an economy where more and more people came to depend on wage income and where the possibility of deflation hence had greatly rivn as compared to an economy in which large section of the population were still engaged in subsistence farming. Since the Great Depression western governments have implicitly or explicitly recognized the stabilising function, or at least the inevitability of such institutions. During the crisis of the last two decades even those governments who felt strongly that the dominance of market forces should be reinstated after the interventionist Keynesian interlude have not dismantled the welfare state nor have they abolished trade unions and collective bargaining. But whereas the possibility of deflation has disappeared for good since the change wrought during the Great Depression, the problem which already caused the regime shift in the early twenties, namely how to contain inflationary pressures, is also at present the core problem for economic policies.

It cannot be the task of an essay like the present one to advance suggestions for solving some economic and political problems, yet, in concluding some speculations may be permissible. It seems obvious that a change in the ownership structure of the economy, although perhaps desirable for other reasons, will do little to solve inflationary problems. One might envisage an economy in which all enterprises are owned by their employees but where the allocation of credit and labour remained decentralised. There is no reason why such an economy should be less prone to inflationary problems under tight demand and labour market conditions than an economy in which a handful
of 'capitalist' owns the means of production. Conversely one might imagine an economy with private ownership of the means of production but state directed allocation of credit and labour. It is hard to see how such a type of economy can avoid the problems of a Soviet type of system.

Rather the requirements for recovery from the present policy regime seem to be partly political and partly institutional. In the short-run, governments will simply have to muster the courage for a more relaxed monetary policy. As long as any upturn in growth or even a decline in unemployment rates causes Central Banks to become very nervous about a future increase in inflation, full employment and high growth rates are completely illusory.

In the long run durable growth and full-employment will require an institutional which structure can guarantee an acceptable degree of price and wage stability even under relatively tight labour market conditions, thereby allowing for a regime which assigns the Central Bank the primary task of stimulating growth. The experience of Norway and Sweden does not necessarily imply that the days in which a large part of the responsibility for containing inflation could be delegated to centralised bargaining between the labour market partners are gone for good. The breakdown of centralised bargaining in both countries was in large part due to the strains exerted on peak organisations by excessively tight labour markets. If, for example, the Riksbank had decided to revalue the Krona in, let's say 1985-86, even by a small amount, it might have set a signal which could have prevented much of the subsequent inflationary boom. And despite the structural changes in labour markets, it is not at all clear that trade unions have become structurally unable to engage in centralised bargaining. The so-called 'solidarity alternative' pursued in Norway at present relies on a high degree of centralisation. In Sweden the LO has given up on its policy of compressing overall wage differentials, and thereby has removed one of the main obstacles to centralisation. And indeed some recentralisation has taken place after the decentralisation of the eighties.

But a return to centralised bargaining would at best seem feasible in a handful of countries. In abstract terms what would be required would be institutional structures which can prevent local labour as well as employers to react to tight labour markets by offering and accepting higher nominal wages. Overlooking recent policy history, it seems that only two countries have been able to successfully combine full-employment and inflation without relying on highly centralised wage bargaining, namely Switzerland and Japan. But although Switzerland frequently is interpreted as a success case,\footnote{See, for example, Soskice 1990.} it is not clear whether it qualifies. Rather the Swiss case might merely illustrate that the level of unemployment may not always be a good indicator of labour market pressures and
potential trade union market power. In response to the first oil price crisis the Swiss National Bank pursued an even more restrictive policy than the Bundesbank. Accordingly the crisis of the seventies was more severe in terms of GDP and employment. That the dismal employment performance failed to have an appreciable impact on the rate of unemployment was mainly due to a particularity of the Swiss labour market. The Swiss labour force consists for over a quarter of foreign workers, many of whom will lose their residence permit upon loosing their job. As a result the reduction in labour demand caused by restrictive macroeconomic policies led to an almost automatic reduction in labour supply while unemployment showed up in the surrounding countries. Such a strategy obviously is not an example to emulate.\footnote{Conversely a situation in which overall employment grows but the labour force grows with it also would lead to an overestimation of the actual extent of tightness on the labour market. The continuous influx of foreign labour in Germany in the sixties is an example of this.}

The Japanese model might offer a more promising example. One crucial reason why the Japanese economy has been able to achieve a superior unemployment-inflation trade-off is that both its system of seniority wage as well as the widespread presence of family firms have the effect of making it quite more difficult to attract labour from other firms by offering higher wages. The drawback of such arrangements is that they restrict the exit options of individual employees. Yet, if the alternative to such restriction is the toleration of large-scale unemployment the first option seems to be the more equitable one.

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