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Money and Trade Wars in Interwar Europe

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Alessandro Roselli
Honorary Visiting Fellow, Cass Business School, London

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To Cesare,

With thanks

Contents

List of Figures and Tables

Figures

Tables

Preface

The origin of this book must be explained by starting from the end of the period it describes, with the Nazi plan for European economic unification. Several years ago, while researching another book on the Bank of Italy in the fascist period, I found a letter from the bank's representative in Berlin, who alerted the bank's governor about work secretly in progress at the German Ministry of Economics and Central Bank, involving plans for Europe's future economic and financial organization under the aegis of the Axis powers, Germany and Italy. It was 1940, the war had started one year earlier and victory then seemed close. I set aside this topic, as it was not central to the theme of my research.

My attention was later caught by a speech made just after the war at the Italian Constituent Assembly, delivered by the eminent Italian economist and statesman Luigi Einaudi on 'The War and the European Unity'. Einaudi said that the issue of European unification 'cannot be solved other than in two ways: either by Satan's, or by God's sword. This time', he regretted, 'the Satan's name was Hitler, the modern Attila. ... If we are unable to carry on a human and modern ideal in today's Europe (which is currently misplaced and uncertain about the path to follow), we are lost and, with us, Europe itself'.[1] The 'uncertainties about the path to follow' were overcome in a succession of steps that eventually brought about the European Union we know today. His approach was, of course, to draw the strongest dividing line between Europe as envisaged by 'Attila', and a continent where 'freedom would prevail over intolerance, cooperation over brute force[,] ... not closed into itself but open to all'. To the creation of this Europe, he stressed, 'Italy must be ready to sacrifice part of its own sovereignty.'[2]

Fifty years later, a lengthy anti-European pamphlet – expanded into a book – took the opposite stance. Rather than contrasting two opposite ideas of Europe as Einaudi had done, this book looked at the 'tainted, undemocratic' origins of the present Union, which in the author's opinion was begotten by the old Nazi idea of European unification.[3] The historically questionable and ultimately simplistic links that the book made were nonetheless based on well-researched assumptions, and I thought that rather than looking at them to explain the present we might find those assumptions useful for clarifying the past: They might be better understood as a result of the troublesome period that culminated in the Nazi project.

From a political perspective, investigations of the framework in which the plan was conceived have explained it as a result of the Nazi regime's unreadiness to deal with its own sudden military success in Western Europe (the *Blitzkrieg*) after a long-standing policy consistently devoted to eastward expansion (*Drang nach Osten*). The sketchy features of the Nazi plan, amended several times and constantly adjusted to take account of developments in the war, confirm the lack of a far-sighted view.

The economic and financial features of the plan, however, seem to merit further investigation. They were focused on some basic concepts: the idea of a multilateral clearing system, with Germany at its centre; the resetting of international economic relations based on the priority of 'goods' over 'money and credit'; the phasing out of gold as the basis of the international monetary system; a new, primary role of reserve currency for the Reichsmark, which was to dethrone sterling and the dollar; the subdivision of Europe, and ultimately of the world, into 'Greater Spaces', with distinct economic roles, each forming currency areas.

Of course, these characteristics of the Nazi plan did not come from nowhere. They were the consequence of developments peculiar to the interwar period – that long interlude during what has been called the twentieth century's 'thirty-year war'. The multilateral clearing system, having the Reichsmark at its centre, can be explained only by taking into account the complex bilateral clearing agreements stipulated by Germany. They predated the Nazi seizure of power in Germany, but were developed into a highly sophisticated system by the inventiveness of the Reichsbank president, and at one stage economics minister, Hjalmar Schacht.

But why set up this network of agreements that essentially appear to be a form of barter? As far as Germany itself is concerned, this means considering the devices adopted by the Nazi government to carry out its economic policies. The motivation for these devices was essentially the result of two factors: the 'gold shortage', that is, the scarcity of means of international payment following the First World War; and Germany's insatiable need for commodities for industrial development and war preparations.

Let us first consider the shortage of means of international payments. The world had entered the First World War with a monetary system solidly based on gold, in which money could be converted into gold at pre-determined parities, and gold could be used to settle cross-border transactions. War financing, however, had brought about huge expansions in the money supply, while gold had moved towards trade-surplus countries. For most countries, these two factors – money expansion and gold outflows – led to the suspension of convertibility and a resort to foreign debts in order to sustain the war effort. And for most countries, a return to convertibility after the war, under a gold standard regime, brought with it the necessity either to reduce the money supply or to increase the quantity of available gold – or to do both. The first alternative, deflation, would be the more painful; the second, the more difficult to achieve. But the second option might also be softened, in turn, through two alternative ways: by increasing official reserves with foreign, solid, currencies, in addition to gold, thanks to foreign loans (the gold *exchange* standard); or by devaluing, that is, by lowering the parity of the country's currency in terms of gold. To varying extents, most countries pursued all of these alternatives, but in a chaotic, uncoordinated manner, with consequent huge disequilibria ensuing in their foreign accounts.

We have, so far, neglected two important protagonists in this story: the United States and Germany. The United States emerged from the First World War as a superpower. Having kept the dollar on the gold standard during the war, it now took on Britain's hegemonic role and maintained a net credit position throughout the 1920s and 1930s. The 'obvious' course of action would have been for the United States to stick to an expansionary policy and not devalue its currency. But a different course was chosen instead: reining in the money supply and devaluing the dollar, thus gaining competitiveness *vis-à-vis* other countries.

Germany was in the opposite position, saddled with a debased currency, and humiliated by the burden of war reparations to be paid to the Allied powers. Foreign loans helped to restore the gold standard, but with an overvalued parity; further foreign borrowing helped to repay the war debt, but this soon came to constitute another enormous burden to the German economy. With an uncompetitive exchange rate and a significant, perhaps unsustainable, foreign debt to repay, Germany was affected more dramatically by the shortage of gold and foreign exchange than the many other countries also hit by an acute misalignment of their currencies. Germany had a shortage of foreign money, but at the same time an enormous industrial potential and, with the Nazis, overwhelmingly *revanchiste* military ambitions. Any devaluation of the mark was ruled out, even as the other important economies, one by one, devalued amid the collapse of the old gold standard.

This now brings us to the second factor providing motivation for the barter system: the need to import foodstuffs and raw materials for the German economy and war machine that could not be produced domestically. Through clearings or similar arrangements, Germany wanted to satisfy this need and to pay its foreign debt.

These agreements were not without their strains: with Western European countries as the financial creditors but trade debtors of Germany; with America, at the same time financial and trade creditor; and with Central and Southern Europe the main providers of commodities which felt the ever tighter embrace of their bigger neighbour.

These strains also existed with Germany's closest ally, fascist Italy. Italy's financial developments in the interwar period mirror Germany's, to some extent: a return to gold in the post-war period, thanks to a substantial inflow of foreign loans; an overvalued currency; an adherence to the gold standard that went too far and culminated in a forced dismissal later in the 1930s; and a similar, though less rigid and comprehensive, level of exchange controls. The history of the Italian–German clearing agreement is a story of mutual diffidence and distrust that finds its most evident expression in the subordinate role that the Nazis assigned to Italy in their European unification plan, where this preface began.

This book is structured in three parts. Part I (Chapters 1–3) provides an introduction to the central themes of the research: bilateralism and *dirigisme* in international financial relations, emerging from the collapse of the gold standard. Part II (Chapters 4–7) deals with the increasing nationalism of the interwar period, and the clearing agreements and debt-reduction policies that were the result of the bilateralism that prevails in the 1930s. Part III (Chapters 8 and 9) is devoted to the Nazi plans for an economic reorganization of Europe, and to early reactions to the project.

Specifically, Chapter 1 considers the economics of inter-Allied war debt and German war reparations and their sustainability, and inflation in the Weimar Republic. The thesis that, historically, appears more convincing is that payment of reparations, and in general the funding of additional public expenditure following the war, would have required a substantial increase in taxation by the Weimar government. This was not done, mainly in order to maintain social peace in a troubled period, at the cost of fuelling inflation dramatically, and of disintegrating, in the end, that same social texture that the government had tried to preserve. In fact, the alternative of resorting to public borrowing was not pursued, thanks to the markets' reluctance to underwrite long-term debt while inflation was mounting and confidence in Germany was low. The remaining alternative was heavy monetary financing by the German central bank, which eventually brought about hyperinflation. Chapter 2 reviews the initiatives taken, both in Germany and abroad, to stabilize the mark and facilitate reparations payments. The divergences between the United States and United Kingdom concerning the German return to the gold standard, or the establishment of a sterling exchange standard, are highlighted, along with the setting of the new parity for the German currency. The Dawes and Young loans are considered in the context of a huge and volatile capital inflow into Germany following stabilization. Chapter 3 aims to provide a simple model explaining how the system of the gold standard is supposed to work, using this context to consider the actual policies pursued by the main Powers and asking whether they were coherent with the 'symmetry' of the system.

Chapter 4 shows that the return to the gold standard was realized in a haphazard way, with currency misalignments that provoked huge imbalances and asymmetrical behaviour by the most important creditor country, the United States, while cross-border debts and the growing effects of the Depression worsened the whole scenario. The chapter provides evidence of a shift from deflationary policies aimed at maintaining the pre-existing currency parities to domestically oriented policies which moved away from deflation either through devaluations (the United Kingdom, the United States) or through complex networks of foreign exchange controls (Germany, and to a lesser extent Italy), while the restoration of the gold standard appeared an increasingly distant and elusive goal. Chapters 5 and 6 deal with the pervasive practice of bilateral trade and currency agreements, which aimed to overcome the shortage of means of international payment by adopting a form of barter. A description is given of these complex schemes. Germany had a central role in these agreements, of which two types emerge: agreements with West European countries that were simultaneously trade debtors and financial creditors towards Germany; and those made with Central and Southeast European countries, where a political component prevailed, dominated by the Nazis' war preparation requirements. The peculiar position of the United States, Germany's financial and commercial creditor, is also stressed. Chapter 7 argues that the clearing agreements between Fascist Italy and Nazi Germany, notwithstanding the appearance of collaboration, reveal an uneasy relationship already evident in their competition for economic and political penetration in the Balkans, with Italy constantly experiencing a sense of subordination to her powerful ally.

Chapters 8 and 9 consider Nazi Germany's plans for an economic and monetary overhaul of Europe, and of the world in general, after a victorious war that would give Germany a pre-eminent position. Again, fascist Italy oscillated between unconditional adhesion to these plans and a more critical attitude born out of concern at the oppressive role Germany would take, even *vis-à-vis* its ally. But Italy had no serious alternative plan. Germany's plans for economic primacy were a challenge to Britain's role, and Keynes's reaction to these plans is a mix of intellectual appreciation for the plans' technicalities, and disdain for the enemy nation.

The Postscript raises an open question about how to avoid dysfunctionality in the workings of international monetary arrangements: A comparison is made between the interwar gold standard and the current euro system.

Notes

1. Einaudi, Luigi: *La guerra e l'unità europea*, speech of 29 July 1947, in the volume with the same title, Edizioni di Comunità, 1953, pp 157 e 161
2. p 161
3. Laughland, John: *The Tainted Source. The Undemocratic Origins of the European Idea*, Little, Brown and Company, 1997

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Part I

The Gold Standard Reinstated

1
War Reparations and Hyperinflation in Germany

1 Inter-Allied war debt and Germany

The First World War was characterized financially by a complicated web of loans between the Allied powers. At the end of the war (November 1918), total indebtedness amounted to around $21.6bn.[1] The defeat of Germany was followed by huge reparations imposed on her by the victors. However, payment of reparations was closely linked to the settlement of the war debts, and the attitude of the Allied powers towards Germany was strongly influenced by their respective debit–credit positions. The United States had the biggest net credit position, followed by Britain. The American position was one of credit for $7.1bn, with a debit of just $0.4bn. The United Kingdom had lent $9.3bn to other Allies (mainly Russia, France and Italy), but also borrowed $6.1bn, mostly from the United States.

The rest of the Allies were net debtors: France lent $3.1bn, mostly to Russia, Belgium and the United States, but borrowed $4.2bn from Britain and the United States; Italy was in debt to the United Kingdom and United States for $3.2bn, having lent a total of $0.3bn; Russia was the biggest debtor, owing $4.9bn, mostly to Britain.[2]

The burden of lending fell on the United Kingdom in the first three years of war, before being passed to the United States. After the Armistice of 1918, inter-Allied lending continued, in particular on the part of the United States and Britain; France was also an active lender in both periods. Germany had been the banker of the Central Powers.[3]

Mainly because of the accrued interest, total debt among the former belligerents had accumulated by the end of 1923 to around $28.3bn, with the United States and Britain attaining net credit positions of $11.9bn and $4bn respectively. Loans were measured in terms of money, but actually consisted of indispensable commodities that a country could not obtain at home: A variety of goods including clothing, food, cotton nitrates, chemicals, steel, copper, engines, ships, and munitions.[4]

It is understandable that France was particularly anxious to get money from Germany, in view of the heavy losses suffered in terms of lives and physical assets, while the animosity of the United Kingdom was tempered by its different financial position. The United States, the most significant Allied creditor, did not even claim war reparations from Germany. In the early months of the 1919 Paris Peace Conference, Hjalmar Schacht, who would become a prominent figure in both the Weimar Republic and the Nazi regime, still expected a generous peace, thinking that the real European problem was the huge pile of debt already accumulated by every belligerent country, and that what was badly needed was a reconstruction plan rather than an additional debt burden on Germany.[5]

'Germany's economy was exhausted but not in ruins',[6] after signing the Armistice without even having been invaded by the Allies: Many Germans felt that their country had been defeated not by the enemy's army but by faltering morale at home. The Treaty of Versailles, signed on 28 June 1919, produced deep disillusionment and, in Germany, it was often seen as an attempt by the Allied powers to gain an economic victory after failing to win the war on the battlefield.

Article 231 of the treaty – the 'article of shame'– humiliatingly attributed to Germany sole responsibility for all war losses and damages. Article 232 stated that Germany would make compensation for those losses and damages, but did not specify the total German reparations bill. It also considered Germany's specific violations of its treaty with Belgium as a separate case. In addition to all the above, Germany would reimburse Belgium the sums it borrowed from the Allies. Article 233 stated that the total amount of reparations would be fixed by a Reparation Commission which was to be established. Article 235 determined an 'interim payment' of the equivalent of 20bn gold marks, to be paid in 1919, 1920 and the first months of 1921.[7] Out of this sum, the expenses of the armies of occupation and the cost of some supplies of food and raw materials would be met. The balance of the interim payment would be reckoned towards the amount due for reparations, according to Article 233.[8]

In the words of Moritz Bonn, an adviser to the German government who was firmly opposed to the Allies' position, these 20bn gold marks 'were merely a kind of *hors d'oeuvre* after which the real feast was to begin'.[9] In fact, in the 'interim period' Germany paid in capital goods, and – according to this critic – these goods were valued far below the price they would have fetched on the German domestic market. According to the Reparation Commission, the value of these goods was esteemed at only 2.6bn gold marks, while the Germans valued them at several times more: '[A]bout 8bn gold marks' – wrote Bonn – 'although the loss to Germany far surpassed this sum'.[10]

At Spa in July 1920, the Allies allocated the proceeds from reparations among themselves, with the largest share going to France.[11] After long and difficult discussions, the precise amount of total war reparations was determined on 27 April 1921 by the Reparation Commission, *de jure* an independent agency established by the Allied governments, at the value of 132bn gold marks, a figure based neither on specific Allied claims nor on any estimates of Germany's debt sustainability. In fact, the commission received itemized initial 'estimates' of the damage suffered by all the Allies and by the 'associate' countries: 18 countries in total, with France, Britain, Italy and Belgium presenting the highest claims. But the commission dismissed these specific claims and officially stated that they were not used as a basis to calculate that final figure of 132bn gold marks. The commission pointed out that it was unclear whether the amounts, denominated in different currencies (for instance, Italy's claims were in lire, France's in francs, Britain's in pounds), were at current or 1914 monetary values, and concluded that any conversion to German gold marks would be practically impossible. The commission refused, however, to make public both the items not accepted, and the haircuts of the accepted items.[12]

That sum of 132bn gold marks was more than double the German net national product (NNP) at gold parity for 1913 and, according to some estimates, would be more than three times the NNP for 1921 (we shall return to national output statistics later, while dealing with the sustainability of German war debt). The denomination of reparations in gold marks implicitly fixed the amount in dollars ($31.4bn), since the dollar price of gold had not been altered during and after the war.[13] In addition, the Schedule of Payments which the commission submitted to the Germans included the Belgian debt owed to other Allies, which was equivalent to 4bn gold marks, although some items – whose total amount would be determined by the commission – were to be subtracted from the total sum of 132bn gold marks: The reparations already paid by Germany, as pre-reparation payments, compensation for German state properties in ceded territories,[14] and the sums owed to Germany by other enemy powers.[15] As Barry Eichengreen has pointed out, 'no issue in twentieth-century economic and political history has been more hotly contested than the realism of this bill'.[16]

2 The London Schedule of Payments

The 'London Schedule of Payments', as it is known, was approved on 5 May 1921 by the Allied Supreme Council and, on the same day, presented to the Germans as an ultimatum: If it were not accepted, the Ruhr region was to be invaded (the Ruhr, rich in coal resources, would anyway become a very contentious issue, as we shall see below). The schedule also defined the instruments through which those payments were to be made. The sum of 132bn gold marks was divided into three categories of bonds, named A, B and C. The A bonds amounted to 12bn gold marks and required annual servicing payments of 6 per cent (5 per cent as interest and 1 per cent as a contribution to the bonds' sinking fund): The B bonds carried the same interest and amounted to 38bn gold marks. The capital of 50bn gold marks (12bn + 38bn) was, in effect, the figure that would have burdened Germany, since the remaining 82bn gold marks (which were represented by the third category of bonds, the C bonds) would be credited, at no interest, to the same Reparation Commission and would be effectively issued *sine die*: That is, only after it had been established that Germany, by then on its way to recovery, really would be able to pay.[17] Arguably, payment on this item was never seriously expected.[18]

In reference to the A and B bonds, there was no official earmarking for specific purposes, even if it was implied that each category would fulfil a certain function related to different kinds of debt.[19]

The schedule's request was accepted on 10 May 1921, under pressure by the Weimar government of Joseph Wirth (whose delegation was led by Walther Rathenau, a cultured and highly respected man and a prominent industrialist).

A 'reparations accounting' was presented by the Reparation Commission in 1922.

Table 1.1 Statement of German obligations, 30 April 1922 (in billions of gold marks)

Amount of reparations	132
Allies' loan to Belgium, to be repaid by Germany	4
Less: Pre-reparation payments (coal deliveries, cost of occupation armies)	2.5
Net total	133.5

Source: Reparation Commission: *Statement of Germany's Obligations,* HMSO, 1922, pp 26–28.

Unclear is the number of years it would take for the 50bn gold mark debt to be discharged. If any annual payment included 1 per cent for amortization (see above), this should have been 100 years; instead, a time span of 30 years was frequently cited. Certainly, no specific maturity was indicated in the Schedule of Payments. One cannot escape the impression that nobody really believed that this huge obligation – even for the lesser sum of 50bn gold marks – would ever be duly fulfilled.

There was a dilution of the German debt over time, which reduced the net value of the bonds as given above. C bonds, however, cannot be seen as mere window dressing to appease public opinion in Paris: Even if partly postponed, a total debt of 132bn gold marks was hanging over Germany and could not simply be met with indifference by public opinion in Germany.[20] The Allies had hoped to place these bonds with investors, but were disappointed. Given the inability, or at least reluctance, of the debtor to pay, they were hardly considered a good investment.[21]

We need only consider the annual repayment on 50bn gold marks to confirm the shaky foundations of reparation accounts. At 6 per cent this would have come to 3bn gold marks; instead, German annual repayments were determined by the Reparation Commission using a different method, which set them at 2bn gold marks plus 26 per cent of the value of German exports (or an equivalent sum based on an index proposed by Germany that had to be accepted by the commission). The adoption of such a parameter was meant to make the debt more sustainable, by partially linking repayments to German economic strength: If and when a German economic recovery occurred, its payments would proportionally increase.

Given that German exports at the time were estimated at 5bn gold marks per year, of which 26 per cent would be 1.3bn, this would result in a total annual payment of 3.3bn gold marks which would exceed the 6 per cent value originally mentioned. The 1.3bn was mostly to be taken directly from the levy on exports, but also from maritime and land customs duties along with other sources proposed by the Germans and accepted by the commission. The Committee of Guarantees, established by the Allies, would secure the implementation of the schedule. The problem, of course, was how to find those 2bn gold marks that were to make up the bulk of the annual payments. The difficulty of reaching agreement on this highly contentious issue is demonstrated by a note from the Committee of Guarantees addressed to the German government on 28 June 1921, which estimated that each year Germany could pay 1.2bn gold marks in kind, 200 million gold marks from customs duties and 1.25bn from a levy on exports, thus leaving a payment deficit of 650 million gold marks.[22]

Following the presentation of the schedule, Germany paid, mostly in foreign currency, the equivalent of around 1.5bn gold marks between August and November 1921, and a final sum of around 150 million gold marks in the first half of 1922. These payments were not the result of any surplus in German foreign accounts, but were done mainly by Reichsbank's purchases of gold and currency on the foreign exchange market (through the creation of additional paper marks), and by loans granted by Dutch and Italian banks.[23] It should be noticed, in this regard, that in 1921 the paper mark was still attractive as a speculative currency. Numerous small-scale foreign deposits were made at German banks, in the (mistaken) expectation that the mark would finally recover, given the relative strength of the German economy (as we shall see later).[24]

No further substantial cash reparations payments ensued until after the Dawes Plan of 1924, although payments in kind continued (mainly coal,[25] timber, chemical dyes, pharmaceutical drugs, livestock and machinery, but also state-owned property in territories transferred to the victors).[26] As a result of the cash shortage, on 6 October 1921 the German minister of Reconstruction, Walther Rathenau, and the French minister of Liberated Zones, Louis Loucheur, signed an agreement by which Germany would pay a larger part of its reparations in kind, with up to 7bn gold marks' worth of German goods to be transferred to French businesses by May 1926.[27] French industrialists opposed the agreement because any delivery in kind from Germany would have reduced their own production opportunities. The underlying idea that Germany would have a substantial trade surplus, with a possible contraction of German imports and a huge expansion of its exports, conflicted with the victorious powers' interest in preventing a flood of German goods in their own markets, particularly that of France.[28]

Germany had abandoned the mark's gold convertibility on 4 August 1914, and its exchange rate had steadily deteriorated during the war. The signing of the Treaty of Versailles in 1919 triggered a steeper fall in the German currency – the paper mark – by provoking a psychological crisis and, for the first time in its history, a real 'flight from the mark'.[29] At the end of 1919 the dollar exchange rate was around 47 marks (well above the pre-war parity of 4.2). On average, in 1920 the rate was 63 marks. Then it hovered around the rate of 70 to the dollar until mid-1921, in spite of continuous increases in the money supply and in price levels. As mentioned earlier, this relative exchange stability was the result of speculative, short-term investments in the paper mark. But then the dollar started appreciating on the foreign exchange market, and its appreciation accelerated as a consequence of the Allies' decision in November 1921 to give Upper Silesia to Poland. The dollar climbed to a value of 84.31 paper marks in August, and 262.96 in November.[30] That same month, Germany made frantic efforts to obtain a loan from the Bank of England, but this was refused until Germany could obtain more favourable terms for reparations.[31]

French intransigence increased after Raymond Poincaré succeeded Aristide Briand as prime minister in January 1922, and was also sustained by French industry's opposition to reparations in kind. France, mindful of its national security and aware of its own net debit position, wanted to constrain Germany's economic and military potential for as long as possible using territorial demands, military control and reparations. From the French perspective, the main purpose of reparations was to keep Germany in a state of continued weakness and dependency. The French also hoped to relieve their own financial burden by negotiating with the United States for the reduction of their war debt.[32] Britain was less concerned by any German menace, and rather stressed the significance of economic factors: Notably, Germany's inability to fulfil its financial obligations. Britain's – and the United States' – main concern was political: The fear that a Bolshevik revolution might develop in Germany. This prompted efforts to appease the German government and not to impose excessively harsh treatment.

In December 1921, Germany asked for a moratorium on its debt,[33] and in the following March France presented to the commission a memory in fully negative terms. It reminded that Germany had not fulfilled its obligations before the Schedule of Payments had been approved, in particular, insufficient deliveries of coal and missed payment of the 'interim' sum of 20bn gold marks. The French government added that the small payments made following the schedule had been faced by selling marks on the open market and by obtaining short-term loans, without any serious effort to implement fiscal reforms; the mark's weakness was not due to reparation payments, but to 'the "ill-fated" fiscal policy' of the Weimar government.[34] Confronted with a substantially negative position of the commission,[35] Germany reacted by stressing the extreme poverty of the German people, the trade deficit, the mark *degringolade* caused by reparation payments, the impossibility to further increase the tax burden, and observed that only by means of a foreign loan it would be possible to procure the currency necessary to cover reparation payments.[36] (we have just mentioned the failed attempt to obtain a loan in London). The 1922 assassination of Rathenau, then the German foreign minister, further clouded the political landscape as inflation turned to hyperinflation and, in December 1922, the average dollar rate reached 7,589.27 marks. More and more economists, bankers, industrialists and politicians recognized the need for a revision of the reparation clauses. Britain, in particular, was prepared to see a reduction of inter-Allied debt followed by a partial cancellation of reparations, but the United States, fearing this would mean a loss of American war loans to European countries, avoided being drawn into these discussions. The United States was, in this phase, far less active than might be expected, considering subsequent developments.[37] The American government had not signed the Versailles Treaty and, in 1922 – under president Warren Harding – was unwilling to intervene on the issue of reparations, even though it was convinced that a moderate settlement would be necessary for a European recovery.[38] The United States, the only country in a position to broker a compromise by forgiving war debts owed by France and Britain and asking for moderation in their claims on Germany, retreated into isolation.[39]

By the end of 1922, stalemates had been reached between Britain and France, and between Germany and the Allies. Germany pushed for a revision of the reparation clauses, a reduction of its liabilities and a transformation of that 'political' debt into a 'commercially viable' one.[40] In a note sent to the Reparation Commission on 14 November 1922, the German government wrote again that the mark could not be stabilized without the support of foreign loans, and asked for a moratorium on all payments except those earmarked for devastated areas.

According to the Schedule of payments, the total amount to be paid by Germany between 1 May 1921 and 31 December 1922 should have been 4.4bn gold marks, but the amount credited to Germany as payment, either in cash or in kind, was just 2.2bn.[41]

On this basis, on 9 January 1923 the Reparation Commission (with Britain abstaining) declared Germany to be in voluntary default on coal deliveries to France. In response, French and Belgian troops invaded the coal-rich Ruhr region, accompanied by French, Italian and Belgian engineers for extracting the coal. National output declined as a result of the Ruhr occupation, and Germany had to start importing coal.[42] The German chancellor, Wilhelm Cuno, launched a costly campaign of passive resistance in the occupied region.[43] A new war fever erupted, with France forcing payments from Germany and pressurizing other Allies to join in its campaign. Britain, instead, hardened its attitude towards the debts it was owed by France, distanced itself from the invasion and declared the occupation 'immoral and illegal'. Britain also successfully campaigned for a comprehensive study of the whole reparations problem, and the United States now joined the inquiry. From this juncture on, America adopted a leading role in determining the outcome of the reparations question. It might be argued that the First World War did not truly come to an end until 1924, when the comprehensive, American-sponsored Dawes Plan was approved.[44]

3 Reparations and hyperinflation: the balance of payments perspective

Why Germany did not fulfil its reparations payment obligations is a long-debated question: Was it unable or unwilling to pay? This question is closely linked to two others: What were the causes of the German hyperinflation of 1921–1923? And could Germany's real national output have sustained the burden of reparations? To put matters in context, the issues of mark devaluation and domestic inflation must first be considered. Here, we shall look at this issue from two main perspectives: (a) the balance of payments, and (b) the government budget.

Between June 1919 (the Treaty of Versailles) and December 1922 (the eve of the default declaration), the value of the German currency plummeted from around 14 paper marks to the dollar to slightly below 7,600, with the worst to come in the following year. In his 1919 best-seller, *The Economic Consequences of the Peace*, Keynes had advocated the lenient treatment of Germany, suggesting a total settlement of $10bn to cover both reparations and the costs of the armies of occupation. At the gold mark's pre-war exchange rate of 4.2 marks to the dollar, the amount suggested by Keynes would have been 42bn gold marks. This sum was of course well below the figure of 132bn gold marks that the Reparation Commission would set two years later. In particular, according to Keynes, the surrender of ships, war materials, state-owned properties, and Germany's claims on debts owed it by other Central Powers, should have been valued at $2.5bn (11.5bn gold marks). Therefore only a balance of 31.5bn gold marks should be paid in cash. Keynes added that this amount should not be subject to any interest, and should be subdivided in 30 annual instalments of $250m[45] (1.05bn gold marks).

His sympathetic stance towards Germany was reiterated in several subsequent writings, especially after the Reparation Commission's decision on the amount of reparations. Keynes saw a close connection between the cost of reparations and the dramatic fall of the German currency. Unable to draw resources from any foreign accounts surplus, Germany had to print money to purchase the necessary amounts of currency to pay for reparations. This provoked the paper mark's depreciation and domestic inflation as a consequence. 'The violence of the [mark's] fall is due to the complete absence of support by the Reichsbank, which lacks resources as a result of its last payments to the Allies', he wrote in August 1922.[46] He gave specific estimates of the German war debt's sustainability, writing that 'Germany could not pay more than 2 milliard [bn] gold marks (£100m) as a continuing annual payment, and it would be wise to ask her somewhat less. ... Beyond 2 milliards one is in the realm of fantasy'.[47] In passing, it should be noted that this limit was well above his original proposal of 1919, though still below the 3bn gold marks target envisaged by the Reparation Commission.

Meanwhile, according to Keynes this huge depreciation on the exchange market was causing a near-standstill in Germany's economic activity: '[It] has so far outstripped the rate of inflation that the amount of Reichsbank bank notes and bank balances is at the present depreciated value quite insufficient to carry on the business of the country'.[48] This continuous Marathon race between the inflation rate and the resort to printing more money has also been highlighted more recently by Heinz Haller, who stresses that the monetary needs of the economy were higher than the actual monetary circulation, while prices continuously rose in step with the ruinous fall in the mark's exchange rate.[49] 'The high rate of inflation made holding money extraordinarily costly. German money holders responded rationally by reducing the real amount of marks they held. The minimal real purchasing power of marks made money appear scarce.'[50] Given the price increases, the monetary or nominal value of German output required an amount of cash that exceeded the productive capacity of the printing works. Substitutes for banknotes were printed. In a country flooded with paper money there were, paradoxically, complaints of a shortage of money, and municipalities and businesses started printing their own banknotes, but even this was not enough.[51]

Keynes saw these developments as 'terrifying and disintegrating', with prices in the shops changing 'every hour'. In this environment the young Weimar Republic was faced simultaneously with a fight against 'reactionary organizations', and with a working class that, although still broadly loyal to the government, was increasingly menaced by inflation and unemployment.[52] It should, however, be noted that the unemployment rate in industry remained subdued, at least for a while. This was consistent with the trend in national income, as we shall see later. Unemployment was 1.5 per cent in 1922, and climbed to 13.1 per cent only in 1924, the year of the mark's stabilization (well below, however, the peak of 43.8 per cent that would be reached in 1932 during the Great Depression[53]): This helps to explain the continuing support of the Weimar government among the working class, at least until the hyperinflation of 1923. This support was bolstered by what Bresciani-Turroni calls 'latent unemployment': The absorption of large numbers of the unemployed into state-run enterprises (railways and postal administration). In addition, a system of reduced working hours, to be adopted before dismissing employees, was introduced along with an eight-hour day work law. This is why, in the summer of 1922, unemployment had practically disappeared. What is interesting, and puzzling, is a strong inverse relationship between declining unemployment and deepening devaluation in 1921.[54] 'Contrary to the expectations of Keynes and other like-minded Cassandras, Germany shared in the prosperity of the immediate postwar boom.'[55]

In December 1922, on the cusp of the declaration of default and the Ruhr occupation, Keynes further dramatized the situation: '[N]o competent person disputes that Germany cannot pay reparation in the near future, and that a postponement of her liabilities, certainly for 2 years and perhaps for 5 years, cannot be avoided. Any proposal to the contrary is, therefore, not bona fide, that is, intended, not to secure payment, but either to crush Germany's economic life or to extort from her some non-pecuniary concessions.'[56]

Keynes in fact considered the question of German reparations from a 'balance of payments perspective'. 'Since the Armistice Germany had to sell mark notes, mark balances, and mark securities to meet three main demands for foreign currency – 1. cash payments to the Allies, 2. her adverse balance of trade, 3. the flight from the mark'. Keynes calculated that, in cash, Germany had already contributed a total of £115m, the equivalent of 2.3bn gold marks, to both reparations and the settlement of pre-war debts. Keynes noted a declining, but persistent, deficit in the trade balance for the years 1919–1921 and the first half of 1922: The figure for each year was, in billions of gold marks, 4.84, 1.9, 1.1, and 0.1.[57] Moreover, big German businesses moved funds to steadier currencies to escape – or indeed gain from – the effects of inflation.

Keynes essentially argued that the demand for foreign currency, which had given rise to the huge fall in the mark's exchange rate, was caused by a combination of reparations payments, the trade deficit and a flight from the national currency. The chain of events was therefore the following: German trade was unbalanced, and reparations could not be paid through balance of payment surpluses; the state had therefore to resort to the central bank's buying currency on the market, with two consequences: A mark depreciation and an increasing debt of the state towards the Reichsbank. That depreciation, and the expansion of money supply, drastically raised internal prices and hindered the economic growth that might have made the burden of foreign debt more sustainable. According to this model, when it came to war reparations Germany was not a reluctant debtor, but simply a debtor unable to pay. Keynes and Gustav Cassel, in the *Report of International Financial Experts on the Mark's Stabilization* (1922),[58] stressed the importance for stabilization of the balance of payments and foreign credit. Moritz Bonn, adviser to the German government, echoed this view. In 1922 he wrote that 'it has become evident ... that a country, whose whole balance of payment is unfavorable, cannot pay an indemnity without an utter collapse of the exchange'; and later that 'the reparation problem has become a purely political problem', advocating a response in the following sequence: A restoration of political confidence, a reasonable moratorium, and the start of negotiations for an interim loan with its proceeds destined mainly for France.[59]

From a balance-of-payments perspective, a consistent demand for German products might have generated a German surplus in foreign accounts, possibly providing a boost in national income and making reparation payments easier. If we look for some statistical support, we notice that full balance of payments data for the current and capital accounts are unfortunately not available for the relevant period. The 'relevant period' here is 1919–1923. It starts in the year that a provisional quantification of the claims was made as part of the Treaty of Versailles, as the 'interim payment'. It ends in the year of extreme hyperinflation prior to the mark's stabilization and of the Dawes Plan – a plan which would completely alter the whole issue of war reparations.

On the current account, in particular, figures for the 'invisibles' are almost non-existent. However, trade statistics show that the balance of payments was, in fact, an unreliable source for reparations payments. There was high monthly volatility, but on a yearly basis an almost constant deficit emerged (which was particularly significant in 1919 and 1921).

Table 1.2 German trade balance 1919–1923 (in billions of 1913 marks)

	a	**b**
1919	−4.3	
1920	−0.2	−0.2
1921	−1.3	
1922	−0.1	−0.1
1923		+0.5

Source: (a) Webb, *Hyperinflation*, p 91; (b) Mitchell, Brian R.: *European Historical Statistics,* Macmillan, 1981, p 514.

These incomplete figures show that foreign trade could not be instrumental to reparation payments – payments that, in order to fully satisfy Allies' total claim, would amount to 29bn gold marks: 20bn for the interim period, and 9bn according to the first three years of the schedule. Moreover, tariff barriers to German exports were increased in France, the British Empire, and the United States, making less competitive the goods that Germany needed to sell to acquire foreign currency.

It seems that the capital account of the balance of payments could be more significant. A lot depended on the confidence foreign markets might have in a strong recovery of the German economy. As Webb points out, 'German borrowing to pay reparations might have been attractive to all parties if German productive capacity were expected to grow, if economic recovery abroad were to increase demand and employment in the future and, of course, if Germany were to repay the loans [eventually through] trade surpluses and budget surpluses.... Apparently [foreign lenders] did believe enough in 1920–1921 to lend almost 8 billion gold marks to the German economy in paper-mark denominated assets'.[60]

Once it became apparent that the Weimar government was being swayed by domestic policy considerations into dangerously fuelling inflation, the capital inflow ceased, with consequent losses to the investors. As we have seen, towards the end of 1921 the German government pushed the British for a loan, unsuccessfully. It was more and more clear that no substantial injection of money would come from abroad without currency stabilization in Germany.

4 The fiscal policy/national output perspective

A contrasting position, particularly common among contemporary French experts, argued that Germany was deliberately ruining the mark – partly to avoid tax and currency reforms and partly to boost exports, but mainly to escape reparations. More recently, Niall Ferguson has criticized Keynes' argument as exaggerated; he has lamented that 'even today the idea that reparations were to blame for Germany's descent into hyperinflation continues to enjoy widespread scholarly support'.[61] Marks similarly stresses German reluctance, noting that 'those historians who have accepted the German claim that reparations were the cause of the inflation have overlooked the fact that the inflation long predated reparations'.[62] According to Agnete von Specht, the shared view of the Weimar government and the Reichsbank was not to curb inflation – a position taken in order to persuade the Allies of the impossibility of Germany paying reparations.[63]

If Germany's foreign accounts did not leave room to pay reparations by trade surpluses or capital inflows, we should consider whether national output and government receipts might have provided enough resources to make reparation payments sustainable, as – in fact – the French stressed. To this end, it is opportune to lift the veil of inflation with a 'real' assessment. To 'deflate' the economy and look at the economic variables in real terms is no easy task. Brian Mitchell's widely used series of figures for Net National Product (NNP) at constant and current prices has, for Germany, a gap between 1913 (the last pre-war year) and 1925 (the first year after the return to the gold mark).[64] National income estimates[65] for the missing years of the war and for the immediate post-war period have been produced by a variety of scholars and collected by Albrecht Ritschl in a recent economic history of the First World War. For the war and post-war years we will use Dieter Witt's series, as reported by Ritschl, and Steven Webb's estimates. The full series is shown below (see Table 1.3).

These very uncertain estimates were of course not available to Bresciani-Turroni who, writing in 1931, was nonetheless able to state correctly that

Table 1.3 German national output 1913–1924 (in billions of 1913 marks)

	a	b
1913	49.5	
1914	44.6	
1915	40.3	
1916	39.7	
1917	38.8	
1918	37.0	38.1
1919	33.2	34.2
1920	36.6	37.7
1921	39.2	40.4
1922	40.9	42.1
1923	36.8	37.9
1924	43.2	44.5

Sources: Elaboration from (a) Ritschl, The Pity of Peace, p 44; (b) Webb, p 76.

in the aftermath of the Great War the German economy was not in a state of total collapse. In the light of the limited evidence at his disposal, he wrote: '[F]rom the Armistice onwards the economic and social situation of Germany remained extremely complex. Light and shade, alternating phases of depression and prosperity, a strange combination of disintegrating forces and constructive energy, almost unforeseen changes of the situation, and apparently inexplicable contradictions characterize [the] post-war German economy.'[66]

In line with this view, and contrary to the association of high inflation with severe economic contraction, the above estimates of German national income in the post-war years do not show a dramatic decline – even if, in real terms, at the end of the war it was a good 30 per cent below its pre-war level.[67] It should also be added that after the war Germany lost an eighth of its continental European territory: The return of the economically important regions of Alsace and Lorraine to France may, in particular, help to explain the fall in national output. In general, German real output alternated between phases of growth and recession. Its trends were, however, disconnected from those of other major countries: It grew at substantial rates in 1920 and 1921 (10 and 7.2 per cent, respectively) when the United States and Britain were in recession, but it experienced a downturn in the first months of 1923 following the Ruhr's occupation, just as the American and British economies were recovering.[68] It is worth noting that the initially modest pre-1923 unemployment rates are consistent with the view of a rather unstable, but not collapsing, national income. How great was the burden of reparations, in light of this (admittedly uncertain) series of figures of national output at constant prices?

As we have seen, the total debt owed by Germany as determined by the Reparation Commission in 1921 was 132bn gold marks (and the choice of the gold mark fixed the real worth of the debt at the pre-war mark/dollar parity of 4.2 – paper mark inflation or depreciation could not change its value). As mentioned earlier, this sum was more than three times Germany's national income for that year. Realistically, we can consider only the A and B bonds – 50bn gold marks in total – since, as we have seen, the C bonds – 82bn gold marks – were indefinitely postponed. The sum of 50bn gold marks was a somewhat more affordable debt, equivalent to approximately 123 per cent of national income. But it was imposed on a country with profoundly damaged morale in a decision that, to Germans, just seemed like a punishment. In an assessment of the burden on Germany, however, the stock of foreign debt itself is ultimately less important than the growth rate of the economy and the amount of payments that Germany, each year, had to make on that stock of debt.

Table 1.3 shows real growth. Regarding debt repayment, we must make a distinction between what was legally claimed by the Allies and what was actually paid. It is inappropriate to conclude – as some historians have done, belittling any pretence to the contrary – that the Germans paid 'little' for reparations and, therefore, that their complaints to the Allies were unjustified. If Germany paid little because the 'legal' burden really was unsustainable, that conclusion would be wrong. To address the question of German reluctance or inability to pay, we shall start by considering the flows needed to meet the Allied claims, as stated by the victors, comparing them to real German output for the relevant period 1919–1923, and then we verify how much of these claims Germany actually paid. For that period there was a total 'legal' claim of around 29bn gold marks (20bn, the 'interim payment' for 1919–1920, plus 9bn, the total in annual payments due for 1921–1923[69]). Let us now consider these figures for the legal claim as a percentage of the annual national income (assuming for the sake of simplicity that the 20bn gold mark sum would be equally split between 1919 and 1920). The resulting percentages, in reference to the slightly higher figures for national output given by Webb, are the following:

1919	29%
1920	26%
1921	7%
1922	7%
1923	8%

If this was the burden of the 'legal' claims, what did Germany actually pay? Here, we encounter further problems. The evaluation of these payments is difficult, for several reasons. Firstly, many deliveries were in kind and, as we have seen, assessing their value was a rather subjective exercise. Secondly, disbursements for various other reasons (for instance, feeding occupation armies) are not reliably included in reparations accounts.[70] Thirdly, there was a discrepancy over how to record the confiscation of German private property abroad and relinquishments of claims against former German Allies.[71] Most importantly, the numbers provided by different sources simply do not correspond: The German government claimed to have paid 51bn gold marks by August 1922, while Keynes and other independent observers mentioned a figure of 13.2bn gold marks paid between 1919 and 1922.[72] The Reparation Commission credited the Germans with a still smaller sum: 7.9 bn gold marks (subdivided as follows: cash 1.9bn, deliveries in kind 3.5bn, ceded property 2.5bn[73]). We shall stick with this official figure, at the cost of underestimating German payments, given the above-mentioned difficulties.. The gap between the Allies' 'legal' claims and Germany's actual payments would be around 21bn gold marks.

The unsustainability of the 'interim payment' can be clearly seen in the huge percentage of national output it would have required (around 25–30 per cent: see above). But what about servicing the debt in the following years? Bresciani-Turroni studied German hyperinflation and war reparations in 1931 and produced the first in-depth analysis of the German mark crisis, concluding that to comply with this huge foreign obligation would have required a tough fiscal reform that the Weimar government preferred to avoid.[74] Bresciani paid due attention to the prevailing theory in German academic circles (and supported by Keynes) that inflation was not the cause but the consequence of the paper mark's depreciation, and that this depreciation was in turn caused by the excessive burden of war reparations and France's aggressive policy towards Germany.[75]. However, Bresciani was inclined to give more weight to a different factor, not by chance raised by the French: The lack of structural reforms of German fiscal policy, specifically an increase of taxation. 'Daring fiscal reforms would have been needed, but the revolutionary government [of the Weimar Republic] either wasn't courageous enough to adopt them, or feared that these measures would have given too grave a blow to the weakened political and economic structure of Germany. Increasing paper money appeared the simplest way out. It is curious that it was a socialist government that adopted the most irrational and unjust kind of taxation'.[76]

How 'daring' should fiscal reform have been? The feasibility for the Weimar government of resorting to taxation can be assessed by following the later approach of Heinz Haller,[77] using the estimates of German national output that we have quoted above (Table 3.3) and actual government revenues in that period. Haller observes that in pre-war Germany, 'ordinary' (non-war related) taxation was around 10 per cent of national income. The Reich's government funded its war expenditure (which reached more than 50 per cent of the national income in 1917, before falling below 40 per cent in 1918) with bond issues (when the war ended in 1918, the stock of outstanding public debt stood at around 50 per cent of German output for that year).[78]

In the post-war years, Germany was, on one hand, able to get rid of the enormous burden of war expenses while, on the other, additional expenditure was now required for assistance to war victims, servicing the war debt, and paying war reparations. War reparations payments were much lower than the huge war expenditure. Haller calculates war reparation payments at 10 per cent of the national output, in the worst case; assistance to war victims at 5 per cent; and war debt service at 8–10 per cent of national output. All these additional expenditures accounted for around 25 per cent of national income. Total revenues needed to fund both ordinary expenditure and service of war debt, forms of assistance to the victims and war reparations, in 1920 would have therefore required around 35 per cent of national output (10 per cent as ordinary expenditure, and 25 per cent as additional, war-related expenditure), that is, an amount in the order of 13bn marks, in real terms.

A level of taxation at around 35 per cent of national product would have been a big jump from the pre-war level of taxation,[79] even if today it does not seem so dramatically high. As Haller himself observed, in a psychologically traumatized economic and political environment the huge weight of the fiscal burden would probably not have been tolerable. In this way, his conclusion is quite similar to Bresciani's.

In that year, total expenditure in the equivalent gold marks was, in effect, 9.7bn, with tax revenues of 3.5bn and a 'floating debt' of around 6.2bn.[80] The question was how to collect this latter amount (or a bigger one, in order to reach that 35 per cent of national output), whether by taxes or by long-term borrowing. Neither alternative was chosen. Printing money was favoured instead. The inflation enabled the German government to pay off its domestic debt, including the war debt. In terms of 1913 marks, the service of the 'funded' debt (including the war debt) declined from 717m in 1920 to 51m in 1922, and to zero in 1923.[81]

The most relevant attempt at fiscal reform had been made in 1919 by Germany's finance minister, Matthias Erzberger, based on moving the burden of taxation from from households income to capital and wealth, and on centralizing the tax administration into the hands of the Reich, which would get a virtual monopoly of direct and indirect taxation. Erzberger had also announced the Emergency Capital Levy and a variety of new indirect taxes. But counter-revolutionary sentiment prevailed at the National Assembly; the extreme right had no interest in an effective tax programme and claimed that the Allies would just seize the receipts from the Emergency Capital Levy for reparations purposes, not permitting its use for domestic stabilization. In the meantime, huge capital flights provoked a fall in the exchange rate and a law against such flights was approved. A forced loan was also issued, on the proposal of the Reichsbank.[82] But any hope of a more incisive tax reform vanished. However, until 1922 the fiscal situation was not disastrous. Higher tax revenues and a decrease in expenditure caused a reduction of short-term borrowing, in real terms, to 5bn in 1921 and 4bn in 1922. But the government was in the end running a losing race with inflation, and the necessary further twist in taxation did not occur. In 1923, expenditure jumped, in real terms, from 6.2 to 9.7bn, while tax revenues decreased from 2.2 to 1.1bn, with a corresponding expansion of the floating debt.[83]

The fact is that the institutional framework of the new Weimar Republic was still weak in the immediate post-war period. The transition to a democratic parliamentary system in the aftermath of the German Empire's collapse needed time, and the Weimar government, attacked from every political quarter and struggling for its own survival, could not afford to impose on the country the heavy burden of new taxes. As we have just seen, its fiscal position further deteriorated after the Ruhr occupation by France and Belgium in early 1923, following which revenues from coal tax collapsed, while additional expenditure was needed to finance passive resistance in the occupied region.[84]

Faced with insufficient tax revenues, the state had to consider debt financing, but in the end opted for a monetization of the debt. This monetization was the result of the extreme difficulty, indeed the outright impracticality, of issuing any significant amount of new public debt for private investors. The danger of inflation was already a concern for potential investors, many of whom had bought war bonds during the conflict only to be hit by war inflation and, after so many 'burnt fingers', it would have been almost impossible to find people willing to lend to a defeated and weak state. At the same time, inflationary expectations were leading to the flight of capital, as previously observed. Rudolf von Havenstein, the Reichsbank's president, faced a dilemma: He could either refuse to buy up any more floating government debt, thus obliging the government to issue long-term paper, risking a prohibitive rise in interest rates; or he could consent to monetize that debt. He believed the first option would have brought about a severe economic contraction, mass unemployment and social upheaval, perhaps triggering a revolution. He chose the second option.[85]

In the light of the government's reluctance to raise taxes, and its inability to borrow considerable amounts of money on the market, debt financing was pursued with the issue of short-term bills by the government. These were mostly discounted by the Reichsbank, thus inflating the money supply and price levels. The collapse in the mark's exchange rate and the accelerating increase in price levels were due to the over-issue of banknotes by the central bank in order to finance the government deficit.

The stock of short-term government debt owed to the Reichsbank increased exponentially. From 51.2bn paper marks in 1919, it rose to 91.6bn in 1920, 166.3bn in 1921 and 271.9bn in 1922 (end of March data).[86] Even stronger, however, was the increase in wholesale prices. The wholesale price index (1929 = 100) rose from 291 in 1919 to 1,040 in 1920, 1,338 in 1921, and 23,927 in 1922. After the Ruhr crisis, the short-term debt climbed dramatically, and on 15 November 1923, on the eve of the stabilization of the paper mark *vis-à-vis* the dollar (see Chapter 2), it reached the astounding figure of 192 trillion marks.[87] This increase in public debt corresponded to the increase in wholesale prices, whose index, in 1923, reached the level of 11,634,000 million.[88]

Still worse, if we look at the creation of money by the central bank, we should stress not only Treasury financing but also the additional credit extended by the Reichsbank to the banking system. In this regard, the Reichsbank adhered to the widely preached 'real bills only' doctrine, a recipe for supposedly maintaining financial and monetary stability. According to the doctrine, inflation cannot occur if only commercial bills, aimed at financing the working capital of enterprises, are accepted at the discount window of the central bank: No credit can be granted in a measure greater than what is deemed necessary to the 'real' needs of the economy, so that an inflow to the central bank of notes previously issued should occur when the working capital cycle is completed.[89] But, in Weimar Germany, given the inflation which originated from the government's borrowing needs, the outflow of notes issued by the Reichsbank to satisfy the demand for trade was greater than the inflow of previously issued notes. In other words, the central bank's credit to the private sector did not counteract, but rather reinforced, the monetary financing of the Treasury.[90] An increase in the discount rate, which might have helped to reduce the extent of the central bank's financing of the economy and cool down inflation, was instead seen as likely to raise production costs, and further stimulate inflation as a consequence.

Inflation initially appeared to be the only way politically to consolidate the Weimar Republic. It created a tacit 'inflationary consensus' linking German industrialists, organized labour, and debt groups. According to Gerald Feldman, inflation served three basic purposes: Social pacification, particularly in the years 1918–1920, in order to prevent revolutionary unrest by public works, reduction of working hours, social legislation, and formal cooperation between labour and capital,[91] stimulus to economic recovery; and providing an economic and political weapon to make the war victors moderate their demands on Germany.[92] In this context any real attempt at fiscal and monetary stabilization might have led to the Weimar Republic's destruction and the collapse of social harmony. This shared good intention was frustrated, however, by the destabilizing effects of price increases.

In fact, hyperinflation radically altered Germany's social structure. Who gained, and who lost from it? Large-scale industrialists and holders of real assets – factories, residential properties, land, material goods – did well, often extremely well, as inflation pulverized their debt. Unionized workers also did well because up to 1922 their wages kept up with inflation and, as noted above, unemployment was low. Then their situation worsened, with the collapse in confidence accelerating price increases while unemployment soared. The big losers were any holders of monetary assets, in particular civil servants and professionals, the backbone of German society, whose salaries did not follow inflation while their financial assets – bank deposits, government bonds – became worthless because of 'the State's disregard for their fortunes'.[93] Hyperinflation also contributed to the substantial cancellation of the public debt: A classic instrument for the state to get rid of its obligations. The flip side of hyperinflation was a radicalization of the political struggles, besides the generation of a series of purely speculative investments which did not really contribute to economic growth. Disrupting social cohesion through the massive redistribution of income and wealth, it sowed the seeds of the Weimar Republic's destruction.[94]

We can now go back to the questions raised above regarding the sustainability of war reparations. It is difficult to find mutually exclusive 'causes', or motivations, for the substantial default of the German government, but it is possible to say, tentatively, that reparations could have been paid in these first post-war years through a substantial increase in taxation. The Weimar government refused to follow this alternative out of the probably justified fear of social unrest and of an almost certain grave recession. The government preferred to resort to monetary financing of the budget deficit, a deficit related – as we have seen – not only to reparations but also to other unavoidable expenses. It was probably confident that inflation might be contained, and in this, the government was not alone: Speculative foreign investment in paper marks was widespread. Excessive money creation fuelled inflation.

Other commentators add a malevolent twist: They conclude that the main culprit was, in fact, fiscal policy, but the policy's main purpose was not so much to elicit public consensus as to deliberately avoid reparations payments through currency depreciation. Contentiously, this latter explanation carries the obvious implication that the Weimar government actively wanted to sabotage the Allies' demands by undermining the reparations regime. However, it rather seems that behind the specific fiscal and monetary policies – adopted by the government and endorsed by the Reichsbank – there were problematic, but plausible, domestic policy objectives which were seen as a priority. On the positive side, perhaps for a while the inflationary policies saved the Weimar Republic, the first parliamentary democracy in German history.

2
The Reichsmark: Stabilization and Foreign Loans

1 The mark stabilization of 1924

Germany's political situation worsened in 1923. Passive resistance in the Ruhr meant that whenever Allied troops moved into a factory, a mine or an office, everyone stopped working. Government payments to finance passive resistance in the region fuelled further printing of money and subsequent inflation. The government made huge amounts of credit available to firms in the region while funding welfare and unemployment benefits, wages for unproductive work, and subsidies to railroads and postal services. The economic importance of the Ruhr meant its loss had significant consequences for the entire national economy.[1] Real wages started to decline, and industrial unemployment, until then fairly subdued, leapt from 1.5 per cent in 1922 to 10.2 per cent in 1923.[2] National solidarity was severely strained as interest groups vied to belittle one another's suffering. In 1923 hyperinflation reached its peak, with prices increasing by 29,525 per cent in a month.[3] The political unity of the Weimar Republic started wobbling.

The vice president of the Reichsbank, Otto von Glasenapp,[4] wrote in alarmed terms to the governor of the Bank of England, Montagu Norman, observing that 'the extraordinary devaluation of the mark is in large measure and to an essential part the result of the growing effect of the occupation of the Ruhr'. High inflation, 'called forth by the measureless devaluation [is in turn preparing] the ground upon which the seed must ripen and mature which the communists are increasingly sowing. A communist rebellion is certainly to be supported by the French. It admits no doubt that such a communist rebellion would lead to the complete ruin of the country'.[5] This mention of the supposed French interest in communist subversion in Germany is a clear indication of the extreme tensions between the two countries.

Keynes again spoke out for moderation in the matter of German reparations payments. He advocated a reduction of the debt to 50bn gold marks[6] (which was in fact the same net amount determined by the Reparation

Commission, after subtraction of the 82bn of C bonds), accompanied by a cancellation of the inter-Allied debt.

In August 1923, Wilhelm Cuno's centre-right government resigned and President Friedrich Ebert appointed as chancellor Gustav Stresemann of the German People's Party, who formed a new coalition government that included the socialists.[7] The velocity of price increases was such that Stresemann had to convince peasants to bring to the markets the products of their harvest: paradoxically, a catastrophic famine threatened to occur, and with it a hunger revolt, at a time when granaries were full.[8] The autumn saw revolts break out in the Rhineland, Saxony and in Bavaria, where the insurrection culminated in Hitler's abortive Munich Beer Hall Putsch.

In a conciliatory gesture towards the Allied powers, the Stresemann government stopped subsidising passive resistance in the Ruhr. The new American president, Calvin Coolidge, moved towards closer involvement for the United States in finding a solution to the reparations issue, albeit using private American bankers, rather than diplomatic channels, as a conduit. The Baldwin government in Britain began to feel that a more interventionist policy was necessary. The idea of holding an international gathering of experts to overcome the current *impasse* gained ground and, in October 1923, the French attitude finally started to soften: Poincaré accepted in principle the proposal of setting up an advisory committee, on which the United States was also to be represented.[9]

Meanwhile, the worsening domestic situation in Germany demonstrated the urgency of creating a new means of payment with a stable value. It was at this point that the necessity of currency stabilization started to converge with Germany's need for foreign financial assistance. Various projects to stabilize the mark were proposed. They can be divided into three groups: The first was based on the use of fiscal and foreign exchange measures, along with a credit freeze, to stop further depreciation of the paper mark, which would remain the German currency. The second advocated a return to gold convertibility. The third was based on the adoption of a new currency, backed by mortgages on real assets.[10] The second and third plans were viewed more favourably: It was felt that the bank of issue needed a 'real' collateral that could be handed over in the event of its failure. During Cuno's government, food and agriculture minister Hans Luther and finance minister Rudolf Hilferding proposed the establishment of a bank that would issue 'rye' marks: deposits redeemable in rye.[11] It was noted, however, that the ratio between the new monetary unit and the price of rye would float according to the variability of rye harvests, and this was a critical point that led officials to favour a real asset that could maintain a stable relation with the new currency. The collaboration and financial support of foreign powers was necessary for any project to work, and both Britain and the United States preferred for Germany to return to the gold standard.

In Germany, the prevailing option was in fact to return to the gold mark, but secured by something that people could believe in as solid and valuable: German land and industry. Stresemann appointed Luther, one of the proponents of the 'rye mark', as minister of finance. Largely on Luther's proposal, a new institution, the Rentenbank, was established on 15 October 1923, and a new currency, the Rentenmark, introduced. Its purpose, pending a complete reorganization of the fiscal and financial system, was to provide a stable domestic currency that would command confidence and assist the government to pay off its obligations to the Reichsbank and to meet its current spending obligations. The Rentenmark was intended as an intermediate step towards the return to the gold standard and was given the value of one gold mark, although it was not specified how much gold that now meant. The capital and reserve of the Rentenbank were set at 3,200m Rentenmarks, raised by compulsory contributions from holders of agricultural land, for one half, and from industrial, commercial and banking concerns, for the other half (urban property was exempted because a policy of rent control had altered its market value). This contribution took the form of a mortgage amounting to 4 per cent of the value of the properties pledged. The obligations ran over a minimum of 5 years and had 6 per cent interest. The Rentenbank balance sheet was structured as follows[12]:

Table 2.1 Balance sheet of the Rentenbank, as of 30 June 1924 (millions of Rentenmarks)

Assets		**Liabilities**	
Mortgages	3,200	Capital	2,400
Loans to Government	1,200	Reserve	800
Loans for commercial purposes	800	Notes in circulation	2,000
Total	5,200	Total	5,200

Source: *Federal Reserve Bulletin*, August 1924.

The creation of new money was put under tight control. Its success rested – more than on the 'real assets' of its balance sheet – on the rigid limitations on its issue: The discount of Treasury bills by the Reichsbank was suspended, and only limited credit lines could be extended by the Rentenbank to the government.[13] It should be added that the Reichsbank continued to issue paper marks for 'commercial' purposes, that is, to provide credit to the private sector.[14]

The value of the Rentenmark was not officially fixed as one gold mark, but this rate was commonly accepted as a result of the promise to their holders that 500 Rentenmarks could be converted on demand into a bond having a nominal value of 500 gold marks.[15] The paper mark, in fact, remained legal tender while the Rentenmark, officially, could only be accepted by public entities.[16] But all over Germany prices started to be expressed in Rentenmarks: '[The Rentenmark] is sought by certain classes of retail trade', *The London Times*'s Berlin correspondent reported. '[F]or example, the Berlin dairies begin to refuse to sell butter except for Rentenmarks; retail shops give considerable discount on the amount of the paper marks prices if paid in Rentenmarks.'[17] With the introduction of this new currency the various other forms of unofficial, non-state currency ceased to be issued, in particular, the fixed-value *Notgeld* which had been issued both by public entities and by private companies such as Krupp,[18] and of which a significant amount was in circulation.

The German authorities were faced with a problem. The market exchange rate of the paper mark against the American dollar fluctuated wildly on a daily basis, especially after its huge domestic depreciation; the Rentenmark, as we have seen, was ultimately fixed at a one-to-one rate to the gold mark, which was soon to return. But first: What would be the gold content of the new gold mark, which was to take place of the Rentenmark? And second: What would be the exchange rate of the paper mark to the Rentenmark? With regard to the first question it was decided that the new gold mark would have the same gold content as the pre-war Reichsmark: 358.432 milligrams of fine gold. As for the second, it should be noted that the paper mark's market trend in the summer and autumn of 1923 was indisputably characterized by a sustained, dramatic plummet in its value, as shown by Bresciani-Turroni's record of its rate against the dollar.[19]

3 July	160,000
4 Sept	13m
6 Nov	420bn
13 Nov	840bn
14 Nov	1,260bn
15 Nov	2,520bn

The paper mark was initially pegged at the rate of 2,520 billion to the dollar in the week 15–19 November 1923. But on 20 November, the paper mark was further devalued to 4,200 billion per dollar, and 1,000 billion paper marks per Rentenmark (reflecting the 4.2 mark to dollar exchange rate).[20]

This 4.2:1 ratio of Reichsmark to the dollar was, as Bresciani observed, an 'arbitrary rate', not corresponding to the rate then prevailing on the open market.[21] To make it permanent was the hard part. The disorderly condition of the exchange market can readily be discerned in the wild fluctuations that continued to affect the paper mark rate, even in different locations: At the end of November the dollar was quoted at 10–12,000bn in the French-occupied Rhineland, while staying firm at 4,200bn in Berlin. But the Reichsbank managed to stabilize this rate, and by December 1923 the pre-war parity was firmly re-established on the market[22]. Germany resisted a further, market-induced devaluation: A 'strong mark' policy was introduced and consistently pursued.

In this regard, it is worthwhile listening to Schacht: 'It is to the credit of ... a member of the Board of the Reichsbank ... , that he made the request that this rate [of around 4bn to the dollar] be maintained. He may possibly have been influenced by the consideration on that the peacetime rate for the dollar had been 4.2 marks. If, therefore, it was devised to transpose the paper mark to the old gold mark basis it was only necessary *to leave out the billion sign* [italics added] which made the transposition in bookkeeping amazingly simpler'.[23]

On 20 November, the day of the paper mark's stabilization, Reichsbank president, Rudolf von Havenstein, died. On 18 December an overwhelming parliamentary majority recommended Hjalmar Schacht over Karl Helfferich as Reichsbank president and, on 23 December, President Ebert confirmed Schacht's appointment.

It is pertinent to ask why the Reichsmark's new value was set at the pre-war level – a question relatively neglected by historical research, but key to explaining German monetary and exchange policy in the 1920s and 1930s. The conventional answer is that, after the war, a return to the gold standard was seen as a political priority by all the main Powers. However, the additional question that faced each country after the war was at which level (in other words, at what gold content) any specific currency should be stabilized. Countries such as the United States or Britain, less severely hit by inflation, were able to maintain or return to the pre-war parity, while others, which had suffered more violent inflation, could only stabilize at gold contents representing a fraction of the previous value, even after they had endured a period of heavy deflation (as was the case in Italy and France). Germany – a great power, and even in the 1920s the third-largest economy in the world,[24] but suffering from the consequences of a total military and monetary collapse – could have similarly adopted a monetary unit stabilized at a fraction of its pre-war value. This might have made its economy more competitive, its exports cheaper, and its balance of payments more capable of sustaining the burden of reparations. But a return to the old gold parity had a strong political meaning and was seen as a decisive factor in restoring confidence, both domestically and abroad. Confidence was a prerequisite for re-starting the economic system and restoring social peace.

One might wonder what role Britain and the United States had in choosing that gold parity: Were they afraid of a more competitive German currency? They would not have accepted a devalued mark to boost German exports at their expense. Restoring the pre-war parity, however, required a considerable foreign loan (which would materialize with the Dawes Plan, see later).[25] It appears that Britain was in favour of putting Germany on a sterling standard, while the United States preferred a return to the full gold standard. Both of these policy options were considered when the composition of the Reichsbank reserve was being decided (see below: the Dawes Committee's report would favour a gold exchange standard, while the German Banking Act of 30 August 1924 would move the monetary system closer to a pure gold standard). Was Schacht himself convinced that only the pre-war parity would give Germany the standing of a world power? Was Germany afraid that, against the benefits of cheaper exports, the cost of reparations (fixed in pre-war gold marks) would otherwise rise?

According to Carl Holtfrerich, it was the government – and principally the two successive finance ministers, Hilferding and Luther – that chose the pre-war gold parity.[26] But the role of Schacht should not be underestimated. On 12 November 1922 the government had appointed him as currency commissioner, a role which gave him a strong influence over both the Rentenbank and the Reichsbank.

Schacht wrote that pressure from the finance ministry, which needed the Reichsbank to discount a huge amount in Treasury bills in order to fund additional public expenditure, left him with no choice but to print more money for this purpose and provoke a further increase in the dollar exchange rate, which thus rose to 4,200bn on 20 November. Amazingly, as to whether that level was the right one, he declared it 'a mystery'. Schacht also wrote that tensions arose between the Rentenbank, which would have preferred of a further slide by the paper mark, and the Reichsbank, which wanted to stick to the 4,200bn rate. He sided with the Reichsbank's hard line. He later professed to not have been against a further slide, but only once the pre-war parity had already been chosen, rendering a slide impracticable.[27] By then, according to Schacht, the question was purely academic.

The same ambivalence was in evidence when Schacht touched briefly on this issue during a 1926 lecture in Vienna on the stabilization of the mark: '[I]t was also debated whether the old gold mark with the original fine gold contents should be reintroduced, or whether it would be more advisable to choose a smaller gold unit. I confess I was a supporter of the latter measure but it was not possible to put it into practice at that time because the Rentenmark was also theoretically supposed to be equivalent to the original fine gold content. A smaller gold unit would be more useful when it came to the question of the revaluation of the old debt.'[28] This comes across as somewhat surprising: Schacht said the Rentenmark was 'theoretically supposed' to have 'the original gold content'. This apparent obstacle can only have been his own preference since, as currency commissioner, it was he who had masterminded the whole process of transition to a new monetary system. Perhaps, when speaking *ex post facto* in Vienna, he had second thoughts on this issue. In conclusion, on this point we might say that the Allies' 'suggestion' to go back to the old Reichsmark parity found, in Schacht, a good listener.

In a further attempt to consolidate currency stabilization, in March 1924 the Reichsbank and the Rentenbank were joined by another public bank, the Gold Discount Bank (*Golddiskontbank*). Its purpose was to assist German trade and industry in securing the foreign credits they needed. Half its shares were subscribed by the Reichsbank, and the other half by a consortium of German banks[29]. The Gold Discount Bank was the result of contacts between Montagu Norman and Schacht, and British credit assistance was instrumental in its establishment. In 1924, it was expected that the three institutions – the Reichsbank, the Rentenbank and the Gold Discount Bank, each using different currencies to denominate their statements of condition: The paper mark, Rentenmark, and pound sterling respectively – would be reorganized and consolidated into a single institution. But while the Reichsbank and Rentenbank were indeed consolidated in 1924 according to the Dawes Plan (see below), the Gold Discount Bank continued to exist as a separate entity until 1945, even though it soon became a subsidiary of the Reichsbank. It is worth noting that the Gold Discount Bank never issued banknotes.[30]

2 The Reichsbank reorganized: the Dawes Plan

We have already discussed the more conciliatory attitudes taken by both the Stresemann government and the Allied powers, including the Poincaré government. The time appeared ripe to transform the problematic reparations system from what many (especially in Germany) saw as an instrument of French expansionism and power projection into a multilateral international financial undertaking. American influence became hugely significant at this time. On 30 November 1923, a few days after the introduction of the Rentenmark, the Reparation Commission decided to revisit the entire matter of reparations, reasoning that financial stabilization was a prerequisite for Germany to settle its reparations bill. The commission established two new committees of experts, entrusting the First Committee of Experts with the task of proposing a means of balancing the German budget and stabilizing the currency, and the Second Committee of Experts with estimating the extent of German capital flight, with a view to returning capital to Germany. By far, the more important was the First Committee, which was chaired by Charles Dawes, a Chicago banker who co-managed it with Owen Young, chairman of General Electric and RCA-Radio Corporation of America. Both committees reported on 9 April 1924.

The Second Committee – chaired by Reginald McKenna, the Midland Bank chairman and a former British chancellor of the Exchequer – estimated the amount of German capital abroad at between 5.7bn and 7.8bn gold marks at the end of 1923 (about a sixth of the 1923 national output, using 1913 prices). Not surprisingly, the report attributed the rapid capital flight that followed the Armistice to imbalances in the Reich's budget and the government's enormous borrowing needs, and the printing of money by the central bank. Both speculators and cautious investors had contributed to the relocation of assets abroad. However, the committee refrained from raising proposals aimed at punitive repression of the phenomenon and, instead, observed that preventing the flight of capital and encouraging its return could only be achieved by eradicating the underlying causes of the exodus, which meant bringing domestic inflation under control.[31] This opinion reflected the consensus of the time which still prized the free movement of capital, as opposed to the growing preference for exchange controls that would be seen in Germany and elsewhere just a few years later.

In this matter, Schacht was fast to act. In his memoirs, he relates how 'by means of most careful treatment of our [non-bank] customers we began to counteract injustices.... We did not decrease our portfolio but maintained it at the same level. Any money which came back to the Reichsbank from matured bills was used to grant credit to those businesses in special need of it. Since the Reichsbank controlled nearly four hundred undertakings and subsidiaries throughout the country, this policy soon proved its worth. The hoarders ... were obliged to ... hand over their hoarded foreign bills to the Reichsbank in return for Reichsmarks.... Between 7 April and 3 June ... no less a sum than eight hundred million marks in foreign exchange bills returned to the German Reichsbank'.[32]

The matter of stabilization, considered as central by the 'McKenna Committee', leads us to the 'Dawes Plan': the *Report of the First Committee of Experts*, chaired by Charles Dawes (the 'Dawes Committee'). The experts wrote at the beginning of the report that they were primarily concerned with a sole objective: the practical means to recover the German war debt. However, they also noted that any recovery would need to be based on the restoration of the fiscal and economic integrity of the German state (a stance which implicitly criticized the French occupation of the Ruhr). They considered a 'normally' balanced budget and currency stabilization as mutually dependent: Without a balanced budget the inevitable consequence would be inflation and further mark devaluation (which would obstruct any large issue of long-term government securities); and, unless the mark were stabilized, the calculation of expenses and receipts would be so unreliable that it would simply be impossible to achieve a balanced budget.[33]

Turning to the currency problem, the Dawes Committee envisaged a monetary regime based on a gold *exchange* standard system, with a new bank of issue (or a reorganized Reichsbank), and with strong foreign involvement. This arrangement, which would partly rely on a foreign currency reserve kept as a deposit at a foreign institution, was already being adopted by the central banks of several less powerful countries which were also undergoing monetary reorganization at the time. But, in Germany, it would be applied to a country that, its recent defeat notwithstanding, remained one of Europe's Great Powers. So why was a gold exchange standard being considered for Germany? The Dawes Committee believed that any action to stabilize the mark would require a huge loan in foreign currency, but the members were concerned that Germany might soon convert that currency into gold, thus squeezing the world's gold supply and harming gold-standard countries, notably Britain (a much weaker gold hoarder than the United States). This was not an unfounded fear: France was to adopt this policy in 1931, with a massive switch from foreign currency to gold in its official reserve.

According to the Dawes Committee, the reorganized Reichsbank would gradually recall from circulation all the old banknotes, which would be replaced by a single uniform paper currency, protected by a legal reserve of 33.3 per cent and by other liquid assets. This reserve had to be held largely in the form of deposits at foreign banks. Banknotes were to be kept at a stable value in gold and made convertible into foreign currencies, but not immediately redeemable into gold. According to the committee, under current conditions a rush to exchange paper marks for gold for fear of monetary instability would expose Germany to a gold shortage.

It is worth pausing to consider the sheer variety of currencies in circulation in Germany at the time that the Dawes Committee's report was released. This complex picture is evidence of a tendency in the German economy to index transactions in order to maintain their real value amid the turmoil of hyperinflation.[34] Germans had increasingly opted to use more stable currencies (foreign currencies also circulated in the country), not just as a store of value, but also for transaction purposes.[35]

Table 2.2 Currencies circulating in Germany on 31 January 1924, in millions of gold marks

Papermarks		483.70
Notes of four private banks (Bayerische, Würtenbergische, Sächsische, Badische)		0.01
Notgeld		217.00
Instruments of payment in gold or at a fixed value:		
	Rentenmarks	1374.00
	Dollar Treasury bonds	210.00
	Gold loan	486.00
	Treasury bonds	50.00
	Certificates issued by German states	35.00
	Notgeld issued by the railways	131.90
	Notgeld secured by Treasury bonds	110.00
	Rentenpfennigs	158.00
Total		3255.61

Source: *Report of the First Committee of Experts*, p 40.

The Dawes Committee found that in terms of gold marks, circulation, at only just over 3bn gold marks, had actually fallen from the pre-war 6bn.[36]

The new central bank was designed by the committee. In accordance with the common practice of that time, it was to function not only as a bank for other banks or a lender of last resort, but also as a commercial banking institution, dealing with the public on both sides of its balance sheet. It would be independent from the state, and could only make short-term loans to the government of strictly limited amounts. Its capital of 400m gold marks would be subscribed in part from Germany and in part abroad. The president, a German national, would be assisted by a German managing board and a 'general board' of 14 directors, half of them German and half from the United Kingdom, France, Italy, Belgium, the United States, the Netherlands, and Switzerland. One of the foreign directors would take the position of commissioner.

With regard to the Reich's budget, the committee stated a principle of 'commensurate taxation'. The implication was that the burden of taxation on the German people should be no less than for Allied countries. The committee intended to address the insufficient fiscal reform enacted in Germany in the immediate post-war years (see Chapter 1) by ending the 'anomaly of much lower tax rates in Germany than in the victor powers'.[37] Stressing that the budget must be balanced, the committee innovatively determined that the yearly amount to be paid for reparations could not be fixed as an absolute amount, but should be equal to 'the difference between the maximum revenue and minimum expenditure for Germany's own needs'. The committee argued that an absolute amount might fall outside Germany's taxable capacity for any given year, destabilizing the budget and the currency. In other words, the reparation payments were considered not as an independent variable, but as an amount dependent on the trends in budgetary revenues and expenses, and therefore on the economic condition of Germany itself.

Another innovation arose from the First Committee of Experts' proposals regarding the balanced budget. They made a basic distinction between the general budget of the Reich, strictly defined, and the German railways budget. The committee believed that while the general budget could not sustain deficits, the railways, if properly reorganized, had a potential profitability that would permit them to borrow on the market, to a certain extent. To consider running the railways as a separate agency may not sound very controversial today; but in 1924, the railways had always been an integral part of the state sector, whereas the committee intended to re-structure them as a separate, albeit publicly owned, profit-making enterprise. In present-day terms, the German railways can be seen as a vehicle for off-balance-sheet debt, that is, a means of removing debt from official accounts of the state's indebtedness: a sort of 'contingent liability' for the state. Of course, railways were at the time much more central to a country's economy than they are now, and the committee believed them to be full of unexploited economic potential.[38]

Reparations payments were thus to be drawn from:

- The general (ordinary) budget, according to the criteria described above. A commissioner for revenues would be appointed.
- An 11bn-mark issue of railway bonds, and a transport tax. To this end, the railways would be converted into a joint-stock company and reorganized on a more economically efficient basis. The bonds would be guaranteed by a government-backed mortgage, with the company's value estimated at 26bn. A commissioner would be appointed to represent the bondholders.
- 5bn marks in debentures issued by German industry. An organization committee was to indicate which specific firms would issue the bonds, which would be guaranteed by a government-backed mortgage.[39]

A schedule of payments was also provided by the committee. It specified that in the first year (fiscal year 1924–1925), Germany would pay 1bn gold marks (from the foreign loan which will be discussed below, and from interest on railway bonds); in the second year, 1.22bn (from interest on railway and industry bonds, and from the government's budget); in the third year, 1.2bn (from the same sources as in the second year, as well as from the transport tax); in the fourth year, 1.75bn (from the same sources as in the third year); in the fifth year, 2.5bn (from the same sources again).[40] From fiscal year 1929–1930 onwards, it would be possible to increase the annual amount to be repaid depending on an index of prosperity. For this index, the committee abandoned the use of German export figures in favour of a set of statistics representing six areas: railway traffic, population, foreign trade, tobacco consumption, total budgetary revenue and expenditure, and coal consumption. In the absence of official statistics for German GDP, that set of numbers was used to help assess the debt's sustainability. The Dawes Plan anticipated that a further adjustment might be made as a result of changes in the price of gold.[41] The payments were channelled through the Reichsbank.

In a clear sign of the United States's ascendant role in reparations decisions, the Dawes Committee proposed the appointment of an American, Seymour Parker Gilbert, as agent general for reparation payments. Parker Gilbert's role would be to oversee the articulated supervision framework for Germany's finances and reparations payments and to act as an intermediary between the Reparation Commission and the three aforementioned commissioners for revenues, railways and the Reichsbank respectively. Gustave Stresemann, by then foreign minister in the centrist government of Wilhelm Marx, saw the Dawes Plan as the fruit of international understanding and cooperation. But he especially welcomed it because he considered economic cooperation with America as a means of weakening French continental hegemony and thus strengthening Germany's position in Europe.[42]

Arrangements for a foreign loan to the Reich of 800m gold marks formed another substantial part of the Dawes Plan. Such a sum may not seem like much when compared to the huge amount owed for war reparations, but 'despite its modest size, [this capital] played a critical role in cementing German stabilization'.[43] The loan was seen as an essential step in achieving a variety of different goals: establishing the new bank of issue (which in the event meant reorganizing the Reichsbank) and ensuring currency stabilization; preventing the interruption of any deliveries in kind; and generally boosting international confidence in the German economy. The loan would not fund any budget deficit. It would help solve the problem created by Germany's immediate obligations to the Allies. It is to be stressed that from the very beginning, Germany was constantly cautious, if not reluctant, over the assumption of foreign loans. We shall notice this attitude later, in particular with reference to the Young Loan, but it had already emerged in early 1923. The British ambassador in Berlin, Lord D'Aubernon, met Karl Ritter, a German diplomat, who would become the leading negotiator on foreign trade and who observed that if Germany were allowed relief from its war reparations over a certain period, with full authority over its territories, and permitted a period of political rest, then the balancing of its budget and the stabilization of its currency could be carried out without foreign help of any kind.[44]

On 16 August 1924 the representatives of Belgium, the United Kingdom and its Empire, France, Italy, Japan, Portugal, Romania, Yugoslavia and Germany, 'accompanied' by the representative of the still formally absent American government, met in London under the chairmanship of the British prime minister, Ramsay MacDonald, and with the Protocol of London accepted the plan presented by the First Committee, which has been discussed above.[45] 'Behind the scenes, decisive pressure was exerted by representatives of J. P. Morgan and Company whose imprimatur was essential to raise the large loan to Germany upon which the Dawes Plan depended'.[46] The French military evacuated the Ruhr area.

A few days later, the Banking Act of 30 August 1924 created the new Reichsbank in accordance with the Dawes Plan. The different currencies, including the Rentenmark, were withdrawn from circulation, and the new Reichsmark issued. The Reichsbank's legal framework was also brought into line with the Dawes Committee's proposals.

As per those proposals, a gold exchange standard system was put in place. However, the reserve ratio to circulation was set at 40 per cent, and it was specified that the foreign currency component could not exceed 25 per cent of the total reserve. Probably as a result of American influence, the German monetary regime was thus given a system that almost resembled a pure gold standard. In March 1924, before the publication of the *First Committee of Experts' Report*, the United Kingdom had stressed its preference for an exchange standard based on sterling. This was consistent with the resolutions adopted in international monetary discussions at the 1922 Conference of Genoa (see also Chapter 3). The Genoa resolutions reflected a British perspective on international monetary relations, that is, its self-interest, which aimed at restoring sterling's pre-war parity and London as a highly developed financial centre. The United States did not participate: the Genoa meeting was viewed by the isolationist American Congress as a source of foreign entanglement akin to the League of Nations, which the United States had not joined.

'Germany is not rich enough for a [gold] reserve of 40%', Norman had instructed his deputy in Paris, Ernest Harvey. But after the publication of the Dawes Plan, Owen Young, who co-managed the Dawes Committee, had written to Robert Kindersley, its British representative (who promptly informed Norman), that a gold exchange (sterling) standard would be inappropriate for Germany. Cleverly playing the card of an unstable sterling,[47] Young stressed that 'if Germany were placed on a sterling basis, England in returning to an unrestricted gold basis would have to pull not only her own weight, but that of Germany also. It is obvious therefore that if the new German bank is placed on this sterling exchange basis the world must prepare itself to remain on an exchange instability for a prolonged period, the end of which cannot be foreseen, while the adoption of the gold, that is the dollar basis [the dollar being the only major currency then convertible into gold at a fixed rate], would accelerate the return to worldwide stability'.[48]

Given the size and composition of the central bank reserve, the amount of notes in circulation had to be further reduced in order to comply with the new ratio. The minimum discount rate was fixed at 5 per cent, to be reduced only in exceptional circumstances. The Reichsbank could discount Treasury securities only up to 100m Reichsmarks (a limit subsequently increased to 400m).[49]

The 800m-gold mark loan[50] ($190.5m at the re-established exchange rate of 4.2 gold marks to the dollar) was to be converted into a variety of foreign currencies and deposited in several different countries no later than 16 October 1924 (although the loan was actually issued on the 24th[51]). It was issued below par at 92, with a 25-year maturity (thus maturing in 1949) and an interest rate of 7 per cent[52] in the United States, Britain, Belgium, France, Italy, the Netherlands, Sweden, Switzerland and Germany. The loan was secured by the gross revenue of the German government from customs duties, tobacco, beer, sugar and spirits monopolies and other taxes. Various banks (including both banks of issue and commercial institutions) undertook to place the following amounts, or to issue them for public subscription:

J.P. Morgan	$110m
Bank of England	£12m
Société Nationale de Credit à l'Industrie (Belgium)	£1.5m
Various French subscribers	£3m
Two Dutch subscribers	£2.5m
Banca d'Italia	Lire 100m
Stockholm Enskilda Bank	Kr25.2m

A further portion of the loan was issued in Germany, for an amount sufficient to reach the aggregate net sum of 800m gold marks.[53]

As the table above shows, the Dawes Loan was predominantly an American credit to Germany, the American contribution ($110m) comprising around 58 per cent of the total ($190.5m). This factor was greatly to affect Germany's dealings with its creditors when faced with a serious shortage of foreign currency. Significantly, only the American tranche was protected by the gold clause, which stated that principal and interest would be paid in dollar coins of the present standard weight and fineness. This meant that when the dollar was later devalued, Germany could not take advantage of the corresponding revaluation of the Reichsmark.

The loan was oversubscribed. An atmosphere of confidence was restored. It opened the way for a substantial flow of private capital to Germany (mostly American short-term capital). With the return of stability, huge investments were made in Germany, which in the period 1924–1929 amounted to RM32.8bn, of which RM22.4bn was invested in public works.[54] Albrecht Ritschl stresses that the Dawes Plan provided 'transfer protection' to the service of commercial loans,[55] that is, to foreign private creditors. This protection induced 'moral hazard' in both German borrowers and commercial foreign creditors, thus helping to sustain that huge capital inflow: a 'crucial design flaw' of the plan.[56]

The new climate of confidence, the Dawes Plan's transfer protection provisions, and the high level of German interest rates (needed to prop up the Reichsmark's exchange rate) all helped to bring about a large inflow of capital, which was also encouraged by the spread between German and American interest rates. Notwithstanding ominous signs of growing speculation on the American stock market, Benjamin Strong, President of the Federal Reserve Bank of New York, maintained US rates at a relatively low level out of a spirit of international cooperation. For a while, the German economy boomed thanks to this renewed confidence; in the whole period 1924–1928 the NNP registered cumulative real growth of 21.1 per cent, with annual growth reaching a peak of 13.9 per cent in 1927. High interest rates, however, contributed to an uneven performance of the economy. There was also a minor contraction of NNP, at constant prices, in 1926. Yet on the whole, the period 1924–1928 is seen as the Weimar Republic's golden age, evident in statistics and in lifestyle as well (see Table 2.3). 'All over Berlin and even in provincial towns one could see on the streets the display of wealth and the penchant for modern design and consumption.'. The other side of the golden years was 'rationalization': the application of scientific methods of production, for which America was the very model.[57]

As the German economy gradually picked up, this inflow of foreign capital appeared sufficient for Germany to be able to meet its international obligations under the Dawes Plan, both servicing the debt on the Dawes Loan and paying war reparations.[58]

Table 2.3 German NNP for 1924–1932 (in billions of Reichsmarks, 1913 prices)

1924	44.2
1925	46.9
1926	46.6
1927	53.1
1928	53.9
1929	51.7
1930	49.3
1931	43.9
1932	41.8

Sources: 1924, Webb, *Hyperinflation*; 1925–1932, Mitchell, *European Historical Statistics*.

During the period of growth between 1924 and 1928, Germany paid a substantial amount of its reparations under the Dawes Plan, but not the full amount as some authors seem to suggest. However, Schacht was critical of the German government's policy of attracting foreign capital. He saw the reliance on it as a 'tantalising but dangerous game. ... Directly these foreign loans stopped, payment of reparations under the Dawes Plan would also stop automatically ... the political circles of the day persisted in encumbering Germany with foreign loans – that is to say with foreign debts – notwithstanding the Reichsbank's continual warnings'.[59] Specifically, Schacht widely criticized foreign loans to German local governments, which he claimed were particularly unproductive.

At the end of 1926, Schacht wrote to Norman, stressing his unease: '[T]he Reichsbank has between fifty and sixty million pounds' *Devisen* [foreign currency] apart from our gold. This of course facilitates the payments under the Dawes Scheme to such an extent that I am near to consider it to become a real fraud what there is being done [sic], and I think that the time should be rather near when responsible people should think of such a situation, where private foreigners bring their money into Germany and the foreign Governments are taking it out'. The following year, he expressed a similar anxiety: '[O]f course the *Devisen* situation of the Reichsbank was splendid but most of that was borrowed money.' And again, in 1928, he wrote, 'the fact is that Germany is borrowing too much and too hastily[;] ... for more than four years I have fought against this steady borrowing. I have succeeded in few directions, viz., as far as states, communes[,] etc. are concerned, but I have absolutely failed as far as the banks are concerned'.[60]

Deeply concerned by the way in which Germany's payments were being arranged, from early 1926 Schacht had made clear his views on the impossibility of fulfilling the Dawes Plan's obligations. According to him, the agent general for reparation payments, Parker Gilbert, 'realized that Germany's payments of reparations were not genuine, that the country was paying her debt not with honest export surpluses but with borrowed money. It could only be a matter of how long it would take before Germany was no longer in a position to remit foreign currency'.[61]

What exactly, then, was the state of Germany's balance of payments? While it lasted, the policy of fixing the exchange rate and the gold content of the mark at the pre-war level gave investors an impression of stability that helped to attract foreign capital and limit the burden of war reparations; but it did not favour German competitiveness. Between 1924, when the Dawes Plan was adopted, and 1928, the last year of the period of growth, the German trade balance was in deficit every year except for a slight surplus in 1926, a year which saw national output decline and therefore a weak level of imports.[62] The cumulative deficit for the whole period amounted to RM7.8bn. In addition, reparations payments by Germany accounted for 6.1bn. Services and capital income (interest and dividends on investments abroad) were positive for 1.4bn. There was, as a consequence, an outflow of currency on the current account for RM12.5bn (7.8bn + 6.1bn – 1.4bn). While reparations alone might have been a sustainable burden, the imbalance on the current account was considerably larger on account of the uncompetitive prices of German merchandise on the international markets and the needs of the economy during a phase of strong growth. In 1927, the current account deficit peaked at 5.5 per cent of NNP.

The huge inflow of foreign capital, however, substantially made up for the current account deficit: In the same period of 1924–1928, it amounted to a total of RM14.8bn. The Bank for International Settlements (BIS) estimated

Table 2.4 German balance of payments 1924–1928 (in billions of Reichmarks)

	1924	1925	1926	1927	1928
Exports	7.9	9.5	10.7	11.1	12.6
Imports	9.7	12.0	9.9	14.1	13.9
Merchandise balance	–1.8	–2.5	0.8	–3.0	–1.3
Services	0.3	0.5	0.5	0.5	0.5
Interest	0.2	0.0	–0.2	–0.3	–0.6
Reparations	–0.3	–1.0	–1.2	–1.6	–2.0
Current account balance	–1.6	–3.0	–0.1	–4.4	–3.4
Short-term capital movements	1.5	0.3	0.1	1.8	1.4
Long-term capital movements	1.0	1.1	1.4	1.7	1.7
Other capital movements	0.4	1.7	–0.9	0.4	1.2
Capital balance	2.9	3.1	0.6	3.9	4.3
Gold and foreign exchange	1.3	0.1	0.5	–0.5	0.9

Source: BIS *Financial Committee Report*, 1931.

that 6.9bn was comprised of long-term investments, 5.1bn short-term, and a residual 2.8bn registered as 'other movements' (non-bank credit, according to Ellis[63]). The inflow of capital exceeded the outflow on the current account, thus allowing a substantial increase in the Reichsbank's international reserve of both gold and *Devisen*.

The agent general for reparation payments, Seymour Parker Gilbert, only focused on the Reichsbank's growing reserve holdings. He therefore insisted that Germany was able to pay reparations, and that the necessary funds could be transferred from Germany. But even if the balance of payments was in a favourable state, the current account was certainly not. Myopically, he also failed to grasp the flip side of the huge borrowing that had occurred, and the expansion of the official reserve: the deterioration of the net foreign investment position of Germany. This position, according to the Bank for International Settlements, changed from slightly positive in 1924 to negative in the following years, reaching its lowest point of minus RM12.5bn in 1928. That year, on a stock of German assets abroad of RM9bn, the BIS calculated that foreign investments in Germany ('liabilities') were around RM21.5bn (of which RM9bn was in volatile, short-term investments, RM7bn in long-term investments, and RM5.5bn in 'other' investments).[64]

For the German authorities, the high level of foreign indebtedness – particularly on the short-term – was a cause for serious concern. As noted above, the central bank had to maintain a reserve of at least 40 per cent of the amount of money in circulation. This is why, even at a time when Germany was enjoying a substantial increase in the official reserve, Schacht could say that the burden of reparations was unsustainable. He was aware of the precariousness of the situation: a huge outflow of money would have reduced the gold reserve and a contraction of the circulation would have been necessary, leading to deflation and economic recession.

The constraints of gold standard rules were well explained by Ralph Hawtrey, a contemporary economist and theorist of the gold standard: 'If an amount of external indebtedness has to be paid within a short time in excess of the Central Bank's available reserves of gold and foreign exchange, the result will be a suspension of the gold standard', he observed in his *Gold Standard in Theory and Practice* (1931). In 1928, Germany's extremely volatile short-term liabilities were 9bn Reichsmarks, while official gold reserves were 'only' 2.2bn.[65] However, the German response was to stick with an uncompetitive exchange rate, resisting further reparations payments. 'There is almost an ineradicable popular belief that public policy requires a high exchange', Hawtrey wrote. 'Like all popular beliefs this has some foundation. [It] is a sign of increased exporting power or economic strength. ... People may legitimately say, "See how we have reduced our handicap". But that does not mean that it is desirable for the player to assume a reduced handicap when his skill does not deserve it. ... [In Germany] gold parity is imposing palpably too severe a handicap'.[66]

3 The Young Plan

The relatively buoyant state of the German economy changed in 1928, when monetary policy was tightened in France and the United States. France had stabilized its currency in 1926–1928 at a very competitive level. This permitted its current account to improve, and a capital inflow followed.

In August 1928 the US Federal Reserve changed course, abandoning its accommodative stance and raising the official interest rate to curb stock market speculation. After the premature death of the Fed's Benjamin Strong, monetary policy took an even tighter turn under his successor as president of the Federal Reserve Bank of New York, George Harrison. The direction of capital flows switched, with the United States attracting a large portion. Interest rates in Germany had to be gradually raised from 5.2 per cent in 1926 to 7.5 per cent in 1929,[67] when NNP saw a severe contraction of 4.1 per cent.

The increasing bill for reparations, as envisaged by the Dawes Plan (between 1928 and 1929 it would jump from RM2bn to 2.5bn), forced Germany to continue seeking foreign capital. However, the inflow of capital shrank, particularly short-term capital, and in 1930 it became a net outflow. Containing the onset of the Great Depression would mean lowering interest rates, but the need to rekindle capital inflows and to service foreign debt made it necessary to stick to a restrictive fiscal and monetary policy. It does not seem that the alternative of a depreciation in the exchange rate was ever considered. What was, instead, once again considered was the possibility of alleviating the burden of reparations and obtaining additional funds from abroad. Falling output made reparations payments harder for Germany to bear. In 1929, the reparations bill alone (that is, not counting other items on the balance of payments), amounted to 3.1 per cent of NNP.

Schacht continued to protest. We have mentioned his letters to Norman and his complaints to Parker Gilbert. He continued to put pressure on the latter to alleviate the reparations burden, proposing lesser payments. Already in 1928, Schacht had suggested the sum of 1bn Reichsmarks per year to Parker Gilbert as the maximum amount Germany could pay for reparations. Then, in 1929, he cited RM800m as a plausible amount to J.P. Morgan and, later, a maximum of 1.2bn, asking in return for a free continental trade regime and for the return of the Polish corridor and of some colonies to Germany, in order to increase the 'domestic' provision of raw materials and foodstuffs,[68] something of an obsession for the Reichsbank president and, later, for the Nazi government. All the amounts Schacht advocated were well below the sum actually due. Parker Gilbert was unmoved by his concerns.

Germany's opposition to reparations payments, set against the backdrop of a dwindling investment position, triggered a revision of the debt situation: '[T]he last opportunity for cooperation rested on the converging interests in revising the Dawes Plan.'[69] The Allies were not prepared, however, to make significant concessions.[70]

The Young Plan, prepared in 1929 and formally approved on 30 January 1930,[71] superseded the Dawes Plan. It reduced Germany's total reparations liability to 110bn Reichsmarks, plus RM5.2bn-worth of deliveries in kind, around 160 per cent of nominal German NNP for that year. It should be noted that in comparison to what Germany had already paid, the reduction of the total reparations bill from RM132bn was relatively minor. The full amount was to be paid over 59 years. As we have noted above, however, the stock of debt was perhaps less important than the outflow of annual payments. The annuity to be paid by Germany was set at RM2,050m, a figure below that envisaged in the Dawes Plan, but above what Schacht saw as sustainable. The annuity was in fact divided into an unconditional part worth RM660m and a conditional part which was made dependent on the state of the German economy. It is therefore difficult to assess their burden. If paid in full, the annuity of RM2,050m would have amounted to 2.9 per cent of 1930 NNP (in fact, the sum paid for reparations in 1930 was just RM1.7bn; it was still less in 1931 when RM0.9bn were paid in the first half of the year and nothing in the second half[72]). But German national output was declining, as it would continue to do in the following years.

According to the Young Plan, the annuities would be guaranteed by the general revenues of the Reich and would be unchanged until 1966; smaller annuities would cover the period 1966–1988. Importantly, responsibility for the collection and distribution of reparations was transferred from the agent general of the Reparation Commission, Parker Gilbert, to the newly created Bank for International Settlements in Basel. The seven countries participating in Young's Committee of Experts intended that the establishment of this bank, scheduled for 1930, would bring about a de-politicization of war reparations: the 'commercialization' of war debt that Germany had long awaited, in which 'policy would cede the ground to commercial interests and to the skilful handling of dispassionate central bankers'.[73] In Germany, hostility to the Young Plan became acute, as expressed in a plebiscite in December 1929 in which Hitler gained visibility and right-wing financing.[74]

In March 1930, with discussions surrounding the creation of the new Bank for International Settlements ongoing,[75] Schacht resigned from the Reichsbank after a longstanding confrontation with his government (as we have seen, he had lambasted the profligacy of German municipalities). But his resignation was mostly out of dissatisfaction with the Young Plan, which his government had supported and he himself had signed.[76] In fact, Schacht saw the restitution of Germany's former colonies for the provision of raw material and foodstuffs (a request that, as we have seen, he had made before) and the restoration of free trade as preconditions for a successful loan and for Germany's compliance with foreign-debt obligations. According to press reports, he also wanted Britain to relinquish sequestered German property and France to renounce military and political sanctions. He thought that these conditions had not, in effect, been met.[77] His decision was not unrelated to the rise of the National Socialists: He hoped they would bring additional strength to his campaign to use the convoluted revision process to change previously settled questions.[78] As the press observed, however, Schacht was left 'stranded high and dry' by his own compatriots.[79] While still Reichsbank president he did refuse to allow the Reichsbank to participate in the new Bank for International Settlements, but the German delegation rejected his intervention and instead offered to replace the Reichsbank with a group of German banks. In the end, the Reichsbank decided to join the new BIS and, as mentioned, Schacht resigned in March 1930.

As in the Dawes Plan, a significant part of the Young Plan involved granting a new loan in order to help Germany better bear the burden of reparations. The Young Loan was granted for a net amount of $300m (RM1.26bn), at 5.5 per cent and with a 35-year maturity (thus set to mature in 1965). Following the formal establishment of the BIS in Basel, the loan was made in June 1930. Bonds were issued at 90, well below par, with coupons maturing on 1 June and 1 December. The loans was issued in Reichsmarks, dollars, belgas,[80] French francs, British pounds, Dutch florins, Italian lire, Swedish crowns and Swiss francs. According to the loan's omnibus contract (dated 10 June 1930), the tranches, in the equivalent U.S. dollar amounts, were divided as follows: Italy 5m; Belgium 4m; Germany 7.5m; France 84.5m; Britain 50m; the Netherlands 25m; Sweden 25m; Switzerland 15m; and the US 84.5m. The loan came with a 'gold clause' requiring Germany to pay in gold or gold-linked currencies, whereas only the American tranche of the Dawes Loan had been protected in this way.[81] But unlike the Dawes Plan, the Young Plan did not provide transfer protection for foreign commercial creditors, a measure which had strongly favoured the flow of capital into Germany.

Two thirds of the loan ($200m) went back to the creditor nations as reparations payment. This payment was distributed as follows: 6.5 per cent to Italy, 66.1 per cent to France, 25 per cent to Britain, and the rest to Japan, Yugoslavia and Portugal.[82] As a matter of fact, the sums received by those countries were smaller because the money earmarked for them was partly used to settle inter-Allied debt, primarily that owed to the United States. The other third of the loan ($100m) was invested in Germany to increase its foreign exchange holdings, and was officially allocated to the German railways and post office.

German Finance Minister Paul Moldenhauer declared in June that Germany would honour its reparations debt, and in 1930 and 1931 the total of 2.6bn Reichsmarks (as mentioned above) was paid as reparations.[83] But it soon became clear that even the Young Plan was a failure. It was hoped that the success of the new Bank for International Settlements in de-politicizing the reparations mechanism would create a more cooperative environment. Far from it: From the very beginning revisionist German leaders favoured a renegotiation, if not a repudiation, of the Young Plan.[84]

The sharp economic contraction that deeply affected all the advanced economies did not spare Germany, where it began in 1929 and continued until 1932, when it reached its most severe point with a cumulative reduction in real NNP of around 23 per cent. In that year the unemployment rate in German industry reached the unprecedented level of 43.8 per cent.[85] This contraction made the financial burden on Germany much heavier.

3
Golden Fetters Revisited

1 The gold standard: a few basic principles

The following sections deal with one of the most explored topics in the study of economic history: the shortage of gold, and the international struggle for it, which in the interwar period led cooperation between countries to become weaker and increasingly bilateral, as domestic concerns were prioritized. One relevant question is whether a close examination of these developments might lead us to challenge the widely accepted notion that national sovereignty and international cooperation are complementary. In the debate on the gold standard, our particular focus will be on how the 'arithmetic' of the standard worked in the turbulent years that followed the First World War.

It is therefore useful to recapitulate some of the main features of the gold standard.[1] Even though the quantity theory of money – linking the quantity of money, however intended, to the price level – has been formalized in the 20th century (by Irving Fisher, Milton Friedman and others), the gold standard was implicitly based on such an assumption, and its central purpose was to put a limit to the creation of money in order to stabilize prices.

In the classical form of the gold standard regime, the state defines its monetary unit in terms of gold, and exchange rates are derived from the respective gold content of each currency; gold coinage is free; gold can be freely exported and imported, and this feature makes the gold standard an international system. If demand and supply of a national currency do not balance, cross-border gold flows are activated. These flows would only actually occur when the price of a national currency deviates by a certain percentage above or below its parity (around 1 or 2 per cent, the 'gold points', which represent the cost of insuring and shipping gold, and might make its physical transfer inconvenient if the exchange rate remains within that narrow range: their percentage may vary according to the changing costs of freight and insurance).

In terms of a currency's convertibility into gold at a fixed rate, it is important to distinguish between a full convertibility, and one that is limited to external transactions. In the first case, gold can be stored by agents in the economy's private sector (households, businesses, financial institutions) and traded within that sector and with the public sector (the central bank, if that is the authority in charge of the gold reserve). In the second case, it is illegal for the private sector to store gold or use it for monetary transactions, while the authority holding gold can export and import it unless exchange controls limit that freedom.

Ralph Hawtrey distinguishes three possible forms that the gold standard can take: the gold *specie* standard, based on the free coinage of gold and its use in the form of coins as a medium of exchange (the purest form of the standard); the gold *bullion* standard, under which the central bank is committed to buy and sell gold on demand at a fixed rate, but in bullion only; and the gold *exchange* standard, based on the convertibility of the national currency into a foreign currency at a fixed rate, the foreign (or "hard") currency being kept at a parity with, and convertible into, gold.[2]

When the supply of gold cannot keep up with demand (for monetary and non-monetary uses), there is an incentive to 'economize' gold: to limit the size of the gold reserve by using 'paper money' substitutes. Indeed, in any advanced monetary system the central bank can create money through its advances and discounts to the banking system.

However, under the gold standard regime this money creation will be strongly contained. The central bank must be ready to comply with public requests to convert paper money into gold (in systems where domestic convertibility is allowed, at least), even though in practice such requests might be legally curbed by minimum requirements concerning the threshold of conversion. Therefore, in a 'fractional reserve gold standard', the money supply is dependent on the amount of available gold in the central bank's reserve. External and domestic convertibility are of course mutually dependent, because if an external imbalance causes a gold outflow, then domestic money supply must shrink in order to preserve the right of holders of banknotes to exchange them for gold. In other words, only if internal convertibility is guaranteed can inflation and the expansion of the money supply be properly contained. Price stability keeps the economy competitive enough to allow external convertibility. Vice versa, maintaining only external convertibility exposes the economy to the risk of unchecked growth in money supply and credit, which will ultimately also threaten external convertibility.

When, in the interwar period, a severe shortage of gold emerged to threaten international trade, it was thought that the legal requirement of maintaining a minimum gold cover for the money supply was keeping a large amount of international reserves from being freely used as a means of settlement in international transactions. Limiting or abolishing domestic convertibility was a device to which several countries resorted under stress, although they kept the external convertibility of their currency into either gold or a reserve currency. It should not, however, be forgotten that the gold standard was founded on the use of gold internal convertibility as an instrument to control the domestic money supply and keep credit expansion in check. The gold standard's supporters believed that the demise of domestic convertibility would be followed by excessive credit expansion and financial instability. This is why many countries were reluctant to abandon gold as the backing of their domestic money supply and to start using it only in international transactions.[3]

With the gold standard model, banks use this newly created money, which is held at the central bank ('bank balances at the central bank'[4]), to extend credit. A portion of the new money, rather than staying with banks, goes into circulation as banknotes or coins. 'Bank balances' and 'circulation' constitute 'base money' (the 'monetary base'), so called because its increase can result, through bank lending, in a much larger increase in bank deposits, and thus in the country's money supply. In its narrowest definition, 'money supply' is the amount in circulation and bank deposits. The increase in bank deposits is, in turn, not unlimited: Bank credit extension and deposit creation, are limited by the necessity for a bank to be ready to redeem deposits; hence, the need for some sort of reserve requirement that banks have to follow, which is set according to custom, prudence or regulation. This is what is called a 'fractional reserve banking system'.

Together, these two 'fractional systems' (fractional reserve gold standard and fractional reserve banking) portray a sort of inverted pyramid, with three layers: gold at the base, banknotes at an intermediate level, and bank deposits at the top. These three are so closely interrelated that separating banking debt and money seems, in Hawtrey's words, 'as transcendental as to separate the grin from the Cheshire Cat'.[5] Both fractional systems respond to the same question. To quote Bagehot: 'Why should a bank [either a central bank or a commercial bank] keep any reserve? Because it may be called on to pay certain liabilities at once and in a moment'.[6]

How is the system supposed to work at an international level? As we have seen earlier, an imbalance in the supply and demand of a national currency activates a gold flow (if it exceeds the limits set by the 'gold points'). A contraction in the gold reserve caused by, for example, a trade imbalance, obliges the central bank to reduce the domestic money supply in order to keep the gold convertibility of its currency. Note that a fractional reserve gold standard, where money supply is a multiple of the gold reserve, multiplies the effect of a given gold outflow on the quantity of money. Thus, the decline in the money supply is much higher than a decline in the gold reserve, with a correspondingly significant effect on domestic spending and price levels.[7]

The contraction of money supply and the fall in prices that follow a gold outflow (which may be particularly severe, unless successfully counteracted by interest rate movements: see below on this point) serve to equalize price movements across countries and restore equilibrium in the international monetary system. The deficit country is exposed to all the consequences of a severe contraction in the quantity of money: lower output, rising unemployment and recession. Such effects tended to be neglected by supporters of the gold standard, who saw them as a pre-requisite for restoring a country's competitiveness and rebalancing foreign trade; but they became increasingly relevant to policymakers in the interwar period, a time of growing political awareness, worsening social tensions and more influential trade unions.

The gold outflow can be reduced, or indeed entirely avoided, by changing the level of interest rates. In this regard, a pivotal role was held by the Bank of England. Its classical policy instrument was, in fact, the manoeuvre of its official discount rate. Short-term capital inflows can be stimulated by raising the interest rate. Long-term capital inflows enable borrowing resources and may rebalance a persistent trade deficit without entailing gold outflows. The specific role played by the Bank of England should be stressed. 'If sterling weakened, funds would flow to Britain in anticipation of the capital gain that would arise once the Bank of England intervened by strengthening the rate. Because the central bank's commitment to the existing parity was beyond question'.[8] The credibility of the system, and the consequent international cooperation in maintaining the gold standard, derived from the ready availability of gold at the Bank of England. If the United Kingdom had a payment deficit, the creditor would deposit his pounds in London, rather than asking for gold. 'Britain had built an enormous financial edifice on very thin foundations, represented by the gold reserve of the Bank of England .... The gigantic flow of foreign portfolio investments by Britain ... was made possible by enacting the unwritten but universally accepted rule, according to which those who received capitals from Britain would keep them deposited in London ... British gold losses were therefore minimized, and the Bank of England was not compelled to adopt a suffocating policy of deflation, which would have destroyed the confidence of savers and the British consensus to continue capital exports. [British reserves were] insignificant in comparison to the volume of transactions in sterling.'[9] This is, to some extent, only one side of the story, because Britain rested on a solid foreign investment position, enjoying a surplus on its balance sheet of overseas investments against foreign debt.[10] The notable trade deficit was more than made up for by service exports and, above all, by interest, profits and dividends from the private sector's investments abroad.[11]

However, raising the interest rate could not provide a lasting solution in cases where payment deficits were structural and potentially permanent; this was particularly true for many peripheral countries which could not afford such a policy. Continuous borrowing would have raised the level of foreign indebtedness until it exceeded the borrower's capacity to repay capital and interest, making the debt unsustainable. Therefore, a deflationary bias was constantly present and, in the end, domestic conditions had to be altered: the interest rate increase raised the cost and reduced the availability of credit; investment fell, unemployment followed, and the slowdown in aggregate demand exerted a downward pressure on prices, finally restoring the equilibrium of the balance of payments.[12]

The gold standard is thus potentially stable as a monetary system, but exposes economies that adopt it to instability in output, wages and employment. Unless a steady relation between prices and wages is maintained, an 'internal devaluation' in terms of prices and wages is the substitute for 'external devaluation', that is, a fall in the exchange rate.

Here we touch upon a very controversial issue, which is remarkably important to the interpretation of monetary policies in the interwar period: the question of what would happen in the opposite situation, when a country experiences a gold inflow due to a substantial trade surplus.

Anna Schwartz, in accordance of the standard view of what is generally labelled as 'monetarism', thinks that the gold standard '*rule*' implies that domestic monetary supply 'must' rise and fall in line with the rise and fall of gold reserves – 'a form of pre-commitment by monetary authorities'[13] of the country that decides to adhere to the gold standard. A surplus country (one accumulating gold) should therefore expand its money supply, keeping a stable relation between it and the increased gold stock.

This means that 'when additional gold enters the monetary system from whatever source, it tends to raise money prices. Offsetting the potential price-level increase are the nominal increases in goods, services, and capital that normally occur. Successive approximation of goods production and money production through the market system generate an ongoing monetary equilibrium'.[14]

'A true gold standard provides an economy with a *"set of rules"*... Human design... must refrain from meddling with the ultimate product – the quantities of both base and common money.'[15] In this framework, any monetary and output contraction in a deficit country (that is, a country experiencing a deficit in its foreign payments) must in a timely way be absorbed by an opposite behaviour in the surplus country. 'The gold standard's rules of the game... prescribed that changes in a country's gold reserve should be accompanied by multiple or at least parallel changes in the domestic credit supply [but] the practice of neutralizing the effect of gold movements on the domestic credit base became increasingly common'.[16]

A different view, recently reiterated by Eichengreen and Temin, stresses that 'as a result of this [gold standard] *ideology* [italics added], monetary and fiscal authorities implemented contractionary policies [in the late 1920s] when hindsight shows clearly that expansionary policies were needed. No analogous pressure to adopt expansionary policies was felt by the authorities with the *freedom* to do so'[17] (italics added). The gold standard could not operate properly if the surplus country adopted measures of 'sterilization' of gold inflows, that is, if the inflow were not reflected in an increase in the money supply.

Eichengreen and Temin talk of an 'asymmetry' embedded in the gold standard, which made its sustainability impossible. On the one hand, the adjustment mechanism for deficit countries was deflation rather than devaluation, while on the other no penalty existed for accumulating balance of payment surpluses and gold reserves, and no expansionary monetary policy was required of surplus countries, particularly in 'the absence of an international coordinating organization'.[18]

To some extent, this debate is merely one of semantics. Schwartz's and Eichengreen's views both imply that the correct response for a surplus country requires the adoption of an expansionary policy. From the monetarist perspective this is the clear, if unwritten, 'rule' of the gold standard. Opponents of this stance maintain that the gold standard is an ideology, or a *mentalitè,* characterized by a deflationary bias, which was shared by deficit and surplus economies alike. This ideology leads to a 'managed' (or rather, mismanaged) system, in which no automatic stabilizer can effectively work. However, in hinting at the lack of an 'international coordinating organization', Eichengreen seems to imply that if such an organization had existed and fixed the 'rules', then the gold standard might theoretically have survived (although the same author would probably counter that this 'if' is only counterfactual history, that the prevailing *mentalitè* would have hindered or prevented any international coordination and the defining of symmetry rules to encourage balance, as in fact it did). In reference to the policies of the interwar period, it has been observed that 'if the measure of a hegemon is to ensure that nations cooperate in their economic policies, the United States [the hegemonic country, with an ample creditor position in that period] failed miserably'.[19]

The gold standard was further undermined by the very adoption of the specific form of the gold *exchange* standard – a form that, in the intention of its promoters, aimed at maintaining the standard in operation in a situation of gold shortage, in order to avert recession. As mentioned earlier, the gold exchange standard linked many national currencies only indirectly to gold, by permitting the accumulation of international reserves in the form of 'hard' foreign currencies, which themselves were linked to gold. Countries like Germany, which had returned to gold after the First World War thanks to huge foreign loans from reserve currency centres (the United States and United Kingdom), were ambivalent about this particular form of standard. On the one hand they knew that without these loans and an increase in their currency reserves, any return to the standard would have been impossible to achieve; on the other hand, they looked with suspicion at this arrangement, seen as an instrument of exploitation by the Anglo-American reserve centres. This feeling was strong in countries, like Italy, where the political regime viewed the 'plutocracies' of the West critically.[20]

When the gold exchange standard's main reserve currency, the pound sterling, abandoned the gold standard in 1931, central banks that had a portion of their reserves invested in pounds, understandably liquidated their foreign exchange holdings and scrambled to replace them with gold. Further deterioration followed when the same step of devaluation was formally taken by the United States in 1933–1934. 'The gold exchange standard collapsed back into a pure gold standard',[21] and a shortage of international means of payment suddenly arose. The country on which such gold exchange constituted a claim might well consider it necessary to maintain a larger gold reserve in order to meet possible demands resulting from the conversion of these claims into gold'. In this sense, the gold exchange standard truly had a restrictive bias.

Neither a coordinated increase in the gold price (taking into account the different inflation rates and economic performances of the various countries), nor a reduction in interest rates which might have redistributed gold towards deficit countries, were adopted. The 1933 World Economic Conference in London, aimed at restoring orderly conditions in the international monetary system, 'went nowhere'.[22] 'There were no proposals for an all-round alteration in the price of gold to regulate the supply of international currency.'[23]

In conclusion, asymmetric obligations and rigid exchange rates (changes in the gold content of currencies) were important causes of the gold standard's demise. Perhaps, as Schwartz suggests, the standard could have survived if obligations had been symmetrical, or if (as Eichengreen and Temin seem to imply) coordinated gold price changes had been made?

2 Institutional factors

Let us now consider some of the gold standard's legal features in different countries, and we shall notice that this monetary standard is not incompatible either with changes in the terms of trade of gold against commodities (that is, in the gold price), or with varying levels of gold backing for the monetary base (or circulation).

We shall begin by looking at the gold content of the currencies of the principal belligerents in the early 20th century, just before the First World War (we shall omit Russia, whose relation to the Western powers changed utterly with the 1917 revolution, and Turkey, for which statistics related to the working of the gold standard are not available).

US dollar (US$)	=1,504.656 milligrams of fine gold (1 troy ounce=20.67 US$)
Reichsmark (RM)	=358.423 " "
British pound (GBP)	=7.322382 grams of fine gold
Italian lira (ITL)	=290.322 milligrams of fine gold
French franc (FF)	= same as the Italian lira[24]

Note: Italy and France were both members of the Latin Monetary Union, established in 1865.

As a consequence of these gold contents per monetary unit, Reichsmark parity exchange rates were, for example, 4.2 per US$, 20.4 per GBP, and 1.23 ITL or FF per RM.

As mentioned above, the quantity of money was institutionally linked to the gold reserve. Statutes did not refer to total money supply (monetary base plus bank deposits), even though this was the most relevant aggregate for evaluating movements in the price level. Legislation instead referred to banknotes (circulation), the most immediate means of payment convertible into gold, and sometimes to bank deposits at the central bank ('bank balances'). The 'monetary base' can in fact give a reliable idea of potential money creation. Legislation might determine different percentages of cover, for banknotes and bank balances.In the United States, for example, legislation determined a gold cover of 40 per cent of Federal Reserve banknotes in public circulation, and of 35 per cent (not necessarily in gold) of 'bank balances', that is bank deposits held with the Federal Reserve.[25] In Germany, a gold cover of at least 30 per cent was established for circulation, while sight liabilities at the central bank had to be covered by non-gold assets.

The particular emphasis on circulation was probably due to the importance (especially in less financially developed economies) of banknote circulation relative to deposits and, perhaps, to the idea that a fractional reserve banking system could not expand the money supply beyond a certain limit, whether through changes in the reserve requirements or by other means. For instance, as we shall see, the 'real bills only doctrine' (to the extent that it was effectively followed) was an instrument of credit containment in the United States.

Although there was no specific theoretical ratio for the minimum reserve that a central bank must hold, what Walter Bagehot called a 'minimum apprehension reserve'[26] might be empirically fixed on the basis of experience. As the table below shows, 40 per cent, or somewhat below, was the most commonly adopted proportion for gold cover: this meant that circulation (and bank balances) could not exceed a multiple of 2.5 (or somewhat above) of the international reserve.[27] It is, perhaps, correct to say that numbers like this represented the true essence of the 'golden fetters'.

Sometimes, as in the case of the Italian legislation, a fixed, absolute amount of banknotes was legally permitted, and any amount in excess of that limit must be backed solely by gold. Sometimes, a tax on circulation was used to restrain its expansion.

The difficulty of maintaining the legally determined monetary base and gold ratios, particularly in times of war, prompted countries to limit their adherence to the gold standard, or simply to abandon it altogether while keeping open the option of re-entry when conditions permitted. In the latter case, the question was whether to re-join the standard at the old gold content, mostly for reasons of prestige or 'muscle-flexing', but also to counteract inflationary pressures coming from a devaluation, or at a smaller gold

Table 3.1 National statutes on gold 1930

Country	Liabilities to be covered	by gold or foreign exchange (forex)	by gold	by forex	by other means	Convertibility
Italy	notes and sight liabilities at the central bank	40%				gold bars (min. 5 Kg) or forex
France	notes and current accounts at the central bank		35%			gold coins or bullion (min.215,000 FF)
Germany	notes	40%	min. 30%	max.10%		gold coins or bars (min 1,000-max35,000 RM)or cheques in forex on a central bank
	other sight liabilities at the central bank				40%	sight deposits, cheques, bills of exchange
Great Britain	notes		100%			bars of 400 ounces troy
	fiduciary notes, up to 260 m GBP				100%	Government debt, other securities
United States*	public sector liabilities					
	gold certificates (Treasury)		100%			gold coins
	silver certificates (Treasury)				100%	silver dollars
	US notes (Treasury)		not less than 150m			gold coins and bullion
	National bank-notes (nat. banks-Treasury)				100% bonds; 5% in legal tender money	legal tender money (gold coins, gold certificates, US notes)
	Federal Reserve notes		40%			gold (or legal tender money within narrow limits)

Note: *In the US, in 1929 most of circulation consisted of Federal Reserve notes (46%), gold certificates (22%), National bank-notes (15%)
Source: Elaboration from League of Nations: *Legislation on Gold*, 1930, pp 54, 55–57, 64–65, 86–89.

content in order to take account of domestic rates of inflation or possibly gain a competitive edge with a devalued currency.

In the long history of the gold standard, for instance, Italy suspended convertibility in 1866 then restored it in 1883. Significantly, except in the United States, the First World War brought about generalized restrictions on convertibility, or suspensions of the gold standard (whether *de jure* or *de facto*). Many of these suspensions were due to losses of gold, but still more were caused by explosions in the money supply. The result was inflation and an increasing 'discount' of the currency's market rate *vis-à-vis* its gold content.

In the period following the First World War, the currency parities mentioned above were adjusted, evidence that the gold standard was not incompatible with their revision. The problem was that these adjustments were insufficient to keep the standard smoothly operational, and were inconsistent in light of the various disequilibria that had arisen.

After 1936, as we shall see, the gold standard was effectively dead. Just before the outbreak of the Second World War, the paradox was that the only country formally on a gold standard base, and the only country with an unchanged gold parity, was Germany, with a gold reserve of just $28m in 1938 compared to $498m in 1914[28]. Meanwhile, the United States, with the largest gold reserve at $14,512m (albeit at the 'new' content of 35 dollars per ounce) compared to $1,526m in 1914, had taken the historical course of dollar devaluation in 1933–1934.

3 The gold standard leverage

To evaluate the soundness of the gold standard in different countries, and whether the policies of these countries were coherent with it, we can compare a country's central bank liabilities (of which banknotes in circulation and 'bank balances' constitute the most relevant components) to its gold reserve (and foreign exchange reserve, in cases where the gold standard was adopted in its more 'light' form, the gold *exchange* standard).[29] For the ratio of central bank liabilities to the gold reserve, the term 'gold standard leverage ratio' (GSLR) will be used. If C denotes circulation, bb the bank balances at the central bank, g the gold in reserve, and fx the foreign currency in reserve, the GSLR is expressed as:

$$\frac{C + bb}{g + fx}$$

The higher the leverage, the greater the risk to the currency's convertibility into gold. In this regard, it is interesting to consider the greatest discrepancies of these two ratios across different countries and periods. It is important to observe that, in our calculations, the GSLR is not dependent on the varying, specific (and changeable) legislations. It is an indicator by

Table 3.2 Gold standard leverage ratio 1914–1919

		1914						1919					
		USA US$m	**UK GBPm**	**Fra FF m (1915)**	**Ita ITL m**	**Ger RMm**	**Aus equiv US$m**	**USA US$m**	**UK GBPm**	**Fra FF m**	**Ita ITL m**	**Ger RM m**	**Aus equiv US$m**
A	Gold	1526.0*	69.0	5,015.0	924.2	2,093.0	309.8	2707.0*	90.3	3,600.0	790.5	1,089.0	64.2
B	Foreign Exchange			1,410.0	142.9	1,198.0				3,546.0	148.1	493.0	
C	Bank Balances	264.7	128.1	2,183.0	302.2	612.0**	59.0	1,635.7	180.6	3,265.0	599.2	13,368.0	1,675.7
D	Circulation	3,400.0	69.5	7,325.0	3,593.0	5,862.0	431.5	4,900.0	440.0	34,744.0	18,814.0	50,065.0	10,210.1
E	**GSLR (C+D)/(A+B)**	**2.40**	**2.86**	**1.48**	**2.84**	**1.97**	**1.58**	**2.41**	**6.87**	**5.32**	**20.68**	**40.10**	**185.14**

Notes: * Incl. gold in circulation; ** value is from 1913.

Sources: United States Gold and bank balances: Federal Reserve: *Banking and Monetary Statistics 1914–1941*, 1943; circulation Carter, Susan (ed.): *Historical Statistics of the United States-HSUS*, Cambridge University Press, 2006, vol. 3, tab 3–614.France and United Kingdom Gold, foreign exchange, and bank balances: Federal Reserve: *Banking and Monetary Statistics,* tabs 164 and 165; circulation: Mitchell, *European Historical Statistics,* Macmillan, 1981.Italy Gold, foreign exchange, and bank balances: Banca d'Italia: *I bilanci degli istituti di emissione 1894–1990*, Laterza, 1993, pp 302–309.Circulation: Mitchell. Italy had, until 1926, two additional banks of issue, Banco di Napoli and Banco di Sicilia; but their role was not relevant to this context.Germany Gold, foreign exchange, and bank balances: Deutsche Bundesbank: *Deutsches Geld- und Bankwesen in Zahlen 1876–1975*, tab C1–1.01; circulation: Mitchell. Austria-Hungary. *Federal Reserve Bulletin*, December 1919 (statistics in US$).

which we may make, across countries, a comparison of the working of the gold (exchange) standard and the relative riskiness of convertibility.

Here (Table 3.2), we compare those ratios in the United States, United Kingdom, France, Italy, Germany and Austria-Hungary (the main belligerents) immediately before and after the First World War (the years 1914 and 1919).

A number of observations can be made: The ratios appear to be quite comfortable before the First World War, with excess, or free, gold reserves in almost every country except, notably, Britain and Italy. It should, however, be pointed out that Britain's circulation perfectly balanced its gold reserve. What expanded the GSLR were the bank balances at the Bank of England. The war generally brought about a strong deterioration in the ratios, but the effect was markedly uneven for the six countries considered here. The ratios were influenced by huge gold flows between countries and by varying increases in the monetary base. In fact, the United States and United Kingdom registered remarkable growth in their gold holdings (+77.4 per cent and +30.9 per cent, respectively). Meanwhile, Italy enjoyed relative stability (–1.1 per cent), and France saw a decline (–28.2 per cent), while collapses occurred in the defeated countries, Germany (–48 per cent) and Austria-Hungary (–79.3 per cent). In 1919, the U.S. stock of gold amounted to more than half of the central banks' gold reserves of the main belligerent countries. The United States was the only country whose ratios were virtually unaffected by the war – an indication of the gold accumulation mentioned above and of a relatively low expansion in money aggregates.

For France and Italy, in particular, the 1919 GSLR appears better than it could have been because the availability of foreign credit during the war permitted an accumulation of 'strong' currencies in their reserves. Britain can be placed in the same group as France, with a steady, but less pronounced, deterioration in its ratio, while Italy suffered from a huge expansion of circulation.

The expansion of the monetary base raised the GSLR of defeated powers to extremely high levels. Particularly dramatic was the situation of Austria-Hungary, a state in the process of dissolution, where the 1919 GSLR (referred to Austria) of 185.14, is a clear indication of a collapsing monetary system. Meanwhile, in Germany the enormous expansion of base money, leading to hyperinflation, had yet fully to appear in 1919.

4 Methods of de-levering in the post-war period

How could such a currency debasement have occurred? The answer is mainly to be found in war expenses and in the way they were financed. The burden of war expenditure on national income was of course heavy, but varied among the belligerents. The percentage of war expenditure to GDP in Germany, not particularly high, has even led some to suppose that 'given the bad news from the front, extreme economic mobilization was not easy to sell to the Germans'. This might partly explain why, while Britain devoted 50–60 per cent of its output to war financing, for the Reich it only made up about 40 per cent (with the exception of 1917).[30] To take another case, the United States entered the war in 1917 and reached its highest level of war expenditure the following year at between 17 per cent and 23 per cent of national output (according to different estimates). As Rockoff puts it, '[O]verall, the impression that emerges is that the war was well within the capacity of the American economy.'[31]

The huge war effort could be sustained in three different ways, not necessarily alternative: by increasing taxation, by long-term public borrowing (the 'war loans') and by printing money. This book is not the place to dwell on the choice of each country. However, 'it is fatally easy to create money out of nothing', as Hawtrey commented. He adds that 'France and Germany imposed no additional taxation worth mentioning till the war was half over .... Some Finance Ministers found it so surprisingly easy to raise money by the issue of short term securities like Treasury bills, that they actually seem to have preferred this to other methods.'[32] The recourse to this third way (printing money) was widespread, and we have seen already how amply it was practiced in Germany, particularly in the aftermath of the war. To varying degrees, the expansion of the monetary base (the GSLR's nominator) provided the main source of inconvertibility and inflation. Worthwhile remembering that national outputs in wartime did not always undergo contractions. This may have been the case for Germany, Austria-Hungary, Russia and, markedly, France (–36 per cent); but not for the United States, Britain and Italy, whose respective GDPs grew by 13 per cent, 15 per cent and a surprising 33 per cent from their 1913 levels.[33]

To put it differently, the dramatic increase in money supply and price levels had not been matched by a corresponding increase in the gold value (gold content) of the monetary unit in any country. The gold standard leverage had grown: that is, the gold 'terms of trade' had worsened (the same amount of goods or commodities could buy a larger quantity of gold). For countries with a 'debased' national currency, reverting to an operational gold standard would mean bringing the GSLR down to around 2.5 (depending on the applicable legislation), a rate roughly equivalent to the generally accepted legal gold coverage ratio of 40 per cent of the monetary base.

As present-day events clearly demonstrate with regard to banks, de-levering can be done in two different ways: either by raising new capital (in this case, by increasing the gold reserve, and thus the ratio's denominator), or by downsizing the balance sheet (in this case, by reducing the monetary base, that is the numerator of the GSLR). Both ways of making the gold standard operational again would be painful, but to different degrees. As we have seen in the above table, after the war the United States was in a relatively favourable position. At the other extreme were Germany and Austria, whose leverage was so high that a total disruption of their monetary system could hardly be avoided.

Reducing the monetary base (the nominator) would require a credit crunch; the alternative, that is, increasing the reserve (the denominator) would mean gold purchases, perhaps by starting a trade war.

The quest for gold (the gold shortage) was high in the mind of Keynes when, writing in 1923, he expressed the fear that 'if pre-war conventions about the use of gold in reserves and in circulation had to be restored – which is, in my opinion, the much less probable alternative – there might be…a serious shortage of gold leading to a progressive appreciation in its value'.[34] Keynes's idea was therefore to go beyond the gold standard and stabilize currencies quite independently of the use of gold, so that *'gold…will have become a fifth wheel to the coach'* (italics added).[35] Between a fluctuation in the price level and a fluctuation on foreign exchanges, Keynes would have chosen the latter. For Hawtrey, on the other hand, '[T]he main advantage of the use of a common standard by different countries is that variations of the rate of exchanges are kept in a narrow limit.'[36]

But there were other ways to reduce the gold standard leverage ratio and achieve convertibility: increasing the price of gold (that is, reducing the gold content of each country's monetary unit); or adding components other than gold to the ratio's denominator.

If a reduction in the gold value of the monetary unit were chosen, and the reduction roughly matched the growth of the money supply and price level, the gold terms of trade would remain unchanged as before (the same amount of commodities would buy the same quantity of gold), gold prices would stabilize, and the gold standard leverage would also remain unchanged. If the reduction of the gold value of the monetary unit were bigger than the reduction in the monetary aggregates, the gold terms of trade would improve (the same amount of commodities would buy a smaller quantity of gold), gold prices would rise, the gold standard leverage would decrease, convertibility would be facilitated, and the economy's competitiveness would also improve.

Consider, now, the option of increasing the gold price – not in individual countries, but in all those that adhered to the gold standard system (it was not by chance that this issue surfaced again in the early 1970s with the concomitant crises of dollar devaluation and global inflation, which were in turn connected to the 'oil shock'). Given the uneven distribution of gold in different countries, this solution could probably alleviate the pains of countries that were suffering currency debasement, but would not change their competitiveness in relation to the other countries. Disequilibria would thus remain.

Instead, action to alter the ratio's denominator took the form of adding another component to the country's international reserve with the 'gold *exchange* standard'. This allowed the addition of a hard currency (one directly convertible into gold at a fixed rate) component to the official reserve. The necessary funds could be raised either by acting on the current account component of the balance of payments, or on its capital account component: that is, either by avoiding the conversion into gold of a trade surplus, or by means of large foreign loans. They would constitute a reserve of foreign gold-convertible currencies in the form of bills or other liquid assets. This reserve would serve the purpose of a gold reserve, with the added advantage of yielding interest; and its fluctuations would not unsettle the world gold market.[37] This variation of the gold standard already had a long history: Hawtrey cites the case of its adoption by Russia in 1878,[38] when the government succeeded in fixing the gold value of the rouble. The inter-Allied loans during the First World War created a pool of currency reserves in the debtor countries, as we have seen in previous chapters; but it was only after the war that the gold exchange standard was increasingly adopted. The Genoa International Conference, in resolutions approved on 18 April 1922,[39] 'recommended': independent central banks, 'free from political pressures' (Resolution 2); cooperation between central banks (3); setting a common standard for European currencies – note the U.S. absence – and gold as common standard (4 and 5); maintaining balanced national budgets based on reductions in government expenditure (7); a decision by each country either to go back to the old gold parity or to adopt a new parity, approximating the current exchange rate (8); to 'economize' the use of gold as a reserve by stipulating a convention that would centralize the demand for gold and permit the use of foreign currency balances as a reserve component (9); inviting U.S. cooperation in this regard (10). It is notable that, contrary to the view that the standard would hardly tolerate devaluations, the explicit supporters of the gold standard who made the above recommendations (the senior officials are listed in the footnote) openly admitted adjustments to the exchange rates (in the form of changes to the gold content of each currency), as per Resolution 8 in their statement.

5 The completion of 'realignments', 1924–1928

In the previous chapter we saw how in 1924 the Reichsmark, after the hyperinflation of the immediate post-war period, returned to the pre-war level of gold content and, therefore, to the exchange rate of 4.2 to the US dollar. The country remained formally committed to this parity for the whole interwar period, but the gold standard in Germany became something of a mockery with the introduction of pervasive foreign exchange controls and other international arrangements: primarily bilateral clearing agreements, which shall be discussed later.

Let us now turn to other countries' policies. When dealing with currency realignments (the confirmation or adoption of new gold parities), we notice that all currencies lost some value in terms of goods and services during and after the war, although to varying extents. The market exchange rates of different currencies moved approximately with different rates of inflation. A country that had suffered a relatively higher inflation rate and wanted to re-enter the gold standard might choose a gold content for its currency that was a fraction of the old one, but which at the same time represented a revaluation of its current market exchange rate (in this regard, we have just seen that the Genoa Conference resolutions[40] had recommended the choice of parities that would reflect the current market rates: this did not always happen).

America never left the gold standard during the war, a brief suspension of gold exports aside. One might wonder why the government of the United States, which emerged from the war with its GSLR barely changed (mainly thanks to a huge accumulation of gold), chose to deflate the economy. The wholesale price index peaked in 1920 at more than twice the pre-war level,[41] but the United States's main competitors fared much worse. It is no surprise that, as a result, between 1914 and 1919 the dollar exchange rate against other currency currencies rose considerably.

Table 3.3 Cents of US$ per unit of foreign currency, yearly averages

	1914	1919
GBP	493	442.6
FF	19.6	13.7
ITL	19.3	11.4

Source: Federal Reserve, *Banking and Monetary Statistics 1914–1941.*

If we look at the balance of payments current account of the countries considered here, one country stands out as the hegemonic economic 'superpower': the real winner of the war and the most powerful economic engine, with a remarkable payments surplus. The United States was the only belligerent to enjoy a strong merchandise balance during all five years of the duration of the war,[42] and the surplus continued in both the 1920s and 1930s. This positive balance allowed a smaller, but still comfortable, surplus in the total current account.[43] Strengthened by this favourable current account, the international investment position of the United States remained hugely positive for most of the 1920s and 1930s. There was a fundamental imbalance between the European and the American economies, and the latter showed that the real winner of the war could act unbound by the constraints of the old monetary system.

During most of the 1920s the United States government preferred to avoid a 'gigantic expansion of credit' and followed an 'independent route' (that is, an asymmetrical pattern of behaviour in terms of gold standard rules), permitting only moderate credit expansion and showing that, in Hawtrey's words, '[T]here is no conflict between financial soundness and economic expansion.'[44] As Hubert Henderson, an economic adviser to the U.K. government, was later to observe, '[I]n the United States, in the 1920s, the superabundance of gold reserves had made it possible to experiment with the deliberate regulation of internal monetary conditions, but these experiments were tentative and any ambitious purpose of maintaining a steady price-level was emphatically disclaimed.'[45]

No such freedom was available to other countries, which could not rely on such an impressive gold stock. In Britain, after the wartime suspension of the gold standard, with the pound depreciating in relation to its gold content by up to 34 per cent, deflationary policies led in 1925 to a return to the standard at the pre-war content of 7.322382 grams of fine gold, in the form of gold *bullion* standard, which of course limited the practical use of gold in the private sector.[46] With an increase in prices worse than that seen in the United States (British wholesale prices similarly peaked in 1920, but at a level three times higher than in 1914), it is puzzling that Britain should have opted for the old, pre-war parity. What makes it all the more puzzling is that Britain's merchandise balance was in constant deficit (a large surplus in the 'invisibles', however, helped to maintain an overall positive balance on the current account[47]). The plausible explanation is a policy of international prestige that, while damaging British trade, might have enticed investors (including foreign central banks, under the gold exchange standard regime) to keep their reserve balances in British pounds, according to the operational system of the gold standard described above. Indeed, that is what happened for a while. It must not be forgotten, however, that even after the war Britain's foreign investment position remained positive. 'The fact that Britain was still a large creditor nation had a great bearing on the decision'; however, 'the over-valuation of the pound ... persisted because it was found impossible to reduce wages, taxes, overheads and other fundamental costs beyond a certain point'.[48]

For countries such as France and Italy, both members of the old Latin Monetary Union and which therefore had a par exchange rate in the pre-war years, to go back to the old parity after their suspension of the gold standard during the First World War was out of the question. Brutal rates of inflation, large expansions in their money supply made to finance the war, and unfavourable trade balances together made such a move impossible. Meanwhile, both countries received substantial loans from the United States and Britain, which inflated their reserves, thus contributing to an improvement in their GSLR[49]. Notwithstanding these loans, by 1919 the GSLR had greatly deteriorated in both France and Italy. There were, however, significant differences in the economic performance of each country.

GDP followed different trends in each country, with France suffering a huge loss of output and Italy experiencing strong growth (as shown above). With regard to inflation, wholesale prices in France climbed strongly during the war and, after an abrupt decline in 1921, climbed again to peak in 1926 at six times the price levels of 1914.[50] Italy underwent a similarly long period of very strong wholesale price inflation, which also peaked in 1926, when price levels reached 6.45 times those of 1914. Notwithstanding the relative similarity of France's and Italy's rates of inflation, the two currencies behaved differently on the foreign exchange market. The franc's value slumped, with the dollar exchange rate rising from 19 to 41 francs in 1925–1926. The slump was less pronounced for the Italian lira, whose dollar rate moved from 20 in 1920 to 27 in 1926.

Why should these two Latin Monetary Union currencies, with similar inflation performances, have followed such ultimately different trends? The explanation is at least in part to be found in the divergent economic policies of Italy and France, where different political forces had been at work in the turbulent post-war period. In France, the *Cartel des gauches* had attempted in 1926 to impose a capital levy while, in Eichengreen's words, 'uncertainty devastated financial markets' and the country was on the verge of hyperinflation. Then a government of national union was formed under Poincaré, 'a staunch opposer of the capital levy'.[51] Without scaring the wealthy classes, he relied instead on increases in indirect taxes and reductions in spending, and money returned to a battered franc. After the huge depreciation in 1925–1926, these fiscal measures stabilized the franc, although at a low level which was consistent with the inflation that had so far occurred. The gold standard parity was restored, *de facto* in 1926 and *de jure* in 1928 – with a devaluation of 79.69 per cent, and with the return to convertibility limited to gold bars of 400 ounces (gold bullion standard, as in Britain). The new gold content was fixed at 58.95 milligrams, which meant an exchange rate to the dollar of 25.5 French francs. The French franc devaluation was much more pronounced than that of the Italian lira.

In Italy, reasons of prestige made the Fascist government uncomfortable with an exchange rate it saw as too low in comparison to Britain's or America's, without being low enough to reverse the substantial deficit of Italy's trade balance. The Italian authorities strongly wanted a contained lira devaluation in terms of gold. A 'strong lira' policy was therefore pursued, in the expectation that a deflationary stance would strengthen capital inflows, balancing the current account deficit.

6 The story of the Italian return to the gold standard

The preconditions of the lira stabilization of 1927 were set by a tight monetary policy and by an inflow of foreign capital that strengthened the reserves of the Bank of Italy. In March 1925 the discount rate was abruptly raised from 3 to 6 per cent and then again to 6.5 and 7 per cent in June.[52] The 'battle for the lira' – in the bombastic language of Il Duce – started in August 1925, when all functions and regulations pertaining to the defence of the currency, previously scattered among various government departments, were concentrated in the Treasury. One year later, Mussolini announced publicly, in a speech at Pesaro, that the aim of his policy was a return to the gold standard at a level that would imply an exchange rate with the pound sterling of 90 lire, while at that particular time it stood at around 150.[53]

The capital inflow was deemed indispensable to stabilize the lira, but it was thought that it could materialize only when a series of conditions would be met: that the war debt of Italy towards the United States and Britain would be settled; and that, in turn, reparation payments from Germany would make that settlement politically and technically feasible. Immediately after the war, this issue came at stake. According to an agreement reached on 18 February 1919, Italy pledged to repay Britain a capital sum of £30m, upon receipt of the first payment from reparations. Few years later, however, Britain complained that Italy had received already an amount equivalent to £24m in reparations from Germany, but had not yet made any repayment on its war debt, either to Britain or the United States.[54] When the German reparation problem found an (albeit temporary) solution with the Dawes Plan of 1924, the British claimed that the Italian government could no longer say the reimbursements to the Allies were hindered by missed reparation payments by Germany. In 1925–1926 a settlement was reached with the American and British governments, after which foreign investors became confident that there would not be a serious credit-default risk in lending money to Italian entities.

At the end of 1925, the Italian debt towards Britain amounted to £560m,[55] and towards the United States to $2,036m (£419m, at the exchange rate of 4.86).[56] On the other hand, Italy was receiving payments from Germany. The issue was, for Italy, to get a good spread between the amount annually due to the lending powers and the amount received from Germany.

In both cases – the United States and Britain – the scale of payments was agreed in 62 years. The difference regarded the amount to be settled for each year. The obvious interest of Italy was that payments should be initially very small, only gradually increasing over the years, so as to leave the bulk of payments to the final stage of the repayment schedule. There were good reasons not to bear a heavy burden in those difficult, immediate post-war years, but also 'nobody really thought that more distant instalments would be actually paid'.[57]

The Italian finance minister, Count Giuseppe Volpi, negotiated first with the Americans, and an agreement was reached in Washington D.C., in November 1925, on very favourable terms to Italy. The amortization had a telescopic form, meaning that instalments would gradually increase, while for the first years payments would be relatively light.[58]

With Britain, the accord was reached in January 1926 on more onerous terms for Italy. Britain, whose currency had been restored in terms of gold to its pre-war level the previous year, was in a less-solid financial position as compared to the United States, and preferred faster repayment. At the start of negotiations with the Italian delegation, led by Volpi, the British Chancellor of the Exchequer, Winston Churchill, raised objections to the Italian pretension that the settlement with Britain should be on the same terms as America's. The British noted that they could 'quite fairly claim that the settlement of the Italian debt to us should be based on the terms which the United States of America accorded to us, and not on the terms accorded to Italy'. They observed that the Exchequer's needs for revenues were greater at an early date of the repayment schedule, and far greater than America's. The British were therefore oriented toward a flat rate of annual payments by Italy, with a shorter scale during the first four years only. Regarding the debt sustainability for Italy, they stressed that, even with their proposed flat schedule, payments to the United States and United Kingdom would be 'more than covered by Italy's reparation receipts, if the Dawes annuities are transferred in full, and there would be a surplus [for Italy]', for 1926–1930. In fact, on the whole, it can be calculated that the balance between payments obtained by Italy under the Dawes loan, and the amounts paid by her to the United States and Britain between 1924 (the year of the Dawes loan) and 1927 (the year of the lira stabilization) left a surplus of Lit183.7m in favour of Italy.[59]

According to the agreement of 27 January 1926, the schedule of payments stated, in fact, that payments in earlier years had to be proportionately higher than what Italy requested, but not so high as to contrast too unfavourably with the American settlement. Large sums would be paid later, even though the British government appeared to share the widespread opinion, mentioned above, that 'in all probability, these large payments would never be made'.[60]

The problem was further complicated by the gold 'deposit' made in London by the Italian government in 1915 (when Italy entered the war), as a collateral for British war loans. In this regard, it should be remembered that, with two agreements (reached in Nice, in June, and in London, in November 1915), Britain had lent Italy the amount of £182m, against a collateral of Treasury bonds, and 31.4 tons of gold (£22.2m) that was shipped to London. After the war, the question arose about whether that gold should be returned only when all Italian debt would be repaid, or just the £182m advance. Negotiations took place in 1920–1921, and an understanding was reached that the gold would be kept by Britain until the total debt had been repaid by Italy.[61] The above-mentioned agreement of 1926 defined the terms of Italian debt repayments and specified that gold should be returned to Italy according to a precise schedule: in eight bi-annual instalments of £1 million each, from September 1928 to March 1932, while the balance of £14.2 million would be returned later, in bi-annual instalments, until September 1987 (55 years), conditional on the extinction pay-off the Italian debt towards the United Kingdom.

A lateral, but important, question regarded the ownership of that gold 'deposit'. The importance came from the fact that – it is worthwhile remembering – in any country adopting the gold standard, money supply had to be related to the gold in the official reserve. If that gold had been a deposit at the Bank of England, Italy would continue owning it, and it could be accounted for in the Bank of Italy's official reserve, as a backing for the Italian money supply. If, on the contrary, that gold had been ceded to the Bank of England by a sale with repurchase agreement (a 'repo', in modern parlance), it would belong to the Bank of England for the entire period of its material holding.[62] Consequently, it could not be included in the Italian official reserve and accounted for backing of the Italian money supply. The obvious implication would be that the money supply should be shrunk once Italy – as planned – returned to the gold standard.

Italy continued to consider that gold as an asset of its central bank, even if held abroad, while, according to the British, the figures the Italian reserve made public were inflated, 'fictitious', because in their opinion the gold belonged – at least for the time being – to the Bank of England reserve. The Italians observed that if – as the British sustained – that was a 'repo', then the gold should have been returned to Italy when the corresponding advance of 182m had been repaid, while the 1926 agreement stated that gold had to be returned only when the whole debt would be extinguished.

Commenting on the general settlement with Italy on the issue of the war debt in his speech of 2 February, King George V was able to announce that the agreement with Italy had been reached 'on fair and honourable terms'.[63] But, in fact, the gold issue remained pending. The gold originally pledged was 31.4 tons; 5.9 tons were returned in the period 1928–1931.[64] Then, with the Hoover Moratorium in 1931 and the Lausanne Agreement of the following year (see Chapter 4), the inter-Allied debt was practically, if not legally, suspended *sine die*: no further payment was made by Italy and no further gold restitution by Britain.

The important point was that the conclusion of these agreements with the Allies opened the way to a huge capital inflow towards Italy, in particular from American sources, similar to what had happened in Germany after the Reichsmark stabilization in 1924. Again, similar to Germany, this inflow regarded both central and local governments in Italy. The most important operation was the Kingdom of Italy 25-year loan for $100m, at 7 per cent, granted by J. P. Morgan in 1925, which brought the gold clause: 'the Obligor covenants to pay ... in gold coins of the United States of America of the standard and weight and fineness existing December 1st, 1925'. This was followed by other loans: to local governments (cities of Milan, Rome, Genoa), industrial and banking firms and state-controlled entities, all at the interest rate of around 7 per cent.[65] Between 1925 and 1933, the net amount of these loans totalled around Lit8.2bn, most of them (88 per cent) granted in the years 1925–1927, just in view of the lira stabilization that was finally reached in December 1927.[66] As a consequence of these loans, the reserves of the central bank correspondingly increased.[67]

Italy re-entered the gold standard with a gold content of the lira that, even though it was a fraction of the pre-war value, represented a meaningful revaluation of the lira's market rate. It will be remembered that the Genoa Conference of 1922 had recommended the adoption of gold parities close to the current market exchange rates. But the Italian government followed a different course. Against the British pound (the choice of currency being a deliberate one: the pound's market rate was 'targeted' by Mussolini as a symbol of the 'battle for the lira'), the lira's exchange rate climbed from a trough of 125.26 in 1926 to 94.34 in 1927 (when the lira was again pegged to gold) and in 1928 reached 92.82 (the 'quota novanta' that Mussolini had proclaimed as his government's target). The dollar rate similarly moved from 25 to 19 lire.[68] The lira's 72.47 per cent devaluation in terms of gold produced a new content of 79.17 milligrams of fine gold.

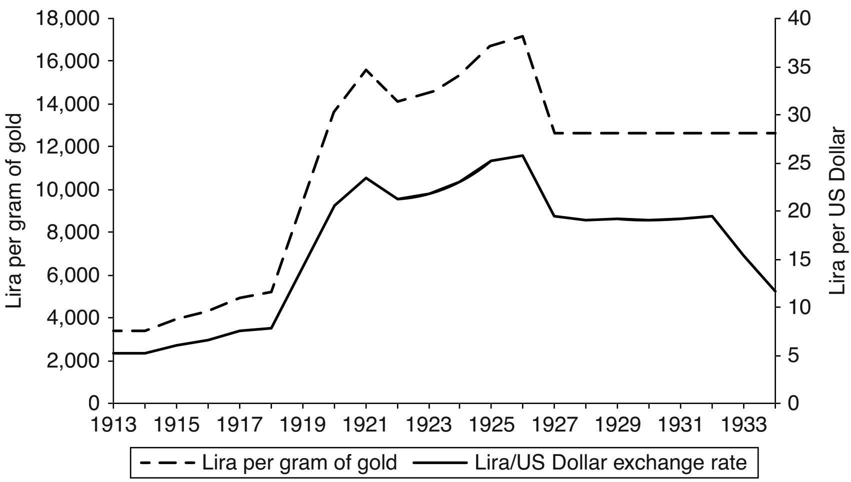

Figure 3.1 Lira–dollar exchange rate and the official gold price of the lira 1914–1933

Note: About gold price, according to the pre-war parity, until 1914, it was 3.444 lire per gram of gold. Between 1914 and 1927, when the gold standard was suspended, it moved sharply upwards, to a peak of around 17,000 in 1926 (with ample fluctuations). In 1927 the gold standard was reintroduced with a smaller gold content of the lira: 12.628 lire per gram. The market exchange rate lira–dollar, stable at around 5.2 lire per dollar until 1914, moved abruptly upwards, to touch more than 25 lire in 1926, then went down in connection with Mussolini's strong-lira policy, stabilizing at around 19 lire until 1933. In this year, the lira climbed to 15 lire per dollar, when Roosevelt opted for the dollar devaluation.

Source: lira gold price: Banca d'Italia: *I bilanci degli istituti di emissione 1894–1990*, Laterza, 1993, p 45; exchange rates: Ciocca, Ulizzi, I tassi di cambio, p 355.

What should be stressed is that, in 1927, the lira was devalued in terms of its gold content, but its market rate climbed in reference to the previous year.

The different policies followed by France and Italy are clearly visible in the lira–franc exchange rate. In 1914 the ratio was 1:1 within the Latin Monetary Union. The market rate was around 83 French franc cents to the lira in 1925, but the French currency fell to 1.33 francs in 1928, after the realignment of the two currencies. The new parity rendered the French economy competitive again, and France was able to accumulate gold, becoming a major gold hoarder in the subsequent period.

It is worth bearing in mind that when, in July 1933, the World Economic Conference in London ended in failure with Roosevelt's refusal to stabilize the

Table 3.4 Gold standard leverage ratio in some countries 1914–1928

		1914						1928				
		USA US$ m	**UK GBPm**	**Fra FF m (1915)**	**Ita ITL m**	**Ger RMm**	**Aus equiv US$m**	**USA US$ m**	**UK GBP m**	**Fra FF m**	**Ita ITL m**	**Ger RMm**
A	Gold	1,526.0*	69.0	5,015.0	924.2	2,093.0	309.8	3,854.0*	153.8	31,977.0	6,787.8	2,729.0
B	Foreign Exchange			1,410.0	142.9	1,198.0				32,726.0	5,988.2	156.0
C	Bank Balances	264.7	128.1	2,183.0	302.2	612.0**	59.0	2,389.0	69.5	7,018.0	1,591.7	633.0
D	Circulation	3,400.0	69.5	7,325.0	3,593.0	5,862.0	431.5	4,800.0	393.0	60,061.0	17,456.0	5,653.0
E	**GSLR (C+D)/(A+B)**	**2.40**	**2.86**	**1.48**	**2.84**	**1.97**	**1.58**	**1.87**	**3.01**	**1.04**	**1.49**	**2.18**

Notes: * Incl. gold in circulation; ** Value is from 1913.
Source: see Table 3.2.

dollar (see Chapter 4), France and Italy, together with Belgium, Switzerland, Holland and Poland all declared their willingness to remain on a gold base. The 'Gold Bloc' was dismantled in 1936,[69] and that year can be considered as the moment when the last vestiges of the gold standard disappeared.

We can now look at GSLR at the end of this process of realignment and compare the values for these leverage ratios to those of 1914 (see Table 3.4, previous page). It is interesting to consider how the gold standard had been restored: that is, how smoothly the system could work.

Certain factors must be taken into account to help explain the ratios' dramatic improvement. A correct reading of this table must consider that three countries – the United States, United Kingdom and Germany – retained the gold parity of the pre-war period even though Germany was in a highly peculiar position, having had the Reichsmark parity set *ex-novo*, after the dramatic experience that had ended in the total collapse of the monetary system. The ratios of France and Italy, the other two countries, of course reflect the new smaller gold parity, which increased the value of their gold stocks in terms of national currency. The year 1928 was, moreover, part of the very short period when the gold *exchange* standard appeared to be the answer to the gold shortage and to deflation calls. The gold exchange standard, by including hard currencies in the reserve account alongside gold, enormously improved the legal compliance of countries that were less 'rich' in gold. The non-gold component of the reserve was particularly strong for the Bank of Italy and the Banque de France (whose foreign exchange position was roughly equal to the gold in reserve). The case of France is interesting because, as Hawtrey notes, '[W]hen a gap is to be filled in the assets of the Banque de France it is apt to be found that gold is the *only* asset with which it can be filled. In 1926, however, exceptional powers were taken. The Bank was enabled to buy foreign exchange…bills and deposits at foreign centres (mainly London and New York).'[70] This non-gold component of the reserve was less noticeable for the Reichsbank (where the inflow of foreign capital did not deeply affect the central bank's balance sheet in terms of foreign balances, but greatly increased its gold holdings).

In 1929, the United Kingdom emerged as the only European country whose central bank had no foreign currency assets. This meant the continuing benefit of having a reserve currency, but also an increasing gold standard leverage. The United Kingdom was potentially vulnerable, and in the least favourable position among the sampled countries: a sign of trouble ahead. If we see the ratio of around 2.5 as the 'minimum apprehension reserve' (using Bagehot's terminology), the United Kingdom is the only country above that threshold. In 1931, the United Kingdom was to become the first country to leave the standard.

On the whole, given those stocks of 'paper money' and 'reserves', it seems that domestic convertibility might have continued to operate in all countries. But what of external convertibility? Here, problems emerged, because an unfavourable foreign position in terms of payments deficits or of a negative international investment position could make convertibility difficult to maintain and expose the whole system to a sudden conversion of currencies into gold. The 'excess reserves' – above the legal threshold – might be wiped out. Deflation was required not by domestic convertibility, but by international market pressure. This was, in fact, a European problem; and America, aware of its strength, preferred to mind its own business.

In 1928 the process of return to the gold standard had been completed in the main economies. In the same year, Irving Fisher published *The Money Illusion,* where, while applauding the reinstatement of this standard as 'the only practical road to international stabilization', he stressed that the *danger* ahead would be 'the belief that the gold standard should be kept *automatic*, that is not affected by any act of government'(italics added).[71] Fisher's position was therefore critical of any view that saw the gold standard as a synonym of ever-lasting currency parities and automatically restrictive policies. Here, we are not interested in the specific proposal that he raised[72], but in the fact that, as he saw it, international cooperation was at that crucial time a missed opportunity. Cooperation lacked when it would have been most needed. In retrospective, in 1947, Fisher wrote in the preface to the Italian edition of his book: 'If [my] programme of stabilization had been enacted, perhaps the 1929–1933 deflation would have been prevented, perhaps the Great Depression and the consequent unemployment and discontent that brought Hitler to power would have been avoided, and – perhaps – this horrible war would have never occurred'.[73]

Part II

The Gold Standard Collapse: Nationalism and Bilateralism in International Financial Relations

4
Towards Nationalism

1 German banking crisis and economic depression

From May 1930 onwards deposits at German banks shrank, mostly because of the withdrawal of foreign capital. Capital outflows accelerated after the Reichstag elections in September, which substantially increased the Nazi party's representation. The Reichsbank's gold reserve also shrank as a result: by the end of 1931 it had fallen below RM1bn, and one year later it was only RM0.8bn.[1] Already in mid-1931, the event finally occurred that Schacht had feared the most: the reserve fell below the statutory threshold of 40 per cent of the amount of money in circulation. In this condition, the Reichsbank's balance sheet could not expand, and banks were not legally permitted to rely on central bank support. British historian John Wheeler-Bennett relates his meeting in June 1931 with Schacht's successor at the Reichsbank, Hans Luther: '[T]his is a historic day in German banking,' [Luther] said quietly. 'For the first time in our history[2] we have not enough gold to cover our paper.'[3]

It is not central to this research to investigate the reasons for the German banking system's collapse in 1931, in particular the relevance of the 'mixed bank' model of German (and Italian) banking, or the extreme volatility of banks' (predominantly foreign) funding. Gerald Feldman argues that by the early 1930s in Germany the 'mixed bank' model had evolved into something much less threatening and problematic than it was in Italy, where it precipitated the worst banking and industrial crises in terms of bailout costs and economic losses. Instead, he writes, 'the deficiencies of the [German] banking system must be seen in the context of the post-1924 financial and political settlement, and this was not the creation of the German bankers. It was that settlement which had enthroned Montagu Norman along with ... the "Morgan ideology" – the return to the gold standard at pre-war parities in England, Germany and certain other key countries ... the faith in central bank cooperation ... and the policy regimes of balanced budgets which so exacerbated the problems when the Great Depression hit'.[4] These are words that, 60 years earlier, Schacht would have fully subscribed. In addition, the equity base of big German banks, already low thanks to inflation and currency reform, had fallen further in the 1920s as a result of concentration, expansion and increasing competition.[5]

In May 1931 the Austrian Credit-Anstalt bank went bankrupt. Burdened by a poor-quality portfolio which was over-reliant on a small number of firms, and unable to rely on government support, the German Darmstädter und Nationalbank then failed in July after losing around 41 per cent of its deposits to a bank run, and further financial panic ensued.[6] On 13 July, all German banks were closed for two days by a government decree, and full operations were not resumed until 5 August.[7] An extensive public bailout of stricken banks formed the basis of the subsequent restructuring of the banking system.

Germany, however, stuck to the gold standard parity. In 1929 the economy had slid into deflation, and the wholesale price index declined from 100 in 1929 to a low of 68 in 1933.[8] Real interest rates remained stubbornly high (in 1932 they were 17.3 per cent) in order to keep the gold standard and try to maintain foreign investors' confidence – not an uncommon reaction among countries hit by the Depression. Monetary contraction was accompanied by a severe decline in national output, both in nominal and real terms. It was only in 1933 that a modest recovery started to occur.

Devaluing the mark and pegging it to a devalued pound might have reduced the burden of deflation. From the UK's decision to devalue the pound in 1931 onwards, also in Germany the Reichsmark devaluation came to be regarded as a possible alternative to the foreign economic policy pursued by the government. Luther wrote that the central bank was flooded with proposals advocating this measure.[9] The decision not to devalue, and instead preferring a policy of domestic deflation, has received different explanations. First, given the worldwide turn to protectionist policies, it was considered highly doubtful that a devaluation would significantly increase German exports. A second reason for not devaluing is that, when the proposal was discussed, the government of Heinrich Brüning, chancellor from 1930, was pursuing a revisionist policy on the reparations issue, and it was felt that a German export increase would have badly affected the Allies' willingness to make concessions on Germany's reparation debt.[10] A third motivation was related to the Reichsbank's fear that a Reichsmark devaluation would unleash an inflationary spiral bringing Germany back to the revolutionary situation of the early 1920s.[11] Finally, devaluation would have increased the cost of servicing Germany's debt (which was mostly denominated in foreign currency), especially for the portion of it that was covered by the gold clause. While the Bank of England looked favourably on the prospect of the mark's devaluation, the United States insisted that Germany must continue to service its debt, instead protecting the mark by means of foreign exchange controls – which is what ultimately happened (see below).[12]

Therefore, Brüning responded to the deterioration of German finances and the difficulty posed by reparations with several deflationary measures in accordance with gold standard orthodoxy: higher taxation, higher social contributions, and the reduction of wages and prices. A member of the Centre Party, Brüning governed mainly by decree, as a stepping stone to the more fundamentally authoritarian reshaping of the republic that was to follow.[13] A general system of banking controls was set up, starting with the adoption of emergency measures for the banking industry. Clearing and settlement activity between commercial banks, which had been brought to a standstill, was set again in motion by a new Transfer Association (*Überweisungverband*), which was designed to facilitate the settlement of bank transfers using a Reichsbank account during the short period between 21 July and 4 August, when normal settlements were restored. A new institution, the *Akzeptbank*, was established with capital mostly provided by the national government, with the function of extending emergency loans through a rediscount window at the Reichsbank. (Later, a lengthy Bank Enquiry in 1933–1934 led to the new Banking Act, which was approved in December 1934. This act dispensed with the principle of free trading, created an extensive network of authorizations and licences for banks and brought the banking system under permanent state supervision.[14] This legislation was similar to measures adopted in other advanced economies that had been heavily hit by banking crises, such as the United States or Italy. In total, banking reform cost the government some RM500m, but confidence was finally restored.[15])

2 German exchange controls; the end of reparations

The foreign debt position of Germany, in connection with the banking crisis of early summer 1931, was further deteriorating. Concerned by the prospect of a default on large American private loans to Germany, which would force bank failures in the United States,[16] US President Herbert Hoover responded to this crisis on 20 June by announcing a one-year moratorium of all payments of intergovernmental debt – reparations and inter-Allied debt – adding the condition, however, that the Reichsbank must restrict its discounts to the banking system in order to thwart capital flight.[17] France's reluctance to agree to the Hoover Moratorium made investors more nervous, and nervousness soon changed into panic.[18] To satisfy the demand for foreign currency, on 25 June 1931 the Reichsbank obtained a loan of $100m from the central banks of France, Britain and the United States and from the Bank for International Settlements (BIS), but this proved insufficient to neutralize the net outflow: within just five days, enough capital flight had occurred to offset more than half of the loan. The Hoover Moratorium suspended reparations payments for one year from July 1931, and provided only for a RM600,000 nominal tender of the unconditional annuity to be paid.[19]

Of particular interest are the measures taken by the Brüning government to institute foreign exchange controls. July 1931 marks the beginning of this new regime, even though Germany formally retained the gold standard.

'Modern money' would require, over time, 'three general exchange control laws, upwards of 50 separate decrees of amendment and adaptation, and something in the neighbourhood of 500 administrative rulings, to say nothing of clearing, compensation, and payment agreements with partner countries…a juristic maze'.[20] Anyway, few decrees on 15, 16 and 18 July sufficed to give the Reichsbank a monopoly on all foreign exchange transactions, prohibit any deviation from the official exchange rate and abolish forward transactions in foreign currencies. Regulations limited the reasons for which foreign currency could be acquired. All who held sums of foreign currencies were required to offer them to the Reichsbank. Foreign securities could still be purchased, but the purchase had to be registered; German residents with part ownership of foreign enterprises were also required to register if their equity was above 50 per cent of the total and there were no more than five owners. Postal authorities prohibited the sending of money by post. Following the regulations imposed by these decrees, a Currency (*Devisen*) Law of 1 August stated that the purchase of foreign currency was only possible upon presentation of a certificate issued by a new *Devisen* office, whose permission was also needed for: opening new credits to non-residents, the disposal of Reichsmark accounts in Germany by non-residents, and the transfer of Reichsmarks to accounts with firms located abroad. A general embargo on existing domestic means of payment was thus introduced.[21] A wide range of categories of 'blocked' marks were created.

Thanks to these capital controls and to the removal of the need to protect the currency with restrictive monetary policies, the Reichsbank was now able to assist banks in recovering from the runs they had suffered. Bills presented by public sector institutions were now amply discounted by the Reichsbank. The 'economics of control' was set in motion.[22] Germany was at first alone in its adoption of currency controls, but other countries soon followed suit and, in 1931, 22 states, 15 of which were European, adopted forms of exchange control; they were joined by 6 more in 1932.[23]

The effectiveness of the German exchange controls was enhanced by a suspension of German private short-term foreign debt (while official government debts had been already addressed by the Hoover Moratorium). In this regard, an international conference was convened in London on 20–23 July 1931, attended by Germany and the main creditor countries: the United States, Belgium, France, Italy, Japan and the United Kingdom. Its main effect was to open the way for a suspension of Germany's private short-term foreign debt. In fact, the conference recommended a freeze on all German private short-term debt and the establishment of a financial committee at the Bank for International Settlements to study its implementation. This committee, chaired by the American Albert Wiggin, reported on 18 August.[24] We have already dealt with the part of this report concerning the period 1924–1928, when a massive inflow of funds inundated Germany. In 1930, the report added, Germany's gross foreign debt had reached RM25.5bn, against German investments abroad of RM9.7bn. That inflow had made it possible for Germany to pay interest on commercial debt, to increase the gold and foreign exchange reserve, to pay reparations of RM10.3bn, and to pay for the trade deficit. In 1930, when the price of raw materials collapsed, Germany also registered a trade surplus which covered two thirds of debt servicing and reparations, while the remaining one third was covered by further capital inflows. The weakness of the country's foreign currency position was visible in its high level of short-term debt: RM10.3bn, 37 per cent of which was owed to American creditors. This short-term foreign credit had been used for financing domestic needs, but was largely spent on operations that should instead have been financed by long-term capital – an observation that Schacht had made in the late 1920s, when the economy was flourishing.

The 'Wiggin Report' also observed that in 1931 foreign capital had been partly recalled, at the expense of Germany's international reserve and, as a consequence, the short-term debt had declined, at the end of July, to RM7.4bn[25] (although this was still a substantial amount). The report raised two questions: whether it would be possible to consolidate the existing debt into long-term investment; and whether additional foreign capital could be raised to replace the capital that Germany had lost. In the end the most practical solution seemed to be a 'Standstill' agreement guaranteed by the Gold Discount Bank, whereby foreign creditors would undertake not to withdraw their credit for six months, starting on 1 September. This restructuring of Germany's foreign short-term debt was a step towards a gradual but substantial default, after the default on reparations that had already occurred on the London Schedule. The Standstill applied to the total amount of private short-term credit, around RM6.6bn.[26] A second Standstill agreement, reached in January 1932, lasted for one year and included provisions for a 10 per cent reduction of Germany's private international debts.[27] Other Standstills followed in 1933 and 1934.[28]

On 19 November, in accordance with this framework and with a view to pursuing domestic priorities unhindered by external constraints, the Brüning government sought to remove external constraints on its domestic policymaking by asking the Bank for International Settlements to convene a special committee to address its financial problems, reasoning that 'Germany's exchange and economic life might be seriously endangered by the transfer in part or in full of the postponable proportion of annuities'[29] which was payable under the Young Plan. Attention was shifting from the short-term banking debt to the long-term German debt, and Germany found the Bank for International Settlements to be a complacent interlocutor. In fact it was the issue of reparations that needed to be faced as a priority.

To deal with the worsening situation, the BIS created the Special Advisory Committee, chaired by the Italian Alberto Beneduce, which reported in December 1931.[30] If the previous 'Wiggin Report' had produced the

Standstill agreement, the 'Beneduce Report', with its bleak view of the German economy, in effect brought about the end of war reparations by strengthening Germany's 'cancellationist' position.[31] The Special Advisory Committee made a distinction between the international and domestic (German) causes of the current crisis. In the international sphere it identified a fall in international prices due, in turn, to: the concentration of gold reserves in a few countries; a huge global stock of outstanding debt; barriers to trade in the form of tariffs; banking crises; a virtual stop to cross-border interbank lending; collapsing confidence in debtor countries; and the phasing out of the gold standard in some countries (notably in Britain, which had left the standard a few months earlier in September, followed by a group of countries). As it is possible to note, at least part of the diagnosis coincided with German complaints. On the domestic side, the committee found that Germany was plagued by a disproportionate short-term foreign debt, excessive government spending, and inefficient fiscal coordination between national and local governments. It concluded that the priority was to restore a degree of confidence sufficient to induce foreign capital to stay in, or return to, Germany. The situation was, the committee recognized, worse than that envisaged by the Young Plan, which had relied on an economic recovery that had never materialized.[32]

It started to become clear that international monetary cooperation was suffering a breakdown – and also that it was unrealistic to expect war reparations to be paid. The United States, in turn, realized that it would not be able to recover the money it had lent to other Allied powers.

Germany obtained a *de facto* end to reparations under the short chancellorship of Franz von Papen, who had succeeded Brüning after the failure of his deflationary policy. Against the will of the Americans, Britain and France agreed to cancel reparation obligations by making a final end to all German obligations dependent on a cancellation of their own war debt to the United States. The result of much diplomatic wrangling, the Agreement signed in Lausanne on 9 July 1932 effectively meant the end of further reparations payments even though the agreement was never officially ratified. The total amount paid as war reparations, under the Dawes and Young plans, had been RM11.3bn.[33] (in 1931, only one billion had been paid in the first half, and nothing in the second). Britain made a final payment in gold to the United States in December 1932, while France and other countries simply defaulted.[34] The Dawes and Young loans continued to be serviced, but the Lausanne Agreement provided an important respite for the German economy.

3 America and the inter-Allied debt

America reacted badly to the Lausanne Agreement. Disillusion and resentment followed the settlement. As we have noted, where inter-Allied debt was concerned America enjoyed the unique position of being a huge creditor without holding any substantial debt. The American attitude after the Lausanne Agreement of 1932 is well summarized by a pamphlet of the Carnegie Endowment for International Peace.[35] The United States had lent \$9.45bn to the Allies during the war.[36] No money had actually moved to Europe: It had been used to pay American suppliers: manufacturers, farmers, and other firms. What was provided to Europe were munitions, food, and other supplies, as well as transportation facilities and shipping services. Even though \$3bn had been repaid, by the early 1930s the debt had accrued enough interest to reach \$11.5bn. The frustration of the Americans over this huge, unpaid debt was mostly directed towards France, which by the way enjoyed a lower interest rate than Britain. France held a much higher gold reserve, yet had defaulted. The French government had told the United States that it could not pay unless it received reparations from Germany; but the United States claimed that there was no agreed link between German payments to France and French payments to the United States. 'France has gold. Why can't France pay?' the pamphlet asks. 'France cherishes this delusion that this money was a gift to make the world safe for democracy'. The Americans believed the French saw the loans not so much as a debt but as a moral due, a paradigm that ran contrary to the American rhetoric of debt. The pamphlet disconsolately claimed that this moral dimension originated 'mostly in the French imagination', a claim which speaks volumes about the strained relationship between America and France.

Germany had at least partially paid what it owed, but the payments themselves came mainly from money borrowed from the United States. The \$3bn mentioned above had already been repaid by France and Britain, but this had happened only because Germany was paying reparations, using money borrowed from the United States. So, in this chain of payments (from the United States to Germany, from Germany to Britain and France, and from these two countries to the United States) '[H]ow much was paid out of American money loaned to Europe?' asks the American pamphlet. 'All of it. Then, the US hasn't collected a cent. We have merely loaned the money with which we have been repaid'.

The United States government was increasingly convinced that the money the Americans had lent could not be recovered. The fundamental reason, from the American perspective, was that 'we made the loans in the form of goods, and we insist on being repaid in gold'. American creditors (public and private) claimed \$26.5bn in repayment, but all the gold in the world outside the United States was valued at only \$6bn. The only way out, according to the American pamphlet, would have been voluntarily to accept a deficit in U.S. foreign trade, that is, an increase in American imports from Allied debtors. However, imported goods would have displaced the market share of an equal quantity of domestically produced American goods: 'The fact is that we have paid \$26bn for a European valet, and don't want him to work . ... In theory we say "pay", but in practice we say "cancel" ... and all will end in cancellation.'

In conclusion, the entire inter-Allied debt question can be reduced to a transfer of resources from America to Europe. To be paid in gold for these goods was impossible, and to be paid in other goods was inconvenient, because this would have caused a proportionate disruption in the market for American-manufactured goods.

With the default of France (along with Belgium, Greece, Poland, Estonia and Hungary), 'America was no longer able to hold the ring in Europe.'[37] Disappointingly, the U.S. effort to help solve the problem of war-related debt, begun under Calvin Coolidge in 1923, was now abandoned.

The American position, however, raises the question of whether additional imports from European countries *would* necessarily have disrupted American manufacturing. The answer would have depended on the domestic policies of the United States: Disruption would have been very likely under a restrictive fiscal and monetary policy, but much less so under an expansionary policy. Considering that the gold standard was still in existence, and that the United States had by far the largest gold reserve in the world and the best international ratio between money supply and gold, a more expansionary domestic fiscal and monetary policy, along with the easing of imports, probably could have been adopted by the American government. But it was alarmed by the financial crisis which, in the early 1930s, was at its height, and opted instead to devalue gold in order to strengthen exports: the opposite of what international adjustment would have suggested.

It should also be noted that when negotiations were held at the end of 1932 between Britain and France on one side and the United States on the other, it came, politically speaking, at the worst possible time. Presidential elections had been held in America on 8 November and, after Franklin D. Roosevelt's victory, Hoover was a 'lame duck', on his way out of the White House. It is worth adding that in 1934 the US Congress passed a law (the 'Debt Default Act' or 'Johnson Act') which demanded payment of war debt 'at one hundred cents on the dollar'.[38] The struggle for gold (particularly between the United States and France) was heading towards new complications and the end of the gold standard.

4 The Nazis in charge

As mentioned above, the exchange controls introduced in 1931 were the cornerstone of German trade and financial policies in the following years. Before considering them, it is worthwhile giving some background information on crucial economic and political developments in Germany. The slump in NNP continued unabated in 1932, when it reached its trough and unemployment peaked, while wholesale prices also continued to decline in 1933. Brüning resigned in May 1932. The Reich's president, Paul von Hindenburg, increasingly appeared as the sole focus of legitimacy of the state. 'The year

1932 brought [however] the death-agony of presidential government.'[39] The government led by the conservative Franz von Papen lasted for few months only, under political pressure from the Nazis. Elections for the Reichstag were held in November 1932.[40] Even though the Nazi party registered a sharp fall in votes and was outnumbered in parliament by the combined total of two Marxist parties, it still was by far the largest; but Hitler refused to be part of a government of which he would not be the head. Another 'presidential government' was formed under General Kurt von Schleicher. Von Papen and von Schleicher definitively abandoned the deflationary policy of Brüning's government and started a programme of public works. Its budget of RM740m under von Papen and RM500m under von Schleicher was spent on housing, land improvement and road works, as well as on financing capital expenditure by the railways and the post office.[41]

Schleicher's failure to win over the Nazis proved decisive, however. He also alienated the sympathies of the conservatives by declaring that he favoured neither capitalism nor socialism, and he was not able to pursue his intent to re-examine the possibility of eventually departing from the gold standard in order further to stimulate recovery and employment. Schleicher even flirted with the idea of establishing an authoritarian corporate state (perhaps on the Fascist model of Italy), eliminating the Reichstag and suppressing both Nazi and Marxist parties. He resigned and, on 30 January 1933, Hitler was sworn in as Reich Chancellor, at the helm of a coalition of different parties.[42]

On the 2 February, the American chargé in Berlin, Alfred Kliefoth, met Schacht, who stated that Hitler had asked him to become finance minister, but he had preferred to be appointed, for the second time, as Reichsbank president. Kliefoth wrote that Schacht already appeared to be 'the economic and financial adviser to Hitler, and constantly in consultation with him'.[43] According to Schacht's memoirs, he was summoned the following month by the new chancellor. 'At the moment there can be only one urgent duty for the new national government – Hitler said –, and that is to do away with unemployment. For this it will be necessary to find a very large sum of money. Do you see any possibility of raising such a sum – other than through the Reichsbank?' Schacht replied that a recourse to the central bank would be unavoidable and added that at that moment it would be impossible to give any definite estimate of the figure that would be involved. But he concluded that 'whatever happens we must put an end to unemployment and therefore the Reichsbank must furnish whatever will be necessary to take the last unemployed off the streets'.[44] Was this the correct answer of a central banker, if he was truly independent from his government? In his apologetic memoirs, Schacht wrote that he would have given the same answer, if asked by the former chancellor, Brüning (who was too orthodox in his monetary views to raise this question, anyway). Yet, even without considering the very different political affiliations of the two chancellors, with reference to the functions and purposes of a central bank the question remains: Should it actively support deficit spending by the government at the cost of substantially raising the money supply? At any rate, on 17 March Schacht resumed his office at the Reichsbank, while the incumbent president, Hans Luther, was sent to Washington as the German ambassador.

Schacht was a staunch supporter of the gold standard, and the gold content of the Reichsmark in fact remained unchanged over subsequent years. In order actively to pursue an expansionary policy, to promote recovery and reduce unemployment and, later, to prepare for war, he would have needed a solid foreign investment position for Germany, supported by a strong trade and current account balance – features that, at that decisive juncture, were hardly present.

Even though Germany had, in practice if not formally, got rid of the burden of war reparations after the Lausanne Agreement of 1932, its pile of foreign debt, particularly towards the United States, was substantial, and to meet repayments the Reichsbank's gold reserves had been dramatically eroded.

As evidence of the state of the Reichsbank when Schacht was reappointed as president, the deterioration of its international reserve and the consequent worsening of the monetary base/reserve ratio (the GSLR) in the period from 1930 (when the ratio was still well below the 'apprehension level') to 1934 are evident from the following table:

Table 4.1 Germany, gold standard leverage ratio, 1930–1934

	in RMm	**1930**	**1931**	**1932**	**1933**	**1934**
A	Gold	2,216	984	806	386	79
B	Foreign Exchange	469	172	114	10	5
C	Bank Balances	525	604	460	558	881
D	Circulation	5,409	5,389	4,163	4,220	4,471
E	**GSLR (C+D)/(A+B)**	**2.21**	**5.18**	**5.03**	**12.07**	**63.71**

Source: gold, bank balances: Deutsche Bundesbank, *Deutsches Geld- und Bankwesen*, tab C1–1.01; foreign exchange: Federal Reserve, *Banking and Monetary Statistics,* tab 167; circulation: Mitchell, *European Historical Statistics,* p 710.

It should be borne in mind that 1931 was the year of the banking crisis, with the introduction in Germany of strict foreign exchange controls to stem capital outflows. Despite these controls the international reserve contracted sharply, particularly in its currency component, and the GSLR climbed well above the 'apprehension level'. The devaluation of the British pound in 1931 and of the US dollar in 1933 might have lessened the debt burden, but the gold clause attached to the Dawes and Young loans (to the American tranche only – however, the biggest – for the Dawes Loan) made the devaluation mostly irrelevant. On the contrary, those devaluations made German exports internationally uncompetitive. The surplus of trade balance became thinner, and the whole current account registered a deficit in 1934 (Tables 5.1 and 5.2).

The thesis that the policy to be adopted in accordance with the gold standard should have been a significant reduction of the Reichsmark's gold content – that is, a meaningful currency devaluation – is indeed attractive, but very different from the course of action that Hitler and Schacht chose. It should be noted, however, that sticking to the old parity was not a specific Nazi policy: It had been constantly pursued by the Weimar governments. The impending task of the government – the absorption of the huge level of unemployment by a substantial increase of public spending – had to be reconciled with the continuing formal adherence to the gold standard, even though that standard, as can be seen in Table 4.1, was nothing more than a fiction. However, the very concrete consequence of this mockery was that the German economy was highly uncompetitive internationally. 'Hitler and Schacht made the defense of the official gold value of the Reichsmark into a symbol of the new regime's reliability and trustworthiness.'[45] The dollar devaluation of 1933–1934, which lowered the dollar value from 23.7 to 39.4 cents to the RM, made German exports immediately more expensive but, on the other hand, the dollar value of the German debt towards the United States, if not protected by the gold clause, fell.

The course of action that the Nazi government followed was to build on the foreign exchange control system introduced in 1931 and to adopt significant measures of economic stimulus. Was Schacht successful in his endeavour? Germany's foreign debt declined from around RM26bn in 1930 to around RM10bn in 1938, with the decline particularly concentrated in the short-term sector. Foreign debt was 36 per cent of German NNP in 1930 and 10 per cent in 1938.[46] The trade balance was in almost constant surplus in the 1930s.

In the following chapter we shall deal in some detail with the various technical devices Germany adopted in order substantially to reduce the burden of its foreign debt. Germany resorted to moratoria and transfer limitations on debt repayments, adopted implicit export subsidies and selective hidden devaluations and created a large network of bilateral clearing agreements with specific trade partners, strictly arranged according to the needs (either growth- or war-oriented) of its economy. In summary, Germany virtually abandoned the use of international currencies and resorted to various forms of international barter through rigid foreign exchange controls.[47] These controls, created to stem capital flight, became an instrument of trade policy. In the present chapter we shall focus on some of the political and institutional developments that help explain the German government's attitude towards this apparently intractable problem.

5 Germany: the international side

In May 1933, a few months after his re-appointment to the helm of the Reichsbank, Schacht visited the recently elected American president, Franklin D. Roosevelt, in Washington and alerted him that Germany was ready to proceed to a transfer moratorium on its foreign debt. 'The reaction was completely calm', he wrote,[48] but creditor countries started becoming aware that they might meet serious difficulties in obtaining a full repayment of their loans from Germany.

A few days later, Schacht presented his plan for a transfer limitation in a letter to Hitler, stressing however that its final aim was a return of the Reichsmark to the 'free international payment system again as soon as possible', and that his measures were not permission for a suspension of payments by the German debtors, but only a 'matter of foreign exchange policy'. This letter (at first sent, cautiously, in draft form) had all the arguments in favour of the adoption of a moratorium. He explained that following the collapse of Credit-Anstalt in May 1931, and the German banking crisis, a huge outflow of gold and foreign currency had occurred. The exchange controls adopted in July had slowed down the haemorrhage, but the legal cover of the Reichsmark's circulation had been lost. The reduction of available international means of payment had caused foreign trade to shrink more and more, and the ensuing sharp decline in the German trade surplus; the 'arbitrary currency measures taken by a number of other countries [had recently] created a further danger … if we don't want to jeopardize the payment of imports, especially of raw materials and semi-finished goods, the processing of which forms the basis for the employment of a *highly qualified German labour force*[,] … Germany can transfer debt payments into the creditor currencies only if the German export remains in existence'.[49]

This letter was immediately followed by a cabinet meeting in which Schacht alerted his colleagues that certain countries that were financial creditors of Germany, but at the same time in a trade deficit towards Germany, had already threatened to introduce compulsory clearings whereby any German trade surplus would be tied up for payment of coupons that became due on their bonds.[50]

It should be remembered that a couple of important measures affecting German foreign debt had been introduced before Hitler's seizure of power. A decree of 9 November 1931, under Brüning's government, permitted foreigners to sell their holdings of German bonds within Germany, but forbade the transfer of proceeds abroad.[51] The values of German bonds on foreign markets declined. In addition, from the middle of 1932 the Reichsbank began granting permission to German exporters, whose exports qualified as 'additional' (that is, concerning goods that could not be otherwise exported because of their uncompetitive price) to purchase German bonds on foreign market at a low price, and to cover their trade losses by reselling them at a higher price in Germany. This measure established a connection between exchange controls and trade promotion.

But a further, more-decisive step was taken under the Nazi government in 1933. On 9 June, the Transfer Law suspended payment of a large part of German liabilities in foreign currency. The scheme adopted by the German government did not formally deny any claim by foreign creditors, thus avoiding a legal declaration of default, but reduced the amount in foreign currency available to creditors, applying a substantial 'haircut' to the face value of their credits.

A short digression is necessary to show that this law had a hidden story of very informal contacts between Schacht and the Western creditors. As we can learn from the archives, Schacht had elaborated a scheme of cutting drastically the amount of currency that foreign creditors might obtain from their holdings of German debt. He had presented a draft of it to the Americans, well before its official introduction and even before his re-entry to the official scene as central bank president. Thanks to his personal relations with Montagu Norman, it was as a private citizen (before his attainment of any public position) that, in early October 1932, he presented a memorandum containing the main parts of the scheme to the American bank that had the most significant credit position, J. P. Morgan (when von Papen was the chancellor). It therefore seems that the plan was known to the Americans even before it was officially presented to Hitler.

Schacht had met Norman on 4–6 October 1932, and the Bank of England governor had in turn informed Morgan Grenfell, the London subsidiary of J. P. Morgan, of Schacht's proposal.[52] While short-term debt had already been covered by the Standstill agreement, Schacht 'suggested' that German long-term foreign obligations should be treated as follows:

(1) No scaling down of either principal or interest;
(2) All obligations, including Dawes and Young loans, to be treated similarly;
(3) All interest to be paid in Reichsmarks into a blocked account at the Reichsbank;
(4) These blocked Reichsmarks would be kept without interest at the Reichsbank, or invested in German securities; and
(5) 'Scrips' (debenture notes) in foreign currencies would be issued as the interest matured.

J.P. Morgan's reaction to Schacht's suggestion – Norman being the usual intermediary – was, as expected, quite negative: A transfer suspension would be 'most damaging to German credit abroad'.[53] Schacht met an envoy from Norman a few days later and admitted that his position might be interpreted as a 'suspicion that Germany would like to carry out a policy of systematic evasion'.[54] In December, Schacht and Norman met at Thorpe Lodge, the governor's private address in London. It seems that the governor, at this point, was accepting the inevitability of the German plan (even though Schacht himself admitted to being 'on my own'). Norman merely suggested that it would be better to adopt the plan by an administrative decision of the Reichsbank, instead of by a government decree which would emphasize its unilateral nature and give the appearance of a deliberate default. Schacht replied that a transfer suspension should not be confused with a debt moratorium (a thin distinction, indeed), and that anyway legislative action would be needed to enforce the denomination of German debtors' payments in marks rather than in the currency in which the specific loans were denominated. He added that the American warnings regarding the Dawes and Young loans would be taken into account.[55]

The Transfer Law of 9 June 1933 followed the above-mentioned principles, albeit with some important variations. The German government declared that until further notice there would not be foreign exchange available for any maturity after 1 July with respect to external long-term obligations.[56] German debtors would continue paying amortization and interest (which is why the law could not be qualified as a formal declaration of default), but payments would be in Reichsmarks when they fell due, and made not to foreign creditors but to a new institution, the *Konversionkasse*, which would release the needed currency only according to the ways and times dictated by the Reichsbank and the finance ministry. It was decided that only 50 per cent of the service of long-term debt would be paid in foreign currency[57] while, for the other half, creditors – unable to receive payment in their own currency – would receive, for their blocked claims, debenture notes issued by the *Konversionkasse*, named 'scrip' and denominated in marks.[58]

Creditors could ask the Gold Discount Bank to purchase the scrip at a price of 75 per cent until January 1934. Afterwards, those proportions were changed: the percentage payable in foreign currency was reduced to 30 per cent, and the remaining 70 per cent might be sold to the Gold Discount Bank, but only at a price of 67 per cent. In other words, the foreign creditor was able to cash a gradually shrinking amount of his credit in free currency. These scrips would then be resold by the Gold Discount Bank to German exporters, who would gain from the spread between the scrip value abroad and on the domestic market, in a sort of concealed devaluation.[59]

Following the American warnings, interest and amortization of the Dawes Loan and interest on the Young Loan were, however, to be transferred in full, that is, not on a *pari passu* with other foreign obligations.

This legislation was approved while the World Economic Conference in London (more details on this later) was dragging on without yielding any tangible results, let alone the reintroduction of a fully fledged gold standard: rather, it was producing an awareness that the United States was abandoning that standard, as Britain had done two years before (although in very different circumstances). The German government ostensibly showed generosity, albeit with a thinly veiled touch of irony: the Transfer Law included a 'grace period' of three weeks, to give the conference the opportunity to take up the transfer problem in the meantime. The 'solution was not found', and the deferment of currency transfers, as described here, entered into force on 1 July.[60]

Predictably, a scramble occurred among foreign creditors to either avoid or contain the effects of the deferment. In general terms, what emerged was that Germany could pay its debt through a transfer to the creditors of goods and services, rather than of free foreign currency; in other words, it was becoming necessary for Germany to maintain a net trade surplus. In the event, things did not proceed so straightforwardly. Western creditor countries that had a trade deficit with Germany had a weapon at their disposal: holding back payment of German imports if their financial credits were not satisfied. Various countries, such as Holland and Switzerland, were forced through special arrangements under which their nationals would receive interest in full in return for extra purchases of German goods.[61] The Gold Bloc countries – that is the countries that had maintained the gold parity of their currencies, such as France and Italy – wanted Germany to discriminate in its debt repayments against countries that had devalued their currencies (as the United States and United Kingdom), but Schacht rejected this idea.[62] However, by rejecting this discrimination, he admitted another: discrimination between West European countries and America. For Western Europe, Schacht pressed on with the stipulation of agreements that made payments dependent on the ratio of imports to exports of goods and services, taking into account the structural trade surplus which favoured Germany. This was impossible in respect to the United States, Germany's biggest creditor, which also had a considerable bilateral trade surplus. John Foster Dulles, then a lawyer with the law firm Sullivan and Cromwell of New York acting on behalf of the American creditors, vigorously complained to Schacht that this was an 'economic war system', against the 'equality of all creditors', and – the United States being unable to threaten not to pay for net imports from Germany, given the American surplus – he raised the risk that unilateral action would lead to the seizure of the substantial assets held abroad by German obligors of dollar bonds, and the 'virtual wiping out of German economic activities beyond her own borders'.[63]

The declining trade surplus notwithstanding (in 1934 a deficit would emerge), at the end of 1933 the German government was still convinced that the trade surplus with Western European creditor countries would exceed Germany's interest and amortization obligations to the point that full service of the external debt might be resumed. This could not be possible with respect to the United States, given its trade surplus. In the end, 'the total or partial moratorium would in these circumstances be directed ... against the United States'.[64]

In May 1934, the Conference on International Transfers was held in Berlin. The representatives of the creditor countries had to fight against Germany's increasing reluctance to service its foreign debt. Germany presented a long list of complaints. It observed that even though international trade had sharply contracted since 1929, and despite its need for huge quantities of raw materials for domestic industry, Germany had been able to maintain a trade surplus: 'An unprecedented result in history.' This result had been mitigated by: the loss of its colonies, which had been strong providers of raw materials; by the devaluation of major currencies like the pound and the dollar; and by high tariffs and quotas that had discouraged German exports. According to the German delegation, the London Economic Conference of 1933 had given rise to expectations that transfer restrictions on debt servicing might be temporary, in a general revival of international cooperation, but the results of that conference had served as a disillusion. The Germans returned to the old theme of war reparations, and noted that the amount paid under the Dawes and Young Loans had in fact been made possible thanks to the foreign capital inflows that Germany had previously enjoyed. 'The problem of German transfers is, today, the same as the reparation problem, yesterday'; they added: it had 'a political origin'. Interest rates on the main loans had increased, in real terms, as a consequence of the fall in prices. The gold and foreign exchange reserve had been totally depleted (see Table 4.1) but, at the same time, Germany fully rejected any suggestion of either deflating the economy or devaluing the Reichsmark.

More specifically, deflation, they observed, had been quite ineffective in 1931–1932 under Brüning's chancellorship, because against more competitive German exports foreign countries had responded with trade barriers and currency devaluations. Deflation had simply made six million unemployed, and the German authorities did not want to repeat that experience. As for Reichsmark devaluation, it would raise the prices of the imports of raw materials necessary to German industry. 'We must maintain the Reichsmark stability, and we have the power to do that', was the final conclusion, with an addendum: 'on the basis of their current consistency, Reichsbank's gold and foreign exchanges do not have any more, in practice, the function of a banking reserve: their only purpose is to permit the technical operations connected with foreign payments, and they are already insufficient [also] to carry out this function'.[65] And the inescapable consequence was that Germany would not service its debt.

It was consistent with this rigid position when, through the president of the Bank for International Settlements, Leon Fraser (the BIS was acting as Trustee of the Young Loan), German Finance Minister Count Lutz Schwerin von Krosigk, announced to the creditor countries at the end of the Berlin Conference on 14 June that, in accordance with the Transfer Law of 1933, further restrictions had been decided for all debt maturities falling in the year July 1934–June 1935. No cash transfer would be carried out in the second half of 1934, and the issue of scrip would be suspended, while foreign creditors could receive, upon request, from the *Konversionkasse* (where German debtors had deposited the amounts in Reichsmarks), mortgage bonds, denominated in the currency of their claim, with a 10-year maturity (1945), earning 3 per cent interest and guaranteed by the Reich's government. If creditors preferred cash, the Reichsbank would purchase their claims at 40 per cent of their nominal value and would pay more only 'if it was able to do so' (that is, within the limits of currency availability). Importantly, the new measures were extended to the service of the Reich's loans: the Dawes and the Young loans.[66] After the announcement of this general moratorium, quotations for these loans plummeted: The Dawes Loan – dealt on the New York exchange at an average of 79.18 in 1932 – fell to 37 in the first months of 1935; the Young Loan fell from 59.5 to 28.63.[67]

The goal of the German government was simply to achieve strict containment of debt repayments, at the same time as trying to avoid trade retaliation – through unilateral clearings – by the creditor countries. Krosigk wrote to the interested governments that any link between debt service and foreign trade should be rejected: 'I have come to know that in some countries the idea has been floated, in case of missed transfers on the Reich's loans, that measures of [unilateral] clearing or similar restrictive measures might be adopted .... These ideas imply that economic transactions would be carried out through anti-economic means. Such provisions ... would prove in a short time totally vain, and the counter-measures would create new obstacles to international trade, thus shattering the principles on which a recovery of the world economy should be based.'[68]

This position of the German government was later explained by Karl Ritter, the diplomat involved in trade negotiations, in an article in an American journal in 1936. Ritter wrote that the creditor countries 'had in common that not only were they financial creditors of Germany but that in every case their trade balances, and in most cases their balance of payments also, were passive in respect to Germany. These countries have one by one confronted Germany with the following alternative: either she must consent to bilateral clearing arrangements which will satisfy the financial as well as the commercial claims of these countries; or, if she refuses to do this, they will adopt unilateral clearing measures for the same purpose .... After mature consideration the German Government decided to give way to the pressure exerted upon it and agreed to a bilateral clearing'.[69] In other words, according to the Germans clearing agreements with creditor countries had been signed under duress and these devices would have been avoided if these countries had given up their financial claims, or had opened their frontiers to German goods by abolishing tariffs and quotas.

This position angered Fraser, but it appeared clear that any possibility of even partial continuation of debt servicing would rely on a German trade surplus, and that debt repayment and trade deals would proceed together on a bilateral basis. The Trustee still had funds partly to service the interest of the Reich's loans falling due on 15 October and 1 December 1934, but after that any repayment would depend on separate agreements between Germany and the individual countries where the loans had been issued. With these agreements Germany attained the goal of 'dismantling the last vestiges of the Dawes and Young Plans'.[70]

6 Germany: the domestic side

Nazi Germany saw the establishment of a 'state capitalism' that retained enterprises' private ownership, but carefully directed the economy through state agencies. On the 1st of May 1933, Hitler announced a plan aimed at drastically reducing unemployment, and a specific law was approved to this end on 2 June. The law provided for the expenditure of one billion Reichsmarks on housing, roads, agricultural and suburban settlements and public utilities (the so-called 'Reinhardt Programme', named after the new secretary of state at the finance ministry, Fritz Reinhardt). A second law in the same month instituted a 'grandiose' plan for the construction of 7,000 km of motorways, with a budget of RM3.5bn.[71] The 'battle for work' was the first compelling programme that the Nazi government started, confronting an unemployment rate that at the start of 1933 stood at 34 per cent, with over 6 million people unemployed. Its results are somewhat belittled by some commentators, who claim that the drop in unemployment that occurred in the first three quarters of that year could not be attributed to the new legislation. 'Because Hitler's government had no work creation policy until the enactment of the June Reinhardt programme, very little of the sharp decline in unemployment during the first three quarters of 1933 could have resulted from Nazi policies and programs.'[72] According to this interpretation, the recovery was mostly due to other factors: an incipient 'natural' economic upswing, the modest impact of measures previously taken by the von Papen government and by Gunther Gereke, an economist made commissioner for labour under the Schleicher government, and an improvement in market confidence accompanying the Hitler chancellorship.[73] In September, while the Reinhardt programme took time to come into effect, a second programme was announced that relied not on credit-financed government spending, but on indirect subsidies to private activity: RM500m for building repairs and RM300m for interest rate subsidies to mortgage holders.[74] In September–October 1933 the labour minister, Franz Seldte, and the president of the Institution for Placement and Unemployment Insurance (RfAA), Friedrich Syrup, produced a report that exalted the progress made in reducing the unemployment rate, but stressed that in October the number of unemployed was only 1.4 million less than a year earlier (5.1 million people in October 1932, 3.7 million in October 1933[75]). Reinhardt dismissed the factors of spontaneous recovery and stressed the economic relevance of the new *autobahns* and of the RfAA's programmes. At the end of 1934, the number of unemployed stood at 2.6 million, and had even climbed from a level of 2.5 million in June.[76] The real turning point would only come in March 1935 when the rearmament effort was announced; the final step in reducing unemployment was the introduction of compulsory military service in the same year.[77]

On the whole, the amount allocated for the reduction of unemployment between the summer of 1932 (that is, under the Papen and Schleicher governments, and Hitler's), and the end of 1934 was around RM5bn. Of this, RM3.9bn were actually spent as follows.

Table 4.2 Germany, public expenditure to reduce unemployment, 1932–1934 (in billions of Reichsmarks)

Employment creation programmes	1.5
Reich budget	0.7
Employment board (relief works, labour service)	0.4
Railways	1.0
Post Office	0.1
Motorways	0.2
Total	3.9[78]

Source: Guillebaud, p 51.

Most of the outlays regarded the years 1933–1934, in which years they constituted 3.2 per cent of national output. How could such a stimulus be financed, and how substantial was this amount? A tax increase would have removed purchasing power from the economy's private sector, counterbalancing the higher public expenditure without an appreciable demand stimulus. The alternative of directly borrowing on capital markets was also ruled out, for fear it might cause a crowding-out of private investment. What remained was a recourse to the credit of the central bank, against the orthodoxy of the time and the evidence of the disastrous effects of this policy under the Weimar Republic; a large part of the expenditure was, in fact, financed with the central bank's money. We have already seen the consequences that 'money printing' had led to in the early years of Weimar, but it was estimated that the financial situation was then very different. Firstly, in terms of sheer size: The burden of war reparations, of domestic war debt and of additional post-war-related expenditure was then much higher as a share of national output. Secondly, in 1933 formal gold coverage (and the perception of solidity with which it imbued the currency) gave a stronger basis to the decision to resort to Reichsbank credit. It was, at any rate, a bold and perhaps unprecedented experiment: Certainly a pre-Keynesian initiative at a time when the *General Theory* had yet to be published and its author had written unsuccessfully to Roosevelt to advocate an American recovery through deficit spending.

Technically, the public works scheme functioned as follows: the government commissioning agency issued 'work creation bills', given as payment to contractors. They discounted these bills at state-controlled banks, which – in turn – cashed the bills at the Reichsbank. According to a certain timetable, the finance ministry reimbursed the central bank by paying cash obtained from two sources – additional tax revenues and the issue of long-term government bonds. To function properly, the scheme had to rely on economic recovery for additional tax revenues, and a receptive capital market for raising long-term loans,[79] alternatives that, as just mentioned, had been ruled out to kick-start the recovery.

The relevance of that programme must be considered against the prevailing fiscal policies of that time, which were aimed at overcoming the Depression through a 'sound' budget. Suffice to say that in the same year, in 'A Bill to Maintain the Credit of the United States', Roosevelt, the new US president, called for a balanced budget, and the bill was actually passed. The same orthodoxy had been maintained in Germany over the years of deep economic contraction. Chancellor Brüning had refused to adopt an expansionary fiscal stance. However, von Schleicher, during his short-lived chancellorship before Hitler's ascent, had already budgeted for a credit-financed work-creation programme, although no money had been spent by the time Hitler took office.[80] It may sound like a paradox that Germany started an important programme of public works with monetary financing, while keeping the formal gold parity of the Reichsmark, whereas America abandoned the standard and underwent dollar inconvertibility into gold for the domestic private sector, but maintained a conservative fiscal stance (as mentioned, Roosevelt was afraid to abandon the principle of the balanced budget, and was substantially deaf to Keynes's pleas). Trade balance considerations and the eventuality of more relaxed Federal Reserve monetary policy, probably contributed to Roosevelt's decision, while the *de facto* international inconvertibility of the Reichsmark – in addition to domestic inconvertibility – permitted Germany to go ahead with fiscal expansion.

From April 1934, as the Nazi government adopted an increasingly bellicose attitude, this unorthodox method of government funding took the shape of 'Mefo bills' financing. The arms procurements were paid with short-term debt securities – the Mefo bills – issued by *Metallurgische Forschungsgesellschaft mbH* (Mefo), a company created by important German concerns such as Krupp and Siemens, some of which were heavily involved in arms production. Mefo was what we would today call a 'shell company': a 'Special Purpose Vehicle' that allowed the central bank not to be directly involved in war financing. Two purposes were served: to contain the banknote circulation (an important indicator of sound policy), and to shield arms expenses from foreign observation. The volume of these bills was kept secret.[81] Mefo bills were discountable at the Reichsbank but, yielding a good interest and enjoying the government's backing, they remained in circulation. In the end, they constituted an important form of 'quasi money'. In 1936, half of military expenditure was funded by these Mefo bills, and in 1938 their outstanding amount was RM12bn against a banknote circulation of just RM8.6bn.[82] At that point, just when war preparation was intensifying, Schacht, still at the helm of the Reichsbank, tilted towards a bigger recourse to taxation and borrowing, aware of the inflationary potential of these bills. His position within the government was increasingly weak, and this decision put him on a collision course with the ruling elite of the Reich.

The following year he resigned from the central bank (on this point, see also Chapter 8).

7 The United States and Britain

The uncompetitive parity of the pound sterling chosen by Britain in 1925 led to a deterioration of British foreign accounts. Because of a serious outflow of gold, a tight monetary policy aimed at containing the volume of circulation was not enough to stem a considerable worsening of the ratio between the 'monetary base' and the gold reserve. This ratio (the gold standard leverage ratio, or GSLR) climbed well above any 'apprehension level' (to use Bagehot's words). We should bear in mind that, depending on different countries' legislation, a ratio above 2.5[83] would generally be considered potentially dangerous to currency stability. Britain's ratio had surpassed that apprehension level by far, reaching 4.16 in 1931, notwithstanding a deflationary policy and a contraction of the circulation, as the table shows:

Table 4.3 UK, gold standard leverage ratio, 1928–1931

	in GBP m	**1928**	**1929**	**1930**	**1931**
A	Gold	154	146	148	121
B	Bank balances	70	71	132	127
C	Circulation	393	383	380	376
D	**GSLR (B+C)/A**	**3.01**	**3.11**	**3.47**	**4.16**

Sources: Gold and bank balances: Federal Reserve, *Banking and Monetary Statistics,* tab 164; circulation: Mitchell, *European Historical Statistics,* p 712.

Another factor that contributed to the gold outflow and raised fears of an international scarcity of gold, was French gold policy. France had adopted the gold exchange standard with a competitive parity in 1928, and accumulated gold through balance-of-payments surpluses and conversion of its foreign currency holdings into gold.[84] Hawtrey wrote:'At the beginning of 1929 the Bank of France started reducing its holding of foreign exchange. … Thereupon began that tremendous inflow of gold that continued with occasional intervals up to the crisis of 1931. … Here is the cause, at any rate the principal cause, of the loss of gold suffered by the Bank of England in 1929.'[85] In mid-1931, France was the second gold hoarder in the world after the United States. Its gold reserve increased from $0.7bn at the end of 1926, when France had stabilized the franc, to $2.2bn.[86] At the end of 1931, the United States and France held almost 60 per cent of the world's monetary gold stocks.[87] Similarly to the United States (see below), 'despite the dramatic increase in French reserves, accumulated at first in foreign exchange and later in gold, the authorities did not respond to this by inducing a corresponding increase in the money supply'.[88]

The huge foreign short-term balances at the Bank of England – 'a singularly treacherous form of liability'[89] – became not a sign of strength and confidence, but a serious worry for the British authorities. Was Britain's international investment position in such a state to support the sterling parity under stressful conditions? It was still positive in that period, but the problem was that British assets abroad were mostly long-term, and belonged to the private sector (the gold reserve of the Bank of England was, as we have seen, relatively modest).

It is pertinent here to make a short digression that may help to explain how this specific imbalance in Britain's foreign investment position (a long-term position on the asset side and a short-term position on the liability side) had already created difficulties in the past. During the First World War, Britain had to ask the United States for war loans, and American banks required collateral. The British government relied on the huge long-term foreign investments of the British private sector, patriotically appealing to the investors to provide negotiable securities to use as collateral. A great quantity of these securities was obtained, mainly in the form of municipal securities and railway stocks and bonds. British investors received interest-bearing receipts from the government: foreign assets became domestic in order to support the war effort. As a consequence, British-owned foreign investments shrank during the war. However, they remained substantial and, in 1930, the net foreign investment position of Britain was still positive, estimated at £5.45bn.[90]

During the difficult circumstances of 1931, the British authorities did not exploit this positive investment position as they had done during the war. Why? As before, the Bank of England was encumbered by short-term sterling liabilities, while British assets abroad were mostly privately owned long-term investments. But, unlike in wartime, the authorities were probably not, politically, in a position to demand further patriotic sacrifice by asking Britons to transfer their foreign holdings to the public sector in support of the national currency. Was the government unable or unwilling? 'The idea that the British departure from the gold standard was influenced by a desire to devalue the pound is entirely baseless', the economist Hubert Henderson, an adviser to the British government, wrote in an internal cabinet memo years later: '[W]e were driven off gold, despite strenuous efforts to remain on.'[91]

Events unfolded rapidly in 1931. Britain was involved in a political crisis over balancing the budget, which the government of Ramsay MacDonald saw as essential to the restoration of international confidence. The mutiny of the fleet at Invergordon over pay cuts was the last straw, and on 21 September the pound abandoned the gold standard. This dramatic development was seen, years later, as an unqualified national defeat. One contemporary observer commented that 'if western capitalism founders in our time[,] posterity surely will give as its verdict, "Suicide, whilst of unsound mind"'.[92]

But Britain's commitment to the gold standard had been weakened by the necessity to expand the money supply and stimulate domestic demand, even though the *mentalitè* still prevailing in the 1930s kept macroeconomic policy, both monetary and fiscal, cautious enough. Britain was, at any rate, appreciative of the freedom of action that a floating exchange rate allowed, and uncommitted to a return to a fixed-rate and gold convertibility.[93]

In fact, for several months after it was driven off gold, the weakness of the pound was a source of serious anxiety to the British monetary authorities but, in early 1932, the pound began to recover. British public opinion viewed the appreciation unfavourably and was still more hostile to a return to the former parity, fearing the loss of competitiveness that would result. In view of these circumstances the Exchange Equalization Account was created, with a substantial capital of £167m provided by the government.[94] Its objective was to moderate, or 'smooth', exchange-rate fluctuations, if necessary by accumulating reserves in gold and foreign currencies. Significantly, its operations would remain secret and its accounts would not be published. 'To try for some sort of stability at a lower level seemed, therefore, the course of wisdom',[95] along with replenishing the almost-exhausted international reserves.

The practice of smoothing exchange-rate fluctuations by buying and selling foreign currencies or gold, and at the same time keeping the money supply stable by offsetting open market operations, is well established in our day, but in that period (when a gold standard framework was still the predominant system) any accumulation of gold or foreign currencies would have entailed a domestic monetary expansion, which the British authorities wanted to avoid (or, at least, to subject only to domestic policy objectives). Through the Exchange Equalization Account, that accumulation of foreign reserve would remain hidden to the markets, and the authorities could pursue the course of policy considered more suitable to their domestic needs.

Britain's Exchange Equalization Account set in motion the creation of similar devices elsewhere, most importantly, in the United States. Were these new institutions used as an instrument of competitive exchange rate depreciation? The British claimed that their Exchange Equalization Account was simply aimed at avoiding an overvaluation of the pound. What is certain, in any case, is that through these exchange manipulations, governments were able to hide their true foreign positions by making statistics less reliable, and to divorce their monetary policies from their foreign positions (severing a link that was the *raison d'etre* of the gold standard). It was only gradually that some transparency emerged in these currency positions. The Federal Reserve wrote in 1943 that 'many government funds have never reported their gold holdings, but in recent years the three leading exchange funds – the British Exchange Equalization Account, the United States Exchange Stabilization

Fund and the French Exchange Stabilization Fund – have rendered certain reports on a delayed basis'.[96]

As we have seen, during the 1920s the United States had refrained from the monetary and credit expansion that its gold stock would have permitted, in accordance with the gold standard's unwritten rules of automatic symmetry. Rather than inflating through an accommodative policy, the United States adopted a policy of 'managed money' aimed at domestic price stability and, in 1928, abruptly increased interest rates in order to curb stock market speculation. The yield differential that emerged between European and American interest rates provoked a capital (and gold) inflow to the United States, contrary to the direction that its huge gold reserve would have suggested. The Federal Reserve sterilized this inflow using open-market operations, and the Smoot-Hawley Tariff, introduced in 1930, put up barriers to imports while the balance of trade continued to be strongly favourable to the United States. The US gold stock reached a peak of $4,306m in 1930.[97] Given the country's solid international position,[98] this asymmetrical policy accentuated the existing imbalances.

One might argue that this tight monetary stance was justified by the impending banking and financial crisis, and that a more accommodative policy in the spirit of the gold standard 'rules' would have simply accelerated the onset of the crisis. We shall not deal extensively here with the financial crisis in the United States, but it does not seem that 'excessive' credit extension by banks was at its root. Looking at the American statistics related to those years, we can note that it was in the households sector that the greater increase in financial assets occurred. Specifically, in the period 1922–1929 bank assets grew by 46 per cent, while household financial assets – largely corporate securities – grew by 80 per cent.[99] A relevant part of bank intermediation consisted of brokerage, underwriting and dealing in securities, and therefore worked largely by putting directly in contact the 'end users' (business and households), so that securities issued by business ended up in households' portfolio. The stock market collapse brought a huge portfolio loss to households, pushing them to make massive withdrawals of deposits from the banking system. The origins of the crisis are still the subject of endless debate, but it is perhaps only in the present day that we are starting to appreciate the relevance of banking and financial regulation to avoiding financial crises, rather than exclusive reliance on monetary policy. An appropriate regulatory framework for the banking system, which was finally introduced with the Glass-Steagall Act of 1933, might perhaps have been more effective in preventing stock market speculation and have avoided the necessity of resorting to a tight monetary stance and enduring the severe bank credit contraction that followed.

Was it a failure of the gold standard model *per se* that happened, or rather a dysfunction of the system? To return to our ratio (the gold standard leverage ratio, or GSLR), it is notable that for the United States it changed as follows in 1928–1931:

Table 4.4 US, gold standard leverage ratio, 1928–1931

	in US$ m	**1928**	**1929**	**1930**	**1931**
A	Gold	3,854	3,997	4,306	4,173
B	Bank balances	2,389	2,355	2,470	1,961
C	Circulation	4,796	4,746	4,522	4,822
D	**GSLR (B+C)/A**	**1.86**	**1.78**	**1.62**	**1.63**

Source: Gold and bank balances: Federal Reserve, *Banking and Monetary Statistics 1914–1941*, tab 156 and 85; circulation: *Historical Statistics of the United States*, Cambridge University Press, 2006, vol. 3, 3–614.

Far from worsening, the GSLR fell in that period. The American restrictive monetary policy was not motivated by a fall in the gold reserve which, on the contrary, increased. 'The volume of internal currency was divorced from the volume of the gold reserve. Under the gold standard, they have been linked rigidly together[;] this, it should be noted, was an essential link in the chain of automatic reactions by means of which international equilibrium was maintained under the gold standard system', as the British economist Henderson observed.[100]

According to the gold standard 'rules', what would the correct behaviour have been when the American economy was characterized by still better ratios than in 1928, thanks to restrictive monetary policies and a gold inflow? If we think of the standard as a symmetric system, with equal obligations for surplus and deficit countries, then since the United States appears clearly as the hegemonic, surplus country, there should have been room for an increase in the monetary base and in credit without disruption for the monetary system, while stock market speculation might have been curbed by means of stricter regulation.

Was the United States following the deflationary bias intrinsic to the gold standard? Not so, according to those who maintain that American policymakers, in adopting a tight stance, were instead following a specific credit 'doctrine': the 'real bills only doctrine'. We have briefly explored this doctrine (or the distorted use of it) in the different context of Reichsbank policy in the early 1920s (Chapter 1), and it is worth further consideration as we appraise the Federal Reserve's behaviour. It was the opinion of many observers that banks' inability to adjust to crises had resulted from 'actions of risk-prone banks that loaned speculatively or on a long-term securities and mortgages'.[101] The doctrine suggested that only 'real bills' issued in proportion to the needs of trade should be discounted by banks, so that the money expansion would just follow those needs and would not suffer from excessive lending. This view was supported by the very act that had created the Federal Reserve. The Federal Reserve Act of 1913 defined as 'eligible' paper discountable by Reserve Banks as 'notes, drafts, and bills of exchange arising out of actual commercial transactions ... issued or drawn for agricultural, industrial or commercial purposes'. 'Fed banks' faithful adherence to the real bills doctrine (bills short-term and self-liquidating) would make the monetary system self-regulating, with or without the gold standard'.[102] To the Federal Reserve, we might say that the gold standard ended up appearing not so much symmetrical or asymmetrical as superfluous.

In the same vein of national interest, the United States abandoned domestic gold convertibility *de facto* in 1933 and formally in 1934, at the same time hugely reducing the dollar gold content. Whether this move was consistent with gold standard symmetry is, again, highly questionable. From 1928 to 1933 the dollar exchange rate had remained stable against the other main currencies (appreciating, however, against the British pound), but after relinquishing the gold standard it depreciated heavily, boosting America's competitiveness and creating troubles for many countries which had instead expected symmetrical behaviour on the part of the United States.

The decisive role played by this decision of the United States in the collapse of the gold standard raises the question of whether the American economy was in an unsustainable situation, like that of the British economy in the summer of 1931. The British did not think it was, at any rate. The internal memorandum of the British cabinet cited above also includes the following statement: '[O]ne of the most startling of these experiments[103] was the deliberate depreciation of the dollar by the United States in 1933. ... This policy, adopted in face of the vast American gold reserves, was something entirely new in monetary history. ... It seems to have been largely inspired by a crude statistical generalization to the effect that the price level varied proportionately to the price of gold, which ... commended itself to President Roosevelt as an hypothesis worth testing.'[104]

But even some Americans did not see that step as necessary. In 1932, in the midst of the banking crisis, the American authorities were confident that the U.S. gold reserve might allow a substantial credit expansion without any urgency to devalue the dollar. Randolph Burgess, a leading figure of the American financial scene, and at the time a deputy president of the Federal Reserve Bank of New York, wrote in a memorandum for the Bank for International Settlements as follows:

> My own judgment about the problem is based first on certain broad considerations:
>
> (1) The United States holds, despite recent losses, more gold than was ever before assembled by one country.

(2) We are a creditor country, and over a period other countries must make payments to us. In fact, the foreign claim on us is relatively small and has been diminishing rapidly in recent months. It does not seem possible that other countries can put us off the gold standard.
(3) We have a credit mechanism better adapted to economizing gold and adjusting itself to gold changes than any other country in the world. The Federal Reserve Act, with its provision for reducing the reserve percentages if necessary, makes it possible to export almost unlimited amounts of gold.
(4) This is now the only country paying out gold coin on demand, and the 'gold bullion standard' has become so generally accepted that we could meet any excessive domestic drain of gold by a shift to that standard, although, of course, this would not be done except in extreme emergency.
(5) This country more than any other has committed itself to gold by making government obligations payable in gold, and many corporate obligations, so that *to go off the gold standard would involve a moral breach of contract if not a legal one.*
(6) It is very doubtful whether going off the gold standard would benefit us any economically. It would, in the first place, be a terrible shock. In the second place it is not at all certain that the dollar would decline and prices rise. A rise in prices depends upon an increase in the amount of credit in use, and this might not take place. *Our gold reserves are sufficient to form a basis for any necessary increase in the volume of credit without going off the gold standard. ...* (italics added)

'Most of the discussion about our going off the gold standard is quite uninformed as to what it all means. The idea is rather taken over from European discussions. The reason that European countries have always faced that possibility is that they are so closely interdependent. Foreign trade and foreign financial relations have become relatively so small a part of the business of this country that the same reasoning does not apply to us.'[105]

At the very start of Roosevelt's tenure, the banking crisis was provoking a shift among the public from bank deposits to gold, and the Federal Reserve had to intervene with injections of liquidity to support the many banks that were facing huge withdrawals of funds. Even if gold in circulation as coins contributed to the country's total gold stock, that shift meant a decrease in the official reserve. In response to the banking crisis, the administration proclaimed a national Bank Holiday in March 1933 to stop deposit withdrawals and banned the storage of gold by the private sector: these measures were specifically aimed at closing these two serious gaps. They were interpreted by the markets as a sign that the United States was abandoning the previous policy of keeping the gold standard, and the dollar lost ground to all major currencies. Between 1932 and 1933, for instance, the exchange rate went from $3.50 to $4.24 per pound, from 3.9 to 5 cents per French franc, and from 23.7 to 30.5 cents per Reichsmark.[106]

This decline was, however, more the result of market speculation – which correctly perceived Roosevelt's reluctance to stick to the gold standard – than an evidence of a fundamental weakness in the American monetary system.The current account continued to register a comfortable surplus, and no serious gold loss had actually occurred. The gold reserve started the year 1933 at $4,074m, and finished the year at $4,012m, after a drop to $3,800m in February: hardly an unsustainable trend. The restriction of gold payments could perhaps have been a temporary expedient,[107] and the gold standard might not have been relinquished.

In 1933 the American disentanglement from gold was enacted through two acts: the Emergency Banking Act of 9 March and the Federal Emergency Relief Act of 12 May. They authorized the president of the United States to fix the weight of the gold dollar at a level much lower than the existing one and required the delivery to the U.S. Treasury of all gold held privately, other than for the purposes of art, industries, professions, and exports to foreign purchasers. The following year, the Gold Reserve Act of 30 January fixed the maximum weight of the gold dollar at 60 per cent of the previous level. The following day, President Roosevelt proclaimed a devaluation of 59.06 per cent, equivalent to $35 per fine ounce.[108] The act simultaneously established the General Fund of the Treasury, an exchange stabilization fund to stabilize the exchange rate of the dollar (similar to the account that the United Kingdom had set up a few years previously), with an endowment of $2bn for the purpose of dealing in gold and foreign exchange.[109] The acts of 1933, in any case, gave the strongest sign yet that America was leaving the gold standard, even though the GSLR hovered at around 2 for the whole 1933, and saw only a very minor increase which was well within the 'apprehension level'.

At the time of the World Economic Conference in London of June–July 1933, that ratio was not deteriorating. The purposes of the American authorities in leaving the gold standard, namely the priority given to domestic policies, were well stressed by the statement of Cordell Hull, the American secretary of state, at the conference in July: '[T]he world will no longer be lulled by the specious fallacy of achieving a temporary and probably an artificial stability in forex [foreign exchanges]. … The sound internal economic system of a nation is a greater factor in its well-being than the price of its currency. … Restoration of world trade is important[, but] temporary exchange fixing is not the true answer. We must rather mitigate existing embargoes to make easier the exchange of products which one nation has and other nations have not'. Alberto Beneduce, the Italian member of the BIS board and a sort of financial plenipotentiary for Mussolini, reacted angrily to these words, writing that, as Hull had announced with 'feeble and troubled voice', President Roosevelt wanted 'the renunciation to the policy of defense of gold-based currencies'. Beneduce severely castigated the United States as responsible for the 'elevation of a credit castle which was the only innovation of the U.S. international policy in the last decade. This credit castle, day-by-day, was removed from the real foundations of credit, which are represented by actual and perspective real output, coming out of exchange of goods and services. This castle prepared its own fall, that was as spectacular as unexpected by the American market players. Too often Americans say that life is business. Well, in business it's necessary to review past mistakes, while the burden of losses should fall over those who made profits, or believed to be able to make them' (this passage sounds very familiar in the context of today's events). He continued into an expression of chauvinistic pride: 'Latin civilization, with its secular experience, has instead inspired the statement just made in London by countries that have their own currency anchored to gold, and want to maintain it in the interest of the economic and financial world reconstruction.'[110]

Given the prevalence of domestic interests – in Germany, with the introduction of strict exchange controls, in the UK with the pound's devaluation, in the United States with the dollar's disentanglement from gold – a coordinated effort to change the gold parities and lower interest rates would have been quite hard to achieve. Indeed, the London World Economic Conference of 1933 marked the failure of any serious attempt to restore internationally accepted rules and (though most policy makers were perhaps unaware of it) heralded the definitive fall of gold as the standard of domestic and international payments. France and Italy wanted to stick to their parities, and the American announcement of the new US gold policy at the conference was a real blow to them.

The Congressional hearings held in Washington on the occasion of the discussion of the bill that finally increased the gold price to $35 per ounce provide a telling story in this regard. A large part of the debate dealt with relatively minor issues such as the allocation of profits generated by the devaluation (to the Fed or Treasury), the shift of the entire gold reserve from the Federal Reserve to the Treasury, and whether gold prices should be fixed by a legislative measure or by the president's authority; but the central issue here is how the experts interviewed by the competent commission of the House of Representatives reacted to the devaluation bill. In a testimony to Congress the president of the Federal Reserve Bank of Philadelphia, George Norris, said: 'that very low valuation of the dollar is due to several causes. A great many things have conspired to drive the dollar down below natural or proper levels.... American exporters have left their balances abroad instead of bringing them back here. There has been a considerable flight of capital from this country.... The devalued dollar gives us an advantage in foreign trade'.[111] In reference to the gold parity of the dollar, he said: 'I cannot see any sound argument that can be made that there is any shortage of gold in the world, and *certainly not in this country*, where we have the largest stock of any nation in the world'. He admitted that 'there has been a very considerable shrinkage in the deposits' but continued that 'whether we take actual currency [circulation] or whether are taken bank credit currency [deposits], there is ample supply of both.... There never has been a time when any Federal Reserve bank had less than 40 per cent gold reserve against them [banknotes]; there never has been a time when the assets of any Federal Reserve bank were not amply sufficient to retire all of the notes that were issued'.[112]

8 Italy: living with an overvalued currency

In 1927, was the new gold-linked lira based on a solid balance sheet position? Figures regarding the foreign investment position of Italy following the return to the gold standard in 1927 are not available, but its potential capacity to support the lira parity can be assessed on the basis of the balance of payments statistics. Unfortunately, estimates of the Italian foreign accounts vary greatly. Pretty recent revisions of the balance of payment show a weaker position. In the post-war period (1919–1931), the total current account registered an almost constant deficit, because the surpluses in shipping, tourism and particularly in emigrants' remittances were not enough to balance the heavy merchandise deficit. What changed the picture of the whole balance of payments was the capital account, which showed a surplus in 1919–1921, a deficit in 1922–1924, and again a surplus in the years of the lira stabilization. This surplus disappeared after 1928, similarly – again – to the German experience. The result of these trends is visible in the level of official reserves, which decreased for substantial amounts after the stabilization of 1927. The Italian situation presents an additional important similarity with Germany's: an uncompetitive parity of their currencies made harder to stick to the gold standard without devaluation. As we have seen, Germany formally kept the Reichsmark parity unchanged, and introduced very strict exchange controls in 1931. What about Italy?

It should be remembered that, at the beginning of the 1930s, what prevailed in Italy was still an ideology inspired by free trade and freedom of capital movements. This ideology found the support of several influential economists, such as Attilio Cabiati, Luigi Einaudi and Libero Lenti. Only later, exchange controls and trade restrictions were introduced, under the pressure of falling reserves, Ethiopian war financing and restrictive policies by the main trade partners of Italy.[113] It is therefore not entirely surprising that, notwithstanding the strong erosion of the official reserves, the first decision on foreign exchanges taken in March 1930 by the new finance minister, Antonio Mosconi – who had succeeded Volpi in 1928 – went in the opposite direction, by abolishing all measures of foreign exchange control and restriction to capital movements.[114] Beyond that ideological background, this apparently inexplicable decision had, however, a specific – if insufficient – motivation: The price of Italian government bonds on foreign markets was falling, and the government hoped that, if Italian investors were allowed to purchase those bonds abroad, their yield would fall, to the advantage of a better funding of new Treasury issues. As a matter of fact, the loss of reserves consequent to these purchases of foreign-denominated securities, as Morgan bonds, proved to be more costly than the benefit of a lower yield on public debt.[115] The governor of the Bank of Italy, Vincenzo Azzolini, had to write to all the branches of the bank in order to discourage investors from these purchases. Azzolini wrote: 'It has come to my attention that the Morgan bonds 7 per cent [reference is to the J. P. Morgan stabilization loan to the Kingdom of Italy, mentioned above] are requested by Italian savers. Investments of this sort are not convenient to our country, and these funds might be better employed to buy domestic securities. The branches should deter investors from these foreign purchases'.[116]

The alarm bell would, anyway, ring pretty soon, with the devaluation of the pound in September 1931. This year had rather unusual features for the Italian balance of payments. The merchandise deficit decreased, because the Depression brought lower imports. Foreign remittances and tourism contributed to generate a surplus in the current account. With a slight surplus also in capital account, this should have been reflected in an increase in the official reserves. On the contrary, in 1931 they decreased by around Lit1.8bn: evidence of unregistered capital flights, of lags in export payments and of decreasing confidence in the Italian lira.[117]

The pound devaluation led to a change in the composition of the Italian reserve, with a tendency to move towards a pure gold standard and a decreasing proportion of foreign exchange. Therefore, the unfavourable situation of the balance of payments led at first to a decline in the currency component of the reserve but, then, the gold component was also substantially affected (see below, Table 4.5). The Italian government, however, appeared reluctant to take drastic measures. The only decision that followed immediately the pound devaluation was the Decree Law of 29 September 1931, which authorized the finance minister to issue new regulations for the foreign exchange market. As we shall see, only in 1934 were regulations actually introduced.

Nevertheless, there was enormous pressure in Italy to adopt protective measures, given the unshakeable willingness to defend the parity introduced in 1927, and the intricate network of foreign exchange controls, tariffs and quotas that were being introduced elsewhere (Germany was a good case in point). Some countries – the United States and most Western European states – preferred in the 1930s to abandon the gold standard and rely on trade-protection measures. Italy followed its own path: On one side, it preferred to stick to an uncompetitive gold parity, as did Germany; on the other side, Italy opted for continuing, at first, with free foreign exchanges while adopting trade restrictions, similarly to the Western countries. Similarly to other free exchange countries, the Decree Law 21 December 1931 stated that trade with countries that had adopted exchange controls might be subject to safeguards regarding Italian exports.[118] The obvious fear was that those controls could hinder transfers of currency to Italy, even when the bilateral trade balance was favourable to the foreign country. This approach would later become usually adopted in bilateral clearing agreements.

Why not to devalue? In Germany, as we have seen, the vivid memory of hyperinflation was a disincentive to gain competitiveness through that device; and after 1933 the old parity became a flag of honour and prestige, and a sign of strength of the Nazi government. In Italy, this argument found very receptive ears in the Fascist regime (which very much pre-dated the Nazi regime in Germany): Mussolini had been the prime mover of a return to gold, at the cost of having an overvalued currency, and was adamant on preserving the overvalued lira parity.

Both the Treasury and the central bank were acutely aware of the consequences of an overvalued lira but would not dare to openly defy the dictator's views. Very telling in this regard is the harsh debate between the governor of the Bank of Italy and the finance minister, about the sustainability of the lira exchange rate. Azzolini explicitly proposed the introduction of foreign exchange controls to Mosconi at the start of 1932. He stressed that huge physical movements of banknotes were underway at the Italian–Swiss border; this money then reached New York, where the Italian currency was negotiated at a deep discount. Azzolini also proposed that purchase of foreign securities should be banned, and that a mandatory registration for those who already possessed them should be imposed: all measures similar to those adopted by Germany a few month before. Mosconi replied that Mussolini was opposed to restrictions to capital movements. In May, Mosconi asked Azzolini for an opinion about 'shifting the lira stabilization point' (!), which anyway should not mean 'a fast and perhaps precipitous devaluation process'.[119] Azzolini did not compromise himself with any firm opinion, believing that any decision should be a government responsibility. Mosconi complained about the 'absence of proposals' from the governor,[120] but no decision was in fact taken, and Mosconi's resignation shortly afterwards put this sterile debate to an end.

Increasing signs of operational stress in the gold standard in Italy are evident by looking at the critical ratio of monetary base/gold and foreign currency in reserve, the GSLR (Table 4.5). It gradually increased, notwithstanding a strong deflationary bias and continuous contraction of circulation, from 1.79 in the aftermath of the return to the gold standard, to 5.05 in 1935, when the ratio climbed well above the 'apprehension level'. In 1935 lira convertibility had to be suspended.

The disastrous reaction of the countries of the Gold Bloc to the dollar devaluation – Britain strove to avert a similar appreciation – can be better appreciated by considering that only two alternatives were open to them:

Table 4.5 Italy, gold standard leverage ratio, 1930–1935

	in ITL m	1930	1931	1932	1933	1934	1935
A	Gold	5,297	5,628	5,940	7,092	5,812	3,027
B	Foreign Exchange	4,289	2,193	1,309	403	88	299
C	Bank Balances	1,452	1,366	805	837	414	490
D	Circulation	15,681	14,295	13,672	13,243	13,145	16,296
E	**GSLR (C+D)/ (A+B)**	**1.79**	**2.00**	**2.00**	**1.88**	**2.30**	**5.05**

Sources: Gold, foreign exchange, bank balances: Banca d'Italia, *I bilanci degli istituti di emissione*, pp 310–317; circulation: Mitchell, *European Historical Statistics,* p 711.

either to devalue, that is 'to align' their currencies to the dollar's new value, or to deflate their economies. Both Italy and France at first avoided devaluation; they undertook deflation, accompanied in Italy by increasing foreign exchange controls. Then, Italy, caught by the necessity to finance a new war adventure – conquering Ethiopia – devalued again in 1936, by 40.94 per cent, to a content of 46.77 milligrams of gold, and lira was made inconvertible. The pound, dollar and lira devaluations in the phase 1931–1936 exerted, in turn, a strong pressure on the French franc. In France, the severe deflation led to the victory of the Popular Front of Léon Blum in the elections of 1936. His social programme and capital flights abroad made the decision to devalue unavoidable, and in September the gold content of the French franc was reduced to 44.1 milligrams. An exchange stabilization fund was also created (further reductions followed, to 38.7 in 1937, and to 24.75 in 1938).

In the same month, the devaluation of the French franc was accompanied by simultaneous declarations by the governments of France, Britain and the United States, the so-called Tripartite Currency Agreement, containing the assurance that the franc devaluation would not be the occasion for further competitive depreciations of the other two currencies. 'It recorded a *modus vivendi*, vague, but none the less effective.'[121] After the devaluation of the main currencies that had remained stuck to their old parity (the Gold Bloc), a flexible gold-settlement system was given a formal basis under this agreement, according to which the US Treasury would provide a market for gold at the new price of $35 per ounce fixed in 1934: In most countries, being their national currencies inconvertible into gold, the market price of gold was determined directly or indirectly by the current exchange rate of the dollar,[122] in a sort of gold–dollar standard. An arrangement similar to the one emerged after the Second World War. The British view was that this agreement, by assuring a sort of relative stability, would be the pre-requisite for a progressive relaxation of the current system of quotas and exchange controls.[123] The important exception remained the Reichsmark, whose gold parity was left unchanged, resulting in an increasingly pronounced overvaluation. According to Adam Tooze, who relies on Göbbels' diaries, Schacht may have wanted to hitch the German currency to the Tripartite Agreement by seeking a coordinated devaluation of the Reichsmark and the French franc,[124] but this hypothesis appears rather far from Schacht's monetary beliefs.[125]

Looking back, the publication of the League of Nations we have quoted often accused the French (and indirectly and very cautiously, the United States) of 'exchange dumping and undervaluation',[126] advocating a return to the use of gold in international transactions, if not for domestic ones: It was a late complaint for unilateral actions and an implicit admission of inability to foster cooperation.

Countries tilted towards unilateralism and 'beggar-thy-neighbor' approaches. But the ultimate, if elusive, goal which they tended toward was a restoration of the gold standard, albeit on a 'modernized' base,[127] as soon as domestic and international conditions would permit. It should be recalled that in July 1933, at the closure of the World Economic Conference of London, there had been a consensus that 'in the more distant future, the ultimate aim of monetary policy must be the restoration of a satisfying international monetary standard. The view was formed that the ultimate aim was the restoration of an international gold standard'.[128] This was a widespread opinion almost in any circle, with relevant exceptions, the most notable being Keynes's opinion.

5
Bond Repatriation, Export Subsidies and Clearing Agreements

1 International currency shortage and recourse to barter

The disappearance of the Concert of Nations in the aftermath of the First World War was accompanied by the abandonment of the old common monetary standard based on gold and by increasing economic fragmentation. The panoply of foreign economic and financial agreements which characterized the interwar years, and were mostly signed on a bilateral basis or by very small groups of countries, reflected the polarization of foreign policies through pacts, protocols, understandings and *ententes*, sometimes with bombastic names;[1] they were mutually exclusive and established bonds among their signatories that were as strong as they were potentially inimical to any outsider: This was the result of a petty, mean-spirited approach to international cooperation.

The devaluations that accompanied the gold standard's gradual collapse brought a huge misalignment of currencies. The structure of exchange rates emerged in a piecemeal and haphazard fashion, with consequent disequilibria in trade balances. Moreover, large cross-border capital flows caused further imbalances in the international investment position of various countries, a position already affected by other factors, as war reparations imposed on Germany and war debts incurred by the Allies. Trade and financial debts became the dominant issue in international economic and political relations and generated an acute shortage of instruments of international payment – foreign currency and gold. Debt management became very difficult: That shortage resulted in a reluctance, or inability, to fulfil both financial and trade-related foreign obligations.

These developments occurred in the context of the Great Depression, with big contractions in economic activity and in price levels. The adjustment mechanism of deficit countries was enacted through deflation in order to recover competitiveness, while surplus countries, first of all the United States, were not likely to, and actually did not, accept a system that would force them to reflate their economies.

As we have seen in Chapter 4, the result of this situation was an increasing nationalism in economic and financial policies everywhere, with more attention to domestic markets and attempts to insulate them from external constraints. The slump in output and employment intensified protectionism, starting from the Smoot-Hawley Tariff of the United States in 1930. During the Great Depression there was a contraction of international trade (–40 per cent between 1929–1932), and at the same time the directions and patterns of trade were shifted dramatically, changing the traditional multilateral system into a patchwork of regional settlements.

In the 1930s, international monetary standards were replaced by currency areas or blocs: a residual Gold bloc, the Sterling Area, a group of inconvertible currencies tied to the Reichsmark, and another of currencies, mainly in the Western Hemisphere, linked to the American dollar. The Gold Bloc countries (mostly those of the former Latin Union: France, Italy, the Netherlands, Belgium, Switzerland and Poland) defended their gold parity until 1936. After the pound's 1931 devaluation, some countries, mainly from the British Empire and Scandinavia, linked their currencies to the sterling instead of gold. Besides Germany, the Reichsmark Bloc included Austria, Hungary, Romania, Bulgaria, Yugoslavia: mostly Central and South Eastern European countries (and it is in this area that the origin of clearing agreements is to be found).[2] In general, countries that disengaged from the gold standard mostly relied on tariffs and import quotas to limit access to their domestic market, whereas countries of the Gold Bloc (while it lasted) followed different approaches: some of them, like France, Belgium, the Netherlands, or Switzerland, maintained free or largely free convertibility, while others, like Italy, adopted a growing set of exchange control measures. The Reichsmark Bloc relied heavily on exchange controls, a high degree of inconvertibility, and bilateral clearing agreements. Notwithstanding similarities with the Sterling Area, these features, and in particular the inconvertibility, made the real difference. Whereas foreign exchange reserves in the Sterling Area constituted a form of international currency – and this was indeed the reason for central banks to hold them – the RM holdings at the central banks of the Reichsmark Bloc were, in fact, 'blocked' and could not be used to settle transactions with third countries.[3]

There were not always clear delineations among different currency areas: For instance, Germany's Reichsmark formally remained a gold currency, but was not included in the Gold Bloc because of the complex web of controls that surrounded and protected the German currency. However, *dirigiste* commercial policies everywhere tended to focus on intra-bloc trades, while inter-bloc trades were discouraged by the measures described above. As Eichengreen put it, '[T]he standard determinants of bilateral trade flows – incomes, proximity and contiguity – had a diminished role in the '30s.'[4] These arrangements took the place of previous commitments to free trade and adherence to gold standard and reflected lines of political preference and economic dependence.

It would be misleading to say that free-currency countries relied only on trade measures. In these countries the practice of exchange control took a more nuanced form in the creation of currency defense funds: the exchange equalization accounts (established first in the UK and then in the United States and France), whereby the foreign exchange market, although still formally free, was heavily influenced by the fund's activity thanks to the provision of substantial endowments by the government.

Furthermore, there were differences in the extent of currency controls where they were formally introduced. Germany and Italy are two cases in point. Nazi Germany saw exchange controls as an instrument of state supervision and as a tool for planning the whole economy in order to achieve specific objectives, increasingly related to war preparations. Faced with a large foreign debt, Germany also adopted forms of direct pressure to reduce its burden by linking financial debt repayments to trade agreements – specific export procedures were used as a logical device for tying debt repayment to additional exports.[5] Fascist Italy resorted to similar kinds of intervention, but controls of foreign exchange and trade were less strict and market forces were given more space; later, a worsening balance of payments led to a monopoly of foreign exchanges. In both countries, new institutions were created in order to make state controls more effective.

On the surface, every country stressed that all these devices for protecting domestic markets should be considered as temporary and far from ideal; in reality, they soon became the only game in town. Quoting Hitler, Karl Ritter (the diplomat at the centre of Germany's clearing agreements) observed retrospectively, in 1936, that the clearing system, given its origin and its distorting effects on international trade, could be regarded only as a 'makeshift, involving a number of drawbacks and that it should therefore be abolished as soon as possible'.[6] The widely shared 'wisdom', and not only in Germany, was that a true recovery from the economic and financial crisis could only come from the restoration of 'normal' monetary and trade relations, but policymakers and observers were clueless about what this normality would mean. The restoration of the gold standard remained a distant and elusive goal. According to an enquiry conducted by the League of Nations in 1935, 'most of the Governments have stated that they consider the [clearing] system to be a necessary evil and they ask nothing better than to revert as soon as possible to the normal methods of international trade'.[7] But one may wonder whether, in the absence of those bilateral agreements, international trade might have been at even lower levels in the midst of a collapsing international monetary system and the Great Depression. Clearings 'did much to enable countries which had got into trouble through a heavily adverse balance of payments to restore equilibrium without curtailing their imports unduly'.[8]

Exchange controls and bilateral clearing agreements became a 'crucial determinant'[9] of the activist economic policy of Nazi Germany. Even though exchange controls and clearings had started at the beginning of the 1930s (and thus shortly before the Nazis' attainment of power), Ritter's words were a sort of self-justification for a policy that was to become the benchmark of German financial and trade relations up to the Second World War. Was the final purpose of this policy an autarkic system, a self-sufficient, fully closed economy? The answer is certainly negative. Germany needed commodities – notably raw materials and foodstuffs – that had to be imported, domestic production being insufficient to satisfy the growing needs of its population and industry, especially when the economy was being oriented towards war preparation. Autarky would have involved an increase of the agricultural production and a deliberate reduction of manufacturing, contrary to the policy of fostering industrialization, particularly in the armaments sector.[10]

Instead, a tendency towards a barter system would be a more appropriate description of what German policy aimed at. At its most extreme, a system based on barter does not need any medium of exchange, thus solving the problem of currency shortage, which as we have seen was at the centre of the financial troubles of the 1930s. Theoretically, the same purpose – that of obviating the need for international reserves – could also be achieved by a regime of completely free-floating exchange rates, because any adjustment of the balance of payments would occur through changes in the exchange rate rather than through gold or currency transfers (in fact, the need for international reserves is proportional to exchange rate stability: and the more flexible the exchange rate, the smaller the need for foreign currency or gold). But the German authorities remained adamant on the absolute rigidity of the Reichsmark exchange rate (its gold content), even when faced with competitive devaluations by Germany's main trade partners and while its reserves were dangerously dwindling until eventually reduced to a bare minimum.

Hence, Germany's inclination towards the adoption of forms of barter. With this kind of trade regime, money ceases to perform its essential function as a medium of exchange: '[W]hen, in order to maintain the internal value of a currency at a particular value, that currency is prevented from serving as instrument in trade, it ceases to perform the essential function for which it was created.'[11] Bilateral clearings also denied the function of money as unit of account, because the exchange rate of the two currencies involved was determined case by case – that is, it did not necessarily coincide with their official parities. The function of money as a store of value was instead enhanced, as a hedge against potential adverse events. A country could thus maintain a fictional parity for its currency, without necessarily experiencing or, at any rate, limiting, the consequences of its overvaluation.

For Germany, the aim of these 'barter' measures was on the one hand to preserve imports of raw materials and foodstuffs, relying on markets that could provide them at cheaper prices[12] even under politically stressful circumstances; and on the other hand the aim was also to exploit the export of manufactures – products for which German industry traditionally enjoyed a good reputation. Given the high exchange rate of its currency, which made its exports internationally uncompetitive, Germany either relied on hidden export subsidies, or imposed its products on weaker countries through clearing agreements. In these agreements, different exchange rates were adopted, often according to the convenience of the stronger partner, and the practical relevance of the official exchange rate consequently decreased. The proceeds from exports were delivered to the German authorities and then allocated by them among chosen importers. This allocation might follow different priorities: for payment of merchandise or 'invisible' items, or for servicing Germany's high foreign debt. Different commodities, firms, or countries might also be ranked in order of priority.

2 Germany's trade

In the long period between the early 20th century and the Second World War, it was only in the 1930s that Germany's trade balance went from deficit to surplus. The development of its industrial power had required a huge quantity of imports, mostly of primary products (both foodstuffs and raw materials), while the percentage of manufactures on the import side remained constantly low at around 20 per cent. Consistent with the features of a 'transformation economy', finished products were the single biggest component of its exports. That deficit notwithstanding, it is notable that on the eve of the First World War 12.4 per cent of the world's exports were from Germany: a percentage that would never be reached again in the period preceding the Second World War. After the First World War this figure had fallen to around 4 per cent, a sign of the distressed state of the German economy; it climbed again to reach 12.2 per cent in 1931 before falling back to around 9 per cent in 1938.[13]

If we focus our comments on the 1930s, on the export side manufactured products played an important and growing role during that decade, such that between 1929 and 1939 their percentage share grew from 70 per cent to beyond 80 per cent of total exports (by comparison, in Italy, another transformation economy, that percentage stood at around 50 per cent in 1939). It was this large-scale export of manufactured goods that allowed Germany to enjoy an almost-continuous trade surplus at that time.

As far as the destination of its trade was concerned, in the 1930s Germany maintained a constant surplus with the West European countries which remained its principal trade partners. In relation to the Rest of the world, including the United States, a significant financial creditor to Germany, a constant deficit emerged; but it was not large enough to balance its European surplus.

Numbers regarding German foreign trade vary according to different sources, but evidence converges in showing the trade surplus climbing to almost 5 per cent of NNP in 1931, then substantially declining to around 1 per cent or less; it was only in two of these years – 1934 and 1938 – that the balance registered a substantial deficit. The ratio of total trade to national output (NNP) was 31.2 per cent at the beginning of the decade – evidence of an extremely open economy – but this ratio then fell substantially, and in 1938 it stood at 10.9 per cent, a figure consistent with the general contraction of international trade.

Table 5.1 German trade, 1930–1939 (RMm)

	Export	Import	Balance	% of NNP
1930	12,036	10,393	1,643	31.2
1931	9,599	6,727	2,872	27.9
1932	5,739	4,667	1,072	20.5
1933	4,871	4,204	667	16.0
1934	4,167	4,451	–284	13.3
1935	4,270	4,159	111	11.7
1936	4,768	4,218	550	11.4
1937	5,911	5,468	443	12.9
1938	5,263	5,466	–203	10.9
1939			376	

Sources: trade: Ellis, German Exchange Control, pp 141–142; NNP: Mitchell, *European Historical Statistics*, p 821. For 1939 only; trade balance: Ritschl, Albrecht, Die Deutsche Zahlungsbilanz 1936–1941 und das Problem des Devisenmangels vor Kriegsbeginn, *Vierteiljahrshefte für Zeitgeschichte*, 39, January 1991.

For an economy burdened by a high level of foreign debt, that surplus was however insufficient to generate a comfortable foreign payments position (we must take into account that the 'invisibles' were in red, and that the large foreign debt had to be serviced). In fact, no clear trend is easily detectable in the current account of the balance of payments; between 1929 and 1940, four years saw a deficit. We should add two caveats: These statistics register payments as they actually were, but Germany made every effort to bring the servicing of its foreign financial debt below what was legally due, through substantial (albeit partial) defaults. Moreover, Germany often had a substantial trade debt in its clearing accounts; but these accounts were secret, and their deficit did not show up in the balance of payments' official statistics: a lack of transparency for which Germany is not the sole country to blame, as we have seen in Chapter 4 with the exchange stabilization accounts created by various Western countries (see Table 5.2).

The directions of trade are useful for understanding the international agreements, arranged on a bilateral basis, that Germany reached with a geographically diverse range of countries. In fact a variety of forms of agreement were concocted, requiring a good deal of financial creativity, each designed according to respective negotiating powers, the trade interests involved and the huge debt position of Germany. We can distinguish three different areas of agreement: countries of West Europe, of Central and South Eastern Europe and of (mostly) Latin America. The almost constant and relatively large trade surplus maintained with West European countries, which mostly remained free of foreign exchange controls, enabled Germany to repay, albeit partially and (for its partners) painfully, its financial debt through bilateral 'payment agreements' which entrenched the German surplus. Importantly, these agreements were constantly rejected by the United States, which – as it has been mentioned – had at the same time a trade surplus and a substantial credit position in relation to Germany.

Table 5.2 German balance of payments, 1929–1939 (RMbn)

	1929	**1930**	**1931**	**1932**	**1933**	**1934**	**1935**	**1936**	**1937**	**1938**	**1939**
Exports	13.6	12.1									
Imports	13.6	10.6									
Merchandise balance	0.0	1.5	2.8	1.0	0.7	–0.4	0.0	0.5	0.4	–0.3	0.3
Services	0.5	0.2	0.4	0.3	0.3	0.5	0.5	0.5	0.3	0.2	0.1
Interest and dividends	–0.8	–0.8	–1.2	–0.9	–0.8	–0.6	–0.5	–0.4	–0.5	–0.5	–0.4
Reparations	–2.5	–1.7	–1.0	–0.2							
Current account balance	–2.8	–0.8	1.0	0.3	0.2	–0.5	0.0	0.6	0.2	–0.6	0.0
Capital movements											
Short-term capital	1.1	1.6	0.6*	–0.7	–0.8	0.2	0.1	0.0	–0.2	0.5	–0.5
Long-term capital	0.6	0.0									
Other capital	1.0	–0.9	–3.3**	0.2	0.2	0.0	0.0	(?)	0.0	0.1	0.5
Capital balance	2.7	0.7	–2.7	–0.5	–0.6	0.2	0.1	(?)	–0.2	0.6	0.0
Gold and foreign ex.	–0.1	–0.1	–1.7	–0.2	–0.4	–0.3	–0.1	0.6	0.0	0.0	0.0

Notes: *From 1931, there is only one figure for short- and long-term capital movements; **From 1931, this item is qualified as 'residual'.
Sources: 1929–1930, Bank for International Settlements, *Financial Committee Report*, 1931; 1931–1939, Ritschl, Die Deutsche Zahlungsbilanz 1936–1941.

With Central and Southeastern European countries, mostly belonging to the crucially important Balkan region, Germany's strategic interest was to acquire from them the greatest quantity of raw materials and agricultural produce. This meant a recurring negative trade position for Germany. But – within the clearing agreements that were bilaterally reached with these countries – Germany avoided payment of its commercial debt, and balances in blocked marks (*Sperrmarks*) emerged as a result. These balances became, in fact, an outstanding loan to Germany within the Reichsmark Bloc.

Primary products of Latin American countries were much needed by Germany, with a resulting structural trade surplus in their favour, but these countries were not available to open a large credit to Germany by accepting *Sperrmarks*, as the Balkan countries did. Specific features therefore characterized Germany's agreements with its Latin American trade partners, as we shall see later on.

It has been observed:

> 1. that Germany had sound and sensible, if not moral or ethical, reasons for its [commercial policy] adoption and for its eventual bilateralism; 2. that German monetary authorities successfully manipulated the foreign exchange market to alter the composition, direction and terms of trade, thus exploiting the international market as a discriminating monopolist; 3. that the economic welfare of Germany was therefore enhanced; 4. that, contrary to the opinion of the time, German trade redounded with some net benefits to the exploited nations.[14]

In the following sections and chapters we shall try to assess these four points.

3 Foreign exchange controls and debt reduction techniques as a tool of trade policy

Germany had two overwhelming priorities: to downsize its outstanding foreign debt, and to import huge amounts of primary products – foodstuffs and raw materials – necessary for its economic growth and war preparation, with a resulting and deep intertwining of trade and foreign debt issues.

We shall first deal with debt reduction techniques and related export subsidies. The German government made a clever move in linking export incentives to foreign debt management.[15]These subsidies were conceived in such a tortuous, albeit innovative way that – while winning for Schacht the dubious title of 'wizard' – their costs, and the cost allocation, could not be easily detected: It was unclear who paid for what (Section 3).Then, we shall consider various forms of bilateral trade agreements. Payment and clearing agreements were stipulated and exploited, and became a centrepiece of Nazi's foreign economic policy. Also in these agreements, there was an important financial component, aimed at saving for Germany precious free currency resources (Sections 4–7).

During the 1930s German foreign debt was substantially reduced. Its estimates can be summarized as follows:

Table 5.3 Estimates of German foreign debt (RMbn)

	1930 (a)	1931 (b)	1931 (c)	1932 (d)	1932 (e)	1934 (f)	1938 (g)
Long-term	10.80		9.50	7.90	10.47	7.30	
(of which Dawes, Young and Kreuger[1])			(2.40)		(3.52)	(1.80)	
Short-term	15.5/16			9.90		6.70	
Total	26.3/26.8	23.80		17.80		14.00	10.00

Note: [1] The 1929 Kreuger Loan amounted to $125m and was largely placed in Sweden.
Sources: (a) BIS (in ASBI, Beneduce, 317)
(b) League of Nations (quoted by Ellis, p 74)
(c) BIS (in ASBI, Beneduce, 14)
(d) BoE Archive G/417
(e) Klug, Adam: *The German Buybacks, 1932–1939. A Cure for Overhang?,* Princeton Studies in International Finance, 75, 1993 (the figure of RM3.5bn includes all loans to public entities)
(f) BIS (ASBI, Beneduce, 317)
(g) League of Nations (quoted by Ellis, p 74).

According to the Bank of England, by far the biggest German creditor in 1932 was the United States, which owned 32.7 per cent of the short-term credit and 58.5 per cent of the long-term. Switzerland, the Netherlands and Britain were Germany's other main creditors. Also in connection with the contraction in the stock of capital, debt servicing gradually declined over the years.[16] Net payments for interest and dividends more than halved between 1931 and 1938.[17]

Overall, the stock of foreign debt as a percentage of German output (NNP) oscillated in its relation to the trend in NNP, but remained firmly on a downward path:

1930	36.8%
1931	40.7%
1934	21.7%
1938	10.2%

After the maze of foreign exchange regulations that were introduced from 1931, which made the Reichsmark substantially inconvertible, it became potentially useless for foreign holders to own German assets because their claims could not be freely negotiated on the market. The holders of assets attempted to liquidate their claims by offering them for sale at a discount. 'Considerable quantities of blocked balances may have been sold abroad at a discount by persons anxious to realize their claims'.[18] These marks were generally what were known as 'blocked marks' or *Sperrmarks*,[19] and German regulations restricted their use to specific categories of transaction. These blocked marks originated either commercially in trade transactions, or financially in credit extended to the Reich, to German local governments, and to private entities. As mentioned, these loans had been hit by various measures of official moratoria and interbank Standstill agreements.

We can list various categories of blocked marks according to the transactions that originated them and to their permitted use. From mid-1931, *Kreditsperrmarks* originated from: domestic reimbursement of private credits or from the sale of German properties owned by foreigners; from November 1931, *Effektensperrmarks* originated from the sale or redemption of foreign-owned securities; from February 1932, *Notensperrmarks,* from redemption of banknotes held by foreigners.[20] *Registermarks* resulted as a consequence of the Standstill agreements with foreign banks concluded in 1931, and further extended on a yearly basis. According to a memorandum of the Bank for International Settlements, 'the foreign creditor [was] willing to submit [his claim] to a substantial discount'.[21]

The use of blocked marks was limited by various regulations. In general, they might be destined for travel (*Reisemarks*), investment in Germany or for unilateral payments. Germany being hungry for convertible foreign currency (Germany of course preferred to get free currencies as payment of its exports), the use of blocked marks to pay for German exports was seen unfavourablyand limited to exports that could not otherwise be made because of their uncompetitive international price (so-called 'additional' exports). As a consequence, their value was measured in terms of a fraction of the gold mark parity. In general, their value decreased over time in parallel with Germany's gradual retrenchment from the free currency markets. At the outset of the war, these values ranged between 50 and 30 per cent of the parity.[22] *Reisemarks* were more in demand than other types of mark; for most of the 1930s, they were quoted at around 60 per cent. The limitations to the use of blocked marks apparently favoured the service sector of the balance of payments more than the commercial sector. *Reisemarks* were, according to Child, 'a boon to the German tourist trade'.[23]

Of particular relevance for debt-reduction and trade-balance purposes was the relation between foreign debt management and export promotion. In Chapter 4 we followed the political and institutional initiatives undertaken by the German government in 1933–1934 to reduce its foreign debt. Here we consider the technical aspects of that reduction. The programme of repurchase and redemption of German bonds held by foreign entities – a typical feature of Schacht's policy – was made possible by the exchange control regulations which severely limited their reimbursement to foreign creditors and consequently caused a sell-off of their claims. But how could repurchases and redemptions be made, given the German shortage of foreign exchange?

The convenience of the transaction rested on the huge discount of bonds on the foreign markets. Two factors emerged: firstly, the bondholders' ability freely to dispose of their German securities had been hampered by the currency restrictions, particularly by the severe constraints to the debt service derived from the Transfer Law of 1933 and the general moratorium of 1934 (Chapter 4). Another cause for the fall in their prices was that, for reasons connected to the Great Depression, several big German borrowers threatened to default.

It was in this environment, which was quite unfavourable to creditors, that the 'bond repatriation' took place. We can distinguish between straightforward buybacks of bonds and buybacks linked to export subsidies and promotion. The simple buyback of bonds required a certain availability of foreign exchange because the Reichsbank had to release the amounts necessary to buy the German bonds abroad at a discounted price. In 1934, RM120m worth of foreign exchange was allocated for the purchase of bonds with a nominal value of RM216m. But in the same years a scarcity of reserves emerged: '[A]t present our entire resources of foreign exchange are being spent either on raw materials or on foodstuff from abroad.', Schacht observed to Hitler, and this made buybacks more difficult.[24] They were curtailed in 1935, even though, apparently, this practice of direct repurchases did not cease until the onset of war.[25]

The indirect buybacks were linked to export subsidies by a procedure whose specific features were not always clearly discernible. The scheme operated through a triangle involving the German exporter, the foreign bondholder and the bond-issuer (often, the Reich itself).[26] The German exporter had to demonstrate to the German authorities that his product could be exported only at a loss, given the overvaluation of the Reichsmark (this evidence would qualify his export as 'additional'). With the permission of the authorities, he would then use a portion of the proceeds of his export sale to purchase German bonds on foreign markets, which traded abroad at a deep discount. By selling the bonds in Germany, the exporter would make a net profit from the price difference, if this difference were higher than the losses derived from having sold his goods at internationally competitive prices.

It seems that, until 1934, these bonds could only be sold to the original issuer and – importantly – the issuer did not pay the face value to the exporter, but a somewhat smaller sum. This means that two goals were attained at the same time: export promotion through subsidies, and a reduction in the debt.

In 1934, with the institution of trading in Berlin, the buybacks became real arbitrage operations, thanks to the difference of price between foreign exchanges and Berlin's; for instance, 6 per cent German bonds on the New York market in the 1930s varied between 25 and 40 per cent of their quotation in Berlin. In this case, the net profit of the exporter would not be accompanied by a debt reduction: The foreign debt simply became domestic debt, owed to German nationals.

In summary, this practice placed the burden of the export subsidy on the foreign bondholder. The German exporter benefited from the subsidy so long as the gain from the arbitrage exceeded the loss from the export sale. Germany benefited from the conversion of foreign currency debt into domestic debt, and from its reduction if the redemption were made at a price lower than the issue price.

Was this a form of dumping? Critics observed that the sale of German goods was financed by foreign creditors, who had to sell their bonds as a consequence of German currency restrictions. To this objection, the Germans simply replied that foreign creditors had been deprived of their holdings by the aggressive behaviour of their own governments, which were strangling the German economy with import restrictions and devaluations.

The scrips, which we have described in Chapter 4 in relation to the Transfer Law of 1933, and the blocked marks, which we have mentioned above, were used to serve similar purposes: to reduce debt and stimulate exports. How the scrip mechanism works deserves a few additional words, given the importance attributed to this device by German policymakers. The scrips represented the portion of foreign credit that could not be paid in free foreign currency. This portion, denominated in marks, could be converted into foreign currency only at a substantial (and growing discount) at the Gold Discount Bank. This bank sold the scrips to German exporters who would profit from the difference between the nominal value of the scrip and its purchase price. In addition, according to the scheme envisaged by the German government, the holder of the scrip might sell it, on a sort of secondary market, to an importer of German goods, to pay for them. The use of scrip for export promotion was highly valued by the Germans: '[W]e have been handicapped recently in our exports', Schacht wrote to Hitler, 'by the fact that we were not offered enough scrip.' In February 1934, Germany decided to offer to foreign creditors a larger percentage in free currency on their sale of scrip to the Gold Discount Bank: Schacht believed that 'our exports will be able to get a new boost from this'.[27] Similarly, a secondary market was created for the various types of blocked marks that we have mentioned earlier, and the size of the discount depended on the specific type of mark.[28]

A system of direct export subsidies was introduced in 1935, with a special fund set up using a new export equalization levy on industry (*Exportumlage auf die gewerbliche Wirtschaft*). According to the Germans, this levy was 'a very unpleasant necessity, for the levy comes from home resources and consequently withdraws inland revenue from other purposes, e.g., armaments'.[29] It was formally a private arrangement, but firms' participation was compulsory. The Germans stressed that the state was not involved in its funding, against American charges that it was a dumping device. The foreign minister, Konstantin von Neurath, was in fact afraid of the prospect of countervailing duties being imposed by foreign countries, in particular the United States which had robust anti-dumping legislation.[30] But Schacht expressed strong support, observing that by then 80 per cent of German foreign trade was being effected by means of barter, clearing and other compensation schemes, while on the other hand trade with the United States had shrunk very considerably and subsidies were necessary to revive it. Hitler supported Schacht, and the decree introducing the levy was passed few days later on 28 June 1935.[31] The fund was administered by the Reich's chamber of commerce. The levy was established as a percentage (1 to 3 per cent) of the gross receipts of German industrial and commercial firms, but the details of this measure were shrouded in official secrecy.[32]

Attempts have been made to assess the mark's overvaluation. It was mainly due to other currencies' devaluations, and slightly less to relative price trends during the 1930s: in the mid-1930s, prices climbed at a faster rate in Germany than elsewhere.[33] However, thanks to the widespread use of cheap blocked marks and exports subsidies described above, the consequences of the overvaluation were substantially counteracted. Since these marks had different values depending on the type of transaction, while the subsidies linked to bond repatriation depended on changing price differentials, it is not possible to estimate the effective overvaluation exactly. Ellis struggled with this exercise and ended up quoting *The Economist*, according to which, in 1935, a 25 per cent devaluation of the Reichsmark would have been necessary to put German foreign accounts in equilibrium; Ellis adds that this estimate 'erred in the direction of understatement'.[34]

Ellis made another attempt to calculate the export subsidies in different years by dividing them into the two categories of blocked marks and bond buybacks on one side, and levies on the other. The percentage of subsidies over total exports went down from 37.5 per cent in 1935 to 25–30 per cent in 1938, with levies counting for around 60 per cent of the total funds for subsidy.

4 Payment agreements

In addition to the measures adopted to reduce its foreign debt and provide incentives for exports, as described in the previous section, Germany negotiated a series of exchange and trade agreements tailored to the specific bilateral relations and foreign exchange regimes of each country involved.

These agreements are generally divided into two categories: 'payment' and 'clearing agreements'. The first category involves two countries, one of which – country A, a free currency country – is a financial creditor of the other – country B, with strict foreign exchange controls – while simultaneously having a trade deficit with B. According to the agreement, payments for imports are directly made by country A to the exporter of country B in free foreign currency, just as in any normal trade transaction, without the intervention of a special clearing office. On the basis of the agreement, exports from country A are maintained at a defined fraction of its imports from country B, which releases import permits from A only up to a certain quantity, so that the trade imbalance is not altered. Country B, thanks to its stable trade surplus, is able to ensure the service and amortization of its financial debt to country A.

In this scheme, country A is a West European country and country B is of course Germany. Typically, the West European country had lent money to Germany, but had a bilateral trade deficit. Country A threatened not to pay for its imports from Germany unless Germany paid its financial debt. To Germany, the rationale of a payment agreement was to pay its financial obligations in goods and services. This meant relinquishing any principle of equal treatment for all creditors, since it led to preferential treatment when it came to servicing those foreign obligations for creditor countries that committed themselves to maintaining or increasing purchases of German goods. The United States, which had a considerable trade surplus with Germany and showed no inclination to 'buy German', could no longer expect from Germany the same treatment of its financial claims as the European creditor countries enjoyed.

Neither the Western creditor countries nor Germany considered these agreements as the most efficient way to do business, but at the same time each country also saw them as the only practical instrument for the continuation of trade. In other words, all of them wanted these deals, but only as a necessary and possibly temporary evil, for which the blame invariably fell on the counterparty. However, the narrative of recriminations started with German complaints against the abandonment, in 1931, of the gold standard, first by the United Kingdom and the Scandinavian countries (as well as Japan) – which had obliged Germany to introduce foreign exchange controls in the same year in order to maintain the stability of the Reichsmark[35] – and then by the United States in 1933–1934.[36] These devaluations were accompanied by mechanisms to protect domestic markets through tariffs and quotas. These measures made it more difficult for Germany to consolidate and increase its trade surplus, and therefore to service its debt. Germany lamented that Western countries had adopted aggressive behaviour as financial creditors just when Germany was encountering increasing difficulties with its own international reserves on account of the deterioration of its trade balance. 'Every foreign lender was aware [given Germany's high international debt position] of the situation when he gave Germany credit', wrote Ritter. 'It was a simple matter of arithmetic to find out how many of the foreign claims could be satisfied[;] it should have been clear to everybody that this method would inevitably lead to transfer limitations [in 1933] and, after the exhaustion of transfer possibilities, to a complete transfer moratorium [in 1934]. All the same, or perhaps for that very reason, the foreign creditors vied with one another in calling in their claims, until the German gold and foreign currency reserve had shrunk to a minimum'.[37] Meanwhile, foreign creditors complained that Germany had deprived them of what was legally their due. Their currency devaluations – the Sterling Area currencies and the US dollar – should have made repayments more affordable by reducing, in Reichsmark terms, the burden of foreign debt. West European countries saw bilateral agreements as a way to compel Germany to fulfil its financial obligations.

These were initially 'payment agreements', as described above, because they each involved a country with a free currency and a country (Germany) with an inconvertible currency, and were the result of a compromise between those opposite claims (therefore, unlike under a proper clearing agreement, no clearing office was needed). A first set of agreements was concluded between September 1932 (that is, before Hitler ascended to power) and the end of 1933, involving ten countries from Western Europe, including Belgium, France, the Netherlands, Italy, Sweden and Switzerland but, notably, not the United Kingdom, the country where a large part of the Reich's loans had been placed.[38] The agreements generally covered a portion of total trade, were negotiated between central banks and were not made public. They had a common feature: Within established limits, a certain amount of trade could be carried out using free foreign currency by the country that had established exchange control (that is, Germany). Once the quota allotted by the authorities to German importers had been exhausted, for trade in excess of that amount they would pay in marks (in the form known as *Sondermarks*), which would be accepted by the exporting country. *Sondermarks* could only be used for the purchase of goods and services (for example, for travel or tourism expenditure) or for unilateral payments in Germany. This feature was an obvious disincentive to export to Germany, and contributed to keeping the trade balance favourable to Germany. Indeed, the agreements contained a so-called 'Swedish clause' which stated that the signatory countries intended to maintain the same ratio of imports to exports as previously existed.[39] The benefits of these agreements for Germany derived not only from the discharging of its financial obligations, but also from the fact that the accumulation of foreign free currency they envisaged was necessary for the buyback and repatriation of German securities (see above) held by foreign creditors, and for buying essential goods from third countries.

In fact Germany expected to achieve – with some European countries, in particular France, Belgium, the Netherlands, and Switzerland – such a trade surplus that in addition to repaying the financial debt, it could also be used to cover its import needs from third countries such as the United States or Latin American countries.[40]

The surplus, however, soon began to decline because of divergent price trends in Germany and its partner countries, which increased the difficulties arising from the mark's overvaluation. Germany's trade balance switched from surplus to deficit in 1934 (see Table 5.1).[41] We have seen that this situation prompted the German authorities to change their strategies. They adopted the 'New Plan' (see below, Section 6), which severely limited the availability of foreign currency for import payments and made any payment of foreign debt more problematic. Meanwhile, Western powers had their exports paid in blocked marks, the *Sondermarks*, any accumulation of which they wanted to avoid; moreover, their financial claims as creditors were only partially satisfied.[42] This form of payment agreement went into crisis. New agreements with West European countries took the shape of full 'clearing agreements', which we shall deal with in greater detail in Section 6 of this chapter after having discussed their general features in the following section.

5 Clearing agreements: an overview

The origin of clearing agreements is generally found in a meeting that took place in November 1931 in Prague, convened by the newly established Bank for International Settlements and attended by representatives from the central banks of Central and Southeast Europe countries (Germany, Austria, Yugoslavia, Bulgaria, Poland, Romania, Hungary and Czechoslovakia). Germany had a strong role, because the dissolution of the dual monarchy of Austria–Hungary had increased its influence in this region. These countries were increasingly adopting foreign currency regulations[43] as a consequence of the international credit crisis, of a general reluctance to engage in cross-border transactions, and of exceptional withdrawals of foreign funds; all these developments had seen their epicentre in the banking crises which had occurred that year in Austria and then Germany. Exchange-rate instability had worsened, thanks in part to the sterling crisis of 1931. An exporter to one of these countries might not be able to cash his claim, and a 'blocked commercial credit' would arise. Trade flows were affected by currency restrictions. A lasting solution, it was noted at the conference, could only come from measures that successfully tackled the international credit crisis; in the meantime, it was thought that the adoption of clearing agreements might avoid or contain these restrictive practices by limiting the use of currency in foreign trade transactions. These agreements were therefore seen as a temporary device: a technical facility, covering partially or totally bilateral trade, and in principle aimed at balancing trade flows. Clearings were designed to benefit both exporting countries (which were fearful of not being paid) and importing countries (which had the opposite fear of not being able to pay).[44] Some clearing agreements were implemented through legislation, while others were simply accords between central banks.

At the Prague meeting, the idea was also raised that the newly established Bank for International Settlements might act as a central clearing house, but this suggestion had no follow-up. The idea was reconsidered by the BIS in 1934: Bilateral clearing agreements could not lead to perfectly balanced bilateral trade or to perfect barters, and credit/debit relations would emerge between the two countries concerned. In view of the general inability, or unwillingness, to settle the debt immediately, that relation was set to consolidate itself, and 'blocked credits' would arise again. Blocked credits – at the same time, both a cause and a consequence of bilateral clearings – constituted a significant problem which could possibly have been solved by moving to a system of international multilateral clearings with a clearing house at the centre. 'By increasing the number of [participating] banks', the BIS wrote, 'the possibilities of clearing increase because each bank might become creditor and debtor of several other banks[;] the greater the number of [participating] banks, the higher the possibility that the total balance of each bank *vis-à-vis* all the others will approach zero, and that the uncleared balances will be smaller'.[45] A successful multilateral clearing would assume that debit and credit balances could offset each other, but this would necessitate ensuring that no single country became a unilateral debtor towards any other. The idea was not pursued further at the time. Both France and Italy were explicitly against this option. France noted that it would be necessary to exclude countries bound to be 'debtors incapable of coping with their adverse balances or, at any rate, of exercising sufficient control to limit their purchases to their effective potentialities of payment'; Italy maintained that the adoption of a multilateral clearing would be possible only with a return to a 'fixed and universally accepted standard, such as gold[;] in such circumstances, however, there would be no further need for such agreements'. The idea certainly went against the intent of the country most involved in clearing agreements, Germany, which had every interest in fragmenting its commercial partners into single, unconnected entities. But, as we shall see, the idea of a multilateral clearing later resurfaced and became central to the project of European economic integration put forward by the Nazis early in the Second World War: In a single European market unified by Germany, any fragmentation would become unnecessary, and multilateral clearing could be the right solution for keeping European countries closely knit under its direction.

According to the *ad hoc* enquiry carried out by the League of Nations, 23 countries had clearing agreements in 1932. All were in Europe, with the exception of Chile and Ecuador. The League submitted a questionnaire to the countries that had accepted participation in the enquiry, asking them to state their motivations and the purposes of the agreements they had entered into.[46] The most common motivation arose from the adoption of exchange controls, either in the partner country, which prevented their own exporters from being paid or, in their own country, given the shortage of foreign currency available to pay for their imports. Motivations were generally related to trade in merchandise, but in a few instances also regarded some 'invisibles', such as limits to travel and touristic expenditure or emigrant remittances. Only in one case (Sweden) was the conclusion of clearing agreements explicitly tied to a financial factor: the moratorium imposed by Germany on currency transfers for the service of its foreign debt. According to the enquiry, the purpose of the clearing agreements was therefore the removal of currency transfers through compensatory transactions, with the goal of pursuing an economic policy overwhelmingly guided by domestic considerations in the absence of internationally accepted 'rules of the game'.

Germany had agreements with 19 countries, the highest number; seven of these were Central and Southeast Europe countries: Austria, Bulgaria, Greece, Hungary, Romania, Czechoslovakia, Yugoslavia and Turkey. Turkey had 13 clearing agreements; France and Greece 11 each; Bulgaria and

Yugoslavia 10 each. Italy had six, four of them covering Balkan countries: Bulgaria, Romania, Hungary, and Yugoslavia.[47] The significance of Germany and the Balkans is plain to see.

The figure below (Figure 5.1) gives graphic evidence of the German clearing network in Central and Southeast Europe in 1933.

The complexity of clearing agreements necessitates a short description of their technical features. In a 'clearing agreement', the basic difference from the previously described category of 'payment agreements' is that each contracting country makes payment for imports not directly to the exporter of the other country in free currency, but in its own national currency to a special office in the same country, which is located either at the central bank or at an *ad hoc* institution – the clearing office.[48] From the national currency received by the importers, the clearing office takes the sums necessary to pay national exporters; the exporter is paid not in the currency of

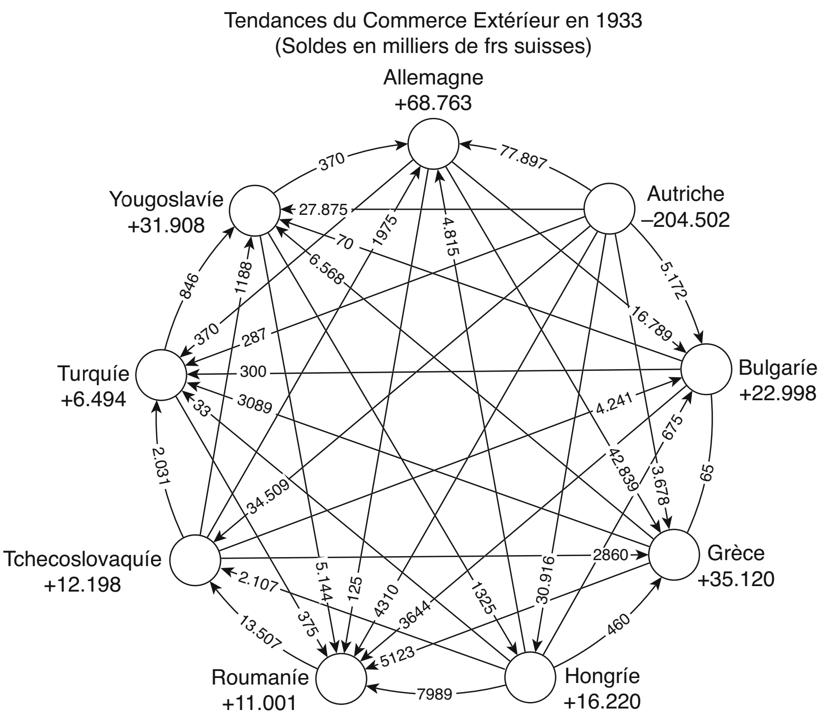

Figure 5.1 The German clearing 'circle'

Source: *La BRI et la compensation international des soldes commerciaux bloqués*, BIS secret memo, n.d. but June 1934, in ASBI, Beneduce, 317.

the other country, but in his own national currency. The same procedure is followed, for both imports and exports, by the other contracting country. The rationale of a clearing arrangement is that bilateral trade should be balanced in a sort of barter, so that any transfer of currency in cross-border commercial transactions is avoided. Trade in merchandise is not accompanied by a currency settlement. Any trade imbalance should disappear through an adjustment of imports and exports. This means that if country A has a trade surplus with country B, it should accept either an increase in its imports, or a reduction in its exports. In both cases, country A enjoys an improvement in its terms of trade (that is, the same amount of exported goods buys a larger quantity of imported goods).

In summary, in a clearing agreement a triangular set of transactions is established between the importers, clearing office and exporters of each country. All transactions are denominated in their national currency. Between the two countries, there is only the relation between their two clearing offices which, if necessary, have to settle reciprocal debts and credits through their respective central banks. 'Each country…ultimately becomes [from a currency standpoint] a self-contained unit.'[49]

A clearing agreement should theoretically bring about balanced trade, without any net payment between the two countries. If an imbalance occurs in their foreign trade, a corresponding imbalance should appear in their clearing account. But in practice, this was very often not the case. Several reasons might explain this counter-intuitive situation:

- A clearing agreement might not cover the whole bilateral trade balance, but only a portion, sometimes a small portion, of total trade: some goods might remain outside the agreement and be paid in free currency. Even if the clearing account was balanced, an imbalance might exist in the rest of the two countries' trade;
- On the other hand, the clearing might cover not only the merchandise balance (either fully or partly, as we have just seen), but also some 'invisible' items of the balance of payments, such as travel or interest on outstanding loans. The clearing account was useful for balancing trade and services when two countries had opposite positions. Therefore, a balanced clearing account might be accompanied by a merchandise balance showing a surplus/deficit;
- Significantly, in a clearing agreement, a country in structural trade surplus concerned about the stability of the other country's national currency and in need of 'strong' convertible currencies, might ask that a certain percentage of its exports be paid in free foreign currency. As a consequence, a situation could emerge whereby the surplus country might have a deficit on the clearing account, at the same time as enjoying an inflow of free foreign currency.

The structure of a typical clearing agreement might therefore be divided into a number of different accounts: a merchandise account; a services account; a financial debt service account; and a free currency account at the disposal of the central bank.[50]

Figure 5.2 in the following page shows how a clearing agreement worked, as opposed to 'normal' payments for foreign trade transactions.

If an imbalance occurred in a clearing account, the problem was how to minimize or fully absorb the resulting debt. The texts of the agreements had provisions addressing this quite-frequent possibility but, in practice, frozen credits (blocked balances) would probably develop. This is the reason why clearings had a provisional, temporary nature and were subject to frequent revisions.

When, at the expiry of a certain period – defined in the agreements in terms of weeks or months – a surplus existed in the clearing account, the understanding in the agreements was generally that the importers of the surplus country should continue paying until the claims corresponding to the surplus balance had been fully met by an increase in the exports of the debtor country. Transfers of unpaid balances from one country to the other had to be avoided to the greatest possible extent, as they were considered inconsistent with the purpose of the clearing system.

Even in perfectly balanced trade, problems might arise in regard to the exchange rate of the two currencies. One issue was the question of potential movements in the exchange rate in case of a time lag between payment by the importer to his clearing office and payment to the exporter by his clearing office. While some agreements provided for a discharge of the buyer/importer when he had paid his debt to his clearing office, leaving the exchange rate risk to the creditor/exporter, other agreements stated that the buyer would not be free of his liability until the seller actually received the amount due in his own currency. *Ad hoc* funds were established to guard against exchange rate fluctuations.[51]

Regarding the exchange rate, another important issue was the choice of the appropriate rate. The choice of the exchange rate to be used was, indeed, not clear-cut and did not necessarily coincide with the gold parities – where they still existed – or the official rate. As it was observed in a Bank of Italy memorandum, the piecemeal way in which the official parities had emerged in the post-war period meant that to rely on them would have probably led to unbalanced trade, contravening the purpose of clearing agreements.[52] Rules had to be laid down in this regard, the choices being: a legal gold parity for the two currencies; an average rate of exchange officially listed on a daily basis on some specified stock exchange; or a conventional rate, agreed upon by the authorities of the two countries or by their respective clearing offices.[53] The accounts kept by the clearing offices might also be expressed in the currency of a third country and, also in this case, the choice of an

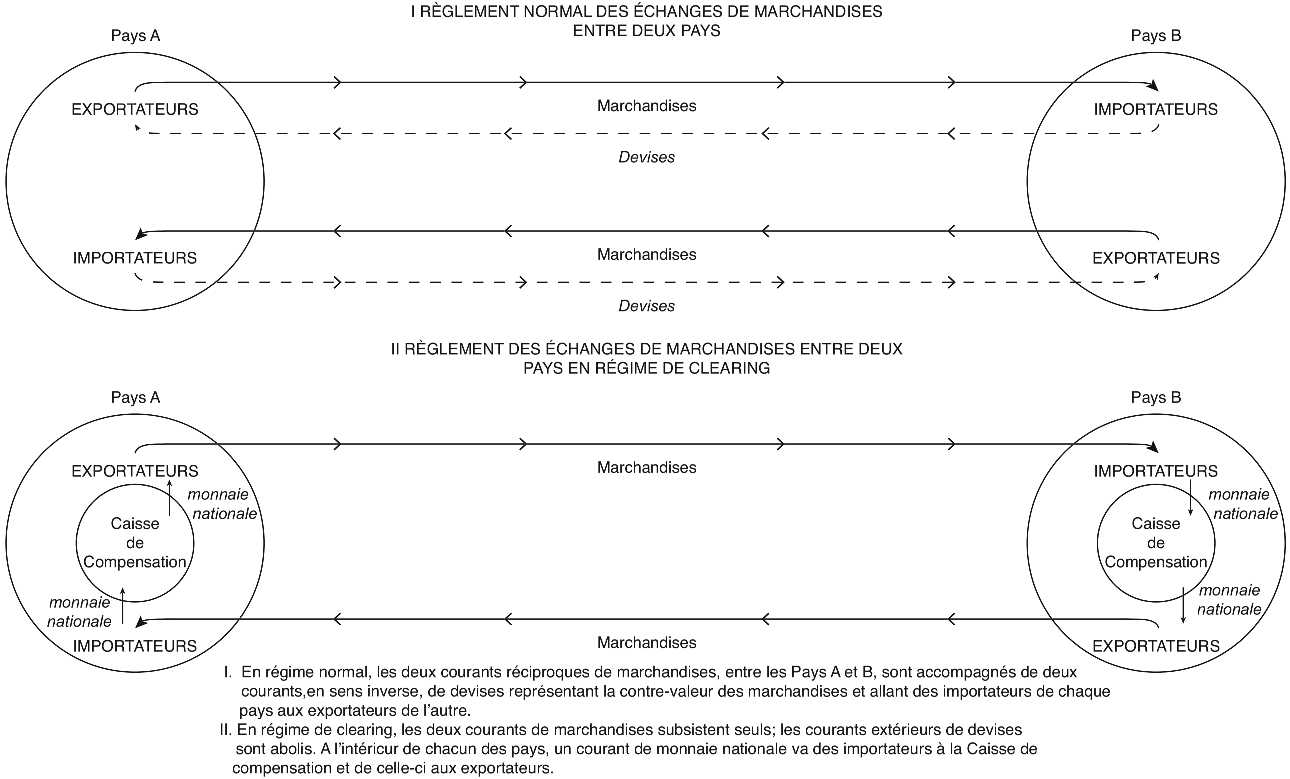

Figure 5.2 The organization of a clearing agreement

Source: League of Nations, *Enquiry*, p 28.

appropriate conversion rate had to be made along similar lines. Uniform monetary standards were replaced by a series of exchange rates.

In other terms, exchange rates in clearing agreements were negotiated according to the bargaining strength of the clearing partners.. Of special significance is that clearing agreements were often stipulated between countries of different economic and political strengths. The manipulation of exchange rates in clearing agreements was often used by the 'strong' partner to exploit the 'weak', in order to get better terms of trade. In 1939, the Italian economist Giovanni Demaria formalized the unequal terms that often defined clearing agreements by distinguishing 'complementary' from 'ordinary clearings'.[54] He wrote that complementary clearings, where two countries are linked by a strong relationship of complementarity, are characterized by a chronic (structural) trade deficit for the stronger contracting party. More specifically: (a) this country purchases from the weaker one all its surplus production, that is, the production exceeding its domestic needs, thus preventing any export to third countries (monopsony[55]); (b) exchange rates are manipulated in order to have different rates for debits and credits. With reference to (a), if the weaker country wants to cash in its trade credit, it has either to accept goods from the stronger country that might have been domestically produced at a cheaper cost, or to use its surplus to buy products from third countries. If that surplus is in an inconvertible currency, the third country will probably accept it only at a heavy discount. The default solution for the weaker country is to keep its surplus in the form of currency balances in the stronger country. As for (b), if imports to the stronger country are too high it will try to manipulate the exchange rate in the clearing account in order to make imports more expensive. Indeed, exchange rates in complementary clearings underwent notable fluctuations determined by the level of imports or exports, the type of goods concerned (raw materials or agricultural produce), and changing economic conditions.

6 German clearing agreements with West European countries after the 'New Plan'

From the second half of 1933, reflationary policies under Hitler's government stimulated both national output and inflation, while price indices abroad continued to fall. In 1934 the German trade balance registered a deficit and, given the scarcity of foreign currency, a growing commercial debt burdened the country. The whole matter of trade had to be reconsidered, in particular, the allocation of foreign exchange by the German authorities to importers strictly according to the needs of the economy, and the redirection of trade away from non-clearing countries.[56]

Barter with specific countries were pursued (with Brazil: coffee for coal and shipbuilding; with Bulgaria: tobacco for railway materials). Given the difficulty of exporting (first of all, because of the mark's overvaluation), further restrictions on the amount of foreign currency allocated to German importers (*Devisenrepartierung*) were decided: They could use their general permit only to the extent of 10 per cent (June 1934) and then 5 per cent (August) of their imports in 1931, which was taken as base year. This quite restrictive allotment was also motivated by the necessity of guaranteeing currency provision as a requirement for honouring obligations under the Standstill Agreement, which the Reichsbank considered an absolute priority, being related to short-term foreign liabilities.[57]

On 19 September 1934, Schacht gave a speech announcing Germany's 'New Plan'. He stressed all the considerations that, during the critical negotiations regarding the country's foreign debt at the Berlin Conference on International Transfers in April–May, had formed the basis of the new German position (see Chapter 4). He repeated the usual refrain, blaming creditor countries for raising barriers to German exports and debasing their currencies, and observed that as a consequence of these hostile measures, German trade was moving from surplus to deficit, creating an overhang of commercial debt in arrears. As in the past, however, he rejected both internal deflation and Reichsmark devaluation, which – he told the Führer and his cabinet colleagues – would be incoherent with domestic policy and would be only a temporary stimulus to exports.[58]

The 'New Plan' aimed at: making imports strictly contingent on the availability of foreign currency; at giving priority to the import of certain raw materials, conducive to the policy of rearmament pursued by Hitler; and at importing mostly from countries that might buy German goods for an equivalent amount, goods whose export should not damage the domestic economy. Germany wanted to increase its self-sufficiency, to minimize currency transfers abroad and to fragment foreign trade by exploiting the advantages that might be obtained bilaterally. It was decided that only the importer owning a specific currency (*Devisen)* certificate would receive from the state the foreign exchange necessary to pay for the imported merchandise, and those certificates could only be released in cases of availability of foreign currency. The *Devisen* certificate had to be issued by special control boards, 25 of which were quickly established.[59] These boards would issue a certificate after considering the desirability of a given import, the permissible price and the methods of payment.

Another, more 'liberal', plan was presented by the mayor of Hamburg, Carl Vincent Krogmann: The exporters would continue delivering their currency revenues to the Reichsbank, but would receive foreign-exchange vouchers. These would be freely negotiable, available to those who had to import merchandise or to repay foreign debt. The price of these vouchers would reflect supply and demand of foreign currency. An increase in their price would be a sign of an incoming, or worsening, deficit in foreign payments; market forces would determine the vouchers' exchange rate. The plan was dropped. The rigid policy of Schacht prevailed.[60]

These measures did not make much of a contrast with previous regulations, but they greatly reinforced the well-established philosophy of foreign trade and exchange controls. This time, it truly tilted towards an autarkic system. The new trade policy enacting the 'New Plan', can be summarised as follows: concentration of imports to prioritise raw materials and reduce their finished goods component; a change in the direction of trade, thanks to the reduction of imports from industrial Western Europe, and an increase in imports from the trusted Balkans. Exports of finished goods had to be directed to Latin American countries, important providers of raw materials. The plan brought about a 'new order of completely controlled trade'.[61]

There was added pressure to denounce previous agreements and to sign new ones, of which several were in fact concluded between 1934 and 1938 but, especially in the summer and autumn of 1934, just following the 'New Plan'. In Europe, Germany took very different approaches for two different groups of countries. On one side were the Western countries, which initially had 'payment agreements' with Germany but, as we have seen in Section 4, Germany's worsening trade balance and reliance on almost useless blocked marks to make payments prompted a wholesale reconsideration of these arrangements and brought about the negotiation of proper 'clearings'. The relationship with countries of the Danube Basin and the Balkans was different; because Germany had a high appetite for their commodities, the trade balance soon turned in their favour, and the main purpose of the agreements was to maintain that flow of imports, even though this might mean a large trade debt for Germany and corresponding frozen credit for the surplus countries. We shall deal with these latter agreements in the following chapter – because of the complementarity of Balkan countries' economies with the German one, and also because of the peculiar, concurrent interests of Italy in that region.

Regarding Western Europe, we shall not dwell on specific agreements but instead focus on a 'model' – the Swedish-German agreement of 1 September 1934, and an important 'variation' – the Anglo-German agreement of 1 November of the same year. As we shall see in Chapter 7, the Italian agreement with Germany, concluded in approximately the same period, followed the 'Swedish' pattern.

The Swedish model covered both merchandise and 'invisible' trade. The Swedish importer would settle an obligation by paying in Swedish krona to his own country's clearing office, and Swedish exports would be paid by drawing on the same clearing office account, held in krona, according to the model we have described above. The same procedure would be followed by German firms. The exchange rate was fixed according to the German gold parity, and the 'Swedish clause' – specifying the proportion to be maintained between imports and exports (see Section 4 above) – would be applied. No currency transfers would occur, provided that trade was balanced. Since the trade balance was, in fact, unfavourable to Sweden, krona accumulated in Germany's favour at the Swedish clearing office. After the Swedish exporters had been paid, the remaining krona balances were to be released, in specified proportions, to the Reichsbank as free currency, and to fund the amortization and interest payments of Reich loans owned by Swedish investors (mostly the Dawes and Young loans as well as other claims hit by the German Transfer Moratorium). For Sweden, the advantages of the clearing agreement were the use of German export proceeds to pay for Sweden's financial claims, and the avoidance of any accumulation of blocked marks on Swedish exports to Germany; Germany benefited by obtaining part of its trade surplus in free currency, necessary to purchase raw materials and other goods from third countries, that is, countries not bound by clearings with Germany.[62]

Britain, which had never stipulated clearings with Germany, reached a 'payment agreement' on 1 November 1934.[63] One priority for Britain was its credit position, especially with reference to the Dawes and Young loans, of which a substantial portion was in the hands of British investors. In fact, the agreement was partly motivated by British complaints regarding the difficult service of these loans following the total moratorium of June 1934, which had finally ended their exempt status.[64] Britain had reacted to the moratorium with the Debts Clearing Offices and Imports Restrictions Act of 28 June, imposing a 20 per cent *ad valorem* duty on all imports. A few days later, on 4 July, a transfer agreement between Germany and the United Kingdom assured that credits under the Dawes and Young loans would be paid in full, provided that bonds belonged to British holders.[65] But this agreement had left open the issue of payment of British exporters, who complained about the huge restrictions fixed by Germany on the release of foreign currency. In Britain, an advocate of free trade, clearings had met strong opposition, but gradually they appeared like a sort of last resort solution to their difficulties. The United Kingdom was at a disadvantage, as the only important country in Europe that did not have these kinds of agreements with Germany, whose trade was diverted away from it. A short-lived agreement was reached on 10 August, but British exporters continued complaining about lack of payments in free currency by German importers.[66] British traders suspected that their government, having reached an agreement with Germany protecting bondholders, was leaving them to their own fate. Matters became only worse with Schacht's 'New Plan', in September 1934.

The British – and in particular the powerful governor of the Bank of England, Montague Norman – were against a proper clearing deal; they instead preferred to take as a basis the bilateral balance of payments and to agree upon a certain figure which could be regarded as the 'normal' German export surplus. With the November agreement, the ratio of German imports to its exports to the United Kingdom was fixed at 55 per cent. And, besides imports from Britain, the proceeds of German exports were to be applied to the amortization of commercial and long-term obligations: Germany confirmed servicing entirely the Dawes and Young loans (and liquidating previously blocked commercial debts). Unlike in a clearing agreement, payments had to be made in free currency. As mentioned, the agreement set the German trade surplus, not as a fixed amount broadly corresponding to the service of the loans, but as a percentage and, consequently, there was a risk that any surplus might shrink or expand without any correlation to the fixed amount of the debt service. As a matter of fact, the overvalued mark did not favour German exports, and therefore its surplus could barely cover the service of its debt. Little benefit – in terms of the acquisition of free *Devisen* – came to Germany from this deal, and German permits to importers to 'buy British' – at first distributed with few restriction besides a particular preference for the import of textiles, coal and coke – had to be curtailed. After the agreement, bilateral trade recovered slowly from the low point reached in 1934, but its value never recovered its pre-Depression level, and the British share of total German trade persistently declined until the war.

With regard to the most important free-exchange country, the United States, Germany never had a bilateral payment or clearing agreement. The United States had a trade surplus with Germany, so a trade deficit could not be exploited to recover a financial credit, as had been the case in Europe. Schacht was only too able to pit his antagonists against each other: America objected that Germany's foreign exchange proceedings were arbitrarily used to service foreign debt towards specific countries that had clearing agreements with Germany (as we have seen above), and were not divided up among all the creditors in proportion to the size of their claims.[67] 'My Government' – the American chargé d'affaires in Berlin, George Gordon, said to the state secretary, Bulow, – 'feels that the adoption of a principle whereby the payment of a German debtor to a non-German creditor should be made to depend on the ratio of imports and exports in the exchange of goods and services between Germany and the creditor country would be an unprecedented departure from the rule of non-discrimination among creditors'.[68] The lack of currency resources to cover Germany's deficit led to a contraction in bilateral trade between the two countries, both in absolute and relative terms. As a percentage of German total imports, imports from the United States declined from 11.5 per cent in 1933 to 5.2 in 1937; exports to the United States also decreased, remaining at a pretty low level, around 3.5–4 per cent.[69]

The service of the Reich's loans was in many cases inserted into the bilateral clearing agreements made with European countries, but with the United States it was a different matter. US political pressure came just when the reserve position of the Reichsbank was considerably worsening. Thomas Lamont of J.P. Morgan, the main lender, bitterly complained to Schacht following the German default on the American tranche of the Dawes and Young loans: It was blatant discrimination against American investors, who were not protected, as the Europeans were, by specific clauses in clearing agreements. Lamont blamed the Germans for the way they insisted on the 'fiction of the gold mark, in so doing taking the life out of their foreign trade'. He rejected any hint at a clearing agreement between the two countries and reiterated the American commitment to free trade. Schacht, he added, should 'break the shackles of the system of quotas and clearing agreements which now surrounds Germany…by returning voluntarily to the regular service of the Dawes and Young loans'. Schacht replied that the discrimination instead came from those European creditor countries which have 'forced upon us the various clearings'. However, in a conciliatory gesture he also proposed an increase in the payment of the coupons of those loans (from 4.2 to 5 per cent for the Dawes, and from 3.2 to 4 per cent for the Young loan), if they were sold at about 60 per cent of their face value as tourist's marks.[70] This was the Reichsbank president's usual tactic: break a deadlock while actually obtaining substantial advantages for Germany.

In the same year, 1935, Germany's diplomatic representatives in Washington tried, unsuccessfully, to persuade the United States to adopt a form of controlled barter, the so-called ASKI procedure (on this procedure, see Section 7 of this chapter). But the US authorities replied that this arrangement would fall within the meaning of the Tariff Act (the American anti-dumping legislation). However, for a short time in August 1936 a sort of barter system was introduced through the Individual Inland Accounts.[71] With reference to the US financial credit, an *ad hoc* arrangement was stipulated: Coupons held by American residents on the two Reich loans could be presented on maturity at J.P. Morgan or at a German steamship company, the Hamburg-American line, for redemption in dollars, but at a reduced rate of around 70–75 per cent of the face value. The arrangement was discontinued on 14 June 1942 (during the war).[72]

7 The ASKI marks

In 1934, largely because of the introduction of the complete Transfer Moratorium and the 'New Plan', and following the increasingly strained relations with the Western countries that were Germany's financial creditors, the Nazi government started thinking that a reorientation of German imports would be necessary.

Clearing agreements were concluded by Germany with a number of non-European countries, notably several Latin American states (Argentina, Brazil, Chile, Colombia and Uruguay). However, the most innovative device introduced by the 'New Plan' with these countries was trade through compensation, using the so-called ASKI (*Ausländer Sonderkonten für Inlandszahlungen*) mark procedure. This procedure was also adopted with Australia and certain African and Asian countries.[73]

The ASKI procedure operated in a similar way to a clearing agreement, with the relevant difference that, whereas, in a clearing national currencies were used within the boundaries of a single partner in the agreement, in an

ASKI procedure the only currency to be used was the German mark. In this sense, the procedure could be likened to a unilaterally imposed clearing.

The ASKI procedure had three 'characters': the foreign trader, the German trader and a German bank. It worked as follows: Payment for the import by Germany of a 'stipulated' commodity (that is, a specific commodity considered by the German authorities as indispensable to the German economy and therefore to be imported if domestically unavailable) was made by the German trader in marks, to an account at a German bank – the ASKI account, opened in the name of the foreign trader who had exported the commodity. This foreign trader could draw on this account to pay for specific goods imported from Germany.

Two categories of ASKI accounts were introduced: 'individual' and 'bank' ASKIs. The former – which is the type described above – required the identification of the account foreign holder/trader and of the German trader; the latter, on the other hand, permitted the transfer of the available balance of the ASKI account from the original account holder to another national of the same country participating in the ASKI trade relationship. In this way, the ASKI would become a sort of bill of exchange and might be used in various ways, depending on each country. For instance, balances credited to an Argentinian firm might be eligible for purchases of goods quite different from those available to Brazilian holders of ASKI balances.

The volume of trade transactions through the ASKI accounts grew considerably throughout 1935, but two related problems emerged, which contributed to the scheme's eventual demise. The German authorities obviously preferred exports that could yield free currencies to replenish the country's international reserves, while the export of German goods under the ASKI scheme were paid in 'ASKI marks'. For this reason, they had to be qualified as 'additional', that is, had to be for goods that could not otherwise be exported by Germany, their price being internationally uncompetitive. Moreover, the German authorities soon found that the procedure was used to circumvent 'normal' trade, hindering the acquisition of free currency. Increasingly, traded goods were 'normal', not 'additional' as required by the authorities. What in fact happened was that, since ASKI marks were non-convertible and could be used only for the purchase of German goods, these goods could only be sold at a discount. The following scheme was set in motion: a German importer would offer the foreign trader (exporter) a higher price (the 'premium', a sort of selective mark devaluation). The foreign trader was in turn able to pay a higher amount of marks when importing goods from Germany. This 'premium' was equivalent to an import duty, with the difference that it pertained not to the tax authority, but rather to the trader: the 'import duty' was ultimately diverted to the German exporter as a subsidy. There was an incentive to divert export trade from the free market to the ASKI procedure, resulting in the loss of the foreign exchange that would have been otherwise accrued to the starved German reserves. Furthermore, in Germany they contributed to an increase in the prices of goods imported through ASKI accounts. At last, sweeping restrictions were introduced by the German authorities in February 1937 that 'sounded the death knell of ASKI'.[74] Importers would subsequently resort to secret payments abroad, with *a metà* (*by half*) deals between German importers and exporters.

What was the view of the ASKI procedure from the (mostly Latin American) partner countries? Were they really exploited by Nazi Germany? It is unclear whether Latin American countries truly were the victims of a rapacious Germany. It has been observed that the commodities sold to Germany through this procedure were 'surplus' products: merchandise that could not be sold elsewhere at the prices that could be charged to German importers, thanks to the mark's overvaluation and to the fact that the ASKI scheme had to regard goods considered by Germany indispensable and not domestically available. Exports of copper, nitrates, cotton, wheat or oil – typical commodities produced by those countries – could perhaps have been directed towards alternative markets, but this could only have been done by offering better terms of trade. In the words of Child, 'It may well have been that Latin America also played the game of exploitation and was quite willing to "dump" its surpluses' in the German market.[75]

8 Germany's dysfunctional clearings, and the final attempts to preserve the peace

Did these new arrangements, as described in Sections 6 and 7, respond to expectations? Not fully. The Nazi government, citing '*imponderabilia* in our export trade', blamed the declining demand for German products on several factors: currency devaluation by other countries; many countries' adoption of nationalist economic policies entailing the development of domestic industry, protective tariffs, and import quotas; and the general economic recession, which was being felt acutely in Southeast Europe.[76]

On 10 April 1935, the powerful Ritter sent to all diplomatic missions abroad a circular with a critical view of the current trade situation and of the issues facing the German balance of payments.[77] There was a basic inconsistency between the rigid criteria of issue of the *Devisen* certificates to German importers, on one side, and the war preparation requirement and the amount of imports permitted by the current clearing agreements, on the other side. In this regard, a few months after the announcement of the 'New Plan', Hitler made explicit his policy of rearmament. Imports involved war materials for the Wehrmacht, which Germany could hardly forego (the army, meanwhile, complained that Schacht's management had not succeeded in making the economy ready for war). Moreover, clearing agreements had been concluded in the (ultimately incorrect) expectation that a balanced trade would not generate any additional need for foreign currency. Even when imports were not permitted according to the prescriptions of the 'New Plan', German importers continued purchasing foreign merchandise within the existing clearing arrangements and paying with marks. This increased German commercial debt within the framework of existing bilateral agreements. This breach of import barriers ('evasion' is the term used by Howard Ellis[78]), contributed to the Germany's huge trade deficit of 1934. 'The capacity of foreign markets to absorb German goods was frequently not in harmony with the capacity or demand of the German market for foreign goods', noted Ritter.

The way out of this impasse was either to limit imports of finished, and in particular industrial, goods which the German economy could dispense with, or to increase German exports. Here, problems arose from different factors: partly from the obstacles set up by foreign countries through tariffs, trade and foreign exchange restrictions, and devaluations; but also from 'the German economy's lassitude regarding exports'. To overcome this 'lassitude', rather than devaluing the currency, the recourse to explicit export subsidies and to the indirect subsidies through scrips (as described above) was stressed, instead.

Ritter reassessed Germany's trade situation one year later. His view remained critical, but no significant innovation was envisaged: clearings were there to stay. These agreements – which by 1936 were in place with more than 30 countries, Ritter noted, and absorbed 75 per cent of German exports – were 'cumbersome', but had been conducive to the working of the German economy and to maintaining the high level of the Reichsmark's exchange rate: a permanent fixture of the country's economic policy. In light of this situation, Ritter observed that German policy 'will be intent on seeing that these articles [raw materials and foodstuffs] are obtained as far as possible from such countries [as those of Southeast Europe] as will be prepared and able to continue to supply Germany even in times of economic, financial and political crisis'. Among the non-clearing countries, the 'ASKI' payment agreements with South American countries had also favoured German exports, until they lasted.[79]

In the meantime, the fulcrum of economic policy was shifting from Schacht to Hermann Göring, the Prussian minister-president. Hitler's secret order[80] of 4 April 1936 stated: '[F]or the purpose of safeguarding the further restoration of military power [*Wehrhaftmachung*], an improvement in the raw materials and foreign exchange situation is necessary .... I hereby charge the Prussian Minister President, Göring, with the investigation and promulgation of all requisite measures.'[81] In September the Führer declared that in preparation for the coming war, the German armies must be operational within four years. An economic plan had to be drawn up to that purpose. This meant a route of collision with Schacht, who thought that because of the scarcity of foreign currency the economic *impasse* should be overcome by scaling down the rearmament programme. The Four-Year Plan was announced by Hitler on 9 September, and soon afterwards Göring was appointed as its commissioner, with direct responsibility for two ministries, labour and agriculture. Schacht felt he was being sidelined; he 'had begun to outlive his usefulness'.[82] In November 1937, Schacht resigned as economics minister, and the management of the economy effectively passed to Göring. In February 1938 Walther Funk succeeded Schacht as minister of economics. This huge shift in policies was completed in January 1939, when Schacht – complaining about the overstretching of public expenditure and the looming danger of inflation, but perhaps still more, bemoaning his fall from grace – also resigned from the Reichsbank. Funk was once again appointed as his successor, accruing the top positions at both the central bank and the ministry of economics in total disregard for even an appearance of central bank independence.[83]

On 5 November 1937, Hitler outlined to a small group of trusted confidants his general strategy for a war in the near future. The main point of interest in this study was that 'autarky, in regard both to food and to the economy as a whole, could not be maintained': an eastward territorial expansion by force would be the next unavoidable step. The official German position regarding the Danube Basin and the Balkans was, however, far from this bellicose attitude. At the Munich conference on 30 September 1938, the Führer confirmed that Germany's intentions in the area were purely related to an expansion of trade. He told the British prime minister, Neville Chamberlain, that 'Germany maintained principally economic relations with Southeast Europe and had no political ties with those countries. In the economic field, Germany was the natural partner of the Danube Basin, whose surplus agricultural products and raw materials she could take and in return for which she could deliver the industrial manufactured goods [not] produced in the Balkans themselves. Germany needed raw materials and food. Above all, her food requirements were increasing, and therefore he attached extreme importance to such mutual trade with producers of raw material and food'. Hitler then elaborated to the British prime minister his own basic economic theory: '[N]amely, that the restoration of the world trade could not come about by artificial means, loans and the like, but by a natural economic exchange between producers of raw materials and manufacturers of industrial products.'[84]

The British government was not convinced, and it unofficially advanced a plan to dismantle two pillars of German policy (upholding the Reichsmark rate, and maintaining Germany's monopsonistic power in the Balkans), while simultaneously trying to preserve peace with economic appeasement. In the final months of peace, and in a fusion of political and economic diplomacy, Britain launched a proposal for Anglo-German co-operation in the Balkans.[85] Frederick Leith-Ross, the chief economic adviser to the government, appealed to common European interests in the face of overwhelming American power (perhaps a sincere intent to keep the United States at arms' length, in order to save Britain's international role[86]). He stressed the need to increase European economic cooperation and cited the Balkan region as a test case. He noted the uniqueness of the relations of Balkan countries with Germany: their ample exports of foodstuffs to Germany, but at the same time their inability to import from third countries because their exports to Germany were paid in blocked marks and 'brought them in no foreign currency'. According to the British proposal, Germany would devalue its currency, thus gaining competitiveness, while in exchange the other three Great Powers of Europe – France, Britain and Italy – would support Germany financially. The ultimate purpose of the proposal was to make it possible for Germany to pay for its imports from the Balkans. The Balkan countries would then in turn be in a position to buy third countries' produce (from the British Empire, one might safely assume), thereby stimulating world trade.[87] The idea of a foreign loan to Germany, accompanied by a devaluation of the Reichsmark, was reiterated by the British government, but the answer was that Germany could only repay any liability through an expansion of its exports.[88]

Germany's main purpose – as clearly stated in Munich by the Führer – was simply to get the additional imports of raw materials and foodstuffs it needed and pay for them by increasing its exports: In other words, to overcome the conundrum of clearing agreements which Ritter so clearly illustrated. With a policy focussed on 'real' transactions, the minister of economics, Funk, even floated the idea of a tripartite agreement whereby Germany would import cotton from the United States, to be paid for by additional German exports to Britain.[89]

German–British discussions regarding a foreign loan to Germany did not completely disappear even after this display of negative attitude by the German government. Perhaps not by chance, negotiations were conducted on the German side by Schacht, by then in a weakened position and in his final days at the helm of the Reichsbank. He maintained a state of discussion with Leith-Ross, within the framework of the possible restoration of a free system of currency in Germany.

A general agreement was also drafted by the German side – we do not know by whom[90] – based on the following points:[91]

- The UK would recognize the Polish Corridor of Danzig as belonging to Germany, which would also receive the return of former colonial territories (it should be remembered that the provision of commodities from extra-European countries made this issue of particular relevance for Germany);
- Germany would receive a gold loan of RM4–6bn, without interest, but with an amortization of 2 per cent;
- German rearmament would be suspended;
- The eastern frontiers (those with the USSR) were to be the object of particular concern;
- In the Mediterranean, a *status quo* would be maintained;

- Germany would cooperate in promoting the rights of white races (!) in Asia;
- Germany, Britain and France would establish a new League of Nations.

Schacht, however, brushed aside the figure of RM4bn or 6bn: this 'Mr X' did not really understand finance and was not to be taken seriously.[92] Schacht suggested a relatively small loan which, if too large, would inevitably have prompted the German government to make 'extravagances': just a 'cushion' of one billion or 500 million Reichsmarks would be sufficient; but, still better, said Schacht – in order to bring German currency back into the fold of freely convertible currencies – would be a reduction of the interest rates on German debts, particularly towards the United States, among other countries (though not the United Kingdom, which had already accepted such a reduction).[93]

What seems to have been the final official contact between the German and British governments to attempt to restore orderly monetary conditions in Europe, and to save the peace, took place in early 1939 between Funk and Ashton-Gwatkin, of the Foreign Office. Funk floated the idea of a commercial mark (*Warenmark*) to be used without restrictions for foreign transactions, eliminating the ASKI marks, *Registermarks*, and all the panoply of different 'currencies' that the inventive Schacht had introduced to reduce the burden of foreign debt. But as a precondition, Funk asked for a full clean-up of the old German debt: an international consortium was to buy up all the Dawes and Young debts, at a rate of 30–35; then Germany would convert the old loans bought by the consortium into a new international loan. When Ashton-Gwatkin asked whether that the *Warenmark* would be a gold currency, Funk gave an elusive reply, with the same apparent indecision that would subsequently characterize his 'European Plan' (see Chapter 8). Funk envisaged either the redistribution of gold as a prerequisite for restarting a system based on gold, or a new standard, an indexed currency, based on stable purchasing power across different countries, which was in turn linked to stable prices and wages.[94] The shaky foundations on which this conversation rested were the best evidence of the true inconsistency of the initiatives discussed.

6
Germany's and Italy's Relations with Southeastern Europe

1 German trade with the Balkans

It has already been mentioned that in the mid-1930s, 7 out of 19 clearing agreements concluded by Germany were with Central and Southeastern Europe countries. These countries were either born as a consequence of the redrawing of the map of Europe after the First World War or had become independent of the Ottoman Empire in an earlier time, and they all had suffered badly during that war. After the war, international stabilization loans were extended under the auspices of the League of Nations in order to sustain their economies, stabilize their currencies, and, in some cases, help with the settlement of refugees following the huge dislocation of peoples. Equivalent to £80m (around $380m) in total, these loans were granted between 1923 and 1928 to Austria, Bulgaria, Greece and Hungary, in addition to the Free City of Danzig and Estonia. But these countries were hit by the international banking crisis that erupted in Central Europe in 1931; furthermore, the Depression contributed to a huge fall in the prices of agricultural products, the export of which was their main source of foreign exchange – particularly for the countries of Southeastern Europe. Their antiquated methods of production made their agriculture prey to American competition. In Western Europe, French self-sufficiency and the British Imperial Preference agreed upon in Ottawa in 1932 (which privileged trade with Commonwealth countries) closed two major markets to Balkan exports. In 1934, loans to Bulgaria, Greece and Hungary – the south side of the region – were in various stages of default, and a League of Nations committee chaired by Austen Chamberlain had to be established to protect the bondholders and safeguard the special status of these loans.[1]

Spurred on by these difficulties, the Balkan countries pursued reciprocal economic integration through a customs union, which was proposed at the First Balkan Conference in Athens in 1930. But the project of integration foundered on the generally unfavourable attitude of the West European powers, and on the very limited degree of intra-regional trade.[2]

The Balkan countries turned their attention to Central Europe, and in particular to Germany. The attraction of the German market for Balkan exports had roots in relationships dating to the final years of the Ottoman Empire. Even before Nazism, under the Brüning chancellorship Germany itself had already attached special importance to a strong presence in the area, mindful of the commodities that might be imported from it.

Especially after the British pound's devaluation in 1931, a growing number of Balkan countries adopted exchange-rate controls, and because of the lack of foreign currency reserves needed to pay for their imports, bilateral clearings were pursued, replacing free trade based on the use of convertible currencies. After the Prague conference of the same year (Chapter 5), the first agreements were signed. They had short durations, lasting one year or less, because the current difficulties appeared to be of a transitory nature. This assumption proved not to be the case, and the share, taken up by clearing arrangements, of the total trade of four Balkan countries – Bulgaria, Greece, Romania and Yugoslavia – became substantial, albeit varying from country to country. According to estimates, in 1934 it was well above 70 per cent in Bulgaria and Yugoslavia, and around 30–40 per cent in Greece and Romania.[3]

The goods these countries exported were of particular interest to Germany, which was in need of foodstuffs and raw materials for its industry. As we have seen, the agricultural component was quite significant for all these countries, but especially for Bulgaria (where agricultural and related products constituted between 80 and 90 per cent of its exports in the 1930s) and Greece (where agriculture provided almost 100 per cent of exports), while in Yugoslavia and Romania a good share of exports was made up of minerals (10–20 per cent for Yugoslavia) and, for Romania in particular, oil (30 per cent).[4]

How did Balkan countries fall into Germany's embrace? Firstly, there was an evident complementarity between their agricultural economies and an advanced industrial country such as Germany. Their geographical proximity was also an important factor in trade development. Before the outbreak of the Second World War a Reichsmark Bloc was established, and together these countries made a small German counterpart to the Sterling Area. Were these developments responding to a foreign policy objective of the Nazi regime: the creation of a large self-sufficient economic space (*Grossraumwirtshaft*) as a strategic safety net in case of war?[5] Was there 'an evident resolution on the part of Germany to press her trade at all costs and to extend her sphere of economic and political influence'?[6]

As pointed out by Milward, two opposite views have been advanced to explain the German policy towards Southeastern Europe countries: on the one hand, the National Socialist government is seen as an example of an especially vicious stage of late imperialism, seeking to preserve archaic capitalistic structures in Germany through external imperialism; this policy had already started under the Weimar Republic. Once more, here is evidence of continuity between the economic policies of the Weimar Republic and of Nazism at its early stages. On the other hand, a second view stresses the dramatic fall in agricultural prices after 1928, as the most relevant event. Through that special link with Germany (that of the bilateral clearing agreements), those countries were able to find a stable and long-lasting market of destination for their commodities, whereas France and Britain had, as we said earlier, commercially retreated from this area. The British policy of appeasing Nazi Germany had this sort of collateral effect, which anyway brought a meaningful growth in standards of living in Southeastern Europe. Milward criticizes both views, finding instead that, rather than a case of explicit exploitation of less-developed countries, or – conversely – a form of cooperation to the benefit of those countries' agricultural economies, the Reichsmark Bloc was the result of the overwhelming priority given by Nazi Germany to its own domestic economic and social objectives. This opinion is not necessarily in opposition to the other two: that domestic priority might well be connected to capitalistic interests, and the growth of that region might be an important side-effect of the German pursuit of domestic interests. Milward also argues that the strategic importance of the Reichsmark Bloc was exaggerated – perhaps a display of independence from the 'plutocratic' international capitalist framework, which was itself exploiting Germany – and that there is little geographic connection between the Bloc and the *Lebensraum* idea (which will be discussed later).

It should be noticed, in any case, that intra-bloc trade increased considerably; in 1939 the Reichsmark Bloc counted for around 18 per cent of both German exports and imports (in 1923 those shares had respectively been less than 4 and around 5 per cent). The importance of trading with Germany was for Southeastern Europe countries obviously much greater, given the smaller size of their economies. The position of economic dominance reached by Germany in the area is testified by the fact that by 1938, 45.9 per cent of the exports and 46.6 per cent of the imports of five countries in the area (Hungary, Bulgaria, Romania, Yugoslavia and Greece) were to or from Greater Germany (which by then included Austria, following the *Anschluss*, and the occupied part of Czechoslovakia, in addition to the old Reich).[7]

The huge increase in German trade with these countries, stimulated by the general economic recovery after the Depression and by Nazi rearmament, was anyway bilaterally uneven. The most connected country was Bulgaria: in 1938, 57.8 per cent of its exports and 63.4 per cent of its imports, were to or from Germany. Political considerations aside, these striking figures can be attributed to the nature of Bulgarian exports: more widely marketable crops such as wheat were giving way to tobacco, cotton, grapes and dairy products, which found a good export channel in the clearing agreement with Germany.[8] Greece had, in comparison with the other four countries, the smallest share of trade with Germany; in the same year, 31.9 per cent and 43.1 per cent respectively for exports and imports.[9]

In addition to the size of trade flows, a further crucial factor to be considered regards trade imbalances. If we consider the five countries mentioned

Table 6.1 German trade balance with five Danube/Balkan countries, 1932–1938 (million RM)

	exports	**imports**	**balance**
1932	199	233	–34
1933	155	198	–43
1934	171	247	–76
1935	253	319	–66
1936	375	386	–11
1937	556	574	–18
1938	544	536	+8

Source: Child, pp 159–161.

above in the period between 1932 (the first year of clearing agreements) and 1938 (on the eve of war), what stands out is an almost constant German deficit. Its size fluctuates, however, at first increasing until the mid-1930s (with peaks in 1934–1935, when the German economic growth rate accelerated), and then contracting, so that 1938 shows a small surplus for Germany. As war approached, 'Eastern European countries were somewhat more cautious in their dealings with Germany. Unfortunately, by this time they were further handicapped in their bargaining with Germany by Germany's growing political and military strength.'[10]

2 Clearing agreements

As discussed earlier (see Chapter 5), the motivations for the German clearings in this area were very different from those regarding trade agreements with Western Europe. At the start, the immediate apparent motivation for stipulating clearings was Germany's complaint that although the principal supplier for these countries, it could not be paid for its exports due to their strict exchange controls and it had been obliged to enter clearing agreements in order to safeguard its trade position.[11] The avowed purpose of the agreements was the amortization of its outstanding commercial credits in the region.

In the spring of 1932 Germany concluded the first clearing agreement in Central and Southeastern Europe with Hungary, a country with particularly strict exchange controls, at a time when Germany had a trade credit and was unable to be repaid. Unlike other clearings in the area, it was an inter-governmental agreement and was made compulsory. Hungary could gradually discharge its commercial debt by increasing its exports to Germany. It was a case of imposed bilateralism, which therefore gave Germany better terms of trade. In fact, the exchange rate fixed in the clearing agreement favoured Hungarian exports, and the German trade surplus dwindled, although it did not wholly disappear until 1934.[12]

Other, similar deals were stipulated with the other exchange control countries – Bulgaria, Greece, Yugoslavia and Romania – between August

1932 and February 1933,[13] but they were negotiated as accords between the central banks and allowed transactions outside the clearing account. It is to be observed that the defence of its unpaid commercial claims was, for Germany, a valid argument to enter clearing agreements with Hungary and also with Yugoslavia, while Germany had a trade deficit with the other three countries in 1932.[14]

The initial consequence of the agreements was a reduction of the imbalances through a fall in trade. Starting in 1934, however, the German economy entered a period of sustained recovery and became increasingly war-oriented. To sustain its military effort, it needed huge amounts of raw materials and foodstuffs. Southeastern Europe was well-situated geographically to provide these products, and the already-signed clearings became the appropriate instrument for channelling their exports to Germany. Bulgaria, Greece and Romania remained in trade surplus with Germany for most of the 1930s; Hungary switched from deficit to surplus in the second half of the decade; Yugoslavia's surplus declined, and by the second half of the 1930s German–Yugoslavian trade was almost balanced. New agreements signed by Hungary and Yugoslavia with Germany in 1934 explicitly aimed to achieve an increase in the flow of goods to Germany, also counteracting French and Italian influences in the Danube region: they created 'a system of secret financial privileges ... whereby both countries, without being granted open preferences, are in fact by means of subventions obtaining preferential treatment of their exports to Germany'.[15] In some cases, even closer political ties helped Germany to attain this goal.

Germany acted as a 'monopsonistic' partner, by buying large quantities of commodities. This monopsony arose from the great disproportion between the relatively high importance of the German market to the foreign trade of each of those countries, and the relatively low share of goods imported from the area with respect to total German imports. In describing the technical features of the 'complementary clearings' and the unequal position of the partner countries (Chapter 5), Giovanni Demaria certainly had these Balkan clearings in mind.

An exclusive seller (monopolist) or buyer (monopsonist) of goods can determine price or quantity, but not both. Germany, the 'strong' partner, used price, while there was generally no formal agreement on the volume of trade.[16] The exchange rate of the mark against the currencies of these countries played a decisive role in fixing the price of imported goods. We do not have a clear evidence of the exchange rates adopted in specific clearings. In general, the overvalued gold parity of the Reichsmark made possible huge amounts of imports from those countries at prices that, albeit relatively cheap for Germany given the strong exchange rate, were consistently above both international prices and the domestic price in the exporting country.[17] Moreover, since these countries had formally retained the old parity of their currencies,[18] their exchange rates did not suffer, in relation to the Reichsmark, the competitive disadvantage they had incurred in relation to other Western currencies that had been devalued.

As we have seen in the description of the general features of clearing agreements (Chapter 5), in any agreement the exchange rate might well be adjusted according to the partners' convenience, which often meant the 'strong' partner's convenience. In clearing agreements with Balkan countries, exchange rates of the mark *vis-à-vis* local currencies actually fluctuated by 30–40 per cent and even more.[19] 'Artificial exchange rates [were] primarily responsible for one-side accumulations on the clearings',[20] these accumulations were closely related to the trade surpluses that the Balkan countries, particularly Bulgaria and Greece, had with Germany.

From Nazi Germany's perspective, the condition of economic dependence on the part of these countries was greatly conducive to the government's political and strategic aims as war preparations became an increasingly important factor. It was beneficial for Germany to depend on more reliable sources of supply than those provided by countries that could cut off their exports in case of conflict.

This one-sided accumulation was made up of blocked marks (*Sperrmarks*) which – because of the strict exchange controls in place in Germany – could not be freely traded on foreign exchange markets. It should be added that for various reasons (mentioned in Chapter 5), the credit position of the Balkan countries in their bilateral clearing accounts with Germany could be even higher than the trade surplus because, for instance, the 'invisibles' added to the trade imbalance, or perhaps because some trades were permitted outside clearings. While trade statistics were publicly available, we do not have access to the corresponding clearing balances: '[T]he central clearing fund [office] set up by the Reichsbank publishes no accounts', as one contemporary observer wrote.[21]

Two questions arise: Did Nazi Germany really favour these clearing imbalances? And were they exploitative of the Southeastern Europe countries?

About the German government attitude to the trade deficit with these countries, historical research tends to stress that the Nazis intentionally exploited that deficit, taking advantage of the commercial credit – 'forced loans' – extended by those countries to Germany on the respective clearing accounts. This was already the view of a well-known study on interwar finance produced by the League of Nations in 1944: '[F]or Germany, the clearing system [with Southeast European countries] provided a welcome means of obtaining forced loans from them in the form of uncleared balances.'[22] Archival sources, though, do not seem to confirm this conclusion as far as the 1930s period is concerned. We can discern in an internal document of 1936, signed by Ritter, that Germany sought to contain the trade and clearing deficit:

> [A]s a result of excessive German import of goods, the clearing with a number of countries showed deficits. A fresh and considerable

> indebtedness towards foreign countries thus *threatened* to arise in the form of commodity debts. Meanwhile it has been possible to reduce the total value of the commodity debts as a result of closer supervision and adjustment of imports to exports. In addition, the mechanism of clearing has automatically compelled many foreign Governments to accord preferential treatment to Germany in the import of industrial products, in order that debts owed them for goods could be transferred and their own exports to Germany maintained. This development has manifested itself ... especially in the countries of South East [Europe] ... Recently, in connection to this, armaments orders, in particular, have been shifted to Germany. In view of this development, this question is no longer being viewed with so much concern as formerly. Although it must of course remain *our objective to eliminate the commodity indebtedness* altogether ... trade relations [with countries in the Danube region] have developed satisfactorily with Bulgaria, Hungary, Yugoslavia, Greece and Turkey. The governments of these countries are earnestly endeavouring to reduce the clearing surplus by higher imports of goods from Germany (italics added).[23]

As for the second question, we should consider what the Balkan countries' perspectives were on trade with Germany. They were not necessarily bleak. Two distinct advantages can be stressed. Clearing agreements with Germany permitted a huge volume of exports that would not otherwise have been possible, in view of the closure of traditional export markets in Europe and the relative overvaluation of most Balkan currencies *vis-à-vis* Western currencies. As mentioned above, Germany ended up being a 'monopsonistic' acquirer of their products. And what of the marks obtained by those countries as payment of their exports: the blocked marks? Given the difficulty of getting rid of an inconvertible currency, Balkan countries had a choice: either to accumulate credit balances in marks, or to import more manufactured goods and machinery from Germany within the framework of the clearing agreement. We have just seen that Germany appears to have had a preference for this second alternative, but it was not so obvious to the Balkan countries. In order to clarify this issue, we can state the choice facing Balkan countries or central banks in these terms:

(1) To accumulate the blocked marks in their reserves, which would be equivalent to an extension of credit to Germany.[24] One consequence of this choice would be that thanks to this inflow of foreign currency, the central bank would be able to expand its money supply accordingly, contributing to the countries' recovery, particularly in case of spare capacity in their economies[25] (this option has been called the 'financing principle'[26]).
(2) To leave these marks in the hands of the exporters, avoiding an expansion in the domestic money supply, and wait until the demand for marks

> could be raised by importers of German merchandise (the 'waiting principle'). But, with its industrial capacity concentrated on war preparation, Germany was cutting down its exports to the Balkan countries. The imbalance between a relatively large supply of marks and a weak demand for them meant that marks would be sold on the market at a discount. In the end, the consequent mark devaluation might stimulate German exports and possibly rebalance the bilateral account.

Balkan countries' behaviour in fact varied between these two extremes. In the case of Bulgaria the exchange rate remained unchanged, the central bank reserves increased, Germany's trade deficit soared (Bulgaria had the biggest surplus with Germany), and Germany effectively received a commercial loan from Bulgaria: a case of the 'financing principle' being applied, or 'a case of capital flow uphill'.[27]

At the other extreme, Yugoslavian policy was a case of the 'waiting principle': by adopting a more independent stance, Yugoslavia let the exchange rate of *Sperrmarks* fall from 17.5 to 12.5 dinars.[28] In this way, Yugoslavia increased its imports from Germany, and its mark credit balances decreased. These German sales of course worsened Germany's terms of trade, but it should not be forgotten that Germany sold Yugoslavia (and other countries that followed the same course of action) obsolete material, from military equipment to cars.[29] This policy is in evidence in the above quotation from Ritter's circular.

Romania's case is another example of the 'waiting principle' being applied. It provides a closer view of the political side of this matter. Romania wanted to shift its trade towards free exchange countries because 'Germany's economic ascendancy was becoming too great', and released to its importers fewer licences for imports from Germany. But Germany needed Romanian grain and paid in *Sperrmarks* which could not be used to import more from third countries. Unable to shift the source of its imports, Romania then sought to get better terms of trade from Germany. Much like Yugoslavia, the Romanian government decided that its exporters had to sell their marks to importers, rather than to the central bank at a fixed rate. Marks were consequently sold against the leu (the Romanian currency) at a strong discount. The mark's bilateral devaluation meant that Romanian grain would cost more to Germany. After difficult negotiations, the exchange rate was stabilized at a level above that which the huge devaluation had produced, but below the previous official rate.[30]

Political considerations were certainly relevant to the behaviour of Balkan countries: Bulgaria was a close ally of Nazi Germany, while Yugoslavia and Romania leant towards the Western side with the *Little Entente* (and were then invaded by Germany in the Second World War).

In short, the first alternative, by maintaining a German trade deficit, brought two important advantages for Germany: better terms of trade, and further availability of commercial credit. This has been seen as a case of 'double exploitation' by Germany.[31] How much this exploitation succeeded is a matter of debate. These countries gained wide access to the large German market for their exports and financed their own economic recovery. As Milward remarks, '[The Reichsmark Bloc countries], almost alone amongst the primary exporters in the 1930s, were able to show an increase in export earnings and an increase in the growth of national income. The concentration of economic policy on achieving the immediate internal aims of the Nazi regime opened up possibilities of development to underdeveloped Europe when the depression seemed otherwise to have foreclosed all such possibilities.'[32] Germany's Southeastern Europe partners were 'willing exploitees'.[33]

It is interesting to compare the economic growth of these Balkan countries to the growth of other important economies in the 1930s. Different countries' economic performances vary, and it is difficult to assess whether, and to what extent, clearing agreements had an influence on different growth rates, but it is notable that the highest growth rate was registered by Bulgaria, Nazi Germany's closest ally, which refrained from revaluing the lev *vis-à-vis* the Reichsmark:

Table 6.2 Cumulative real growth rates (GDP) of selected countries, 1929–1938

UK	18.4%
Germany	30.5%
Italy	15.0%
– – – – – – – – –	
Bulgaria	50.0%
Greece	28.6%
Hungary	14.6%
Romania	20.5%
Yugoslavia	12.4%

Source: Maddison, Angus: *The World Economy*, www.ggdc.net.

3 Germany and Italy in Southeastern Europe: a case of *noli me tangere!*

The German ambassador in Rome, Hans Georg von Mackensen, wrote to his ministry in early 1939 that 'Albania is a *noli me tangere* for the Duce'. This sentence from the Gospel of John (roughly meaning 'hands-off me') was not of course used in a very spiritual sense: The reference was to a *démarche* made to the Italian government concerning German interests in oil exploitation in Albanian territory. Albania, the ambassador stressed, was 'a purely Italian family affair': Italy's exclusive hunting reserve, not to be 'touched' by anybody else.[34] Conversely, if not an extreme *noli me tangere*, a 'hands-off' attitude was constantly asserted by the Germans whenever

Italy attempted serious economic penetration in the rest of Southeastern Europe. Politically, the most contentious issue was Austria, which Germany had long sought to annex[35] (Austria having emerged as an independent country after the dissolution of the dual monarchy); economically, it was the question of four Balkan countries, rich in natural resources. An Italian propaganda pamphlet, published at the end of the First World War in the context of the Peace Conference and aimed at defending Italian 'rights' on the opposite side of the Adriatic Sea, gives a good summary of what other official documents say in more elaborate wording: '[A] trade flow would start through the Adriatic. Italy might export wine, citrus, manufactures, cloth, silk, mechanical and chemical products, while from the Balkans we would import coal, oil, iron ore, timber.'[36]

Like Germany, Italy too was involved in a large network of clearing agreements with Southeastern Europe, initially to recover payment for exports to these countries, which would not pay because of their strict exchange controls. As mentioned earlier, a decree of 21 December 1931 stated that imports from countries that had established exchange controls could be subject to specific conditions aimed at safeguarding Italian exporters' interests. The series of clearing agreements with countries of the Danube Basin and the Balkans were signed in this defensive attitude, having the exclusive purpose of achieving the reimbursement of 'frozen' Italian commercial credits. In the difficult monetary and financial situation that Italy was experiencing, the contraction of trade that would follow was considered preferable to the inability to collect those credits.[37]

Clearings were stipulated with Austria, Bulgaria, Romania and Yugoslavia (with most being made in 1932), in a process similar to what Germany was doing in the region. It was Austria that signed the first Italian clearing agreement, at the end of 1931. This was followed by clearings with the other three countries. These clearings, which generally were expected to last only for short periods and had the limited objective of recovering credit arrears, failed to achieve their goal and were abandoned, to be replaced by accords of a more complex form.[38]

Given the small part these countries constituted in Italy's total foreign trade (for instance, trade with Austria represented around 3 per cent of Italian trade for both imports and exports in the 1930s, with a peak of 6 per cent for imports in 1936[39]), the economic weight of these clearings was of course limited. However, by according special trade treatment they represented a watershed in Italian trade policy, which traditionally had been based on the 'clause of the most favoured nation'. Still greater was their political significance: Through these clearings, Italy was trying to attract the countries of the Danube Basin[40] into its sphere of influence, and this gave rise to problems in its relations with Germany.[41]

As a testament to the relevance of the Southeastern Europe question, it is interesting to observe that at the very beginning of the Nazi regime, German diplomatic correspondence regarding relations with Italy was largely focussed on the economic presence of the two countries in that area. The attrition between Germany and Italy, however, had started earlier, before the Nazi seizure of power. In 1932 Mussolini made a proposal for German–Italian economic cooperation in the Danube Basin, according to which the two countries would agree on which sectors of their industries were to cooperate in that area. This proposal re-emerged from time to time, but the German attitude to it was at best ambivalent, at worst totally negative. At the start of the Nazi regime the German foreign minister, Konstantin von Neurath (sceptical towards the idea and probably wishing to postpone the issue *sine die*), counter-proposed that Mussolini's idea should be submitted to the German–Italian Economic Committee, a body that had been set up, on Italy's initiative, the previous summer. In fact, as later correspondence clearly reveals, the Germans flatly rejected the Duce's proposal: They could not see how Germany and Italy could serve their own interests by dividing up the Danube market according to categories of merchandise.[42]

The German government was nevertheless very careful not to display an openly aggressive policy. 'We do not have in mind entering any political associations or establishing political relations of any *special* kind with the countries of the Danube Basin. There can therefore be no idea of any political expansion towards the Southeast [*Drang nach Südosten*], the only political objective being the eventual breakup of the Little Entente' (the alliance of Czechoslovakia, Romania, Yugoslavia, strongly supported by France), wrote von Neurath to the ambassador in Rome, Ulrich von Hassell. Neurath recommend that Hassell should demonstrate to the Italians that the works of the joint Economic Committee were not to be treated lightly.[43]

This German unease over the Italian presence in the Danube Basin continued for months. The desire to appease Italy, mainly in the interest of putting up a common front against France and the Little Entente, was at odds with the awareness that the Nazis' economic interest ('without necessarily thinking precisely of the slogan *Drang nach Südosten*', in Hassell's words[44]) might well conflict with the aims of Italian policy in that area. It was not by chance that Mussolini returned to the topic in August 1933 in a conversation with Hassell, vaguely mentioning the opportunity of 'doing specific works in groups and among neighbours, for example in the Danube Basin'. Hassell was, of course, noncommittal; he was rather more concerned by current rumours of a customs union to be established between Austria, Hungary and Italy. As Hassell observed in relation to the Danube area, 'German–Italian cooperation is affected badly by the conflict with Austria'.[45] The hypothetical customs union was seen by the Germans as giving Austria new political leverage, making it more capable of resisting Germany's *Anschluss* efforts. Germany's interest in Austria was overwhelmingly political. Their bilateral trade was even less important than Italy's trade with Austria. In the 1930s, German imports from Austria remained at less than 2 per cent of total German imports; exports declined from 3 per cent to just over 2 per cent before the *Anschluss*.[46]

In November 1933, the German government seemed to be more open to a joint economic policy in the Danube Basin, but the issues concerning Austria never disappeared from the background of German–Italian discussions.[47] Italy pursued closer economic links with Austria as the premise for a more active Italian role in the area, but this role was constantly rebutted by Germany, both in general terms (that is, with relation to German economic interests) and in more specifically political terms connected to the Nazis' objectives concerning Austria, which culminated in the *Anschluss* of 1938. However, Germany was particularly careful not to project the wrong image, and formally maintained a constantly friendly attitude towards her close southern ally.

In March 1934, the idea of a closer economic link between Italy, Austria and Hungary came to fruition: they signed the so-called 'Rome Protocols', or 'Three Powers Pact', to develop economic relations and possibly a customs union. Germany was aware of this treaty's economic and political implications: '[W]hen the Austrian problem was becoming more and more acute, the danger of an Italian economic policy in the Danube area that would block us became increasingly apparent.'[48] Germany finally concluded a trade agreement with the new Austrian government in July 1936 – after the assassination of the prime minister, Engelbert Dollfuss – and in August specific accords were signed: a clearing agreement, a trade protocol and a travel agreement.[49]

In the new political and economic environment of the consolidation of German interests in Austria, new opportunities arose for an understanding with Italy. Hassell wrote to his ministry: 'Now that political agreement had been reached over Austria, there was nothing more to prevent effective consultation between us on economic policy in the South East. ... Mussolini responded to this with great animation',[50] But a basic ambivalence remained and, as we shall later see, this undefined partition of economic interests would emerge again, in stronger terms, when in 1940 the Nazi government launched its plans for a new European economic organisation.

In the meantime, the *rapprochement* led to the German–Italian Protocol of 23 October 1936, the 'Axis', signed by the foreign ministers, Galeazzo Ciano and Konstantin von Neurath, whereby the two countries welcomed the 'normalization' of German–Austrian relations (Italy probably hoping thus to put an end to the more bellicose Nazi claims over Austria), and agreed to keep each other informed of the principles governing their economic policies in the Danube region.[51] The confrontation was not over, in any case. In 1938 the question emerged again of a 'serious and precise delimitation of the respective spheres of influence in the Danube–Balkan area, in which Germany's over-activism did not augur well and showed no intention of respecting Italy's hunting ground and the rights Italy had acquired'.[52] Faced with the Nazi *Anschluss* of Austria in 1938, Italy believed that the occupation of Albania (the *noli me tangere* mentioned earlier) would serve as a form of counterbalance and something of a retaliation on Italy's part. Albania was occupied in April 1939.

4 Italy and Albania

The case of Italian–Albanian financial relations has been studied elsewhere,[53] and here we shall deal with topics more closely related to the intertwining of monetary and trade issues, with particular focus on areas of difference from other Balkan countries' experiences. Such differences are important and make Albanian financial organization and policy an unusual case in terms of the approach followed by Germany – and Italy – in the rest of the Balkan region.

Italy's economic interests in Albania dated back to the early 20th century, when Italy was competing with its powerful neighbour, Austria-Hungary, and when the country was still part of the collapsing Ottoman Empire.[54] But both economic and political interests intensified after the declaration of Albanian independence (1912) and the First World War, which totally disrupted the territory of the young state. It was the object of ambitious designs by foreign powers, partly because of its unexploited natural resources. After the war, it initially appeared that the League of Nations could take care of financial assistance to Albania, just as it was doing for other weak nations of Central and Southern Europe (see Section 1 of this chapter). The Economic and Financial Committee of the League sent there a group of experts, led by the economist Albert Calmes of Luxembourg. The main points of the League's plan, as detailed in the Calmes Report of 1922, were the creation of a central bank, issuing banknotes along the lines of the gold exchange standard (that is, backed partly by gold and partly by foreign exchange, as recommended by the international conference held in Genoa the same year), and the implementation of large-scale infrastructure projects for road-building and marshland reclamation, both of which were considered a prerequisite for any agricultural and industrial development. Given the backwardness of the country and the impossibility of finding adequate financial resources (but also, it should be added, taking into account the multiple interests of the First World War's victors), Calmes proposed that the central bank's capital should be underwritten by foreign shareholders.

An attempt was made by the Swedish banker Marcus Wallenberg to set up a bank of issue owned by France, Britain and Italy – the three main victorious powers in Europe – with minority interests held by other countries and by a few individual Albanians as well. But Britain's political stance was weakening: Britain wanted to appease Mussolini, and supported the League's plans insofar as there was no risk of opposing fascist Italy, and as long as its own important oil interest in the area would be protected. In the end, the Italian penetration of Albania took a decisive turn when the League of Nations retreated from the idea of putting the reorganization of the Albanian state under the League's sponsorship, as originally envisaged. The Calmes plan was indeed implemented, but not according to the original design with its provisions for international involvement. With the more or less explicit approval of the League of Nations, which recognized the primacy of Italian interest there, and following the disentanglement of Britain, the fascist government was able to make a firm foothold in Albania. In 1925 Italian government capital, along with a token contribution from local interests, financed both the creation of the National Bank of Albania and a big loan for infrastructure development. Ties were further strengthened in 1926–1927 by a pact of friendship and a military assistance treaty between Italy and Albania, whose government was by then firmly in the hands of a local bey, Ahmed Zogu. These agreements put a seal on what would be a relatively durable (if not always smooth) relationship, which was nevertheless to end badly in 1939.

The national currency, the Albanian franc (AF), was given the gold parity of the old Latin Monetary Union: 290 milligrams of fine gold. When it was introduced in 1925, the Italian lira was still not part of the gold standard; when it re-entered the standard in 1927, its gold parity was set at less than the pre-war level. The exchange parity of the two currencies was consequently determined at 3.66 lire per franc.[55] Since the gold content of the Albanian franc was left unchanged during the 1930s, the exchange rate with the lira moved gradually up, reaching 4.00 lire in 1935, when the lira was made inconvertible, and then 6.22 after the lira's official devaluation of 1936. The Albanian franc has been defined as the strongest currency in Europe before the Second World War.[56] it survived all the devaluations of the 1930s, including the dissolution of the Gold Bloc in 1936 (without all the exchange controls that surrounded the other stubborn gold currency, the German Reichsmark).

If we consider the ratio of circulation plus bank balances at the central bank to the official reserve (the gold standard leverage ratio or GSLR), what stands out is its amazingly low level, and this was the source of the national currency's strength.

Table 6.3 Albania, Gold standard leverage ratio 1928–1938 (million Albanian francs)

	1928	**1938**
A Gold	1.9	9.2
B Foreign exch	11.9	18.6
C Bank balances	6.9	19.4
D Circulation	7.3	14.9
E GSLR (C+D/A+B)	1.1	1.2

Source: Roselli, *Italy and Albania*.

How could this level be sustained? Italy poured an amount of capital into Albania that, although small in relation to the Italian economy, represented a substantial share of Albania's national output. Any estimate regarding this matter is based on shaky foundations. Many inflows were not registered in the balance of payments statistics, and Albania disappeared from official international statistics in the mid-1930s. The only available source for Italy's total financial commitment in Albania is the Italian foreign minister, Galeazzo Ciano, and there may be reasons to doubt his accuracy. According to this source,[57] between 1925 and 1938 Italian capital inflows amounted to Lit1,837m (equivalent to around 510.3 million Albanian francs, at the prevailing rate of 3.66 lire per franc). This would mean an average annual flow of AF36.4m. For 1938, Albania's national income was estimated at around AF175m (the highest estimate among the few private calculations available[58]), a figure that had barely changed since 1927. On average, that inflow would have amounted to 21 per cent of Albania's annual national income. A significant degree of caution must nevertheless be exercised, not only because of the dubious nature of these estimates, but also because between 1925 and 1938 – as a result of the Great Depression – Albanian output endured a contraction, the precise extent of which is not known. The other *caveat* is that the capital inflow from Italy was not evenly distributed over the years: During the Depression (1930–1934) it almost dried up, while King Zog sought a disentanglement from Italy and unsuccessfully tried to tap into other sources of foreign loans.

The huge liability in Albania's foreign investment position, due to the inflow of mostly Italian capital, was not met by any balancing item on the asset side, that is, in Albanian foreign assets, and for two main reasons. Firstly, the capital flow did not set in motion any meaningful economic growth that could have helped to make such level of foreign indebtedness more sustainable. As mentioned above, Albanian output suffered a decrease during the Great Depression, and immediately prior to the Italian annexation in 1939 it was still at approximately the same level of the initial years of Italian involvement in Albania's economy. This lack of economic growth is still more amazing when compared to the growth of other Balkan countries as discussed in Section 2 of this chapter. Such a poor result has partly to do with the composition of Italian funding: It appears, from Ciano's description, that 35 per cent was devoted to military expenses; direct investments made up just 21 per cent; and 6 per cent can probably be classified as 'kickbacks' paid by the fascist regime. Although certain important public works should not be neglected, this expenditure was probably much less than a meaningful upgrade of infrastructure would have required.

The second reason for Albania's unbalanced foreign investment position was that the current account of the balance of payments remained very much in the red, thanks to a persistent trade deficit. In this respect, Albania benefited from the fact that service payments on the Italian loans were negligible (a situation tolerated by the Italian government, which was anxious to maintain an amicable relationship with the Albanian monarchy), but was certainly disadvantaged by the franc's high exchange rate.

Between 1925 and 1938 Albania's trade balance was constantly in deficit, with exports covering less than 50 per cent of imports, and this figure falling as low as 20 per cent in 1932 (for the years reported by the official statistics of the League of Nations, 1926–1933, the current account was also in deficit, because the positive 'invisible' balance, mostly composed of emigrant remittances, was not sufficient to cover the trade deficit).

What most angered the Italians was that this trade deficit was not due to Italian exports to Albania; it was increasingly caused by imports from third countries. An advantageous position had been attained by 'many countries which on their part have done nothing to ease Albania's burden in these very arduous years of economic revival, during which Albania's goods have found a sole outlet in Italy'.[59] Even though Italy remained Albania's main trade partner, and in fact enjoyed a surplus in its Albanian trade, this surplus declined over the years and turned to a deficit in 1937. Italy was the source of 75 per cent of Albania's total imports in 1925, but this figure had fallen to 24 per cent by 1937.

The choice of stipulating a clearing agreement such as the others that were being concluded in that period was not of interest to Italy, because of its continuing, albeit declining, surplus with Albania. The question was how to divert Albanian import flows from third countries to Italy itself. Negotiations for a customs union started in 1932. They did not go well, one obstacle being King Zog's insistence on remaining independent from his ally, the other being doubt over the economic advantages that the union would bring to Italy, given the huge structural difference between the two economies. The project foundered from the start.

The Italian invasion of Albania in 1939 was motivated by considerations both of an economic and a political nature. Part of the motivation for the invasion was derived from the aim of taking full advantage of the country's resources and thus finally turning Italy's involvement to its advantage and profit. The deciding factor, however, was the need to contain German expansionism in the Balkans following the Austrian *Anschluss* and the German occupation of Bohemia just a few days earlier.

We shall not dwell on the union of the two countries, but the point of interest for the purposes of this study is that following the 'Italian *Anschluss*' (as the occupation has been called), further Italian capital inflows reached Albania (which was by that point effectively part of the Italian economy), with the Bank of Albania's official reserves increasing accordingly. A full 'economic, customs and currency agreement' was signed on 20 April 1939. It was amply discussed, in Italy, whether simply to extend the circulation of the Italian lira to Albania and abolish the national currency, whether to issue a new currency (the 'Albanian lira'), or whether to maintain the

Albanian franc, but linked by a fixed and irreversible exchange rate to the lira (a similar debate took place regarding the adoption of the Reichsmark as the sole currency in the Reichsmark Bloc during the Second World War). The third alternative prevailed, and the chosen exchange rate – 6.20 lire per franc – was roughly in line with the market rate. A Lira Area was created, reminiscent of the much greater Sterling Area. The Albanian franc thus survived, but its gold backing disappeared. The Italian lira was the reserve currency, although a proportionally smaller gold component remained. The Lira Area was, anyway, short-lived: the Italian occupation was followed, after the fall of fascism, by the German occupation, and in 1944 the communists seized power in Tirana.

7
The Italian–German Clearing

1 Italy and Germany: their trade balance

In early 1930s, the Italian government was concerned about the rapid shrinking of the currency component of the official reserve, as shown by Table 4.4. But even Germany, a trade creditor towards Italy, lacked the currency to pay for its imports. A bilateral clearing arrangement might prove – wrote the Bank of Italy – the lesser evil (*'il male minore'*), if accompanied by a mechanism that would balance trade and provide a hedge against foreign exchange risks.[1] For a better focus on the arrangements that this general situation of currency shortage was to produce in the commercial relations between Italy and Germany, some background information on the main features of Italy's foreign trade will be useful.

Like Germany, Italy was a 'transformation economy', short of natural resources and raw materials, which largely had to be imported. This reliance on imports increased with Italy's industrialization. The merchandise deficit, which was around 4 per cent of GDP before the war, climbed to 9 per cent in 1918, and during the 1920s it stood, on average, at around 6.8 per cent of GDP. During the 1930s (in a tendency especially marked in the second half of the decade), the restrictions to foreign trade and foreign exchange controls, in particular the great number of clearing agreements entered into by Italy, brought the deficit down to 1.6 per cent of GDP.[2]

The main components of Italian trade evolved in step with Italy's increasing industrialization. Whereas, in the first phase of the country's unification, primary products were the main component of exports, manufactured products took up a gradually increasing proportion and at the end of the 1930s, for the first time, their share of exports passed the threshold of 50 per cent. Conversely, on the import side primary products continued to represent a substantial share, which was approximately 70 per cent in the second half of the 1930s. Within primary products, two important categories of imports emerged: agricultural produce and energy, of which the latter became increasingly important: while at the end of the war (in 1919) these categories respectively represented 26 and 12 per cent of imports, by 1939 these respective proportions had switched to 15 and 24 per cent.[3]

The directions of Italian trade reflected the needs of the economy and the opportunities offered by different markets. Germany had a very important role in this regard. At the start of the 20th century, Germany was the main market for Italian exports. Then, during the First World War and its aftermath, France and the United States took the main roles; but in the 1930s Germany regained its primacy (if we do not consider the Italian colonies, which are anyway irrelevant for foreign currency purposes).

In 1939, around one third of Italian primary products were exported to Germany; they were exported against coal imports, in the framework of the bilateral clearing agreements for balanced trade which will be considered later.[4] The destination of exports of manufactured goods was more varied: At the end of the 1930s, Germany was still the destination market for only 5 per cent of this category of exports (roughly the same proportion as the United States), even though this figure represented an increase on previous years.

In the matter of imports, Germany's importance was overwhelming. Germany was the biggest provider of Italian imports for both primary and manufactured products, but particularly for the latter category: Germany had occupied a prominent position from the start of the century, and by 1939 it was the origin of almost 57 per cent of imported manufactured goods. Among primary products, coal imports were particularly significant. Until the mid-1930s, coal was mostly imported from Britain, but from the 1920s the share of coal imports from Germany grew and in the second half of the 1930s approximately 50 per cent of Italian coal imports came from Germany; this was the result of Britain's choice to reduce exports to Italy in order to exert political pressure on Mussolini[5] (with the unintended consequence of directing Mussolini even more into Germany's camp).

We can now look more closely at bilateral trade. Italian trade relations with Germany were more complex than with other trade partners, and for specific reasons. Germany was rapidly becoming Italy's most important trade partner and enjoying a constant surplus. Moreover, as just noted, Italy was growing as an important industrial nation, and its manufactured products were bound to be in competition on foreign markets with Germany's strong manufacturing sector. At the same time, Germany was a financial debtor to Italy – for war reparations and then for the service of loans, particularly of the Dawes and Young loans which had been partly issued by Italy. Their bilateral trade was characterized by a structural deficit for Italy, which failed to disappear, or even substantially to shrink, with the bilateral clearing agreements of the 1930s. The aim constantly pursued by the Italian authorities, that of moving towards balanced trade, remained an elusive goal. Italy had to live with that deficit; the coverage ratio of imports, at current prices, seldom reached 70 per cent.[6]

Italy had two concerns. Its commercial debt to Germany was a sword of Damocles constantly hanging over it; but paradoxically, the Italian government also feared that given the shortage of foreign currency that afflicted Germany, this country would be unable (or unwilling) to pay for its imports from Italy. Germany, its trade surplus notwithstanding, felt equally uncomfortable in turn, concerned that Italy would be unable to honour its debt, and that, given the chronic weakness of the Italian lira, a foreign exchange risk would be incumbent.

After the introduction of foreign exchange controls in Germany, in July 1931, Italy feared that its exports to Germany could not be paid. Italy's concerns were well founded: Luther, the Reichsbank president, wrote in November to the governor of the Bank of Italy, Azzolini, stressing that the Standstill Agreement on short-term foreign debt, just signed, had not lessened the intense pressure on the Reichsbank reserve caused by the market's new and growing demand for foreign currency.[7] The following month, in the midst of the German currency crisis, the German ambassador in Rome, Carl von Schubert, expressed to the Italian government the usual complaints about the burdens that afflicted the German economy and made any trade surplus insufficient to meet Western countries' financial claims. He wrote to the Italian foreign ministry, which in turn informed Beneduce (who chaired the BIS Special Advisory Committee and acted as a sort of plenipotentiary for the government in financial affairs)[8] that, in addition to the foreign debt service, the 'statistical' trade surplus was damaged by payment 'lags': German exporters, in particular the *Gross-Konzerne* (the big industrial groups), which were simultaneously exporters and importers, preferred 'to build up German assets abroad, as a reserve for the German economy', for payment of future imports. In this way, the German embassy wanted to justify the apparent paradox of a continued shortage of foreign currency coexisting with a trade surplus.[9]

Beneduce felt the need to hear from the Italian perspective, and Eugenio Anzilotti, director general for industrial production and trade at the ministry for corporations, replied that, given the importance of Italian exports to Germany – the first export market – Italy was suffering as a consequence of the German trade situation, as described above, with a consequent, marked decrease in exports.[10] Guido Jung, then president of the Italian Export Institute (and later minister of finance), writing in April 1932 to the minister for corporations, Giuseppe Bottai, noted that the forthcoming Lausanne conference (see Chapter 2) might provide an opportunity for a 'tit-for-tat': supporting Germany in its plea for an end to war reparations, and obtaining, in exchange, a clearing agreement; what Germany would save in reparations payments might be used to pay for Italian exports to Germany.[11]

For a better understanding of this exchange of letters, an assessment of the whole current account of the bilateral balance of payments is necessary, based on Tattara's research results[12] (Table 7.1).

Until 1931, war reparation payments – if included in the current account – created a surplus for Italy. But in 1932, following the Lausanne Agreement that practically stopped war reparations, the current account turned in favour of Germany, thanks to its substantial trade surplus. The expectations of Guido Jung were disappointed: the end of reparations did not mean more largesse in the German attitude towards trade with Italy. Between 1931 and 1932, reparation payments were slashed by RM83m, but the German trade surplus declined 'only' by RM30.4m.

A current account deficit for Italy persisted for most of the 1930s. This was the result of a very large merchandise deficit, not balanced by an Italian surplus in services and interest (payments of the Dawes and Young loans). What is of particular interest is that, towards the end of the decade, the German surplus on merchandise trade increased, but still more grew the Italian surplus on services. Two components of the 'invisibles' were remarkable: travel (mostly, German tourism to Italy) and emigrant remittances, which increased dramatically nearer the Second World War, as we shall see later. As a consequence of this trend, in 1938 the current account balance reversed again, in favour of Italy. This evolution of the bilateral balance of payments can be better understood through the series of agreements stipulated during the 1930s between the two countries.

The first Italian–German trade agreement, signed on 15 June 1932, bears no reference to the German financial debt. It was a secret protocol between the Reichsbank and the Istituto Nazionale per i Cambi con l'Estero (INCE)[13] on the payment of trade debt between the two countries. It focussed on the problem of the shortage of currency available for Germany to pay for its imports, and stated that if the amount of free currency allocated by the government to German importers was not enough to pay for their imports from Italy in full, they would deposit the difference, in Reichsmarks, in a special account held at the Reichsbank on behalf of and in the interest of

Table 7.1 German balance of payments with Italy. Current account, 1930–1939 (RMm)

	1930	**1931**	**1932**	**1933**	**1934**	**1935**	**1936**	**1937**	**1938**	**1939**
Merchandise balance	118.9	72.3	41.9	6.8	61.2	92.0	78.0	87.0	102.0	106.9
Services	–44.0	–26.0	–26.0	–25.0	–21.0	–36.0	–61.0	–67.0	–113.0	–153.0
Interest	–0.5	–1.0	–5.0	–5.0	–4.0	–4.0	–3.7	–3.7	–3.7	–3.5
War reparations	–140.0	–89.0	–3.0	–3.0						
Total	–65.6	–43.7	10.9	27.8	36.2	52.0	13.3	16.3	–14.7	–50.5

Source: Elaboration from Tattara, *Power and Trade*.

Italian exporters. That deposit was made in blocked marks, since it could only be used to pay for German exports to Italy. The scheme worked in this way: The Italian importer would ask the Bank of Italy to provide him with the marks necessary to pay for his imports; and the Bank of Italy would draw on the deposit held at the Reichsbank. If trade was perfectly balanced, withdrawals from that deposit would be sufficient to cover the Italian imports. But the problem was that Germany, as we have seen, had a substantial trade surplus with Italy, and the deposit was not sufficient. So the balance, in marks, had to be provided to the Italian importer by Italian banks and in the end, by the Italian currency reserve.[14] In fact, Germany was reluctant to deposit marks in the INCE's name at the Reichsbank, even for import payments, being justifiably fearful that Italy would not be able to cover the trade deficit. In the short period 27 June 15 August 1932, Germany had an enormous trade surplus (exports for RM14.3m, against imports for RM5.8m); RM8.5m (14.3–5.8) had to be provided by the Italian banking system.[15]

The duration of that agreement was two months, to be tacitly extended on a monthly basis. It only took until September, however, for the German government to renounce it because of the persistent German trade surplus. German currency restrictions therefore returned, and on 26 September the Italian government retaliated by stating that Italian importers would only make 25 per cent of their payments for imports from Germany in free currency, with the other 75 per cent being held in a deposit at the INCE. A new protocol reintroduced the scheme of the previous June, but with the important caveat that it would be applied only if the ratio of imports to exports was consolidated at the level prevailing in 1931. As a consequence, the 75 per cent deposit at the INCE was abolished, and Italian banks provided the importers with the necessary currency.[16]

Currency transfers were made still more difficult by the German Transfer Law of 9 June 1933, and by the full transfer moratorium introduced by Germany, following the Berlin conference on transfers in June 1934, which hardened still more the Nazi government's attitude to foreign debt.

In this context, Germany sought bilateral agreements with Western European countries in order to link foreign debt service – in particular the service of the Dawes and Young loans – to the balance of trade. Germany tried to achieve this by exploiting its favourable trade position: Payment of financial debts would be linked to a sizeable and structural bilateral trade surplus. We have dealt with this link between trade surplus and financial debt in previous chapters and have seen how this link was enacted through bilateral payment agreements tailored to the needs of each particular country. At the beginning of July 1934, in relation to the worsening situation of German trade, it appeared to foreign observers that Germany was studying a new model of clearing agreement. 'It is difficult to specify [in concluding clearing agreements] how relevant the German intent to appease the creditors as far as possible has been, in order to make the solution of the grave problem of raw materials easier',[17] the Bank of Italy's representative in Berlin, Antonino Cimino, wrote to governor Azzolini. We have dealt with German clearing agreements in general in Chapter 5. Here we shall consider the clearing issue with specific reference to Italy.

2 The Italian–German clearing of 1934

Among the clearing agreements reached by Germany with Western European countries in the summer and early autumn of 1934, no mention is made of the clearing with Italy in the first exhaustive study of this matter by Howard Ellis.[18] Dealing with the same topic in the postwar years, Child writes that 'little is known' of this agreement.[19] Not only did the secretive attitude of the two dictatorships help to surround the deal in a cloud of confidentiality, but both had to cover up the large weakness of their foreign positions.

In the early 1930s Germany's foreign trade surplus declined, switching to a deficit in 1934. As mentioned earlier, Italian trade was characterised by structural deficits, including with Germany (Table 7.1); the bilateral deficit at the time was substantial, and for Italy in the period 1930–1934 the coverage of imports by exports averaged just 65 per cent. The size of this bilateral relation as a share of total Italian foreign trade was equally important, at around 13–16 per cent.[20] On the other hand, Italy had a sizeable surplus in services.

On 11 July 1934, Anzilotti arrived in Berlin to negotiate a clearing agreement with Germany. Considering the whole balance of payments, it was obvious that any settlement had to include not only merchandise trade, but also important items of the invisibles: travel and the service of the Dawes and Young loans. The first item was strongly favourable for Germany which, as just noted, had a substantial trade surplus with Italy, while the questions of tourism and loan servicing were in Italy's favour but represented smaller amounts. Notably, unlike for other countries, the financial credit from the Dawes and Young loans was, for Italy, fairly limited thanks to the small amount of these loans in the hands of Italian investors. The necessity of maintaining a substantial German trade surplus to allow for debt servicing, while crucial for other Western countries, was therefore less relevant in Italy's case.

The Italian-German meetings started in August, and the Italian delegation made immediately clear that the 'supreme interest' of Italy was to achieve a balanced trade with Germany. Considering the structural imbalance, however, Italy was open to maintaining a deficit, which was to be determined in percentage terms (the Italian delegation had in mind a deficit equal to around 20 per cent of German exports to Italy), and not as a fixed figure. If this deficit increased, it should be brought back to the agreed percentage by bilateral action in the form of either an increase in Italian exports or a reduction in German exports. Given Italy's current deficit, the latter measure would mean a sharp contraction in trade, which Italy wanted to avoid: Its interest was therefore focussed on increasing its exports to Germany. From the Italian viewpoint, tourism had to be considered as a way of rebalancing the merchandise deficit, at least in part. The Dawes and Young loans should continue to be serviced.

Mindful of its strong trade position, and concerned by the potential inability of Italy to pay for its trade debt, during the negotiations Germany firmly asserted that a portion of Italian imports had to be paid outside the clearing agreement, that is in free foreign currency, to be put at the unrestricted disposal of the Reichsbank (this portion was called the 'peak' or in Italian '*punta*'). As we have seen in Chapter 5, as a general principle a clearing agreement would require that no foreign currency be used, since balanced trade was the main goal of the clearing system. But the Germans were well aware that this balance could not be achieved with Italy, and that trade would remain firmly in surplus for them. Consequently, Germany wanted to receive the largest possible part of that trade surplus as free currency, that is to get a 'peak' as large as possible. That free currency was badly needed for buying from third countries the imported raw materials necessary to German industry. In this regard, Italy had the obvious and opposite interest to minimize the 'peak'. Although initially substantial and wide-ranging, the difference on this issue was gradually reduced by negotiation: the Germans proposed 11 per cent, the Italians 9 per cent.

As for the interest to be paid by Germany on the two Reich loans, the German delegation rejected the Italian proposal that they should be fully serviced, and rather insisted that the interest would only be paid up to 20 per cent of the amount freely available to the Reichsbank.[21] In this way a smaller portion of free currency (a smaller 'peak'), as desired by Italy, would have automatically impacted on the amount available to serve the financial debt, contrary to Italy's interest.

In the middle of these negotiations, on 26 August 1934, at the Leipzig Fair, Schacht, who had also assumed responsibility for the ministry of economics, gave the important speech that laid out Germany's new trade policy, and on 19 September his 'New Plan' was formally announced (see Chapter 5). His strategy was to limit German imports as much as possible, however ring-fencing essential raw materials. Existing payment and clearing agreements had to be modified accordingly, even though this meant relying on more expensive domestic production. Significantly, Schacht added that there was no problem with Germany's clearing arrangements with Central and Southeastern Europe.[22] This of course narrowed any room for negotiation with the Italian delegation and reduced further still the availability of Reichsmarks for German importers of Italian merchandise. The clearing agreement with Italy was finally signed on 26 September,[23] but it was not hard to see that further troubles lay ahead.

The agreement with Italy reflected the clearings' general aims and procedures (as described in Chapter 5). Where merchandise trade was concerned, on the German side payments for Italian exports would be made in RM on an interest-free account opened by the Reichsbank[24] in the INCE's name;

meanwhile, on the Italian side, payments of Italian imports would be made in lire to a similarly interest-free account opened by the INCE in the name of the Reichsbank. Any other form of payment was forbidden (if merchandise trade were perfectly balanced, no currency transfer would be necessary).

For the exchange rate to be applied to transactions, the official parities were neglected; the agreement left this issue open and stated that payments would be settled at exchange rates to be agreed by the respective clearing offices, INCE and the Reichsbank.

Given the current trade surplus in Germany's favour, which meant that the amount in lire credited to the Reichsbank would exceed the amount in Reichsmarks credited to the INCE, the 'peak' issue had to be solved. In this regard, an asymmetrical provision in the agreement stated that a portion to be agreed would be put at the Reichsbank's disposal as free currency. The remaining portion would be used to pay for Italian goods exported to Germany and to pay for German tourism in Italy.[25]

The agreement left unanswered a series of questions that had been debated during the Berlin negotiations: the maximum imbalance that the parties would tolerate, the quota to be made freely available to the German central bank – 'the peak' – the exchange rate to be used, and the service of the Dawes and Young loans. These issues were considered in a set of protocols attached to the agreement. Regarding the maximum imbalance in merchandise trade, one confidential protocol stated that if, on the account opened at the Reichsbank in favour of the INCE for Italian exports, the balance was above RM3m – or if, on the account opened at the INCE in favour of the Reichsbank for German exports, the balance was above Lit17.2m, the INCE and the Reichsbank would ascertain whether the imbalance was due to temporary or structural circumstances (the imbalance's *cause organiche*). If it proved to be structural, they would report to their respective governments. If the structural imbalance reached RM5m or Lit28.7m, the creditor country could suspend acceptance of further payments, which would resume only when the imbalance returned below the stated limit. This provision was formulated in a symmetrical way, but in practice the event that the Germans really feared was the accumulation of a huge credit exposure denominated in Italian lire. That was, in fact, what happened. As mentioned earlier, the Italian delegation had pushed, in this respect, for the balance to be set as a percentage rather than an absolute amount; but they had to give in to the Germans, who feared that the balance, if denominated as a percentage, might swell to unbearable proportions. In the same vein, the exchange rate had to be determined according to the quotes of the two currencies on the exchange markets of Amsterdam, London and Zurich and not – as Italy would have preferred, given the high Reichsmark valuation – to the official parity.

In reference to the 'peak', it was set at 10 per cent. The remaining 90 per cent was 'blocked': the INCE would then notify the Reichsbank of its allocation between trade and tourism. As a rule, 80 per cent would be used to pay for Italian exports to Germany, and 10 per cent to finance the expenses of German tourists in Italy. Finally, as regards the service of the Dawes and Young loans, 25 per cent of the free portion available to the Reichsbank[26] (in practice, 2.5 per cent of the Italian payments for merchandise imports) would be used to pay the holders of the Dawes and Young bonds denominated in lire,[27] while the other 75 per cent (7.5 per cent of Italian payments for merchandise imports) would be the effective free currency available to the Reichsbank. In this way, interest payments on these bonds would be made dependent on the size of the trade surplus – the higher the surplus, the higher the probability of a full interest payment. This was totally in line with the 'spirit' of the payment and clearing agreements stipulated by Germany with Western creditor countries, as we have seen in Chapter 5.[28]

Worthwhile observing that, beyond the Italian case, the issue of payment of coupons on the Dawes and Young bonds remained contentious also with regard to bonds underwritten in other creditor countries. Payments to the holders of bonds denominated in lire were, indeed, just one part of the story. In fact, Schacht skilfully used this issue to divide the foreign creditor countries and make it more difficult for them to reach any common position. Relying on the strict bilateralism of his policy and on the secrecy of these agreements, he led the interlocutor from each country to believe that other creditor countries had already accepted a cut in the coupons, and that this one country was isolated in insisting on full payments. In May 1935, according to Fraser, the BIS president, Schacht had tied full payment for US bondholders to an improvement in U.S.–German trade relations. Schacht had said to the Americans that the German–Swiss clearing agreement included a reduction of the interest rate on both loans to 4 per cent (from 7 and 5.5 per cent). If the United States refused to accept a cut in the interest on the Reich's loans, Germany would retaliate by drastically reducing its imports from that country and the surplus that America enjoyed in its trade with Germany could well disappear (Germany was already reducing its imports of American cotton).[29] This adroit, wily behaviour was noticed by contemporary observers, who remarked on the loss suffered by foreign bondholders thanks to Schacht's devious methods.[30]

A protocol added to the Italian-German clearing agreement of 1934 stated that coupons on bonds issued in lire would be paid to Italian bondholders only (not to non-Italian holders, even if the bond was lira-denominated). Successive half-year agreements confirmed full payments until December 1935, when Germany informed the Italian government that an agreement had been concluded with other creditor countries to pay only a portion of maturing coupons and, therefore, that new, specific accords had to be reached between Germany and Italy for coupons maturing after January 1936, in order to avoid any curtailment of the payments.[31]

The clearing agreement with Italy was to work as follows:

Table 7.2 The scheme of the Italian–German clearing of 1934

General account (100)	
Blocked account (90)	Reichsbank special account (10)
Trade account (80) tourism account (10)	free account (7.5)
	capital movement account, coupons of the Reich loans (2.5)

Source: ASBI, Azzolini, 69.

3 Italy's exchange controls: the new clearing agreement of 1935

In 1934, the worsening of Italy's foreign accounts and of the level of its official reserves (see Table 4.4) finally led to a wave of measures aimed at stopping any cross-border financial transactions not connected to 'real' economic activities.[32] At the end of 1934, following the official devaluation of the dollar and in preparation for the Ethiopian war, it was felt necessary to introduce stricter discipline. This was done on 8 December with two main decrees that introduced a full monopoly on foreign exchanges: The first established that all foreign currencies must be transferred to the state, while ownership of foreign securities must be declared; the second introduced penalties for banks contravening those regulations. Responsibility for this monopoly on foreign exchange was given to the INCE, which operated through the Bank of Italy. The central bank could in turn delegate other banks to carry out functions connected to the centralisation of foreign exchanges and registration of foreign securities. Through these measures, Italy *de facto* abandoned convertibility for the lira, even though it formally continued to be part of the Gold Bloc.

It was necessary to supplement exchange restrictions with trade measures. On 16 February 1935, a decree introduced a regime of general quotas (*contingentamento*) for imports, and stated that the imports of most merchandises subject to customs tariffs would now only be permitted if the importing firm held a special licence (*permesso*), which could only be obtained up to the value of a certain percentage (*contingente*) of what the firm had imported the previous year (1934); within that limit, the importer would obtain the necessary currency. But in practice this was not the case, because the available currency was less than the amount requested by the importer within the *contingente*. In other words, the permitted *contingente* was above the amount of available currency. As a consequence, a foreign trade debt accumulated, which by May 1935 had climbed to around Lit500m. A new *contingente* was therefore determined, stricter than the original one; but the *contingenti* that were allocated to importers constantly proved to exceed the amount of currency that was effectively available. The governor of the Bank of Italy, Azzolini, considered the possibility of secretly reducing the quantity of official *contingenti*, but foreign exporters got wind of this plan and, afraid they would not be paid, started asking for an immediate credit opening at Italian banks. Azzolini thought that a comprehensive new set of rules should determine realistic levels for *contingenti* and *permessi*, ensuring an effective exchange coverage on the basis of a general assessment of the availability of foreign reserves, an inventory of commodities already available in Italy, of the need for foreign goods and services and of Italy's foreign financial position.[33]

The new regulation allowed private clearings outside the *permessi*, if approved by the INCE; and it exempted imports from countries that had general clearing arrangements with Italy. However, private clearings gave rise to the problem that, taking advantage of the relatively strong exchange rate of the lira, Italian importers were available to offer substantially higher prices to foreign exporters. This ended up increasing the level of domestic prices, and in turn discouraging Italian exports as a consequence. It was only for a few goods that import was free.[34]

In the same month, the implementation of these complex regulations was concentrated in a new institution, the Sovraintendenza per lo scambio delle valute (Superintendence for Foreign Exchange), which a few months later, in December, was raised to the level of Sottosegretariato di Stato (state undersecretariat), and finally, in November 1937, to a ministerial rank: ministero per gli Scambi e le Valute (ministry of trade and foreign exchange).

Italy was still on a gold standard regime, and the continuing balance of payments deficit necessitated further restrictive measures. The Decree Law of 21 July 1935 suspended the mandatory level of the official reserve, previously fixed at 40 per cent of circulation. After having been *de facto* suspended in 1934, convertibility was now made *de jure* impossible, too (the lira nevertheless kept the official parity for a short while). With the Decree Law of 28 August, any foreign asset must be transferred to the INCE against Treasury securities.[35] The Decree Law of 20 March 1936 introduced multiple exchange rates, with the *lira turistica*, aimed at encouraging the inflow of foreign currency through tourism by offering a discounted exchange rate.

The new Italian legislation of 1935, and the new doctrine announced by Schacht the previous year in Leipzig, brought about a further clearing agreement that was secretly stipulated by Italy and Germany on 16 April 1935. It stated that the German government would release currency (*Devisen*) cerificates for the same amount as spent in the previous year, to importers of Italian goods; the same rule applied for Italian imports of German goods, which would anyway need specific *permessi* issued by the Italian finance ministry. The agreement included exceptions regarding specific goods.[36] The references to *devisen* certificates and *permessi* closely reflected the new regulations introduced by both countries. The agreement applied exclusively to trade in merchandise and did not refer to services or to debt servicing. It should be noted that in 1934, while Germany's total trade balance registered a deficit, the balance with Italy remained favourable (the covering ratio being 69 per cent[37]); the agreement froze this imbalance.

Schacht, in his positions both as Reichsbank president and economics minister, was following these developments with increasing concern, and the sanctions adopted against Italy by the League of Nations in November 1935 in response to the Ethiopian war made a difficult situation still more difficult. The Italian trade deficit generated an accumulation of lire on the clearing account, and the suspension of lira convertibility meant an increasing foreign exchange risk in case of formal devaluation. Azzolini advised Thaon di Revel, the finance minister, that it was Schacht's intention to reduce trade between the two countries and to seek to contain the large trade credit. Schacht was looking for a more limited clearing agreement, one confined to products that were genuinely of primary interest to both countries, while most of the bilateral trade should be settled in free currencies.[38]

Germany had not joined the League's sanctions against Italy, and the Italian ambassador in Berlin, Bernardo Attolico, pressured Schacht to start new economic and financial negotiations for cooperation and support. On 10 November 1935 Schacht, Azzolini and Beneduce met in Basel at the Bank for International Settlements. Even though no agreement was reached, the decision was made to go ahead with negotiations through the Bank of Italy's representative in Berlin, Cimino. In an implicit admission that the German trade surplus would be hard to remove, the idea was floated of converting the trade credit into a financial loan to Italy. This loan would be collateralized by securities denominated in Reichsmarks or another currency but not in Italian lire, which the Germans deemed too risky an asset[39]. What was crystal clear was that Italian lire were wholly unwelcome. If a loan had to be obtained as a result of the strained situation of its foreign accounts, the Italian government saw Germany as an attractive alternative to other markets where access was made difficult by sanctions. In a comprehensive deal also involving trade, Germany could be an important provider of coal (replacing 'sanctionist' Britain) and other strategic goods, while also serving as a destination for the Italian exports that could not reach other markets.[40]

On 27 November, Azzolini wrote alarmingly to Thaon di Revel that the Germans had difficulty in providing merchandise without payment, were reluctant to accumulate further credit on the clearing account, and had decided to suspend the exchange of Italian banknotes and bills discounted by the Bank of Italy.[41] The Germans feared a sudden devaluation of the lira, which 'might happen overnight'.[42] As the lira exchange market rate dwindled (the yearly rate of the lira to the Reichsmark declining from 4.59

in 1934 to 4.87 in 1935[43]), the increasing concern that the lira would be devalued prompted the Reichsbank to propose to the Bank of Italy swaps of lire against foreign exchange in the Bank of Italy's official reserve. The Germans were all the more disturbed, Cimino observed, because 'the ability to use the lire that accumulate in Italy on the account of the Reichsbank is in practice paralyzed as a consequence of the new Italian currency regulations. As pointed out by the *Verrechnungkasse* (the German equivalent of the INCE), they were not in existence when the clearing agreement was signed, and they made basically void the content of art. 9 [of the clearing agreement, which put a portion of the lire at the disposal of the Reichsbank]'.[44] Paradoxically, Italy was serving Germany, in a sort of retribution, the same measures by which Germany had hit foreign holders of 'blocked' marks.

The German Coal Syndicate refused to make further coal deliveries to Italy, even though a few months earlier Hitler had expressed his view that coal exports to Italy should no longer be based on the average of several preceding years, as the trade agreement stated, but on 'the optimum attained up to the coming into force of economic sanctions against Italy',[45] a sign of firm support to his southern ally. It was not perceived as such by Guarneri, who as superintendent for Foreign Exchange had the responsibility of ensuring a smooth supply of coal to Italian industry: '[This] episode', he wrote, 'which occurred just fifteen days after the [League of Nations] sanctions, gave us a moment of true anxiety…and was interpreted by us as a demonstrating a fundamentally unfriendly attitude on the German side'.[46]

In early December Germany detailed the proposal for a loan to Italy. The transaction was constructed in a similar way to a 'repo'.[47] the Gold Discount Bank would obtain from the INCE securities for a maximum amount of RM40m (these securities would be 30 per cent German, 20 per cent from a third country, and 50 per cent Italian, but denominated in dollars, Swiss francs and British pounds).[48] The purchase price of these securities would be paid by the Gold Discount Bank to the INCE on the clearing account. The INCE would gradually repurchase the securities, until the expiry of the transaction after 7 years.[49] The securities' repurchase price was linked to gold because as stated by the Monetary Law of 1924, one Reichsmark was valued at the official gold parity, not at any current market rate. As a guarantee that the securities would be redeemed by the INCE, the Bank of Italy was to deposit 4.778kg of fine gold, in bars and coins (around 2 per cent of its gold reserve), at the Reichsbank.[50]

We do not have archival evidence of how these negotiations ended.[51] While Schacht appeared to be favourable to the loan, the German foreign ministry had reservations: If the gold transaction took place through the Bank for International Settlements, as the Italians preferred, Britain would have been immediately informed and would be likely to remonstrate. The foreign ministry would have preferred to keep the transaction secret, merely presenting it as something connected to the clearing agreement with Italy. According to the narrative of Guarneri, the superintendent for foreign exchange, the idea of a loan, and of the accompanying gold transaction, were abandoned when Italy made a huge payment on the clearing account. The obstacle was removed, and the account regained its 'elasticity'.[52]

On 20 December, 1935 an agreement was reached in Munich, aimed at reducing the Italian debt on the clearing account. There was a 'real' side and a financial side. On the 'real' side, it was decided to move some payments from the tourism account to the trade account (see above for the scheme of the clearing agreement) in order to permit immediate payment to German exporters and to reduce Italian imports and increase Italy's exports to Germany. However, taking into account the League's sanctions against Italy in response to the Ethiopian war, further extra-quota purchases from Germany would be permitted, but on a case-by-case basis, and payment for them had to be made either in hard currency or commodities. As for the financial side, Germany would pay some dividends, interest and rents in arrears, where private investments were concerned, through the transfer account of the clearing agreement; also, the German authorities would purchase German securities held by Italian residents. Part of them were purchased by the Gold Discount Bank at a discount of 30 per cent (thus facilitating the indirect way of financing German exports we have described in Chapter 5), and part were bought at full value through the transfer account.[53]

The Italian lira was, in the end, officially devalued with the Decree Law of 5 October 1936. The new value of the lira was 'realigned' to the dollar, with the new rate corresponding to 40.94 per cent of the 1927 parity; this value could be further reduced by 10 per cent.[54]

On 23 October 1936 the Rome–Berlin Axis was signed and made public on 1 November. This pact touched only marginally on economic and financial issues. However, from this perspective, it signified that a greater integration of the two countries' economies should be pursued, to the detriment of trade relations with third countries. The overlapping of commercial interests in Central and Southeastern European countries should be avoided; a common front should be maintained at any international fora. Did reciprocal relations develop along these lines? It is impossible to give a positive reply. Leaving aside the question of international economic conferences, which never occurred in a climate increasingly dominated by political confrontations and by the approach of global conflict, the main issue was that of trade policies. We have already dealt with Italian and German trade policies in the Danube area and the Balkans (see Chapter 6). Here, the evolution of their clearing agreement following the establishment of the Axis will be discussed.

Within an upward trend of national output in both countries (in real terms, between the trough of the Depression and the war, Italian GNP grew by 27.9 per cent and German NNP by an amazing 94.8 per cent[55]), and bilateral trade expanded significantly. Germany remained the most important partner for Italy on both sides of the trade balance, but particularly so for imports. In 1938, 19.1 per cent of Italian exports went to Germany, and 26.8 per cent of imports came from Germany. The balance was constantly in substantial deficit for Italy: In 1938, the coverage ratio of imports was only 66 per cent.[56]

On the other side, Italy continued to register a surplus in the 'invisibles' (Table 7.1). Particularly after the bilateral agreements that followed the 'Axis Protocol', which included a clause that would make workers available to the other country on a reciprocal basis, the flow of workers was essentially unidirectional, and the 'services' inflow to Italy was largely due to Italian emigrant remittances. After an initial German request for 200,000 Italian agricultural workers, temporary employment in Germany, in both industry and agriculture, became widespread.[57] Until 1937, the balance of payments current account showed, however, that this 'invisibles' surplus was not sufficient to rebalance the Italian merchandise deficit.

It should be remembered that part of the Italian imports from Germany, according to the clearing agreement, had to be paid in free currency (the 'peak'), and this – other things being equal – worsened the Italian position on the clearing account. It was particularly disturbing for Italy that, according to the clearing agreement of 1934, it had to pay 7.5 per cent of the value of German exports in free currency,[58] the so-called 'foreign exchange clearing balance'. The 'peak' (*punta*) placed an additional pressure on the already strained reserves. Between the end of 1935 – the year before the official devaluation of the lira – and the end of 1939, foreign currency reserves at the Bank of Italy fell dramatically (from the equivalent of Lit299m to 38.3m[59]). The fixing of an appropriate level of the 'peak' remained a highly contentious issue, because it greatly affected the balance of the clearing account.[60]

Felice Guarneri, by then Trade and Foreign Exchange minister, observed that it should be necessary to review the Italian–German agreements in order to abolish the percentage of 7.5 per cent that Italy had to pay in free currency on the amount of German exports. In 1937 it was agreed to put a ceiling to the 'peak' by determining it as a fixed amount rather than as a percentage: the 'peak' was frozen at RM15m, which was in fact equal to 7.5 per cent of German exports in 1934, thus avoiding further increases possibly due to an expansion of German exports to Italy.[61] Later, in the exceptional circumstances of an approaching war, the Italian government asked again for this 'balance' – a 'heavy and morally intolerable burden', in the words of Guarneri[62] – to be abolished. Its repeal was, not surprisingly, protested by the Germans, with the new argument that the 'peak' was necessary in order to cover the cost sustained by Germany in buying the raw materials, which were incorporated into the German-made goods exported to Italy.

This 'peak' problem became bound up with another specific issue: Germany had decided in 1938 to buy 300 aerial torpedoes from Italy for

RM12m, and Italy, probably to exert pressure on Germany on the matter of abolishing the 'peak', asked in turn to be paid for the torpedoes outside the clearing account, that is, in free currency.[63] In fact, 1938 was a pivotal year in bilateral relations because, thanks to the swelling of the Italian surplus in 'services' (emigrant remittances were of particular importance), the current account balance moved in favour of Italy (Table 7.2). All the more disturbing for Italy was the payment of the 'peak' on imports from Germany.

Free currency balance and the torpedo transaction were for some months the dominant issues of bilateral financial and trade relations. Italy's aim was indeed to get rid of that balance, an action which would have helped with the conservation of the precious stocks of free currency and, instead, be paid in free currency for the torpedoes. Germany's aim was exactly the opposite: to maintain the 'peak' and to include payment for the torpedoes in the clearing account. Maintaining the 'peak' was, for Germany, a priority that, as the Führer himself had affirmed, could not be given up even for 'our best friends'.[64]

Both countries envisaged a partial way out of the impasse in the reduction of the German trade-related clearing debt using additional exports to Italy. If Germany was unable to pay for its debt, the only way out, indeed, appeared to be for it to export more to Italy.

To face a trade deficit that called for larger imports from Germany was, in Italian eyes, a paradox; but an additional problem concerned the imports' composition. Here, the main issue was that given Italy's growing industrialization, the two nations were increasingly competing on the same finished industrial products: a long-standing problem in trade relations between the two countries. Germany wanted to export merchandise like cars to Italy, and Italy saw this policy as damaging to its own automotive industry and, more broadly, as the seed of destructive competition in foreign markets. Instead, Italy wanted to import commodities from Germany such as coal, machinery, timber, fertilizers and steel for war production. German coal had to take the place of English coal, the export to Italy of which had been discontinued after the Ethiopian sanctions. But coal was indispensable to the German war machine. 'It is regrettable that the Italian government is constantly endeavouring to obtain an increase in supplies of raw materials from Germany at the expense of German exports of manufactured goods', the Germans observed.[65] Presented with the Italian requests for additional commodities, Germany retorted that Italy had to increase its import licences for manufactured goods. The two economies were not complementary: on the contrary, they were in fierce competition to sell finished goods on the international market. This old problem came back to the fore.[66]

Italy then proposed, again, that Germany should give up the free balance, the *punta*; in exchange, Italy would only take RM6m as payment in free currency for the torpedoes, while the other RM6m would be paid into the clearing account. Germany counter-proposed to maintain the 'peak' while agreeing to pay RM6m in free currency for the torpedoes. At this point, in something of a tug of war, Felice Guarneri returned to the solution of phasing out the 'peak' (but only from the following year, 1940) and putting half the price of the torpedo transaction through the clearing system, with the other half to be paid in foreign currency.[67]

The matter was not over. Funk, by that time economics minister and Reichsbank president, proposed a general reassessment of the issue. He agreed to abolish the 'peak' from the following year, and to pay 50 per cent of the price of the torpedoes outside the clearing account, that is, in free currency. He added that the Dawes and Young loans should be serviced through the clearing account. Notably, however, the Italians had to accept manufactured goods as German exports.[68]

An agreement was finally signed in Rome on 13 February 1939. It confirmed the phasing out of the free currency balance from 1940 (for 1939 the 'peak' had been reduced to 5 per cent), and stated that in 1939, German exports to Italy would increase from RM350m to RM465m. The current deficit on the clearing account would be covered by exports of coal, machinery, equipment and steel, as well as Italian tourist traffic to Germany. The torpedo transaction was finally closed with a 50/50 payment.[69]

Part III

What Europe?

8
The Funk Plan

By Paolo Fonzi

1 The Reichsbank's prospective stance on monetary issues in 1940

Before considering the drawing-up of the Funk Plan of summer 1940 it is necessary to briefly outline the Reichsbank's attitude towards the main monetary issues dealt with in the plan. This attitude was affected considerably by military developments in the earlier phase of war.

A good perspective from which to approach this topic is that of the Reichsbank's Economic Research Department (ERD), which provided the Reich's central monetary institution with in-depth analyses of the state of the world economy and possible future scenarios. The topics at the centre of the ERD's reflections can be broadly summarized under a few headings: economic and currency blocs; alternative exchange rate systems; role of gold in international transactions; relative price levels in Germany and other countries of the same economic area (or 'greater space'); self-sufficiency inside each bloc; and finally the perspective of European unification.

In a series of memos drawn up between March 1940 and the western campaign of the summer–autumn, the ERD considered relevant aspects of foreign monetary relations. A memo dated 8 March contained 'an attempt to outline an economic programme for the peace to come'[1] The future peace settlement, it was assumed, would significantly differ from the hated Versailles system in that it would seek to establish a balanced and stable world economy. The anonymous drafter predicted that the post-war era would witness a general tendency of capitalism to evolve into a state-regulated economy, a metamorphosis that he pompously labeled 'the end of capitalism'. While condemning the chaotic state intervention that most countries had introduced as a consequence of the Great Depression, the ERD official believed that in a post-war settlement the role of the state would be that of a looser controller of the economy, especially in reference to the international flows of money and trade. In order to achieve this, however, the current degree of state control was to be maintained in order to overcome the economic upheavals of the immediate post-war period. For at least twenty years, balance of payment controls, the rationing of raw materials, and clearing agreements were to remain in place. A balanced world economy would in the end take shape. As it has already been mentioned, the large role of the state would mean that this would no longer be the old liberal economy, but a polycentric system divided into currency blocs. As we shall see, a well-entrenched notion of currency blocs can be seen in any of the plans envisaged by the central bank, government institutions, or even private organizations or individuals; but the features of these blocs – their extent or exchange rate structures – vary considerably according to several factors, including contingent war developments. In the 8 March memo six blocs are envisaged, each with a strong currency at its core: the Reichsmark, the pound, the dollar, the yen, the French franc and the lira. Fixed exchange rates within each bloc and a regime of managed float between the currencies of different blocs would provide the ideal balance between exchange rates and price stability. To work, this system would require supervision by the Bank for International Settlements and a collaborative attitude by the major economic powers that should balance two principles: autonomy, and the integration of the world economy. This latter observation was not devoid of self-criticism: prioritising internal stability was exactly what the Reichsbank had been doing, sacrificing integration into the world economy.

Another memo, dated 30 March ('Possibilities of a general currency adjustment after the war'), dealt with the issue of phasing out the multiple exchange rates that (as we have seen, particularly in Chapters 5 and 6) had given the Reichsmark different values according to different types of transactions. Even more decisively than the previous one, this memo advocated a complete reversal of German policy, which was to be achieved both by devaluing the Reichsmark by 50 per cent and by creating a fixed exchange rate area in Europe. 'After a *real* peace treaty', the memo continued, 'that will bring about a clarification of the political situation and lead to a widespread predisposition to reconstruct healthy interstate economic transactions, Germany should do away the soonest possible with all the differentiations [between Reichsmark values]. From the point of view of monetary policy this means an adjustment of the exchange rates to the actual market value, that is, a *devaluation of the Reichsmark*'.[2] What had caused such a change in the Reichsbank's attitude towards a proposal that, as we have seen, it had firmly opposed up until the war? The main reason is what at the time seemed the likely prospect of victory for the German Reich. A victorious peace was regarded by the central bank as the ideal moment to introduce a measure that had previously been ruled out for fear of losing the German public's confidence. In the victorious post-war environment, people would accept moderate inflation. Indeed, inflation would have the positive side-effect of neutralising the excess of purchasing power generated by war financing. As for its second proposal, the memo advocated the creation of a fixed exchange rate system in several stages: first with Southeastern Europe (Romania, Bulgaria, Yugoslavia, Hungary and Slovakia), then with the Baltic and Western states (Denmark, Norway, Sweden and Finland), and finally with Italy.

While confirming these proposals (devaluation of the Reichsmark by 40 per cent immediately after the end of the war and the creation of a European exchange rate system), a third memo drawn up two and a half months later, on 20 June,[3] envisaged the formation of six currency areas with an important difference: Unlike the memo of 8 March this document envisaged the formation of a Russian currency area instead of a French one. This was probably on account of the impending defeat of France, and of the prospect that the settlement reached with the Molotov–Ribbentrop pact would remain valid after the war.[4] The German currency area was to include Belgium, the Netherlands, Scandinavia and Southeastern Europe, whereas the Italian one would be limited to Greece, Spain and Turkey. Reparations in gold would be used by Germany to create an exchange equalisation account, that is, to set up a reserve account to be used in case of a balance of payments crisis without modifying the exchange rate.[5] This memo also returned to the controversial theme of mark devaluation, expressing doubts about whether it was really necessary. On the one hand, the drafter argued that the general price increase in most economies was automatically leading to a general levelling of prices in all European and most non-European countries. On the other hand, maintaining the pre-war parity with gold would make the Reichsmark much more attractive as a reserve currency. This would make for something of a reward to Germans for the sacrifices made to maintain price stability. Nevertheless – in a demonstration of the uncertainties that characterized Nazi institutions at the time – the memo concluded that by devaluing the Reichsmark, Germany would avoid the same mistakes Great Britain had made in 1925 when it returned to the gold standard at an overvalued parity. The option of devaluation was still, therefore, regarded as both feasible and useful. Considering these doubts, it is not surprising that in a subsequent, slightly revised version of the same memo the devaluation proposal was completely dropped and replaced by a rather generic statement that this issue would only be decided upon later, once international developments permitted a better assessment of the situation.

We may summarize the changing attitudes of the Reichsbank in those crucial months by saying that following the first German victories, the formation of a German currency area became a very likely prospect, although military developments changed the way the central bank regarded the relation of this area to the outer world. Until the western campaign a Reichsmark devaluation was sometimes considered a necessary precondition for re-establishing stable exchange rates in an international system divided into several 'greater spaces'. Over the course of a few weeks this prospect changed, both because inflation developed in most European countries while the German price level remained relatively stable, and because the victory over France changed the political and economic outlook: After June 1940 the area over which Germany expected to extend its control increased enormously. As Gustav Schlotterer of the Reich's ministry of economics observed in a speech in October 1940: '[T]o put it briefly, Germany is now the dominant power in Europe and therefore the production costs existing in Germany must be considered as the standard in Europe.' He saw any estimates of the optimum exchange rate as premature, adding however that 'it is clear that the price level of the other economies has to gear itself towards our price level'.[6]

This leads us to consider two further issues which were relevant to the planning phase of summer 1940: that of an autarkic Europe, and that of a monetary unification of the European economies. Several ERD memos examined whether Europe might become self-sufficient after the war.[7] They all came to the conclusion that complete autarky was impossible, as the continent would always be dependent on foreign imports. A document attached to the memo of 20 June 1940 stated that production of breadstuffs and fodder cereals might be increased by a rationalization of Polish and South European agriculture. Some imports might have been delivered from the colonies of countries in the greater space, such as those of the Netherlands or Belgium. But fat and many raw materials would have to be imported through normal trade from outside.[8] This attitude was upheld throughout the war, even in early 1941 when planning for the eastern campaign was underway and many institutions thought that the USSR's foodstuffs and raw materials would make the greater space autarkic.[9] If self-sufficiency was impossible, the issue of inter-area payments, and the role of gold, had to be considered.

We have already mentioned the Nazis' ambivalent approach to gold. On the one hand, some bankers were seen by the regime as gold supporters (and Americanophiles); on the other, many highly ideological German economists and party officials branded gold as a typical expression of liberalism and a tool used by Western powers to affirm their global supremacy. For its part, the Reichsbank generally favoured the reintroduction of gold for the purpose of pegging currencies to a stable and universal value, but – in common with the generally held view in Western Europe and in the United States – it was against a return to the gold standard mechanism of gold convertibility. The pure gold standard was considered outdated and incompatible with an 'independent economic policy' and the concept, prevalent in Germany and elsewhere, of 'managed money'. The solution proposed in most of the Reichsbank's memos was thus something of a 'third way' between national monetary autonomy and a commitment to external convertibility. Most memos proposed the establishment of a fixed parity to gold, but alongside the introduction of a legal provision in the Reichsbank's statute allowing parity changes in time of crisis or in case of war.[10]

Let us now turn to the second theme mentioned above, the monetary unification of Europe, a topic that had come to the fore in 1938 with the

Austrian *Anschluss* and the annexation of the Sudetenland (the part of Czechoslovakia attached to the Reich in 1938).

At that time, the Austrian price level was well below that of Germany. At the existing exchange rate, the union would have meant a price level increase in Austria, more expensive Austrian exports, and consequently the necessity of subsidising them. The Reichsbank proposed delaying the monetary union[11] and first implementing a state-controlled price increase in Austria.[12] However, political reasons prevailed, and the Reichsbank's proposal was refused. The monetary and customs union was achieved with a huge revaluation of the Austrian schilling: by 30 per cent.[13] When the same issue arose with reference to the Sudetenland, the central bank repeated its warnings. Again, the union was implemented immediately and in a similar way – that is, with an exchange ratio corresponding to a devaluation of the Reichsmark, a choice advocated by the economic section of the office of Konrad Henlein, leader of the Sudeten German Party.[14] The central bank's concerns about the negative effects the monetary union would have on the Sudeten economy and in Austria turned out to be correct.[15] This meant that the Reichsbank's opinion was taken seriously in the following years, when the customs and monetary union with the Protectorate of Bohemia and Moravia[16] (the first non-German region with which a monetary union was realized) was on the Reich's agenda. The monetary union between Germany and the protectorate was realized in a way very similar to that advocated by the Reichsbank for Austria and the Sudetenland. The Reichsmark became legal tender in the annexed part of Czechoslovakia as early as 16 March 1939, with an insignificant change in the exchange rate, while the customs union, which was needed for full market integration, was delayed until October 1940. In the meantime a policy of controlled inflation slowly made price levels in the two countries more homogeneous.

2 Different strategies for the unification of Europe

After the Reichsbank studies discussed above, France's defeat prompted the major German economic institutions to design comprehensive plans for the reorganization of Europe's economy after the war. In mid-June 1940 Walther Funk and the state secretary in the Reich's ministry of economics, Friedrich Landfried, were summoned by Hermann Göring, who by that time had ascended to the role of an economic dictator within the Nazi power structure.[17] On that occasion Funk was charged with the task of planning the future European economy. This broad assignment was formalized by a decree a few days later (on 22 June), which specified three issues to be addressed: coordination of the German economy with the economies both in the areas incorporated into the Reich and in the occupied areas; economic settlements with enemy states; and the economic reorganization of Europe and its relations with the world economy.[18] Although a fierce struggle ensued with the foreign ministry over the competence to deal with this issue, Göring managed to assert himself over the foreign minister, von Ribbentrop. In fact, Hitler wanted the political aspects of this New Order to remain in the background. Political issues had to remain undecided until the end of the war, in order not to make promises before the balance of power among belligerents had been definitively settled. Discussion on the greater space therefore focused on technical matters such as foreign trade and currency issues. The Reich's ministry of economics was the natural candidate for accomplishing this task, having been entrusted, since 1934, with increasing powers regarding foreign trade and currency regulations. To undertake Göring's assignment, Funk created a special branch within his ministry: the Preparation and Order Section (*Abteilung Vorbereitung und Ordnung* or VO Section). This was headed by Gustav Schlotterer, who in his early career had been economic consultant (*Gauwirtchaftsberater*) of the Nationalsozialistische Deutsche Arbeiterpartei (NSDAP) and head of the Hamburg Ministry of Economics (*Behörde für Wirtschaft*), and had strong ties with the commercial elites of that city. In 1935 Schlotterer had joined the ministry of economics, his appointment being directly requested to Schacht by Hamburg's Mayor, Karl Krogmann.[19] By 1940 he was director of the Export Branch (Abteilung E) of the Foreign Trade Section (Hauptabteilung V).

The first meeting of the VO Section, held at the beginning of July, was dedicated to a discussion of the currency regime to be implemented within the greater space. Three alternatives were considered: a full monetary union with a single currency, the Reichsmark, in annexed countries; a looser union, whereby the Reichsmark would be introduced in foreign countries alongside their respective national currencies, to which it would be linked by fixed exchange rates; or a monetary federation, in which national currencies would continue to be in circulation in each member country, with fixed but adjustable exchange rates vis-à-vis the others. The choice would depend on the degree of each country's political and economic integration with the Reich.

A second idea discussed at the meeting was the creation of a European bank,[20] which would act as a central clearing house to settle the accounts between members of the greater space. It would also act as a supranational authority, intervening in the event of permanent balance of payments imbalances by imposing an adjustment either of the exchange rates or of domestic policies.

On these two issues – the currency regime and a European bank – the Reichsbank held a sceptical attitude. Regarding the currency regime, being afraid to introduce the Reichsmark in formally sovereign countries, it only accepted the idea of a monetary union with annexed countries such as Austria and the protectorate although, as we have seen, the Reichsbank had advocated a cautious approach in these instances, too. On a larger scale, with countries not politically annexed, any sort of monetary union was rather to be the end point of a long process of economic integration.

On the second issue, the central bank bitterly criticized the European bank proposal, as this would undermine the Reich's prestige. 'The basis of any future organization', according to the Reichsbank, 'will be the Reichsmark and the Reichsbank; any higher international monetary institution is unacceptable'.[21] It is easy to see why, because for the Reichsbank the whole issue was primarily a power struggle, as the new institution would constitute a threat to its authority. Its opposition, however, also involved a different attitude to the future payments system for the greater space. The Reichsbank memo stressed that creating a supranational institution to manage the clearing system would inevitably crystallize the existing forms of trade and foreign exchange control. The challenge was therefore to make an orderly transition to the totally different, long-term objective of constructing the greater space with the widest possible liberalization of international payments: 'the desired final state – complete freedom of cross-border payments and even, if possible, a single currency – must be developed organically and without ruptures from the monetary conditions now prevailing'.[22] The strategy endorsed by the Reichsbank proposed to maintain the existing clearing system and the foreign exchange controls, but simultaneously to take three measures aimed, in the long run, at liberalizing foreign monetary relations: To establish fixed exchange rates among the European currencies; to transfer all payments arising from the clearing agreements to a single account; and to induce the central banks of the clearing partners to accept a trade credit in case of a surplus in their trade balance. With exporters being paid, the domestic money supply would grow, with a consequent increase in price level according to the mechanism we have described in Chapters 5 and 6. The Reichsbank considered the resulting inflation as a positive development, because it would adjust the price levels of the greater space countries to the higher price level existing in Germany.[23]

The Reichsbank's attitude towards monetary union can be understood more clearly by considering its reaction to a plan drawn up in June 1940 by Erich Neumann, state secretary at the Four-year Plan Organization. Neumann proposed to keep the so-called *Reichskreditkassenscheine* in circulation in the occupied Western countries. These were notes issued by special banks to supply the invading troops with readily available cash for purchases in the occupied countries. As the RKK–Scheine's denomination was in marks, Neumann considered his proposal as a preliminary stage to the monetary union, which was to be completed by the introduction of the Reichsmark. Neumann's plan was rejected by the Reichsbank. The central bank argued that if the Reichsmark became legal tender outside the Reich, its stability would be endangered.[24]

In the private sector the idea of a monetary union or, at least of fixed exchange rates with more developed European countries, had many advocates. As an industrialist from Würzburg expressively wrote in a letter sent to the local Foreign Trade Office (*Außenhandelstelle*) around the same time: '[I]n order to stimulate the economy it seems desirable to create the widest possible monetary area in Europe. To this end the different currencies of the European countries should at least be put in a fixed exchange relation with each other, so that calculations in terms of foreign currencies could be made easier. Surely, introducing a single currency in Europe would greatly facilitate everyday work. Presumably, a single currency would meet with insuperable obstacles, but establishing fixed exchange rates is absolutely necessary'.[25] Monetary unification was considered the swiftest and easiest way to liberalize economic relations in Europe. It would also allow the Reich to acquire control of important companies in the defeated countries – what was then called 'capital interlocking' (*Kapitalverflechtung*) – thus laying the foundations for Germany's future economic predominance in Europe. In the meantime, by declaring the Reichsmark legal tender in other countries, the Reich would have unrestricted opportunities to purchase everything it needed for its war economy, something which was not always possible when Germany had to force the central banks of the occupied countries to grant loans to the occupier.

In the midst of often undefined or, worse, confused ideas about the future economic structures of Europe – ideas that the Reichsbank looked at with skepticism if not radical opposition – we can consider the 'Europa-Standard' proposed by Werner Schmidtbeil, an industrialist and self-styled economist.[26] Schmidtbeil supported the creation of this special currency for use exclusively in international transactions within the greater space. Schmidtbeil also advocated the creation of a central European clearing house to manage intra-European payments on a multilateral basis. Promoted through books and conferences, the proposal was part of a rather confused political theory of 'real' socialism which, in polemic contrast to communism, would endorse private property and individual initiative. Schmidtbeil's ideas drew the attention of several German institutions and were widely discussed in the press.[27] Just as in the case of the European Bank, the Reichsbank rejected the proposal, arguing that the Europa-Standard would crystallize controls on foreign exchanges and definitively rule out any form of free market.

It can be concluded that the Reichsbank approached the issues arising from planning the greater space with a general view to achieve payment liberalisation in Europe. Nevertheless, the Reichsbank considered it impossible to achieve this goal by immediately lifting any controls on cross-border transactions, and preferred to maintain, initially, the existing forms of foreign exchange control that had been introduced from 1931. The central bank's approach held that creating a new supranational regulatory system would definitely crystallize the regime of strict controls. It considered easier to eliminate them through a cautious policy of liberalization.

Owing to the opposition of the central bank and to the feeble support it received, the monetary union proposal was very soon dropped. During the second meeting of the VO Section, which took place a few days later, Schlotterer envisaged a closer integration with a small number of countries (the Netherlands, Belgium, Denmark, Norway) in the form of 'an economic and monetary union', but this was not to be done until a preliminary price adjustment had been accomplished. This would develop as a consequence of exploitation by Germany using clearing and occupation costs. It was also to be accomplished by eliminating subsidies for German exports to the countries in question. As these countries were forced to buy German products, eliminating the export subsidies would increase the prices of their imports, thus stimulating a moderate inflation in their economies, which would produce an alignment with the higher German price level.[28] The idea of creating a supranational institution was withdrawn as well. The proposal to multilateralize the clearing system, launched by the Reichsbank in its memo of 6 July, was adopted by the section headed by Schlotterer.[29] It enjoyed broad support and formed the core of the plan submitted by Funk to Göring[30] and to the other economic institutions a few days later. According to this strategy, the current bilateral clearings were to evolve, as described in Chapters 5 and 6 into a multilateral central system (*Zentralclearing*). The intention behind the proposal was to make cross-border payments work more smoothly[31] than under the current system, which was fragmented in a great number of bilateral agreements with no possibility of settling payments multilaterally. The bilateralization of payments had led to the shrinking of trade. Restoring multilateral trade and payments was thus considered of primary importance.

The issue of the European price level was of crucial importance for the popularity of the plan within economic circles. It was not only the Reichsbank that had ruled out the prospect of devaluing the Reichsmark after the western campaign. On 2 July 1940 Schlotterer said in a private meeting: '[R]ecently a number of talks regarding the transformation of the export subsidization have been conducted with experts, during which it has turned out that the representatives of the German foreign economy who previously advocated a devaluation of the Reichsmark, now are against such a devaluation'.[32] The possibility of manipulating the price level of the annexed countries was seen as a convenient alternative. This would allow Germany to eliminate the export subsidies. Before the war, subsidization had given rise to widespread discontent in the private sector, which had to fund it through a special tax, the *Umlage auf die gewerbliche Wirtschaft*. Therefore, by eliminating export subsidization the government met the needs of the private sector, fostering its approval. Summarizing the opinions of the local export-based economy, a Foreign Trade Office official wrote: 'Reich Minister Funk has recently explained that after the war the Reichsmark will play a major role as a currency. When this state is reached, it will be possible to carry out an alignment of the selling prices in all European areas – maybe even outside it. As a consequence it will be possible again to sell all German products at normal prices. Export subsidization was only a makeshift. Export trade can be considered normal again when we do not even need to speak of export subsidization or of a tax to subsidize exports. Our efforts should be geared towards reaching the German price level, insofar as this is possible considering the relatively lower living standard of several European countries. If we do, foreign trade would become more profitable for exporting plants'.[33]

3 The Funk Plan

A memo summarizing the results of the VO Section's activity of June–July 1940 was drawn up by ministry of economics official Carl-Gisbert Schultze-Schlutius, and sent for information of the main economic institutions in mid-July. The memo's title shows, tellingly, that the clearing issue had become the linchpin of the whole plan: 'Transformation of the German clearing system into a European Central Clearing'.[34] The overall goal of the plan was to 'promote and intensify the integration of the German economic area with other economic areas by simplifying the payments and thus to prepare organically the economy of the European Greater Space'.[35] The memo made a distinction between an internal and an external circle. The internal circle was to include Germany and German-occupied countries, that is, the Protectorate of Bohemia and Moravia, the General Government (the parts of Poland not annexed by the Reich), Denmark, Norway, the Netherlands, Belgium and Luxembourg. These countries would be integrated into a 'completely centralized clearing' (*Zentralvollclearing*). Members of the external circle, on the other hand, were instead to become part of a partially centralized clearing area (*Zentralteilclearing*). Which countries would be included in this circle was a matter that had yet to be decided, but a provisional list was provided: all South European states, Sweden, Switzerland, Italy, Greece, Turkey, the USSR, Iran, Spain and Portugal. The difference between the two circles was illustrated with an example: a sum transferred through the clearing system from the Netherlands (internal circle) to a payee resident in Norway (internal circle) or in Romania (external circle) would be paid into the German–Dutch clearing account at the German Clearing House. This in turn would credit the payment to Norway and Romania respectively on the German–Norwegian and on the German–Romanian clearing account. *Vice versa*, a payment procedure between Romania and Bulgaria would be made on a bilateral basis, without Germany being directly involved and according to the agreements already in force. The German occupation authorities had to regulate all transactions among the countries of the inner circle in a way that would prevent strong imbalances arising. A key point of the program was the 'automatic management of the incoming and outgoing payments', that is, the extension to the multilateral clearing of the rules governing the bilateral clearings, which allowed temporary trade imbalances to be financed by credit exposures denominated in German marks. All the currencies of the inner and outer circles would have a fixed exchange rate and would form a unitary exchange rate system in order to prepare the continent for future monetary unification.[36] The Reichsbank favoured the method of taking, as a point of reference, the exchange rates used in 1930, the last year before significant currency devaluations and the introduction of exchange controls. The exchange rates thus chosen did not need to reflect the internal purchasing powers for the different currencies, because lower prices had to be maintained in less-developed countries. The Reichsmark discount in Southeastern Europe had to be eliminated by a return to the official parity. Towards the end of July, the German plan was outlined in an inter-ministerial meeting convened by Funk at the ministry of economics.[37] In his speech, Funk voiced many of the ideas that the Reichsbank had supported in the Schlotterer committee. According to Funk, the currency question was not a primary factor: In the current circumstances, it could only do harm to create a new special currency for Europe. The first question was how to organize the economy after the war, whose end, in the eyes of the Nazis, seemed very near. Germany, Funk argued, had the political power to reorganize the European economy according to her own needs. Other countries would have to adapt their economies to 'our plans and needs'. Following the free interaction of market forces would create too much attrition of national economic interests. Autarky was, however, a relative, not absolute, goal. Germany must be autarkic for war purposes, but otherwise, freedom of overseas trade should be restored. His slogan became 'autarky and exports, not autarky or exports'. Within Europe, bilateral clearing arrangements had worked well, he said; but they tied Germany's hands. It was therefore necessary to move to a multilateral system of payments. In practice, however, European countries fell into two groups: Denmark, Holland and Switzerland shared similar price levels, wages and salaries, taxes and incomes with Germany. But countries of a second group, belonging to Southeastern Europe, were too different to be included in a single payment or monetary union. Germany, Funk argued, now had the occupied economies under its direct control, which would allow her to manipulate their prices. However, this was not the case for countries of other greater spaces with which the Reich would resume trade after the war. Therefore, if the Reichsmark was to become a leading currency, not only in Europe but worldwide, the liberalization of commerce and financial transactions was unavoidable. In the future, therefore, all the different kinds of Reichsmark like the *Sperrmark* or the *Registermark* would have to be eliminated: '[T]here must be only one Reichsmark in circulation. ... In the future the free Reichsmark will become gold again.'[38]

This approach provides notable insights: We can discern an awareness that a single currency must follow on from political and economic arrangements and could not be created before them. It also manifests a wish for the multilateralization of the clearing system (which, on a bilateral basis, was the result of at least a decade of monetary chaos in Europe), and a definitive rejection of the free market economy in favour of a 'directed economy' (*Wirtschaftslenkung*). All European countries were to be subordinated to

Germany's interests, but a significant distinction was made between two different sorts of Europe when Funk spoke of the Central area and the Balkan area, the latter being closely tied to Nazi interests, but a much poorer region. According to Nazi racial *Weltanschauung*, in the future New Order these countries were simply to play the role of exporters of raw-materials and semi-manufactured goods. As for other great powers, Funk's speech contained just a passing mention of Britain, a powerful financial centre which still gave no sign of surrender; it made no mention at all of other significant European countries: the Soviet Union, still an uneasy co-belligerent, France, and – of the greatest interest for our purposes here – no mention of the role of Germany's greatest ally, fascist Italy.

On 25 July, Funk outlined the 'Economic New Order for Europe' to a select group of journalists. The speech was widely commented upon, not only in Germany, but also abroad (see next chapter).

Perhaps not by chance, Funk started by remarking, 'we shall cooperate closely with our ally Italy in all spheres and combine German and Italian economic forces for the purpose of European reconstruction'.

Funk basically reiterated the concepts already expressed a few days before at the inter-ministerial meeting mentioned above, namely that 'currency is always secondary to general economic policy' and that with a rational division of labour between different states, the currency issue would simply be a question of monetary management, although with the Reichsmark in a dominant position; that the gold standard and consequent scarcity of money would disappear, thus making the payment of uncovered clearing balances much easier; that the transition to multilateral clearing was a goal; and that exchange rates would stabilize and exchange controls would not be necessary in the long term. However, on that occasion Funk made official the concept of an ideal division of the global economy into a few large areas: Europe, Russia, North America, South America, and East Asia. This division was different from what previous statements and rumours had suggested, and would be changed over time by adjustments that probably followed war developments. The United States – not yet at war with the Axis – must abandon the 'erroneous idea' of being the greatest international creditor and the greatest exporter at the same time. Even though he rejected the idea of an immediate common currency for Europe, Funk's speech also contained a hint of what it might be, with the observation that his country's war was financed by labour: '[W]hat is spent is what is produced.' Bills based on labour, drawn by the government and discounted by the central bank, were the basis of money, and they had a stable value because prices and wages were stable; wages could be increased only following an increase in production.[39]

A relatively extensive part of the speech was dedicated to the gold issue, as this problem was particularly delicate. During the 1930s, as discussed in previous chapters, the bulk of gold reserves had converged upon the United States. Therefore, the future role of gold hinged on whether the United

States would accept its redistribution. Knowing that his speech would have a wide international audience, Funk said that the future of gold depended on the U.S. attitude. If the United States wanted to reverse the tendency to demonetize gold it must revalue the dollar, thus allowing gold to flow out and again become an effective international means of payment, at the cost of a temporary balance of payments crisis.

The content of Funk's speech is revealing of the way in which the relationship with the United States was regarded in Germany during the war. At least until the United States entered the war in 1941, recovering some sort of economic partnership with the United States was considered as a precondition for the reconstruction of the world economy.[40] An internal memo by an Economic Research Department official pointed out that the United States had conflicting interests on this matter. From a political point of view it had to devalue the dollar, as this would help support Great Britain in its struggle against Germany. From a purely economic point of view, however, the United States had to revalue the dollar in order to reverse the tendency to demonetize gold. The conclusion of the memo was that the Reich had to use the threat of severing any link with gold to force the United States to come to terms with Germany. 'The Americans will have to make some concessions. The American gold reserves have reached such an amount that from an asset they have become a political liability and Versailles is beginning to take its revenge also on the Americans.'[41]

4 National Socialist ideology and the rationale of the Funk Plan

As we have seen, the ideas that converged into the Funk Plan were picked up from different strategies that, in the previous years, had been endorsed by institutions and the business community. At the centre of the whole discussion was the question of how to create an international payments system that would achieve two objectives: (a) to make the Reichsmark an international reserve currency, performing a role appropriate to Germany's victory; (b) to re-establish Germany's integration in the world economy, without undermining this leading role. It was a common assumption that liberalizing foreign economic relations was crucial to the achievement of this second goal. Critical terms such as *Zwangswirtschaft* (command economy) – a completely planned economy akin to the hated communist system – were used to speak of the condition of the German economy. Hitler himself, in a speech delivered on 11 September 1935, had stressed that it was necessary to 'transform the barter [that is, the clearing system] which, frankly speaking, seems primitive, into free and modern trade'.[42] The Reichsbank vice president, Emil Puhl, used to say that foreign trade control, as it had been developed in Germany, was at *Brotkartenniveau*, that is, akin to food rationing for war. When planning for the future, therefore, all participants started from the shared assumption that in the future the *Zwangswirtschaft* would be replaced by its virtuous brother, the *Wirtschaftslenkung* (state-led economy). The state would reduce its role to that of an overseer, and private initiative, excessively restrained as a consequence of economic turmoil, would be restored. This of course left huge room for speculation on which specific form this harmonious interplay between state and private actors should assume. National Socialism never established an ideological orthodoxy on this point. The official guideline was that it pursued a third way between capitalism and socialism, but it was never really explained how this was to be concretely achieved. As in many other fields, National Socialist ideology remained polycentric. It drew sharp borders against its ideological enemies (liberalism, Judaism, bolshevism) but left room for manoeuvre within those parameters.

Therefore, even if it were commonly accepted that the system established by the New Plan in 1934 must be reformed, sharp differences arose when it came to the choice of the actual way to achieve this goal. The method chosen by the Schlotterer committee (see Section 2 above) adopted many of the ideas supported by the Reichsbank. It was a moderate program, as many of the claims for rapid liberalization had to be dismissed. Nevertheless, it met some demands, such as those for the multilateralization of trade, the creation of a fixed exchange rate area, the elimination of export subsidies and, last but not least, the possibility for many larger German firms to acquire company shares at cheap prices in the occupied territories. Moreover, by maintaining the existing currency borders within the greater space, the plan made it possible to transfer inflationary pressures from the German market to trading partners through the accumulation of clearing debts. This contributed to the internal stability of the Reichsmark, which in turn strengthened German war financing and the domestic front.

The planning activity provides interesting insights into the role of the Reichsbank in the Nazi power system.[43] After Schacht's dismissal in 1939, a decree by the Führer subordinated the Central Bank directly to Hitler, thus curbing the relative degree of autonomy it had enjoyed up until then.[44] Nonetheless, the Central Bank could still exert autonomous power when monetary policy measures without any immediate political significance were under discussion. This is demonstrated by the fact that the Reichsbank played the main role in setting the guidelines of the Funk plan. This interpretation is supported by a memo drawn up in September 1940 by the Reichsbank itself, entitled, 'Who is competent to decide on monetary policy?' The drafter complained about the tendency of the Reich's ministry of economics to encroach on monetary policy. The ministry motivated its intervention by arguing that 'today [monetary] stability rests primarily on price and loan policy, which the Reichsbank can in no way influence'.[45] According to the Reichsbank, both Hitler and Göring had the authority to oversee and direct (*Aufsichts- und Weisungsrecht*) monetary policy, but beneath them no institution other than the Reichsbank was competent in this field. This was due in the first instance to the fact that no other institution had the necessary expertise: '[M]onetary policy requires a substantial amount of experience and knowledge, which the officials of the Reich's ministry of economics in question cannot have (see the proposal launched by them on the new bank law or the proposal for a European Bank to direct European currency transactions).'

The planning of the greater space economy in summer 1940 has been considered a typical instance of the polycratic chaos of the Third Reich, which hindered any rational decision-making process.[46] This view must be revised: The interaction between different institutions was, rather, the expression of what the German historian Rüdiger Hachtmann calls, 'New Statehood': a form of statehood peculiar to National Socialism, which replaced the traditional bureaucratic state.[47] According to this interpretation, the effectiveness of decision-making was guaranteed, not by the traditional bureaucracy, but through personalization, informalization, and the creation of special agencies to deal with particular problems. The discussions did not take place at the level of the cabinet, which was never convened after 1937. They unfolded through ad hoc commissions of experts which dealt efficiently with a number of issues, giving them rational responses.

The Funk Plan's rationality lies in the fact that, as has already been pointed out, it largely met the expectations of the private economy, was an effective tool for the exploitation of the European economies, and at the same time set the basis for the future European payments system. It should be noted that ten years later, in a similar situation – the pathological bilateralization of trade and widespread state controls on foreign trade through foreign exchange regulations – a similar therapy was adopted to cure the same disease. The European Payments Union, established in 1950 between the Organisation for European Economic Co-operation (OEEC) countries, was a central clearing system very closely resembling the Funk Plan of 1940.[48] There was, of course, a radical difference between them: The Funk Plan did not contain any provisions to prevent one member from becoming over-indebted towards the others, whereas the EPU did have such a mechanism: a crucial difference, as the Nazi plan was instrumental to the Reich's policy of accumulating debts without any automatic obligation to repay them. As was clear to all its proponents, the multilateralization of payments did not enable the achievement of balance within the greater space, as Germany had only liabilities, and its indebtedness was to increase enormously during the war.[49] Internally, this aspect was admitted by Reichsbank officials. In June 1941 Reichsbank vice president Emil Puhl delivered a speech at the industrialists' association, describing the state of the multilateral clearing almost one year after its implementation. This description of the multilateral system confirms and magnifies the Nazi government's ambivalence on bilateral clearing (see Chapter 5): On one side, the Germans wanted to exploit the possibility of accumulating trade debts (that is, of keeping their trade balance in deficit and thus achieving better terms of trade); on the other, they saw a long-term objective of rebalancing their trade with substantial export growth. 'We must be aware', said Puhl,

> that the feasibility of the multilateral clearing idea depends completely on the possibility to handle the clearing credits freely. Internal trade relations are fruitful only when both parts see in the payments not only force, but also the greatest possible advantage. This, however, also implies that the exchange of goods does not only take place in fixed quotas but that besides the quotas a certain freedom of movement remains. Otherwise an excessively rigid bilateralism would be imposed on all economic relations. So far, we have managed to include a great number of partners in the central clearing. But we still have a good deal of work to do before this system becomes more attractive for all the partners than other forms of international traffic. A substantial precondition for this is an increase in German goods and capital exports, through which member countries will be provided by us with the commodities and the capital they need.[50]

Considering the central clearing merely as a tool of exploitation, however, is only possible with a good deal of hindsight. In summer 1940 it was not clear which way the war was heading and how long it would last. Therefore, seen through the eyes of its proponents, the Funk Plan was more than just the tool of exploitation that it might seem today. A further aspect must also be taken into consideration: If Germany won the war, as was then expected, it would acquire all the political leverage necessary to become the continent's most powerful economy. The recovery of German export strength after the war would restore the Reichsmark as an international currency, and clearing liabilities in Reichsmarks would become widely accepted as a means of payment. In the post-war era as imagined by German officials, Berlin would replace London for international payments. Therefore, it was natural to think that the central banks of foreign countries might consider it convenient to hold assets in Berlin as they previously had done in London. True, the Reichsbank itself believed that some sort of gold peg was necessary to make the Reichsmark an international currency. But as has already been indicated, the Reichsbank considered it possible to come to terms with the United States on redistribution of gold reserves. This would allow Berlin to establish itself as a financial center within the greater space.

In this regard, it is interesting to briefly consider a proposal over which, in those years, a debate was raging in economic journals. Some economists supported the creation of what was then called the *Reichsmarkkernwährung* (Reichsmark Core Currency), a payments system in which Reichsmark reserves would become the coverage of all greater space currencies.[51] The implementation of this system would give Germany the power indirectly to regulate money issuing for the whole European area. The idea developed from the fact that a similar procedure had been adopted in occupied countries such as Poland, Belgium and the Netherlands, where clearing bonds had been used as a money issuance base.[52] Remarkably, the journal of the Reich Group Banks (*Reichsgruppe Banken*) argued against the proposal that an inconvertible currency could not become a foreign exchange reserve. According to the economist Hans Herbert Hohlfeld,[53] the system would work only if all member countries transferred their gold reserves to Berlin, receiving bonds in exchange that would be used to fund money issuance. But being based on gold, Hohlfeld argued, such a system entailed the same automatism as the gold standard. Though Hohlfeld's criticism mirrored many of the opinions it itself endorsed, the Reichsbank bitterly reprimanded him. Indeed, his argumentation involuntarily showed the weakness of the Funk Plan by highlighting that the Reichsmark was not strong enough to become an international currency. Such opinions could only be expressed in internal debates and surely not in the press.[54]

9
Money for the World of Tomorrow

1 Reactions to the plan: fascist Italy

In June 1939 – with the world war not yet started – the Italian ambassador in Berlin, Bernardo Attolico, sent a rather anxious message to the ministries of foreign affairs and of foreign trade in Rome. He reported his meeting with Walther Funk. Funk had started by saying that the two countries – even though not yet at war – were by then 'war economies', and observed that Italian trade policy towards the Reich was not in line with Italy's real economic interest: Italy, Funk had remarked, was developing new factories, not only for war purposes, but also to produce goods that would have been more convenient to purchase from 'fellow countries' (*paesi amici*). The debate that had characterized the trade relations between the two countries (described in Chapter 7), continued unabated. According to Funk, Italy wanted commodities from Germany that were badly needed by Germany itself, and also wanted a reduction in the import of merchandise that 'has always represented normal German exports to Italy'. Funk essentially meant buy less German coal, which serves our needs, and more German cars: a strong Nazi suggestion of a division of labour between the two countries. This imposed geographical specialization was certainly a central feature of Nazi plans for a new Europe. Germany should be the engine of industrial production, while Italy should use coal and other commodities for its war effort only, not to develop its own engineering industry. Since Italy could not afford to reduce imports of German basic products such as coal, iron or steel, Attolico was so concerned by Funk's request that he requested Guarneri, the minister for Foreign Trade and Foreign Exchange (and possessing the necessary technical expertise), to come to Berlin and discuss the matter.[1]

In Rome, Guarneri studied Attolico's report and largely rejected Funk's request. On the one hand, Italy's huge requirement for commodities could not be reduced, partly because the Italian industrial plants were by then mainly fitted for the German type of coal; on the other hand, the development of a national engineering industry was in Italy's own interest and could not be given up. That meant a huge import of commodities from Germany – coal, iron ore – and a reduction in the import of mechanical products. The Italian policy aimed at strengthening the industries which were fundamental for defence and, at the same time, for the stable development of its economy, even after the war, noted Guarneri. He wanted, however, to avoid confrontation: All this, he said, must not affect Italy's good relations with Germany. Mussolini himself wanted to supplement Guarneri's answer to Attolico, and wrote that Italian autarky could not be put in question. Guarneri's letter, he stressed to Attolico, 'can and must set matters straight with Signor Funk'.[2]

After the start of hostilities, the general economic objectives pursued by the Nazi government became increasingly clear. Attolico reported to Rome on a speech by Funk: Germany was fighting for a new economic and social order and against the 'world's social and economic reaction', while Britain aimed at 'overhauling the new social Order created by national socialism, and at re-establishing the privileges of world capitalism'.[3]

As we have seen (Chapter 8), in July 1940, with Italy by then a co-belligerent (and in the context of the belief that war would soon be over, with an Axis victory approaching), the European idea started to take shape in Germany. Reports from various Italian diplomatic sources spoke of a sort of 'United States of Europe' as a solution envisaged by Hitler, and of a world partitioned into large economic spaces. Within Europe, a Mediterranean economic area would be 'directed' by Italy. A single international currency was also envisaged for Europe – the Reichsmark – and a system of international clearing for national currencies would replace the current bilateral arrangements.[4]

It was the new Italian ambassador in Berlin, Dino Alfieri – a reliable fascist who replaced the more tepid career diplomat, Attolico – who confirmed these hints of a new plan under way in Nazi quarters for the reorganization of Europe's economy.[5] There were, in fact – in Alfieri's correspondence – two concurrent plans, and Hjalmar Schacht was working on one of them. The former president of the Reichsbank was still respected in Western financial circles, and his plan was 'traditional', which probably meant gold-centered and more attuned to free trade. But Schacht, Alfieri wrote, was working on his own personal initiative and, even though he still enjoyed Hitler's esteem, was currently out of favour with the group led by Funk, the minister of economics and Reichsbank president. The other plan, elaborated by the government and more 'radical' in its approach, seemed to gain traction, Funk being in charge of the execution of Göring's Four-year Plan.[6] We may add that Funk himself appeared to be less well-informed than Alfieri: evidence that he really was on the outside of any inner circle of command. At the end of July he wrote to Hans Lammers, the head of the Reich Chancellery: '[A]lleged plans of Dr Schacht were being ventilated increasingly in the foreign press – he was said to have a special assignment from the Führer.'[7]

About Schacht's project, we know something more precise than what Alfieri thought about it. In September 1940, shortly after Alfieri's letter to Ciano, Schacht gave an interview to an unnamed Swedish journalist which was published in the American magazine, *The Nation*,[8] and picked up by the *Wall Street Journal*. His ideas, in fact, were not so distant from Funk's plan. More interesting is the fact that, although by then a private citizen without significant public responsibilities, he was working on a plan, apparently at Hitler's instigation. In the interview, he used the usual slogans of the Axis powers: He spoke of how the current war was a 'contrast between rich and poor[,] England and the United States as the "haves" and Germany and Italy as the "have nots".... This war is an uprising against British and American plutocracy'. He shared with Funk the belief in the value of labour as the basis for determining prices of goods and materials (without elaborating on what this would practically mean), and gave the opinion that the gold standard was an issue of only secondary importance (however, 'by seizing South Africa, Germany will become a gold producer too'). While a conference of the world's central banks would sit as a permanent institution (it is noticeable that central banks are not even mentioned in the Funk Plan), a European export and import syndicate, and similar bodies in the United States, Russia and Japan would determine the regulations of international trade. Negotiations between individual firms would be replaced by inter-governmental agreements. Through a clearing account, European debts to the United States would be settled against the purchase of European goods by America.[9]

A recent biography of Schacht, however, denies that a real alternative plan by Schacht ever existed (the interview cited above shows that Schacht was moving along in accord with Funk's guidelines). The biography states that in 1940 Funk asked Schacht for advice about the economic integration of occupied Belgium, given Schacht's technical expertise in currency matters, but did not involve Schacht in more comprehensive plans on the future economic organization of Europe.[10]

Just a few days before Germany's official announcement of the new plan, Funk finally felt the need to inform the Italian ambassador of what was going on. After the meeting, Alfieri alerted Galeazzo Ciano, the foreign minister: 'I've had a long conversation with Funk in regard to the necessity of coordination in the complex study that long since began here for the economic reorganization of Europe'. Funk had confessed to Alfieri that no mention had been made of Italy, because – he said – with Italy there would be special agreements. Alfieri belittled this issue (probably feeling himself diminished in his role as immediate interlocutor with the Nazi government). So, he added, this was not the main point. His concern was the definition of the directives that the Axis powers (Italy and Germany) were to impose on all the European countries, and that concern was clearly related to Italy's trade balance and its commercial relations with Germany and other countries: A problem that, as we have seen above, was very much an issue under the fascist government. Funk in fact said that he would very much appreciate a visit to Berlin by Raffaello Riccardi, who had in the meantime taken Guarneri's position as minister for foreign trade and foreign exchange.[11]

Let us return to the Italian reactions to the Funk Plan. Funk's statement that Italy would remain a close ally, a claim very often repeated in various reports sent to Rome by the Italian embassy in Berlin, nonetheless remained a piece of lip-service to the fascist government, because no concrete details were given in his speech. However, from bilateral meetings in Berlin, Alfieri further elaborated on Funk's views about the economic future of Europe, in particular with reference to Italy's position in the scheme. Africa and Asia Minor would be considered as European appendages. The Soviet Union's role remained uncertain: the USSR was still linked to Nazi Germany by the Non-Aggression Pact (the Molotov–Ribbentrop Pact) of 1939, but Germany was already considering ways to hinder Russia's industrial development, fearful of the deep ideological divide between the two powers. Europe would be divided into two 'economic areas' (*Wirtschaftsräume*), the first one reserved for Germany, the second for Italy. These two main countries would collaborate, particularly because for some European countries there would be something of an overlap (this was the case, for example, for France and the Balkan States), such that special agreements between Italy and Germany would be necessary to coordinate their action. Alfieri added that the *Wirtschaftsraum* would not coincide with the 'living space' (*Lebensraum*), which had a more specific political meaning. But it was a paradox that the Balkans were considered as part of the German *Lebensraum*, and at the same time belonged to a shared Italo–German *Wirtschaftsraum*. And what would compose the Italian economic zone? Funk was reticent and said vaguely that it was the Mediterranean Basin, in particular Egypt and Asia Minor, but deferred the issue for discussion at an unspecified point in the future. Clearing systems would become multilateral, both within each economic area and between the two zones, while outside payments would possibly be settled in gold. In any case, the economies of each country in each European zone would be 'directed by, and subordinated to' the respective needs of the economies of Germany or Italy. Specifically, with reference to Germany, by 'reinterpreting the concept of sovereignty' the countries of its zone would specialise in agricultural produce, thus satisfying German food requirements. The industrial countries of its zone – the Netherlands and Belgium – would restrict their industrial potential. The Reichsmark and the Italian lira would become the two base currencies of Europe in their respective *Wirtschaftsraum*, and the Reichsbank and the Bank of Italy the dominant financial institutions.[12] Funk sometimes appeared 'possessed' (*invasato*) to his Italian interlocutors, who were, incidentally, skeptical about his optimism on the war's imminent end. Forecasting a long war, the Italians stressed to their counterparts that it was in Germany's interest to make more concessions to Italy on the plans for a future unified Europe, in order to obtain more Italian support while the war lasted.[13]

Notwithstanding Funk's vague political statements, the Italian government clearly felt a certain uneasiness about his European plan: the feeling of receiving concessions rather than being actively involved in the plan's design. At a technical level, the objections were still greater. Alberto D'Agostino, the newly appointed managing director of Banca Commerciale Italiana,[14] and a man of unshakeable fascist faith, paid a visit to Funk in early August 1940 and, in a subsequent letter to Ciano, showed his perplexity regarding the German plan. He told Ciano that the plan was 'fictitious and inorganic', devoted more to describing problems to be solved than to providing solutions, and that there was the risk of 'a unilateral definition of its contents'. D'Agostino would not discuss the *dirigiste* perspective of the plan, which he probably shared: the idea of trade based on 'stable prices and pre-defined quantities', the adoption of economic plans that would avoid the vagaries of the economic cycle, the arrangement by which European states would have to adapt their production to German (and Italian) needs, and finally the phasing out of gold as the standard monetary regime, with its use being restricted to settling serious imbalances in international trade. What mattered most to D'Agostino was the boundary of the Italian and German *Wirtschaftsräume* in Europe and the confinement of Italy's zone to the Mediterranean Basin. Italy already had close trade relations with Mediterranean countries, but 'could not entirely rely on them for the development of its economy, given its interests in other European and overseas markets'. On the contrary, Italy should strengthen its trade position with Western and Northern Europe and not lose positions overseas. In this way the difficulties of its balance of payments could be overcome (curiously, D'Agostino found additional advantages from territorial aggrandizements, mostly at the expense of France. Italy could exploit the electro-metallurgical and electro-chemical plants in Savoy and the tourist centres of Nice and Monaco as well, in addition to Tunisian phosphates, Sudanese cotton and Iraqi oil: all products from areas that Italy would gain after the war).[15]

The Germans were aware of this Italian apprehension regarding Funk's plan. The ambassador in Rome received instructions to say that Funk would go ahead step by step, in close cooperation with Italy, so that Italy had no reason for concern.[16]

In 1940 the United States, while sympathetic to Britain's resistance to Nazi aggression, was not yet at war with the Axis powers. The presidential elections of 1940 saw Roosevelt re-elected, but also a swing to the right that was observed by the Nazis as a possible means of influencing American businessmen against Roosevelt, and as a means of slackening the US war effort in support of Britain.[17] It was therefore in Germany's interest to appease America, and to present a positive perspective on their future relations, in order to calm down anti-German sentiment there.[18] Of course, the Italians had a direct interest in the evolution of United States–German relations. Ciano alerted the Italian embassy in Washington about a visit of Funk's envoy to the United States – a visit, he wrote, aimed at potentially reaching mutual understanding on the role of gold in relation to the future economic organization of Europe. The envoy was a Berlin lawyer, Gerhard Westrick, with the credentials of commercial attaché at the German embassy in Washington but in fact carrying out a 'more political than economic mission, because it was directed to seek, with incentives, the collaboration of Wall Street circles and soften [U.S.] interventionism'. According to the Italian embassy, Westrick's views on gold were in opposition to Funk's.[19] In fact, Westrick arranged a loan from the American company, Texaco, to the German Navy and was deeply involved in American–German industrial relations.[20]

In the meantime, the partition of European economic domination between Germany and Italy – a potential reason for attrition – became more precisely defined, albeit only in Germany's intentions. The Germans appeared to give way to Italy's policy aim of developing its own industrial capacity, no longer being restricted mostly to the agricultural sector, a controversial issue, as we have seen. But this opening was related to the future creation of European economic zones, because Italian cars would be absorbed by the Italian-directed zone (without affecting Germany's car market). In Alfieri's words, according to General Adolf von Schell (appointed by the Führer as the supreme comptroller of the German transport industry) 'all European countries will be obliged in future to be consumers of German and Italian cars, and not producers, because the automotive industries of Germany and Italy will be sufficient to cover all European demand … Germany would develop to the utmost its industrial apparatus … destroying any possible competition [in its *Wirtschaftraum*]'.[21]

The fear of being sidelined was a constant one for the Italian government. It wanted to settle matters before its more powerful ally could take additional advantage of favourable war developments. As a Foreign Ministry official put it, '[T]here is a contrast between Italy, which deems it necessary to deal with Germany before the final victory, and Germany, which is taking a "wait and see" attitude before examining, together with Italy, the final arrangements regarding Europe[.] … I therefore fear that on the German side they will continue to "beat about the bush" [*menare il can per l'aia*] if we request to deal with the future situation of the European economy.'[22]

An updated official version of the plan was released by Funk in early September. Nothing new emerged from it, but some points of the plan were made more explicit, even though – in a confirmation of Italian concerns – the minister immediately stressed that a European continental economy, although an attractive concept, was still non-existent, and that his was not 'an already defined plan, but a preparation of a comprehensive plan'. He also stressed the merely technical aspects of the plan and distanced himself from political decision-making, writing that the power of decision rested with Göring, not himself. And he paid the usual, generic lip-service to Italy, saying that the economic forces of Germany and Italy would jointly implement European reconstruction. However, Funk specified four explicit points: The European economies must adapt, in their long-term projects, to the needs of the German market; stable exchange rates should assure a well-working and reinforced system of clearing, so that the flow of goods among countries would not be hampered (but capital movements would continue to be controlled by the state); a division of labour would aim to maximize the production of agricultural products and commodities; and economic solidarity within Europe would make possible a better defense of European economic interests *vis-à-vis* the other world economies[23]. The theme of a new monetary regime for Europe, which was not a priority for Funk, was reconsidered by Friedrich Landfried, state secretary at the Ministry of Economics: he claimed that the Reichsmark was better than gold, because behind it was the power of German labour. He evoked the vague concept of a currency backed by work, which we have already seen expressed by Funk himself and in the private analysis of Schacht.[24]

By October, however, the plan had not reached the top level of policy discussions between the two Axis powers. In the proceedings of the meeting between Hitler and Mussolini at the Brenner Pass on 4 October 1940, there is not even a mention of the European economic plan. They spoke of Britain's stubborn resistance and wondered how it could still not surrender faced with such heavy bombardment, and also discussed a possible intervention by the United States in support of Britain, Italian rights over French territories (Nice, Corsica, Tunis, Djibouti), Franco's Spain almost certainly joining the Axis, and an Italian invasion of Egypt; but in this vast *tour d'horizon* there was no room for discussing the European plan.[25] This is an unequivocal sign that the plan was still in a preliminary phase and that there was no desire on the German government's part to push for it to be given further definition.

Evidence of this may be found in the Italian attitude, which – at least in the media – concentrated on the generic Nazi statements, putting aside any controversial points. The trade and foreign exchange minister, Riccardi, who as we have seen had found the plan rather in conflict with Italian industrial interests, published a long article in the Roman newspaper *Il Messaggero*, repeating Funk's concepts almost *verbatim*, with the exception of his evocation of the typical fascist concept of a corporatist economy, a concept that he also attributed to Nazi Germany's economy (but which was never actually mentioned in the German statements!). The article spoke of an economy: subordinated to politics; continental solidarity; totalitarian continental autarky (where Funk had spoken of relative autarky); the division of Europe into two economic zones under Nazi and fascist dominance; two currencies – the mark and the lira – as currencies of account in each zone, with a fixed exchange rate between them, the other currencies of

Europe all being linked to one of the two; the central role of gold being phased out, with its use limited to the payment of balances between Europe and North America; the 'replacement of gold with a labour currency, backed by the productive potential of the people, that is, the combination of its energies and its productive capacity (industrial, agricultural, commercial)'; and the abolition of free trade, with the adoption of a rule regarding the United States based on a principle of merchandise for merchandise in order to eliminate, as far as possible, flows of currency and gold.[26]

Funk went to Rome one year later, in late 1941. Alfieri told Ciano that it seemed he was coming to appease Italian industrialists who, like their German counterparts, 'had – in the words of Funk – a sacred terror of my plans', unconvinced that the old liberal system was necessarily out-of-date.[27] But the Reichsbank itself had advised Funk to abstain from joint statements on post-war economic perspectives, because this was still a 'thorny issue', and it was not possible to say something really new.[28]

In the following years, the Axis's prospects in the war turned increasingly sour, and the achievement of the new economic order in Europe that was to follow the final Axis victory, appeared at risk. Of course, these doubts did not emerge in Nazi or fascist statements, but the broad sketch of the plan, as described above, remained substantially intact, without the further details that would have been necessary to give substance to what were largely declarations of principles (the 'labour-based currency' is a clear example, unless it simply meant a dominant, managed Reichsmark).

The plan was, however, reiterated in public speeches and press articles, in only slightly different terms. Funk, for instance, again presented his plan in a wider form, citing the nineteenth century German economist Friederich List as the originator of the idea and giving details of how the features of the new multilateral system of clearing would work.[29]

For his part, the trade minister, Riccardi, contributed various lectures and articles on the subject, saying again and again that gold would disappear as a reserve currency and as the standard of the international monetary system but conceding that it might continue to be used as a commodity to settle transactions carried on outside the areas of multilateral clearing arrangements. He also claimed that money would be based 'on labour as the factor of production, and on the political and productive resources, as represented and guaranteed by the state'[30] (whatever this might mean; but the phrase is reported as the most elaborated definition of money in Nazi–fascist plans). Even the often-critical economist, Demaria, repeated the scheme of European economic integration through a political and economic regime extended by coercion to several countries, with each of them specializing in certain economic activities. At its centre would be the strong state, to which all the others would be entirely subordinated by political covenants. He wondered whether all the European states should be part of this regime, and his answer was that the unification should be gradual, and made through

'Great Spaces' (note the terminology) under the direction of a single dominant state.[31]

This relatively passive attitude on the Italian side can primarily be attributed to the enormous imbalance of military strength between the two powers, but also to the direction that debates had taken on the role of Italy after a victorious war. In Italy, a discussion on the 'New Order' had been underway, but it had mostly regarded other, non-economic themes, such as the juridical structure of the fascist state, the role of culture in wartime, the 'social revolution', the international version of fascist corporatism, even the 'spiritual' mission of Italy. These were the issues regarding which even Mussolini feared that, if the Axis victory were to be exclusively decided by the German armies, Nazi Germany would inevitably have a hegemonic role.

From an economic viewpoint, the Balkans were the region on which fascist eyes continued to be focused, and where Nazi competition was most feared by Italy (see Chapter 6). From 1939, the magazine *Geopolitica* had started the elaboration of an Italian 'geopolicy' – in competition with the 'pretentious' German geopolicy – which had to prepare models and find spaces of conquest not only in the Balkans, but also around the Mediterranean and in Africa, in accordance with a 'Romano-centric' perspective. However, it was only in 1942 that a conference 'for the study of the economic problems of the New Order' at Pisa University considered the establishment of an Italian '*Lebensraum*' in the Mediterranean as a 'big autarkic space', and rejected any theories of full European political and economic integration. But it seems that these ideas never effectively filtered out from the academic environment to the fora of political decisions.[32]

2 Reactions to the plan: Keynes and the British government

We shall not deal here with the well-known debate surrounding the drawing-up (mostly by Britain and the United States) of the forthcoming international monetary system, which led to the Bretton Woods agreements of 1944. This subject has been extensively discussed in economic history literature, and recently revisited by Benn Steil with new insights into the relations between the two main negotiators, Keynes and the American, Harry Dexter White.[33] Keynes looked beyond the Schacht–Funk clearing plans, based on barter, to design an international system of free and open trade under which international liquidity would be supplied in the form of prearranged borrowing facilities.[34] But there is a hiatus between this design and Keynes's earlier reactions to the new German plan.

We shall focus on this immediate British reaction to the Funk Plan, which shows how the German plan was attuned to the prevailing policy attitudes of that time – attitudes full of disillusionment over a revival of the old gold standard and the practices of free trade, skeptical about grand designs of reform, and rather reliant on a system of trading goods against goods, centered on a multilateral clearing house. But where would this clearing house be located? Would it be identified with an international organization or with a specific, hegemonic country? And how could the multilateral clearing system work if that central country, rather than resting on a solid international investment position, were in structural debt? It should be remembered, at this point, that Germany was a deeply indebted nation, but expecting, at the start of the 1940s, a decisive victory in continental Europe; Britain was financially weakened, but counting on the (mostly primary) resources of its empire, while the foreign accounts of the United States were characterised by a huge net credit position, which was to be exploited in full, even when it came to its close ally.

As pointed out by Robert Skidelsky, at the onset of war Britain itself had adopted exchange controls that were transforming the Sterling Area into something more similar to a bloc, ring-fenced against any external attempt to gain trade advantages or to attack the stability of its currency. Due to a decline in British exports, Sterling Area countries were accumulating significant surpluses in sterling on their bilateral trade with Britain ('sterling balances'), a case pretty similar to the German–Balkan relations (as described in Chapter 6). Those countries were free to spend the pounds they earned from their exports only within the Sterling Area. Dollars obtained by those countries through their exports to America could not be freely used but had to be deposited in London, to the dismay of the United States. Moreover, according to bilateral payment agreements stipulated with non-Sterling Area neutral countries in both Europe and Latin America, their exports had to be paid in pounds, and any trade surplus in pounds that these countries might obtain could only be spent within the Sterling Area (an arrangement reminiscent of the ASKI procedure, as described in Chapter 5). Import licenses discriminated against non-Sterling Area countries – America, most notably – in order to save precious dollars.[35] Indeed, the whole framework of controls adopted by the UK closely resembled the features of the Reichsmark Bloc and the network of bilateral clearings that Germany had stipulated. As one British government adviser recognized in wartime, 'the accumulating mark balances are of course fundamentally similar to the accumulating sterling balances by which Great Britain has financed a large part of her war-time purchases'.[36]

The British government's reactions to the Funk Plan must be set against this quite peculiar situation of a system that was more and more reminiscent of the enemy's trade and finance arrangements, a system that, as Keynes said, had been 'borrowed from the German experience'.[37] Would the British answer be dictated by the need to extol the virtues of the alternative regime, based on free trade and on impracticable gold-standard rules? Opposing German ideas for the simple reason that they were Nazi in origin was one thing, but saying why to oppose them was a totally different matter.

Keynes's first views on the Nazi plan are entitled, 'A Draft Statement to Counter the German New Order',[38] but the reader will not find a single economic argument decisively against that New Order, only the argument that it was a Nazi order, based on the brutal exploitation of satellite countries.

In his first reaction to the Funk Plan, Keynes is still very much focused on Britain's central role. He claimed that after the war only the United Kingdom, with U.S. support, could carry out a policy of economic progress and social security: not Europe, which was – he wrote – 'starved and bankrupt'. Funk had just one merit: the inclination to 'avoid the abuses of the old *laissez faire*', whereby a country might go 'bankrupt not for lack of exportable goods, but for lack of gold'. At that stage, Keynes saw the British Empire as the last real hope for a reconstructed Europe. He wrote of a 'European Reconstruction Fund out of which central banks of each liberated country will be supplied immediately with the credit to purchase food and raw material from outside. We shall have the means to do this, because the Empire has enormous stocks of food and materials'. Germany offered 'absolutely nothing': an industrial sector concentrated in Germany; and satellite states compelled to confine themselves to agriculture, 'aggravated by currency devices already in operation by which the terms of exchange between German high-quality products and the output of other states will be fixed as to maintain a standard of life in Germany much above that of her neighbours'. As Keynes correctly observed, unlike Germany, the UK was in no position to plan foreign trade. The credit arrangement he envisaged, which makes perhaps the only difference from the Funk Plan, was indeed aimed precisely at dealing with temporary trade imbalances.[39]

The governor of the Bank of England, Montagu Norman, perhaps sharing the UK government's opinion that a more aggressive stance towards the German plan would have been appropriate, was perplexed: Was Keynes clear enough 'to rule out clearings, barter and other bilateral agreements (as the contrast with Germany would suggest)'?[40]

An acid comment by a small group of economists working for the British government (Hubert Henderson and Sigismund Waley from the Treasury, and Austin Robinson from the War Cabinet) described Keynes's draft as 'a sort of half-stated, half-tacit assumption that the German system is a good one, though used for bad purposes, and that one of the fruits of victory will be the adoption by us of that German system, with the difference that it will be used with beneficent instead of malevolent intentions'.[41]

One cannot escape the impression that at the time of this early reaction to Funk's plan, Keynes was moving towards a post-war monetary settlement along the lines of a continuing nationalistic approach, as an unavoidable consequence of the profound changes that had occurred in the world economy. It was therefore unsurprising that he envisaged the UK and its empire at the centre of a multilateral clearing system. It still was a system based on barter, seen in terms of exchange of the material resources available, which alone could support the pound's role as a reserve currency. In this respect, the resources of the British Empire were seen as large enough to support Britain and the pound at the system's centre. Germany could not rely on the same kind of support, and instead had to envisage a division of tasks with its satellites, which would supply Germany with primary products while Germany would provide the world with finished industrial goods.

In fact, Keynes had such a positive view of the Funk Plan that he wrote it would have been excellent 'if the name of Britain were substituted for that of Germany'. Keynes was favourable to the idea of a clearing union, in which the process of adjustment to external disequilibria should be the responsibility of both debtor and creditor countries, not – as had happened in the 1920s – of the debtor only. He also favoured, like Funk, fixed parities to prevent competitive devaluations like those made by the UK itself and by the United States. But he also supported capital movement restrictions, a topic not discernible in the Funk Plan even though Germany had been the first victim of speculative capital movements in the 1920s.[42] According to Harold James, the idea that surplus countries (of which the United States was the main one) had not behaved according to the rules 'attracted the Germans, who were proud of their experiment in welfare economics [and, one should add, in massive rearmament expenditure] and thought also that it should not be constrained by a deflationary international system'.[43]

Only later did Keynes change tack, moving to a markedly broader scheme which, as mentioned earlier, combined the Schachtian clearing approach with the principles of free trade, which were nonetheless framed as part of a discipline that would overcome the asymmetries of the old system. The clearing union envisaged by Keynes would: overcome the 'difficulties and complications of a large number of bilateral agreements'; would have a supranational institution as the central clearing house; would be based on a new international monetary unit (the 'bancor', to be issued by the clearing house to member countries against payment of 'quotas' in gold and national currencies), in proportion to their share in international trade; and would impose adjustments through various forms of constraints on both deficit and surplus positions of member countries ('symmetry'[44]). Debit and credit balances emerging from trade disequilibria would be settled by a transfer of bancor in the books of the clearing union. Suitable collateral would be deposited at the clearing union by the member country having a debit position exceeding certain amounts.

3 Some final considerations on the plan and multilateral clearings

We have seen how a clearing system works on a bilateral basis. We have also seen that during the 1930s the Bank of International Settlements floated, unsuccessfully, the idea of a multilateral clearing system with the BIS at its centre (Chapter 5).

The concept of multilateral clearing arises from the inefficiencies and inherent risks of bilateral clearings. In a fragmented system like the bilateral one, the counterparty risk (the risk that one member of the clearing, A, is unable or unwilling to settle its debt towards member B) is not mitigated by the possibility that member A is in turn creditor of a third member, C. In a system of multilateral clearing, however, credits and debits offset each other. A central counterpart takes the credit risk otherwise associated with transactions between two members. The creditor has a claim over the central counterpart as part of the cleared transaction. In such a system, on one side, the 'systemic risk' is enhanced because the credit risk is spread among all the members (that is, not limited to the partners in the bilateral clearing); on the other side it is mutualized and managed by the central counterpart, the clearing house. The residual net debit is settled by this central clearing house, which extends temporary credit to the indebted member. To this end, the house needs a 'collateral', a guarantee fund that is created by all participating members.[45]

We have numerous examples of multilateral clearings; they are commonly used within many financial systems for an orderly settlement of reciprocal debit/credit positions. The multilateral system we have just discussed regarded inter-state economic relations instead. As we have seen, in Keynes's plan – the one presented in 1943 – a supranational institution (the clearing union) was placed at the centre of the system, and a new international currency (the bancor) was to take place of any national currency. In the Nazi plan, a German institution was at the centre, and the Reichsmark was the reserve currency, used in intra-clearing transactions. The new monetary system would be the Reichsmark exchange standard, and it would monopolise all intra-European payments. The national monetary systems of the member (occupied or Allied) countries would be reduced to mere domestic currencies, which could be exchanged only against RM; all the controlled countries would have to keep accounts with the German clearing house. In turn, the RM would have a floating exchange rate *vis-à-vis* currencies of other non-clearing countries, and a fixed rate that would govern the exchange between the RM itself and the domestic currencies of the exploited countries.

The system might work if Germany was the hegemonic country. A position of hegemony must rest, from an economic viewpoint, on a solid, positive foreign account and international investment position that generate confidence in the users of that country's currency. Otherwise, it should rest on non-economic factors: on the sheer force, to the extreme.

The system that emerged from Bretton Woods, having the (gold-convertible) dollar at its centre, rested on the United States dollar. The United States was the main, persistent, surplus country, and remained so for decades, thanks also to the asymmetry of the system, which involved no pressure to adjust upwards. In a rejection of Keynes' views, the winning option was that of Dexter White, and the International Monetary Fund was created as a mechanism to smooth the adjustment of deficit countries, without any symmetric pressure on surplus countries.

But, was Germany's prospective hegemony based on a surplus position? Far from it.

Germany's foreign debt, although very much reduced by Schacht's initiatives during the 1930s, was still estimated, when war started, at the substantial figure of RM8bn,[46] around 7.3 per cent of the national output in 1939.[47] But a more substantial trade debt was growing on Germany's secret clearing accounts.

In this regard, the experience of clearing agreements with the Danubian and Southeastern Europe countries during the 1930s had shown Germany all the advantages it could obtain by maintaining a large trade deficit with them. As mentioned earlier, these advantages were of both a 'real' and a 'financial' nature. The first category derived from these countries' vast supply of raw materials and foodstuffs, which Germany badly needed for its economy and war preparation. The second advantage was related to the fact that these goods were paid in inconvertible, blocked marks, which those countries could not use for imports from third countries: these mark balances were kept in Germany and for any practical purpose they were a trade credit to Germany.[48]

What it is important to notice is that this experience had shown the potential for exploiting weak trading partners – though perhaps not quite so extensively as an orthodox interpretation seemed to suggest[49] –, by extracting from them both real and financial resources through a foreign trade structure based on clearing agreements.

During the Second World War, the evolution of this complex structure again led to a sharp increase in German clearing liabilities, which by the end of 1944 had reached the astounding figure of almost RM30bn, this time concentrated on the occupied countries of Northwest Europe (France, the Netherlands, Denmark, Norway, Belgium), as shown below.[50]

	German clearing liability (RMbn)
Northwest European countries	–20.9
Balkan countries	–4.6
Central East European countries, mostly Poland	–4.2
Italy and neutrals, mostly Switzerland	–0.1
Total	–29.8

Could a system like this survive? Theoretically, the answer is yes, if the other participant countries were confident that the hegemonic country's currency was stable, so that it could be safely held as a 'reserve currency'.

As mentioned above, this stability should have been based in turn on the country's economic strength, as expressed by its balance of payments or foreign investment position.

Given the large debit position that made Germany a typical deficit country, the system envisaged by Funk was unworkable, because that position was economically inconsistent with a hegemonic country.

For Germany, maintaining its hegemonic position in the vast swathe of Europe under Nazi rule would have meant, from an economic viewpoint, the elimination of the large and persistent imbalance, that is, the achievement of a situation wherein the build-up of any debtor position is limited within the multilateral clearing system. But this would imply economic adjustment in the German-dominated area, through a devaluation of the Reichsmark. The devaluation would, in turn, mean a poorer Germany, and make other countries richer: a politically impossible outcome.[51]

The alternative to adjustment through devaluation is for a deficit country to keep its hegemonic position by sheer force. Nazi Germany was successful in maintaining a large external trade deficit (while it lasted), essentially by force, thus draining resources from abroad. This outcome solved the hegemony issue in German-dominated Europe.

The problem remained, however, *vis-à-vis* the rest of the world. It should not be forgotten that even in the Nazis' plans, other important countries such as the United States and perhaps Britain would remain external interlocutors with Germany, even though the Nazis constantly claimed a sort of global primacy. So, how could foreign countries believe in the Reichsmark as a solid reserve currency, to be used in international transactions, without the protection of convertibility and, indeed, without the possibility of gold convertibility, as the Nazis belittled gold's role, dismissing it as outdated? In other words, how could confidence in the Reichsmark be maintained outside the Reichsmark Bloc?

The answer has to be found in the capital account of Germany's balance of payments. As Ritschl shows with reference to the pre-war period, the pillage of the international reserves – mainly gold – of annexed or occupied countries, such as Austria, Czechoslovakia, and then France in the early phase of the war, had permitted a rebalancing of foreign payments (Italy and other occupied countries would suffer the same looting later in the war). Moreover, the Nazis had in mind to reimburse, when war would be over, at 25–30 per cent, only the above-mentioned stock of foreign debt, thus reducing its amount to around RM2.5bn. This residual debt would have been transferred, *'pro-quota'*, to the defeated European countries.[52] Besides this, as Paul Einzig stressed in 1941, the Reichsmark's strength would rest not only on looted gold, but also on the expropriation of the production machinery of defeated European countries. Already in 1940, after the occupation of France, a report by the UK Foreign Office alerted the Treasury that 'the Germans are said to have a large year-book ... containing the names of all manufacturing and commercial firms as well as armament firms in France. It was proposed to bring all these firms under German control', while similar initiatives were taken with regard to Belgian, Dutch and Romanian firms.[53]

In the end, Germany's foreign indebtedness – either financial or trade-related – would be counterbalanced by all those assets (gold, real investments abroad) acquired by looting and pillage. This was not enough: almost ironically, a good contribution to its foreign accounts would have come, after a victorious war, from ... war reparations! (where it all started).[54]

Postscript

Quite possibly, anyone who has this book will have found the following question unavoidable: Are there similarities to be found with certain current developments? I personally believe that history cannot dispense lessons to be learned. Any particular set of events has its own motivations rooted in its own time and place, of which we shall never see a replica. In particular, to infer conclusions from circumstances, similar to the present, which occurred in the past, is disingenuous at best and intellectually dishonest at worst. This is all the more true if we try to predict future economic developments from seemingly analogous past experiences. Historians are second only to economists in making wrong forecasts. With this caveat, it is nevertheless valid to wonder whether some similarity with those past experiences may contribute to a better understanding of current circumstances.

Today, a recurring theme in both the media and financial literature is a comparison between recent financial developments in Europe and the operative aspects of the international monetary system that is known as the gold standard, with a particular emphasis on the interwar period which saw its final demise. To quote two meaningful examples: John Plender of the *Financial Times* observes that 'the curious feature of this debtor–creditor battle [a reference to the eurozone's entrenched imbalances] is that it mirrors precisely the arguments that took place over German reparations after the first world war, but with the country positions reshuffled. That saga produced the same atmosphere of continual crisis as the present one, with the French adopting a punitive moralistic stance against the defeated Germans'.[1] At a recent conference, Charles Goodhart has explicitly referred to the eurozone as 'our modern simulacrum of the Gold Standard', stressing the reluctance of hegemonic countries to reflate both under the gold standard (as we have noticed in the case of the United States) and under the current monetary arrangements in Europe (in the case of Germany).[2]

It is in fact possible to compare the functioning of these two different systems without either overstating similarities or obscuring differences, starting from the most evident dissimilarity: The eurozone is a monetary union, and the gold countries were not. Here, we examine these two monetary arrangements using the following perspectives: their purposes, exchange rate regimes, monetary policies, fiscal policies and adjustment processes. Then we shall deal with a few statistics regarding crucial issues that were debated then just as they are now.

Regarding the gold standard's purpose, we can rely on Hawtrey's definition: 'a device for enabling the money-issuing authority to decide in any set of circumstances, whether there is a danger of credit expansion (or contraction), and whether any countervailing action is needed'.[3] In this book, we have tried to formalize this rule by using the simple notion of 'leverage ratio', that is, the ratio that connects the two critical terms of the system: money supply and gold in reserve, the connection being the mandatory convertibility of 'money' into gold (see Chapter 3).

The exchange rate regime under the gold standard is based on fixed parities, as defined by the gold content of each specific currency. This gold content is determined by the national legislation of each participating country (here, it is only of minor importance that exchange rates may have quite limited oscillations within the 'gold points', as explained in Chapter 3). The non-gold standard currencies have a floating rate *vis-à-vis* the participating currencies: For instance, the Italian lira exchange rate floated during and after the First World War, because of the gold standard's suspension in view of the huge cost of financing war expenditures. An important point to be made is that in the case of severe shocks – for instance, following a war – the gold standard is not incompatible with exchange-rate adjustments. After a period of suspension, the return of a currency to gold convertibility can be made with a legal definition of the currency's gold content restated at a lower level than the previous one, in order to take into account the effect of the shock – often an inflation process that led to a misalignment of the specific currency *vis-à-vis* the others. This change in the gold parity gives the system a sort of limited flexibility, which distinguishes it from a monetary union.[4]

As for monetary policy, any discretion is limited by the 'rule' that links money supply – circulation plus overnight bank deposits – to the amount of gold in reserve: Any outflow of gold due to a deficit in foreign accounts must be counteracted by a restrictive monetary stance. The clear implication is that money supply should decrease when gold outflows occur. This 'rule' sets a limit to any discretionary behaviour on the part of monetary authorities. If the opposite situation occurs, what would be the consequence of a gold inflow due to a surplus in foreign accounts? We shall leave this question open right now, and revert to it shortly when dealing with the adjustment process.

We can now turn to fiscal policy, which is 'neutral' under the gold standard. No demand management through fiscal policy is envisaged; only balanced budgets and 'consolidation' are required, as expressly demanded by Resolution 7 of the Genoa International Monetary Conference of 1922. The absence of any proactive role is evident when we note that fiscal policy is not even mentioned in Hawtrey's classic work.

Within such a framework, the adjustment process in a situation of imbalanced foreign accounts is carried out through internal measures ('internal devaluation', as opposed to 'external devaluation'): tightened monetary policy that will increase interest rates and contract money supply and prices (thus restoring external competitiveness), but also reduce output and employment. The increase in interest rates may also have the result of making domestic financial assets more attractive, thus causing an inflow of foreign capital that may rebalance the current account deficit. This was the policy pursued by the then hegemonic country, the United Kingdom; but for other countries, which we would today term the 'periphery', not supported by a 'strong' reserve currency such as sterling, this instrument would be blunted and no attraction on the capital account would balance the outflow on the current account, particularly if the currency were perceived by markets as overvalued. What is important to stress here is that freedom of capital movement – even though not explicitly mentioned in the Genoa conference resolutions – was seen as intrinsic to the smooth operation of the gold standard.

The adjustment process raises a central question. What about countries that, thanks to foreign surpluses, enjoy an inflow of gold? Should they boost internal demand through expansionary monetary – if not fiscal – policies? This is the issue of 'symmetry' in the gold standard, which we have considered when dealing, in particular, with the U.S. surpluses in the interwar period (Chapter 4), reaching the conclusion that America did not behave 'symmetrically' as it did not comply with the gold standard's unwritten rules. As a consequence, global imbalances were exacerbated rather than contained. Goodhart says that in practice, 'the process of preaching to the surplus countries on the need for them to reduce their current account surplus [was] a mug's game with little future'.[5]

We can see equivalent features operating in the euro system. The system's primary purpose, according to the Maastricht Treaty, is to maintain price stability using the common currency of the eurozone. We have one monetary policy ('one size fits all'), which is implemented according to a set of guidelines but without, of course, any gold convertibility – as in any modern ('fiat money') monetary system. In this matter, we have to consider an important central bank, the German Bundesbank which, for more than 20 years between the mid-1970s and the mid-1990s, had 'conducted its policy under the banner of public monetary growth targets'.[6] The bank essentially accepted Milton Friedman's monetarist view. Even though the growth target of the money supply was rather nebulously formulated, it is commonly accepted that monetary targeting – based on a money supply policy oriented towards the medium term and allowing deviation from the envisaged growth rate in the short term – proved its worth. Above all, in Germany monetarism created a stability culture that has successfully been transferred to the new euro system. The 'Bundesbank legacy' is very much present (the Bundesbank can be seen as providing a template for the euro system). An official ECB document refers to the 'general principle of the long run neutrality of money that underlies all standard macroeconomic theory', and says 'it is widely agreed that in the long run ... a change in the quantity of money in the economy will be reflected in a change in the general level of prices. But it will not induce permanent changes in real variables such as real output or employment. ... In the long run, the central bank ... cannot enhance economic growth by expanding the money supply'.[7]

Not a lot can be said about the exchange rate – member countries have joined the euro with irrevocable parities. No exit or rate adjustment is provided for. The euro is floating *vis-à-vis* other currencies. Similarly, as regards fiscal policy, no active demand management according to the business cycle is pursued, and the balanced budget has been introduced in some member countries by a constitutional amendment. Fiscal consolidation is also a policy objective. If demand-side management is not a tool of policy, greater weight and reliance are instead placed on supply-side policies such as measures to increase flexibility in the labour market, to enhance competition, to speed up judicial civil procedures, to adjust education to the requirements of industrially advanced (or of post-industrial) societies, and in general any institutional developments that can increase the economy's competitiveness.

Summing up our comparison:

	Gold standard	**Euro system**
Exchange rates	fixed	one currency
Monetary policy	governed by rules	same
Fiscal policy	balanced budget	same
Adjustment:		
Internal	monetary policy	fiscal policy (consolidation)
External	no external adjustment, in principle	floating rate *vis-à-vis* other currencies

Freedom of capital movements in both (no exchange controls).

As an alternative, a discretion-led system relies on the idea that discretion in exchange rate and monetary and fiscal policies (with active demand management) can increase the general welfare.

We can now move to some statistical evidence from both periods, focussing on two issues raised by Plender and Goodhart: the strained debtor–creditor relationship, and the 'symmetry' of the hegemonic country's behaviour, if it is a 'persistent, serial creditor'. While aware of the very different sizes of their respective economies, we shall focus on the United States and Germany for the interwar period, and on Germany and Greece for the present day.

Both debtors – Germany and Greece – registered a huge capital inflow after their currencies' stabilisation (Germany's Reichsmark, stabilised in 1924; Greece, by joining the euro in 2001).

Both countries had (or have) a significant current account deficit in their balance of payments. We have taken for Germany the year 1930 as it marks the end of capital inflows, still includes war reparation payments, and precedes the introduction of exchange controls in 1931. For Greece, we have considered the last available year.

We can see that the result of capital inflows and foreign current account deficits is a very negative international investment position.

In 1931, Germany introduced a complex network of strict exchange controls. Starting in 1933 it substantially, if not formally, defaulted on its foreign debt and embarked upon a Keynesian, expansionary fiscal policy (which soon came to focus on preparations for war) and effectively abandoned the gold standard (though again, not formally): a shift from rules to discretion. In recent times, Greece also partially defaulted, but the adoption of currency controls or, worse – devaluation – would be in contradiction with its belonging to the monetary union, while stimulating the economy through fiscal measures would contradict the fiscal consolidation which the union is aiming toward.

Table PS.1 Germany in the 1920s and Greece in the 2000s: capital inflows after currency stabilization

Net capital inflow: Germany, 1924–1930	Greece, 2001–2012
RM18.2bn (peak RM4.3bn, 1928)	€182bn (peak €30.2bn, 2008)
National output: Germany 1928:	Greece 2008
RM 84bn	€233.2bn

Notes: (1928 and 2008 are both peak years in their respective economic cycles)

Sources: Bank for International Settlements, *Financial Committee Report,* 1931; Bank of Greece, www.bankofgreece.gr; Mitchell, *European Historical Statistics*; IMF: *World Economic Outlook* (imf.org/external/pubs/ft/weo).

Table PS.2 Germany 1930, Greece 2012: current account of balance of payments

	Germany 1930 (RMbn)	**Greece 2012 (€ bn)**
Trade	+1.5	–19.6
Invisibles	+0.2	+15.1
Reparations	–1.7	transfers(EU) +1.4
Interest	–0.8	invest.income –1.6
Total	–0.8	–4.6
	1.1 per cent of output	2.9 per cent of output

Sources: Bank for International Settlements; bankofgreece.gr

The growth rates of Germany in the 1930s and Greece today, starting from the peak of the cycle as year one, are shown in the following figure.

From the perspective of the creditors, meanwhile, the global hegemony of the United States in the 1930s, and the European hegemony of Germany today both rest on solid international investment positions.

The United States behaved asymmetrically, that is, it did not adopt an expansionary fiscal policy: A balanced federal budget continued to be the

Table PS.3 International investment position of Germany (1930) and Greece (2012)

	A	B	C	D	E (C/D)
Germany 1930, RMbn	9.7	25.5	15.8	71.9	22.0%
Greece 2012, €bn	245.8	456.7	210.8	193.7	108.8%

Notes: A. Foreign assets
B. Foreign liabilities
C. Net liabilities
D. National output

Sources: Bank of International Settlements, bankofgreece.gr, Mitchell, IMF, *WEO*.

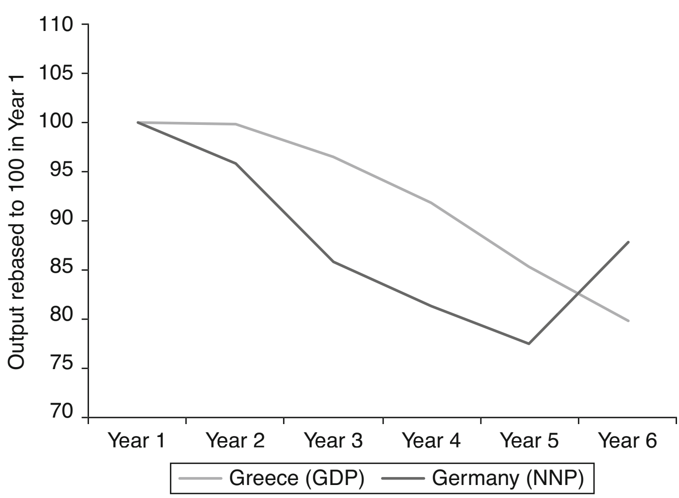

Figure PS.1 Rates of growth in national output, Germany 1929–1934 and Greece 2008–2013

Sources: imf.org/weo; Mitchell

Table PS.4 International investment position of the United States (1930) and Germany (2012)

	A	B	C	D	E (C/D)
US (1930), $bn	21.5	8.4	13.1	91.3	14.3%
Germany (2012), €bn	7035.7	5928.5	1107.2	2643.9	41.9%

Notes: A. Foreign assets
B. Foreign liabilities
C. Net creditor position
D. National output

Sources: *HSUS*; www.bundesbank.de

'rule' and, in 1930, it registered a surplus of $0.7bn, notwithstanding the incoming recession. Monetary policy remained tight: The nominal interest rate at the Federal Reserve Bank of New York was lowered from 5.21 per cent in 1929 to 3 per cent the following year (using yearly averages), but remained unchanged in real terms given the 2.3 per cent fall in consumer prices. Dollar revaluation was out of the question – on the contrary, the dollar was devalued in 1933–1934.

A looser fiscal policy in Germany with a view to rebalancing the national economy towards a higher level of domestic consumption – and to stimulating the 'peripheral' economies, combined with a more lax monetary stance by the ECB for the same purpose – would remove the deflationary bias. That policy would also contain a transfer of resources to other countries, probably placing the German economy in a better condition. But, now as then, a trade surplus is seen as a source and evidence of strength, an expression of virtuous qualities, and not as a policy indicator of adjustment. Symmetry continues to be an elusive goal. With the external debt unsustainable, public capital transfers to debtor countries fill the gap left by reluctant private creditors.

Notes

1 War Reparations and Hyperinflation in Germany

1. Fisk, Harvey E.: *The Inter-Ally Debts. An Analysis of War and Post-War Public Finance 1914–1923,* Bankers Trust Company, 1924. See tables XXIV and XXVI. Similar figures are given by Keynes in *The Economic Consequences of the Peace*, Harcourt Brace and Howe, New York, 1920, pp 261–262, 271 (first edition: Macmillan, 1919)
2. All figures in different currencies are turned into US dollars at pre-war par of exchange. They 'reflect the face of books as published by the finance departments of several countries, without adjustment of any kind' (Fisk, *The Inter-Ally Debts*, p 319)
3. Fisk, p 17
4. Fisk, p 6
5. Ahamed, Liaquat: *Lords of Finance*, W. Heinemann, 2009, p 107
6. Ritschl, Albrecht: The Pity of Peace: Germany's economy at war, 1914–1918 and beyond, in Broadberry, Stephen, Harrison, Mark (eds): *The Economics of World War I,* Cambridge, 2005, p 66
7. At the outbreak of the First World War, the content of the gold mark was 358.4 milligrams of fine gold. The consequent parity rates of the German mark were: 4.2 marks per American dollar, 1.2 Italian lire per mark, same for the French franc, 20.4 marks per British pound. See Pick, Franz and Sédillot, René: *All the Monies of the World,* Pick Publishing, 1971
8. The accounting of occupation costs is one of the most opaque items in war reparation payments
9. Bonn, Moritz J.: The Reparation Problem, in *Annals of the American Academy of Political and Social Science,* vol. 104, November 1922, p 150
10. Bonn, The Reparation Problem, pp 150–151 (while the amount of 20bn would be, approximately, what Germany paid during the whole history of war reparations). It was observed by Frank Graham (in *Exchange, Price and Production in Hyperinflation: Germany, 1920–1923*, Russell & Russell, 1967, p 31 [first edition 1930]) that those payments in kind were declared to be even inadequate to meet the cost of the armies of occupation, and that, consequently, the Germans were held to have failed to pay any reparations at all. According to Sally Marks, these 8bn were 'consumed by prior charges, notably occupation costs and the expense of provisioning Germany'. See Marks, Sally: The Myths of Reparations, in *Central European History*, vol. 11, n 3, 1978, p 233. But it seems that the amount of around 2.6bn was subtracted from the total of war reparation debt: see Table 1.1
11. France 52 per cent, Britain and British Empire 22 per cent, Italy 9.3 per cent, Belgium 8 per cent, Yugoslavia 5.9 per cent, and 3 per cent for the rest. See Steiner, Zara: *The Lights That Failed. European International History 1919–1933*, Oxford University Press, 2005, p 194
12. Commission des Réparations: *Rapport sur les Travaux de la Commission, de 1920 à 1922*, Félix Alcan, 1923, tome I

13. Eichengreen, Barry: *Golden Fetters. The Gold Standard and the Great Depression 1919–1939*, Oxford University Press, 1992, p 129
14. In Poland, Saar, Danzig, and other locations
15. Reparation Commission: *Official Documents, Relative to the amount of Payments to Be Effected by Germany Under Reparations Account*, HMSO, 1922, vol. I, pp 4–5
16. Eichengreen, *Golden Fetters*, p 131
17. Reparation Commission, *Official Documents, Relative to the Amount of Payments*, vol. I, p 5
18. Ritschl, The Pity of Peace, p 70.
19. It is, in fact, unclear which function each category of bonds would serve. According to Steiner and Marks, the A bonds represented the unpaid share of the 20bn gold mark interim payment (Steiner, p 197; Marks, p 237), but it should be remembered that, according to the Reparation Commission, only 2.6bn had been paid (see above). The B bonds were generally considered to be indirect compensation for the inter-Allied debt owed by the European Allies to the United States, but – according to another interpretation – they represented the Allies' war damages themselves (Ritschl, The Pity of Peace, pp 69–70; Gomes, Leonard: *German Reparations 1919–1922. A Historical Survey*, Palgrave Macmillan, 2010, p 66).. The C bonds, according to Gomes, would provide for Allied war debt cancellation (rather than the B bonds). Another author notes that these C bonds could in fact be traded, for a reduction of French debt to the United States and United Kingdom, in a sort of credit transfer. See Rupieper, Herman J.: *The Cuno Government and Reparations 1922–1923. Politics and Economics*, Martins Nijhoff, 1979, pp 7–8
20. Webb, Steven B.: *Hyperinflation and Stabilization in Weimar Germany*, Oxford University Press, 1989, p 105
21. Bonn, The Reparation Problem, pp 152–153
22. Reparation Commission: *Official Documents, Relative to the Amount of Payments*, vol. I, pp 6–13
23. See Bresciani-Turroni, Costantino: *The Economics of Inflation. A Study of Currency Depreciation in Post-war Germany 1914–1923*, Allen & Unwin, 1937, p 95. (The book is an expanded version of *Le vicende del marco tedesco*, Università Bocconi, 1931)
24. Ferguson, Niall: *The Pity of War*, Allen Lane, 1998, p 413
25. Among deliveries in kind, the most important to the Allies (and the most burdensome to Germans) were coal deliveries. The Allies were demanding about 1/5 of the German coal output, which was the main energy source (Webb, *Hyperinflation*, p 105)
26. Marks, pp 237–238
27. Wiesbaden Agreement, in Reparation Commission: *Agreements Concerning Deliveries in Kind to be made by Germany under the headings of Reparations*, HMSO, 1922
28. Ferguson, *The Pity of War*, p 415
29. Bresciani-Turroni, *The Economics of Inflation*, p 54
30. Feldman, Gerald D: *The Great Disorder: Politics, Economics and Society in the German Inflation 1914–1924*, Oxford, 1993, p 5
31. Bonn, p 155
32. Rupieper, *The Cuno Government*, p 11; Steiner, *The Lights*, p 185
33. Dr Wirth to the Reparation Commission, 14 December 1921, in Reparation Commission, *Official Documents*, vol I, p 50

34. Memorandum by the French delegation on Germany's request for a moratorium, in Reparation Commission, *Official Documents,* Second Part, HMSO, 1923
35. Reparation Commission to the German government, 21 March 1922, in *Official Documents*, vol I, pp 118–121
36. Reparation Commission, *Official Documents*, vol I, pp 121–124
37. Rupieper, pp 256–257
38. Steiner, pp 188–189
39. Hetzel, Robert L.: German Monetary History in the First Half of the Twentieth Century, in *Federal Reserve Bank of Richmond Economic Quarterly*, 88/1, 2002, p 5
40. Rupieper, p 11
41. Reparation Commission: *Statement of Germany's Obligations*, IV, HMSO, 1923, p 22
42. Hetzel, p 8
43. Ahamed, *Lords of Finance*, p 120
44. Rupieper, *The Cuno Government*, 258–260; Marks, The Myths, p 243
45. Keynes, *The Economic Consequences*, pp 261–262
46. Keynes: *Manchester Guardian*, 26 August 1922, in *The End of Reparations* (Collected Writings, vol. 18, Royal Economic Society, 1978), p 27
47. Keynes, *Manchester Guardian*, 28 September 1922, in *The End of Reparations*, p 34
48. Keynes, *The Economic Consequences*, p 27
49. Haller, Heinz: Die Rolle der Staatsfinanzen für den Inflationsprozess, in Deutsche Bundesbank (ed.): *Währung und Wirtschaft in Deutschland 1876–1975*, Knapp, 1976, p 150
50. Hetzel, German Monetary History, p 7
51. Ahamed, *Lords of Finance*, p 121
52. Keynes: *Manchester Guardian*, 28 August 1922, in *The End of Reparations,* pp 28–29
53. Eichengreen, Barry, Hatton, T. J.: *Interwar Unemployment in International Perspective*, Kluwer Academic, 1988, p 6
54. Bresciani-Turroni, *The Economics of Inflation*, pp 188–189
55. Steiner, *The Lights*, p 190
56. Keynes, *Manchester Guardian*, 22 December 1922, in *The End of Reparations*, p 89
57. Keynes, *Manchester Guardian*, 28 September 1922, in *The End of Reparations*, p 48
58. Quoted by Pfleiderer. See Pfleiderer, Otto O.: Die Reichsbank in der Zeit der Großen Inflation, die Stabilisierung der Mark und die Aufwertung von Kapitalforderungen, in Deutsche Bundesbank (ed.): *Währung und Wirtschaft in Deutschland 1876–1975*, Knapp, 1976, p 189
59. Bonn, *The Reparation Problem*, pp 153 and 156
60. Webb, *Hyperinflation,* p 112
61. Ferguson, *The Pity of War*, pp 407–411
62. Marks, The Myths, pp 238–239
63. Von Specht, Agnete: *Politische und wirtschaftliche Hintergründe der deutschen Inflation, 1918–1923*, Lang, 1982
64. Mitchell, p 821
65. It is unclear whether these can be identified with NNP
66. Bresciani-Turroni, *The Economics of Inflation*, p 183
67. Depending on different estimates
68. Webb, *Hyperinflation*, p 76
69. This amount of around 9bn for three years may be inferred from Reparation Commission, *Official Documents*, vol I, pp 12–13
70. This item is unclear: according to Marks, 'there developed a certain tacit recognition of [the occupation costs and other items] as reparations' (p 233)

71. Webb, *Hyperinflation,* p 108
72. Webb, *Hyperinflation*, p 108
73. Reparation Commission, *Statement of Germany's Obligations*, p 25. Bresciani-Turroni, without quoting the source, gives a different figure: specifically, 10,027.4m. See *The Economics of Inflation*, 'Debt Passed by the Reparation Commission in respect to transactions outside the Dawes Plan', p 457. The figure is subdivided into (bn): cash 1.9, deliveries in kind 3.4, Reparation Recovery Act 0.4, property transfers 2.6, requisitions and payments of occupation armies 0.7, receipts from the Ruhr 1.0
74. Bresciani-Turroni, *The Economics of Inflation*, quoted above
75. Bresciani-Turroni quotes Helfferich, the German Finance minister, as the main exponent of this view, p 44
76. Bresciani-Turroni, p 39
77. Haller, Die Rolle, pp 137–142
78. See also Ritschl, The Pity of Peace, pp 59–63
79. Haller, Die Rolle, pp 159–160
80. Graham, *Exchange*, pp 40–41
81. Graham, pp 40–41
82. Feldman, *The Great Disorder*, pp 159–164
83. Graham, *Exchange*, pp 37–41
84. Haller, p 169
85. Ahamed, *Lords of Finance*, p 125
86. Haller, p 142
87. James, Harold: The Reichsbank 1876–1945, in Deutsche Bundesbank (ed): *Fifty Years of the Deutsche Mark. Central Bank and the Currency in Germany since 1948*, Oxford University Press, 1999, p 23
88. Mitchell, *European Historical Statistics*, p 774
89. On the real bills only doctrine, see also Chapter 3
90. On this point, see Bresciani, *The Economics of Inflation*, p 75; Haller, Die Rolle, p 148
91. Labour disputes were, if necessary, solved by government arbitration, which met little resistance from employers because they were able to pass higher wages on to consumers through price increases.
92. Feldman, Gerald: The Historian and the German Inflation, in Schmukler, Nathan and Marcus, Edward (eds): *Inflation Through the Ages. Economic, Social, Psychological and Historical Aspects,* Columbia University Press, 1983, pp 390–391
93. Steiner, *The Lights*, p 198; Ahamed, *Lords of Finance*, p 123
94. Haller, pp 151–152

2 The Reichsmark: Stabilization and Foreign Loans

1. Weitz, Eric D.: *Weimar Germany. Promise and Tragedy*, Princeton University Press, 2013, p 135
2. Eichengreen and Hatton, *Interwar Unemployment,* p 6
3. Month unspecified. It is apparently the second-highest monthly price increase in history (the first seems to belong to Serbia, during the hyperinflation period of 1992–1994). See Bernholz, Peter: *Monetary Regimes and Inflation. History, Economic and Political Relationships*, Edward Elgar, 2003, p 8
4. The Reichsbank president, Rudolf von Havenstein, was severely ill
5. Glasenapp to Norman, 10 July 1923, BoE, OV 34/91

6. Subdivided as follows (bn gold marks): British Empire 11, France 26, Italy 5, Belgium 4, other Allies 4. See Keynes, John Maynard: 'The Nation and Athenaeum', 28 July 1923, in *The End of Reparations*, p 188
7. Steiner, *The Lights That Failed*, pp 227–228; Weitz, *Weimar Germany*, p 141
8. Hetzel, German Monetary History, p 9
9. Steiner, *The Lights That Failed*, pp 229–233; Marks, *The Myths*, p 246
10. Holtfrerich, Carl: *L'inflazione tedesca 1914–1923*, Cariplo-Laterza, 1989, p 314 (*Die Deutsche Inflation 1914–1923*, W. De Gruiter & Co, 1980)
11. Hetzel, p 8. This project was based on an idea of the conservative politician Karl Helfferich
12. An excellent source on the Rentenbank is the *Federal Reserve Bulletin* (issues of December 1923 and August 1924). See also the *Report of the First Committee of Experts*, 9 April 1924, in Reparation Commission: *The Experts' Plan for Reparation Payments*, HMSO, 1927, p 40
13. Pfleiderer, pp 182–183; James, Harold: The Reichsbank 1876–1945, p 23
14. Bresciani-Turroni, p 337
15. Bresciani-Turroni, p 335
16. Pfleiderer, p 205
17. *The Times,* 30 November 1923
18. *Notgeld* was an emergency currency regulated by a law of 17 July 1922 and issued by public and private organizations. See *Report of the First Committee of Experts* (*Dawes Committee*), in *The Experts' Plan*, pp 105–110. See later in this chapter for the amount in circulation
19. Bresciani-Turroni, pp 24 and 334
20. Webb, p 69
21. Bresciani-Turroni, p 350
22. Webb, p 63
23. Schacht, Hjalmar: *My First Seventy-six Years*, Allan Wingate, 1955, pp 183–184
24. After the United States and Britain (it would be the fourth if India, part of the British Empire, were included: see Maddison, Angus: *The World Economy. Historical Statistics,* OECD, 2003)
25. Kopper, Christopher: *Hjalmar Schacht: Aufstieg und Fall von Hitlers mächtigsem Bankier*, Carl Hanser, 2006, pp 78–84
26. Holtfrerich, Carl: *L'inflazione tedesca 1914–1923*
27. Schacht, Hjalmar: *La stabilizzazione del marco,* Treves, 1931, pp 103–116 (*Die Stabilisierung der Mark,* Deutsche Verlags Anstalt, 1927)
28. Two lectures on the stabilization of the mark, held on 21–22 September 1926 at the Foreign Press, BoE, OV 34/72
29. *Federal Reserve Bulletin*, August 1924, p 636
30. James, The Reichsbank, p 23; Schacht, *My First Seventy-six Years*, pp 194–206
31. *Report of the Second Committee of Experts (McKenna Committee),* in *The Experts' Plan*, pp 117–121
32. Schacht, *My First Seventy-six Years,* pp 214–215
33. In *The Experts' Plan for Reparation Payments,* pp 4–116
34. Hetzel, p 8
35. On this point, see Annex 7 of the *Report*
36. See also *Federal Reserve Bulletin*, August 1924
37. Marks, The Myths, p 247
38. The German State Railways was by far the single largest employer: at the end of the 1920s, it employed 700,000 persons (Evans, Richard J.: *The Coming of the Third Reich*, Penguin Books, 2004, p 99)

39. *Report of the First Committee*, pp 21–29
40. *Report of the First Committee*, p 29
41. Stucken, Rudolf: Schaffung der Reichsmark, Reparationsregelungen und Auslandsanleihen, Konjunkturen (1924–1930), in Deutsche Bundesbank (ed.), *Wahrung und Wirtschaft*, p 259
42. Houwinck ten Cate, Johannes: Reichsbank President Hjalmar Schacht and the Reparation Payments (1924–1930), in *German Yearbook on Business History*, 1988, Springer-Verlag, 1990
43. Eichengreen, *Golden Fetters,* p 150
44. D'Aubernon to Curzon, Foreign secretary, 19 January 1923, PRO, FO 321/9728
45. *The Experts' Plan*, p 130
46. Marks, The Myths, p 248
47. In 1924 the gold standard was still suspended in the United Kingdom
48. Norman to Harvey, 1 March 1924; Owen to Kindersley, 14 April 1924, and Kindersley to Norman, 15 May 1924, BoE, OV 34/120
49. James, The Reichsbank, pp 24–25
50. Plus expenses for its issue, negotiations, and delivery
51. Clement, Piet: 'The Touchstone of German Credit': Nazi Germany and the Service of the Dawes and Young Loans, in *Financial History Review*, vol. 11, n 1, 2004
52. With coupons maturing on 15 April and 15 October
53. *The Experts' Plan*, pp 318–320 and 325–326
54. ASBI, Beneduce, 342
55. This protection can be inferred from the language used in Section XV of the Plan
56. Ritschl, Albrecht: *The German Transfer Problem, 1920–1933. A Sovereign Debt Perspective*, CEP Discussion Paper, vol. 1155, July 2012
57. Weitz: *Weimar Germany,* pp 146–149. See also Guillebaud, C.W.: *The Economic Recovery of Germany from 1933 to the Incorporation of Austria in March 1938*, Macmillan, 1939, p 7
58. Toniolo, Gianni: *Central Bank Cooperation at the Bank for International Settlements*, Cambridge University Press, 2005, p 31
59. Schacht, *My First Seventy-six Years,* p 219
60. Schacht to Norman, 31 December 1926, 21 May 1927, and 15 December 1928, BoE, G 1/414
61. Schacht, p 235
62. For balance of payments data in this period, we rely on the detailed figures given by the Bank for International Settlements *Financial Committee Report ('Wiggin Committee')* of 1931. See BRI: Rapporto del Comitato finanziario costituito dietro raccomandazione della conferenza di Londra del 1931, 18 agosto 1931, in ASBI, Beneduce, 103
63. Ellis, Howard S.: German Exchange Control, 1931–1939: From an Emergency Measure to a Totalitarian Institution, in *Quarterly Journal of Economics*, vol. 5, n 4, 1940, p 6
64. BIS *Financial Committee Report*. Interestingly, the debt for war reparations is not included. Probably, by then it was considered as financially not meaningful – that is, without any concrete possibility of repayment
65. The Reichsbank's balance sheet is reported in the *Federal Reserve Bulletin*. See also Deutsche Bundesbank: *Deutsches Geld- und Bankwesen in Zahlen 1876–1975*, Knapp, 1976, tab C1–1.01

66. Hawtrey, Ralph G: *The Gold Standard in Theory and Practice*, Longmans, Green & Co, 1931, pp 137 and 145
67. The reference is to overnight interest rates, annual averages. See Hetzel, German Monetary History, p 18
68. Houwinck, pp 86, 93 and 96
69. Toniolo, p 32
70. Webb, pp 127–128
71. On the Young Plan, see Toniolo, pp 33–39; Baffi, Paolo: *Le origini della cooperazione tra le banche centrali. L'istituzione della Banca dei Regolamenti Internazionali,* Laterza, 2002, pp 9–40
72. BIS *Financial Committee Report* of 1931
73. Clement, p 35
74. Marks, The Myths, p 251
75. Two International conferences were held at the Hague in August 1929 and January 1930 (Marks, The Myths, p 251)
76. James, The Reichsbank, pp 26–29
77. *Børsen*, 10 December 1930
78. Houwinck, p 100
79. *Financial News*, 14 January 1930
80. The Belga was a gold currency used for international transactions, worth 5 Belgian francs and introduced in 1926
81. See Clement, 'The Touchstone', pp 34–35
82. ASBI, Rapporti Estero, 350
83. BIS *Financial Committee Report*
84. Clement, p 35
85. Eichengreen and Hatton*, Interwar Unemployment*

3 Golden Fetters Revisited

1. This is done on the basis of the classic text by Hawtrey, Ralph G: *The Gold Standard in Theory and Practice*, Longmans, Green, 1931 (second edition); and of more recent works by Schwartz, Anna: Alternative Monetary Regimes: the Gold Standard, in Schwartz A. (ed.): *Money in Historical Perspective*, NBER, University of Chicago Press, 1987; Eichengreen, Barry: *Golden Fetters. The Gold Standard and the Great Depression, 1919–1939*, Oxford University Press, 1992; and James, Harold: *The End of Globalization. Lessons from the Great Depression,* Harvard, 2001
2. Hawtrey, pp 109–110
3. On this point, see League of Nations: *International Currency Experience. Lessons of the Inter-War Period*, 1944, p 215 (the book was mostly written by Ragnar Nurkse)
4. Hawtrey, pp 24–26
5. Hawtrey, p 3. In Hawtrey's times, the popularity of Alice in the Wonderland was probably higher than now
6. Bagehot, Walter: *Lombard Street. A Description of the Money Market,* John Murray, 1931 (first edition 1873), p 301
7. Schwartz, p 367
8. Eichengreen, p 30
9. De Cecco, Marcello (ed.): *L'Italia e il sistema finanziario internazionale 1919–1936*, Laterza, 1993, p 5

10. Feinstein, Charles H.: *Statistical Tables of National Income, Expenditure and Output of the U.K. 1855–1965,* Cambridge University Press, 1976, T110, table 50
11. Sayers, Richard S.: *The Bank of England 1891–1944,* Cambridge University Press, 1976. See Appendix 32, table C
12. Eichengreen, *Golden Fetters*, pp 35–43
13. Schwartz, p 372
14. Timberlake, Richard H., Jr: Gold Standard and the Real Bills Doctrine in U.S. Monetary Policy, in *The Independent Review,* vol. XI, n 3, Winter 2007, pp 327–328
15. Timberlake, p 328
16. League of Nations: *International Currency Experience*, p 213
17. Eichengreen, Barry, and Temin, Peter: *Fetters of Gold and Paper*, NBER Working Paper 16202, July 2010, p 4
18. Eichengreen and Temin, p 2
19. Temin, Peter and Vines, David: *The Leaderless Economy. Why the World Economic System Fell Apart and How to Fix It*, Princeton University Press, 2013, p 36
20. A good example of this position is the book by Mario Alberti, an able fascist financier: *La guerra delle monete* (The money war), Cavalleri, 1937. Alberti defined the gold exchange standard as 'The Anglican Tables of Genoa' (reference was to the Genoa conference that defined the principles of the gold exchange standard). See *La Guerra delle monete*, vol. I, p 146
21. Eichengreen and Temin, p 15
22. Eichengreen and Temin, p 16
23. League of Nations: *International Currency Experience*, p 22
24. Pick, Sédillot, *All the Monies*, pp 110–111; 323, 469–470; 431–432; 296–297; 165–166
25. Eichengreen and Temin,, pp 5–6
26. See *Lombard Street*. This minimum apprehension reserve was qualified by Bagehot as follows: 'There is no "royal road" to the amount of the "apprehension minimum": no abstract argument, and no mathematical computation will teach it to us … errors of excess are innocuous, but errors of defect are destructive … "apprehension minimum" is not always the same', pp 304–305. The apprehension level was also called 'the proportion' (see also Roberts, Richard: *Saving the City. The Great Financial Crisis of 1914*, Oxford University Press, 2013, p 53)
27. Hawtrey, p 50
28. It should be noted that, from the early 1930s, the statistics regarding the gold official reserves of foreign countries became incomplete and hardly comparable. Gold was often moved to exchange stabilization funds, reluctant to make their holding publicly available. In particular, Germany showed, approaching war, only part of the gold reserve. See Federal Reserve: *Banking and Monetary Statistics, 1914–1941*, 1943, table 160. For the United States, until 1934 the total gold stock included gold in reserve and gold in the private sector. The share in the hands of the authorities was anyway overwhelming. For example, in 1914 gold in reserve was $1,206m, while the total stock was $1,526m
29. A similar exercise can be found in Bagehot: see Appendix I, note A, of *Lombard Street*, pp 317–319. The expression 'central bank' is here used simplifying the institutional arrangements of each country: legally, most countries had a note circulation issued by the state, in addition to the central bank's, and sometimes a circulation made of banknotes issued by private banks; and gold at least partly belonged, in some countries, to the Treasury rather than to the central bank

30. Ritschl, The Pity of Peace, p 45
31. Rockoff, Hugh*:* The US Economy in World War I, in Broadberry, Harrison, pp 333–334
32. Hawtrey, pp 87–88
33. See Broadberry, Stephen: Appendix to Galassi, Francesco and Harrison, Mark: Italy at war 1915–1918, in Broadberry, Harrison, p 306
34. Keynes, John Maynard: *A Tract on Monetary Reform*, Macmillan, 1923, p 168
35. Hawtrey on Keynes, p 101
36. Hawtrey, p 102
37. Hawtrey, pp 57–58
38. Hawtrey, p 57
39. Sir Basil Blackett (UK), chairman, Joseph Avenol (France), Gustav Cassel (Sweden), Rudolf Havenstein (Germany), Louis Dubois (France), Giuseppe Bianchini (Italy), Sir Henry Strakosch (South Africa), Robert Brand (UK), Gerald Vissering (the Netherlands) signed the communiqué.
40. Resolution, 8
41. *HSUS*, vol. 3, tab 3.17
42. Eichengreen, p 82
43. *HSUS*, vol. 5, tab 5–459, for the US; Mitchell, for the other countries
44. Hawtrey, pp 107–109
45. Henderson, Hubert: *UK cabinet memorandum*, 20 January 1944, PRO, CAB/66/45/41
46. Gold Standard Act, 28 April 1925
47. Mitchell, p 867
48. Waigh, Leonard: *The History and Mechanism of the Exchange Equalization Account*, Cambridge University Press, 1939, p 2
49. If foreign exchange is included in the ratio's denominator
50. Mitchell, p 863
51. Eichengreen, pp 181 and 182
52. Cotula, Franco, and Spaventa, Luigi (eds): *La politica monetaria tra le due guerre 1919–1935*, Laterza, 1993, p 826
53. Toniolo, Gianni: *L'economia dell'Italia fascista*, Laterza, 1980, pp 109–110
54. Cabinet meeting, Italian debt funding negotiations, 14 January 1926, note by the chancellor of the Exchequer: PRO, CAB/24/178
55. It should not sound surprising that different sources have different estimates. An internal memorandum in the Bank of Italy's archive reports an amount of £610.84m: opinion given by prof. Vittorio Scialoja, no date, but early 1930s, ASBI, Beneduce, 223
56. PRO, CAB/24/178
57. De Cecco, *L'Italia e il sistema finanziario*, p 59
58. De Cecco, p 59
59. Falco, Gian Carlo: La bilancia dei pagamenti italiana 1914–1931, in Banca d'Italia: *Ricerche per la storia della Banca d'Italia*, vol. VI, Laterza, 1995, pp 207 and 213
60. Cabinet meeting, 19 January 1926, PRO, CAB/23/52
61. PRO, CAB/24/178; the Italian government accepted this deal on 28 June 1921 (see Scialoja's opinion, in ASBI, Beneduce, 223)
62. PRO, CAB/24/178
63. King's Speech, 2 February, 1926, PRO, CAB/24/178
64. Banca d'Italia, *I bilanci degli istituti di emissione*, p 38
65. In ASBI, Beneduce, 72 and 223

66. Falco, pp 208–246
67. Falco, pp 248–249
68. Ciocca, Pierluigi and Ulizzi, Adalberto: I tassi di cambio nominali e 'reali' dell'Italia, in Banca d'Italia: *Ricerche per la storia della Banca d'Italia*, vol. I, Laterza, 1990, p 355
69. Storaci,Marina: L'Italia e il blocco dell'oro (1933–1935), in Banca d'Italia: *Ricerche per la storia della Banca d'Italia. Finanza internazionale, vincolo esterno e cambi, 1919–1939*, vol. III Laterza, 1993, p 442
70. Hawtrey, pp 123–124
71. Fisher, Irving: *The Money Illusion*, Adelphi, 1928, pp 146 and 156
72. The price of gold should be stabilized by altering its price inversely in accordance with changes in the price index
73. Translation from the original, in Italian. See *L'illusione monetaria*, Garzanti, 1948, p XII

4 Towards Nationalism

1. Federal Reserve, *Banking and Monetary Statistics,* tab 167
2. Or, more accurately, the first occasion during peacetime
3. Wheeler-Bennett, John: *Knaves, Fools and Heroes. Europe between the Wars*, Macmillan, 1974, p 46
4. Feldman, Gerald D.: Political Disputes about the Role of Banks, in James H., Lindgren H., Teichova A. (eds): *The Role of Banks in the Interwar Economy,* Cambridge University Press, 1991, p 17
5. Pontzen, Martin J: Banking Crisis in Germany (1931) and the Road to Recovery, in Gigliobianco, Alfredo and Toniolo, Gianni (eds): *Financial Market Regulation in the Wake of Financial Crises: The Historical Experience*, Banca d'Italia, 2009
6. James, The Reichsbank, pp 61–62
7. Pontzen, p 199
8. Mitchell, *European Historical Statistics,* p 774
9. Luther, Hans: *Vor dem Abgrund. Reichsbankpräsident in Krisenzeiten 1930–1933*, Propyläen Verlag, 1964, p 241
10. Schiemann, Juergen: *Die deutsche Währung in der Weltwirtschaftskrise 1929–1933. Währungspolitik und Abwertungskontroverse unter den Bedingungen der Reparationen*, Haupt, 1980, p 285
11. Borchardt, Knut: Could and Should Germany Have Followed Great Britain in Leaving the Gold Standard?, in *The Journal of European Economic History*, vol. 13, n 3, 1984, pp 471–497
12. Tooze, Adam: *The Wages of Destruction. The Making and Breaking of the Nazi Economy*, Viking, 2006, p 21
13. Weitz, *Weimar Germany*, pp 162–163
14. Pontzen, pp 197–201
15. Ellis, German Exchange Control, p 22
16. Gomes, *German Reparations*, p 203
17. James, *The End of Globalization*, p 65
18. Hetzel, p 15
19. Ellis, German Exchange Control, p 8
20. Ellis, p 9
21. Woolston, Maxine, Y.: *The Structure of Nazi Economy*, Russell and Russell, 1941, p 110; Child, Frank: *The Theory and Practice of Exchange Control in Germany. A Study*

of Monopolistic Exploitation in International Markets, Arno Press, 1978 (first edition: Martin Nijhoff, 1958), pp 15–16

22. 'No one would have supposed that [this emergency measure] was destined to be the outstanding feature of the German economy for years to come' (Ellis, p 11)
23. Ellis, German Exchange Control, p 27
24. Bank for International Settlements: *Financial Committee Report ('Wiggin Report'),* 18 August 1931. The Committee included representatives of the central banks of Belgium, France, Germany, Great Britain, Italy, Japan, the Netherlands, Sweden, Switzerland and the Federal Reserve Bank of New York
25. *'Wiggin Report'*, p 7 of the Italian version
26. See Toniolo: *Central Bank Cooperation*, pp 123–127; Bank for International Settlements: *Second Annual Report*, 1932
27. Circular of the German Foreign ministry, 21 February 1933, DGFP, Series C, vol. I, 30
28. Ellis, p 38
29. Bank for International Settlements: Report of the Special Advisory Committee (*Beneduce Report*), 23 December 1931, ASBI, Beneduce, 342. See also Toniolo, *Central Bank Cooperation*, p 129
30. *Beneduce Report*
31. Gomes, *German Reparations*, p 209
32. Outline of the Report, 14 December 1931, ASBI, Beneduce, 342
33. Bresciani-Turroni, p 457
34. A detailed account of European Allies default is in Gomes, *German Reparations*, pp 212–217. Britain was more hesitant than France about stopping debt payment to the US. The City feared that a 'default would seriously damage the creditworthiness of Britain and the reputation of the City of London, particularly after the September 1931 departure from gold' (p 215). For details of the Agreement, see also Steiner, *The Lights That Failed*, pp 685–687
35. Gideonse, Harry D. and Brant, Irving: *War Debts,* Carnegie Endowment for International Peace, 1933. An excerpt is in ASBI, Beneduce, 317
36. See Chapter 1. $7bn were lent before the Armistice, 2.5bn after that
37. Tooze, p 27
38. Gomes, p 216
39. Peukert, Detlev J.K.: *The Weimar Republic. The Crisis of Classical Modernity,* Penguin, 1993, p 263
40. Evans: *The Coming of the Third Reich*. pp 283–301
41. Guillebaud, C.W.: *The Economic Recovery of Germany,* p 34
42. Evans, *The Coming of the Third Reich*, pp 299–307
43. Kliefoth to the State Department, 2 February 1933, FRUS-1933, US Government Printing Office, vol. II, 1949, p 186 (digital.library.wisc.edu)
44. Schacht, *My First Seventy-six Years*, pp 302–303
45. Tooze, *The Wages*, p 41
46. For German NNP, see Mitchell, *European Historical Statistics,* p 281
47. League of Nations, *International Currency Experience*, p 8
48. Schacht to the Foreign ministry, 8 May 1933, DGFP, Series C, vol. I, 215. A more worried Roosevelt is pictured by the same Schacht in his memoirs (*My First Seventy-six Years*, pp 309–310)
49. The directorate of the Reichsbank to the Reich chancellor, 6 June 1933, DGFP, Series C, vol. I, 288. Italics in original: Schacht wished to stress to Hitler the social implications of his policy
50. Minutes of the cabinet, 8 June 1933, DGFP. Series C, vol. 1, 296

51. Ellis, German Exchange Control, p 25
52. Cable from Morgan Grenfell to J.P. Morgan, 13 October 1932. BoE, G1/417
53. J.P. Morgan to Norman, 19 October 1932, BoE, G1/417
54. Note of conversations with Dr Schacht at Rittegut Guhlen [Schacht's private residence in Brandenburg], 21/22 October 1932, BoE, G1/417 (See also *Norman's Diaries*, in BoE Archive, ADM 34/1–33)
55. Note of a conversation between the Governor and Dr Schacht, 7 December 1932, BoE, G1/417
56. See ASBI, Beneduce, 317
57. Provided that interest did not exceed 4 per cent per year
58. Woolston, *The Structure of the Nazi Economy*, pp 113–114
59. Schacht, *My First Seventy-six Years*, p 316
60. Circular of the Foreign ministry, 6 July 1933, DGFP, Series C, vol. I, 353
61. Woolston, *The Structure of the Nazi Economy*, pp 113–114
62. Circular of 6 July, see above
63. Dulles to Schacht, 3 June 1933, DGFP, Series C, vol. I, 294
64. Schmitt, Economics minister, to Schacht, 30 November 1933, DGFP, Series C, vol. II, 43
65. Reichsbank statement, 14 June 1934 (from the Italian translation), ASBI, Beneduce, 317
66. Krosigk to Fraser, 14 June 1934, ASBI, Beneduce, 317. See Chiarimento sulla situazione dei trasferimenti tedeschi innanzi al comitato centrale della Reichsbank, 14 June, 1934, ASBI-Beneduce, 317. See also the circular of the German Foreign ministry, 8 June 1934, DGFP, Series C, vol. II, 490
67. Mühlen, Norbert: *Schacht: Hitler's Magician. The Life and Loans of Dr. Hjalmar Schacht,* Alliance Book, 1939, p 67
68. Krosigk to Fraser, 14 June 1934, see above
69. Ritter, Karl: Germany's Experience with Clearing Agreements, in *Foreign Affairs*, vol. 14, n 3. 1936, p 469
70. Clement, 'The Touchstone of German Credit', p 44
71. Tooze, *The Wages*, p 42; Guillebaud, *The Economic Recovery of Germany*, pp 38–51
72. Silverman, Dan: *Hitler's Economy. Nazi Work Creation Program, 1933–1936,* Harvard, 1998, pp 219
73. p 220. See also Evans, *The Third Reich in Power 1933–1939. How the Nazis Won over the Hearts and Minds of a Nation, Penguin, 2006,* p 329
74. Tooze, op cit., p 47
75. The peak in unemployment was reached in February 1933, with 6,128,000 unemployed
76. Guillebaud, p 46
77. Evans, *The Coming*, p 341
78. Up to RM230m were diverted to 'special measures', meaning military infrastructure. It will be noted the difficulty to reconcile figures from different sources
79. Tooze, *The Wages of Destruction*, pp 43–44
80. Tooze, p 39
81. Woolston, p 145
82. Ritschl, Albrecht: *Deficit Spending in the Nazi Recovery 1933–1938. A Critical Reassessment*, Institute for Empirical Research in Economics, University of Zurich, wp 68, December 2000. Evans, *The Third Reich*, p 345
83. That is, a reserve of 40 per cent of the monetary base (circulation and bank balances at the central bank)

84. League of Nations, *International Currency Experience,* p 7
85. Hawtrey, *The Gold Standard*, pp 124–126
86. Federal Reserve, *Banking and Monetary Statistics 1914–1941*, tab 160
87. League of Nations: *Report of the Gold Delegation of the Financial Committee*, 1932, p 81. On France's accumulation of gold as responsible for the international gold shortage and the Great Depression, see Irwin, Douglas: *Did France Cause the Great Depression?,* NBER wp 16350, 2010
88. Temin and Vines, *The Leaderless Economy*, p 35
89. To quote, again, Walter Bagehot, *Lombard Street,* p 290
90. Finstein, Charles: *Statistical Tables of the National Income. Expenditure and Output of the UK*, T110, tab 50.
91. Henderson*, UK cabinet memorandum*, 1944
92. Fay, C.R.: *Great Britain from Adam Smith to the Present Day*, Longmans, Green and Co, 1944, p 451
93. Eichengreen, *Golden Fetters*, p 320
94. Waight: *The History and Mechanism,* p 12
95. Henderson, *UK Cabinet Memorandum*
96. Federal Reserve, *Banking and Monetary Statistics*, p 525
97. Federal Reserve, *Banking and Monetary Statistics*
98. The net international investment position of the US had a dramatic turnaround during the First World War: still negative in 1914, for 2.2bn, it became largely, and increasingly, positive in the post-war years: for $6.4bn in 1919, and 8.8bn in 1930 (*Historical Statistics of the United States,* tab 5–467)
99. Goldsmith, Raymond and Lipsey, Robert: *Studies in the National Balance Sheet of the United States*, Princeton University Press, 1963, vol. II
100. Henderson, *UK Cabinet Memorandum,* 1944
101. Timberlake: Gold Standard, p 332
102. Timberlake, p 334
103. Reference is to the new types of policy adopted by governments to stimulate recovery
104. Henderson, *UK Cabinet Memorandum,* 1944
105. Memorandum by Randolph Burgess for Leon Fraser, alternate of the president of the BIS, 24 May 1932, ASBI, Beneduce, 223
106. Federal Reserve: *Banking and Monetary Statistics* (yearly averages)
107. Eichengreen, *Golden Fetters*, p 329
108. Or 888.6706 milligrams of fine gold per dollar.
109. The Secretary of the Treasury: *Annual Report for Fiscal Year ended January 30, 1934*, 1935
110. Beneduce to Guido Jung, Finance minister, 3 July 1933, ASBI, Beneduce, 342
111. US House of Representatives: *Gold Reserve Act of 1934. Hearings before the Committee on Coinage, Weights and Measures*, on H.R. 6976, in FRASER. Stlouisfed.org/docs/historical/house/1934, pp 127–129.
112. Ibidem, italics added
113. Tattara, Giuseppe: La persistenza degli squilibri dei conti con l'estero dell'Italia negli anni Trenta, in Banca d'Italia: *Ricerche per la storia della Banca d'Italia*, vol III, Laterza, 1993, p 367; Pavanelli, Giovanni: Il controllo dei cambi negli anni Trenta: il punto di vista degli economisti italiani, in *Storia del pensiero economico*, vol. 22, 1991, pp 40–41
114. The Royal Decree of 12 March solemnly stated that 'Foreign exchange trading is free'. See Raitano, Gabriella: I provvedimenti sui cambi in Italia nel periodo

1919–1936, in *Ricerche per la storia della Banca d'Italia*, vol. VI, Laterza, 1995, pp 316–317

115. De Cecco, p 99
116. Circular letter by Azzolini to Bank of Italy branches, 6 October 1930, ASBI, Raccolte diverse-normativa interna, 84
117. Falco, pp 246–255; Guarneri, Felice: *Battaglie economiche fra le due guerre*, Il Mulino, 1988, p 347. For the balance sheet of the Bank of Italy, see Banca d'Italia*, I bilanci degli istituti di emissione,* pp 310–317.
118. Raitano, pp 319–320
119. Mosconi to Azzolini, 4 May 1932, ASBI, Azzolini, 29
120. Azzolini to Mosconi, 21 May 1932, and Mosconi to Azzolini, 9 July 1932, ASBI, Azzolini, 29
121. Henderson, *UK Cabinet Memorandum*, 1944
122. League of Nations, *International Currency Experience*, pp 8–9
123. Note of 22 January 1941, that collects the opinion of several economists on the Funk Plan (see chapter 9), in BoE, G 1/16
124. Tooze, *The Wages*, p 223. See also James, Harold: Innovation and Conservatism in Economic Recovery: The alleged 'Nazi recovery' of the 1930s, in Garside W.R. (ed.): *Capitalism in Crisis. International Responses to the Great Depression*, St. Martin's Press, 1993; Fonzi, *La moneta nel Grande Spazio. IL progetto nazionalsocialista di integrazione monetaria europea 1939–1945*, Unicopli, 2011, pp 43 and 65
125. It should be added that, by the summer of 1936, the standing of Hjalmar Schacht was seriously eroded by the rising star of Göring
126. League of Nations, *International Currency Experience*, p 227
127. To use the expression of the banker James Warburg. He was the vice chairman of the Bank of Manhattan, and a critical New Dealer. He proposed that gold coins should be retired from circulation and the holding of monetary gold should be confined to central banks. Note issues should be redeemable in gold bullion for exports only. Gold miners should be compelled to offer their output to their respective monetary authorities, other than for professional uses of gold. Under such a system, the legal minimum ratio of metal cover against note circulation might be reduced – he said – to 25 per cent (see *Gold Reserve Act of 1934, Hearings*, p 156)
128. See a note in the Bank of England Archive, 22 January 1941, in G 1/16

5 Bond Repatriation, Export Subsidies and Clearing Agreements

1. Think 'Steel pact' or the 'Axis'
2. Ritschl, Albrecht, and Wolf, Nikolaus: *Endogeneity of Currency Areas and Trade Blocs: Evidence from the interwar period*, CEPR Discussion Paper 4112, November 2003; Eichengreen, Barry, and Irwin, Douglas A.: Trade blocs, currency blocs and the reorientation of the world trade in the 1930s, in *Journal of International Economics*, 38, 1995
3. League of Nations, *International Currency Experience*, p 181
4. Eichengreen and Irwin, p 3 Pavanelli, Giovanni: Il controllo dei cambi negli anni Trenta: il punto di vista degli economisti italiani, in *Storia del pensiero economico*, n 22, 1991, pp 38–39
5. Child, Frank: *The Theory and Practice of Exchange Control in Germany,* p 38. A German economist stressed, in 1939, the importance of exchange controls as a sort of new monetary constitution. See Meyer, Fritz: 'Devisenbewirtschaftung als neue Währungsform', in *Weltwirtschaftliches Archiv,* vol. 49, n 3, 1939, pp 415–472

6. Ritter, *Germany's Experience*, p 473
7. League of Nations: *Enquiry into Clearing Agreements,* 1935, p 17
8. Henderson, *UK Cabinet memorandum*, 1944
9. Ellis, German Exchange Control, p 53
10. Schweitzer, Arthur: The Role of Foreign Trade in the Nazi War Economy, in *Journal of Political Economy*, vol. 51, n 4, 1943
11. League of Nations: *International Currency Experience*, p 18
12. The high exchange rate of the Reichsmark was of course helpful in this regard
13. Statistical Office of the United Nations: *International Trade Statistics 1900–1950*, 1962
14. Child, *The Theory and Practice of Exchange Control*, p 3
15. The whole matter became the 'occult science of a few specialists' (Mühlen, *Schacht: Hitler's Magician*, p 74)
16. ASBI, Beneduce, 301. Higher estimates of German foreign debt are given by Tooze, *The Wages of Destruction*, p 27
17. See tab 5.2
18. Child, *The Theory and Practice*, p 35
19. 'The term 'blocked marks' was for a time shunned by the German literature in favour of 'blocked accounts', and this terminological nicety was taken as a proof that the blocked accounts, negotiable at a discount, had no connection with the Reichsmark. This attitude is completely specious' (Ellis, German Exchange Control, p 79)
20. About different, and not always coinciding, categories of marks, see Pick and Sédillot, pp 469–470, and Child, p 35
21. Memorandum enclosed with a letter from president Fraser to vice president Beneduce, 2 July 1934, ASBI-Beneduce, 317
22. On the quotations of these marks, see League of Nations*: Statistical Yearbook, 1938–39*, 1939, p 225
23. Child, p 35
24. Memorandum from the files of the adjutants to the Führer, 3 May 1935, DGFP, Series C, vol. IV, 67
25. Klug, *The German Buybacks*, p 12; see also a footnote to the letter of the Foreign ministry to the Reich and Prussian ministry of Economics, 19 June 1935, DGFP, Series C, vol IV, 157
26. Child, pp 35–37; Ellis, p 28
27. Schacht to the Reich chancellor, 1 February 1934, DGFP, Series C, vol II, 233
28. Klug, pp 17–18
29. Memorandum from the files of the Adjutant to the Führer, 3 May 1935, DGFP, Series C, vol IV, 67
30. Tariff Act of 1930
31. Ritter to Göring, 19 June 1935; minutes of a conference of ministers, 26 June 1935, DGFP, Series C, vol IV, 157 and 174
32. Child, pp 35 and 137; Mühlen, p 78; on the American view, see memorandum by the Secretary of state on a meeting with Luther, the German ambassador, 2 December 1935, in FRUS-1935, US Government Printing Office, vol II, 1953, pp 472–473
33. Between 1933 and 1936, a period when many clearings were stipulated by Germany, the wholesale price index fell in the Netherlands (Germany's main European trading partner) by 4.2 per cent, in France by 9.7 per cent, in the UK by 4 per cent, while in Germany and Italy the index rose by 8.8 and 7.6 respectively (Mitchell, *European Historical Statistics*, pp 774–775)
34. Ellis, German Exchange Control, p 80

35. Note, however, that the devaluation of the pound in September 1931 came after the German currency regulations of July
36. Circular of the Foreign ministry, 18 June 1934, DGFP, Series C, vol. III, 13
37. Ritter, Germany's Experience, pp 466–468
38. Child, p 45. The full list of countries and their trade balances with Germany, in 1931–1933, is at p 46. Only two of these agreements had been signed before the Nazi rise to power (p 47)
39. Ellis, pp 46–47
40. See letter of the Economics minister, Kurt Schmitt, to Schacht, 30 November 1933, DGFP, Series C, vol. II, 93
41. Ellis, pp 47–49
42. Child, p 169
43. With reference to the Balkan countries, exchange controls were adopted by Hungary in July, by Greece in September, by Bulgaria and Yugoslavia in October 1931, by Romania in May 1932 (League of Nations: *Statistical Yearbook, 1938–39,* pp 221–222)
44. Meeting in Prague on clearing arrangements, proceedings of the second commission, ASBI, Rapporti Estero, 479. See also Bank for International Settlements: *Second Annual Report,* 131, p 21; Lampe, John R., and Jackson, Marvin R.: *Balkan Economic History 1550–1950. From Imperial Borderlands to Developing Nations,* Indiana University Press, 1982, p 461
45. BIS memorandum sent confidentially by Raffaele Pilotti, BIS secretary general ('with a prayer not to divulge reception of this report'), to Beneduce, 30 June 1934, ASBI, Beneduce, 317
46. The UK stated that no clearing had been subscribed. Germany flatly refused to respond
47. League of Nations, *Enquiry*, pp 57 and 155
48. For instance, in Italy the Istituto Nazionale per i Cambi con l'Estero-INCE, in Germany the *Verrechnungkasse*
49. League of Nations: *Enquiry*, pp 27–28 and 34
50. For a better understanding of the typical clearing account, we can think of two water-tanks, one for each contracting country. In the first tank, country A pours water ('pays in', in its own national currency) to pay for its imports, and takes out water ('pays out', again using its own currency) to pay for its exports (the same happens with country B). If bilateral trade is perfectly balanced, the amount of water poured in, and taken out of each tank is equal, and both tanks will ultimately remain dry (no clearing credit/debit will emerge). But if trade is unbalanced, with a deficit in country A, the amount of water poured in its tank (paid in) to pay for its imports will be greater than the amount of water taken out (paid out) to pay its exporters, such that the water will remain in the tank at a certain level (the bigger the deficit, the higher the water level). Conversely, country B, a net exporter, will not have enough water to pay its exporters. The level of water in country A's tank is its clearing debt towards country B, while country B has to pay its exporters even without water in the tank, and this is the corresponding clearing credit towards country A. To explain how the balance on a clearing account might not coincide with the trade balance, let us take the case mentioned above and assume that country B, in trade surplus, wants to be paid 'cash', in free foreign currency, for a percentage of its exports (and obtains this arrangement). This means that in our image of two water tanks, country B will take out of its tank a lesser amount of water (of its own currency). Imports

remain the same, but the level of water in its tank will be higher than otherwise. If the amount not taken out is higher than its trade surplus, country B may end up with a net commercial debt on its clearing account with country A.

51. Regulations concerning clearing operations, n.d., ASBI, Azzolini, 69
52. Undated memo (1932 ?), ASBI, Azzolini, 69
53. For example, the Austro-Italian clearing, stipulated at the end of 1931, originally referred to the official shilling-lira parity which differed from the market value. This favoured Austrian importers, because on the market the shilling was stronger. 'Payments-in' by Italian importers were insufficient to cover the 'payments-out' to Italian exporters; the clearing debt of Austria consequently increased. In order to eliminate the Italian surplus, a substantial revision of the agreement in the following July abandoned the parity rate, in favour of an exchange rate agreed upon by the two central banks on the basis of the market quotations (See Clearing italo-austriaco, a memo in ACS, INCE, 43)
54. Demaria, Giovanni: *Cambi e clearings nella politica autarchica*. Editoriale del commercio, 1939, pp 41–44
55. The monopsonist is the sole acquirer of goods or services from a certain seller
56. League of Nations, *Enquiry,* pp 13–14; Child, *The Theory and Practice*, pp 129–130, 132; Woolston, *The Structure of the Nazi Economy*, p 117. See also Ebi, Michael: *Export um jeden Preis: die deutsche Exportförderung von 1932–1938*, Steiner, 2004
57. Circular of the Foreign ministry, 18 June 1934; Reichsbank Directorate to the Economics ministry, 18 June 1934; Reichsbank Directorate to the Foreign ministry, 21 July 1934. In DGFP, Series C, vol. III, 13; 18; 108
58. Record of a conference in the Reich chancellery, regarding the allocation of foreign exchange, 20 October 1934. DGFP, Series C, vol. III, 261
59. Actually, few Control Boards had been established even before the New Plan, from March 1934
60. Fonzi, *La moneta nel Grande Spazio*, pp 78–79; Tooze, *The Wages*, pp 84–86
61. Ellis, p 54
62. Child, p 127–129
63. The description of British-German agreements is largely based on Forbes, Neil: *Doing Business with the Nazis. Britain's Economic and Financial Relations with Germany 1931–1939*, Frank Cass, 2000, chapters 3 and 4. Copy of the agreement is in ASBI, Beneduce, 317
64. On the contrary – the British said – these loans were fully serviced to the Netherlands and Switzerland. Germany retorted that the two countries had accepted a lower rate of interest – 4.5 per cent – and a big German trade surplus.
65. The other medium- and long-term loans would be subject to the general Moratorium of 1934, with the understanding that if the Reich accorded to a third creditor a more favourable treatment, this would be extended to the UK.
66. The important Lancashire cotton industry was in a dire situation: not being able to be paid by German importers, it decided to stop further deliveries, even at the cost of losing market share to Swiss and Czech producers
67. League of Nations, *International Currency Experience*, pp 178–179: League of Nations, *Enquiry*, p 25
68. Aide-memoire of the American chargé d'affaires to the German secretary of State for Foreign Affairs, 6 July 1933, DGFP, Series C, vol. I, 316
69. Ellis, p 144
70. Lamont to Schacht, 11 July 1935, and Schacht to Lamont, 26 July 1935, DGFP, C, IV, 284

71. See memorandum of the US State Department, 4 December 1935, quoted above; Child, pp 191–197
72. Clement, 'The Touchstone', pp 44 and 46
73. On ASKI marks, see Ellis, German Exchange Control, pp 59–64, and Child, *The Theory and Practice of Exchange Control in Germany*, pp 139–149
74. Woolston, *The Structure of the Nazi Economy*, p 120
75. Child, p 146
76. Memo from the files of the adjutants to the Fürer, 3 May 1935, DGFP, Series C, vol. IV, 67
77. Circular of the Foreign Ministry, 10 April 1935, DGFP, Series C, vol. IV, 22
78. Ellis, p 49
79. Foreign ministry circular, 17 August 1936, DGFP, Series C, vol. V, 511. During the years of the Second World War many clearings became inoperative, particularly between belligerent countries. But clearing agreements also gained ground both between aligned countries, and between belligerents and neutral states
80. Which, the accompanying circular to ministers specified, was not suitable to be passed on *verbatim*
81. 4 April 1936, DGFP, Series C, vol. V, 260
82. Evans: *The Third Reich,* pp 357–358
83. Evans, pp 359–361
84. Memorandum by an official of the Foreign ministry secretariat: conversation between the Führer and Chamberlain in Munich, 30 September 1938, in DGFP, Series D, vol. IV, 247
85. Forbes, *Doing Business With the Nazis*, p 215
86. An intent well visible in the British-American financial negotiations during the war
87. The ambassador in Great Britain, Herbert von Dirksen, to the Foreign ministry, 19 October 1938, DGFP, Series D, vol. IV, 257
88. See the memo regarding a conversation between Frank Ashton-Gwatkin, head of the economic department of the Foreign Office, and Wienke of the Reichsbank, 6 November 1938, in DGFP, Series D, vol. IV, 262
89. Minute by the head of the German economic mission in Great Britain, Ruter, 10 November 1938, DGFP, Series D, vol. IV, 267
90. A German 'Mr X' is the only indication from the document
91. Draft of a UK-Germany agreement, 12 December 1938, PRO, T 118/227
92. Leith-Ross to Ashton-Gwatkin, 16 December 1938, PRO, T 188/227
93. Meeting between Schacht and Leith-Ross, 16 December 1938, PRO, T 188/227
94. Memo by an official of the German Foreign ministry, on a conversation between Funk and Ashton-Gwatkin, 24 February 1939, DGFP, Series D, vol. V, 320

6 Germany's and Italy's Relations with Southeastern Europe

1. League of Nations, League Loan Committee: *Second Annual Report,* June 1934, ASBI, Beneduce, 317
2. Kerner, Robert J., and Howard, Harry N.: *The Balkan Conferences and the Balkan Entente 1930–1935. A Study in the Recent History of the Balkan and Near East Peoples*, University of California Press, 1936, pp 30–41; Lampe, Jackson, pp 457–461
3. Lampe, Jackson, pp 461–463
4. Lampe, Jackson, pp 466–467
5. Milward, Alan S.: The Reichsmark Bloc and the International Economy, in Thomas, Mark (ed.): *The Disintegration of the World Economy Between the World Wars,* vol. II, Edward Elgar, 1996, pp 372–391

6. Ellis, p 101
7. Ellis, p 111
8. Lampe, Jackson, p 464
9. Ellis, p 111
10. Child, Frank: *The Theory and Practice,* pp 161 and 162
11. This position was clearly expressed in Washington by Ritter to Francis Sayre, US assistant secretary of state. See memorandum of 26 September 1935, in FRUS, 1935, pp 461–464
12. Ellis, p 45; Child, pp 40–41
13. Child, pp 42–43
14. Neal, Larry: The Economics and Finance of Bilateral Clearing Agreements: Germany, 1934–38, in *Economic History Review*, vol. 32, n 3, August 1979, p 401; Child, pp 159–161; Ellis, pp 45 and 102
15. Circular of the German foreign ministry, 18 June 1934, DGFP, Series C, vol. III, 13
16. Child, p 151
17. Neal, pp 394–395
18. With the exception of Greece, which devalued the drachma in 1932 following the pound's devaluation. Later, Romania devalued its leu in November 1936, after the demise of the Gold Bloc, and Hungary did the same to the pengo in January 1939. See League of Nations: *Statistical Yearbook, 1938–39*, 1939, p 221
19. Demaria, p 44
20. Ellis, p 106
21. Mühlen, p 137
22. League of Nations: *International Currency Experience,* 1944
23. Italics added. See circular of the foreign ministry addressed to all German missions abroad, 17 August 1936, DGFP, Series C, vol. V, 511
24. 'Export surpluses by the partner countries were being sustained by capital exports to Germany in the blocked accounts' (Neal, p 400)
25. Child stresses the export-led recovery of these countries; he wrote: '[I]t is probable that the German trade, on balance, increased the real income of Eastern Europe.' He mainly supports this view on the multiplier effect on the economy that huge exports to Germany had, in a phase of 'less than full employment', pp 164–168
26. Neal, pp 399–400. He resumed a concept developed by Andersen, Poul Nyboe: *Bilateral Exchange Clearing Policy,* Oxford University Press, 1946
27. Neal, p 399
28. Neal, p 400
29. Child, p 154
30. Ministerial director, Helmuth Wohlthat, to Göring, Commissioner for the Four-year Plan, 13 December 1937, DGFP, Series D, vol. V, 154
31. Child, pp 152–154
32. Milward, *The Reichsmark Bloc*, p 401
33. Child, p 207
34. Mackensen to the foreign ministry, 10 February 1939, DGFP, Series D, vol. IV, 449
35. In March 1931 Germany planned a customs union with Austria, but this was bitterly opposed by France, which withdrew considerable funds from Germany as a means of applying political pressure (Guillebaud, The Economic Recovery p 20)
36. Adriacus: *Da Trieste a Valona. Il problema adriatico e i diritti dell'Italia*, Alfieri & Lacroix, 1918, p 61
37. Memo by INCE to the Finance minister, 1 November 1932, ACS, INCE, 43
38. Guarneri, *Battaglie economiche*, pp 354–355

39. Federico, Giovanni, *et al.*: *Il commercio estero italiano 1862–1950*, Laterza, 2011, pp 110–119
40. Within South Eastern Europe, 'Danubian' and 'Balkan' countries partly overlap. Austria and Hungary are Danubian; Bulgaria, Romania and Yugoslavia are both Balkan and Danubian; Greece is just Balkan
41. Guarneri, pp 370–371
42. Memorandum of the German embassy in Rome, 3 March 1933, DGFP, Series C, vol. I, 51
43. Von Neurath to Hassell, 7 February 1933, DGFP, Series C, vol. I, 14; italics in original
44. Political report on German–Italian cooperation in the Southeast, 23 February 1933, by Hassell, DGFP, Series C, vol. I, 35
45. Hassell to the German Foreign ministry, 8 August and 6 October 1933, DGFP, Series C, vol. I, 397 and 485
46. Child, p 182
47. Ritter, of the foreign ministry, to Hassell, 13 November 1933, DGFP, Series C, vol. II, 67
48. Hassell to the foreign ministry, 15 February 1934, DGFP, Series C, vol. II, 257. Austria and Hungary, although member of the League of Nations, did not participate in sanctions against Italy during the Ethiopian war (DGFP, Series C, vol. V, 165)
49. Circular of the foreign ministry, 17 August 1936, DGFP, Series C, vol. V, 511
50. 5 October 1936, DGFP, Series C, vol. V, 572
51. The Protocol's text is in DGFP, Series C, vol. V, 624
52. De Felice, Renzo: *Mussolini il duce: lo stato totalitario 1936–1940*, Einaudi, 1981, p 543
53. Roselli, Alessandro: *Italy and Albania: Financial Relations in the Fascist Period*, I.B. Tauris, 2006
54. See, for instance, Bosworth, Richard J.B.: The Albanian Forests of Signor Giacomo Vismara: A Case Study of Italian Economic Imperialism During the Foreign Ministry of Antonino di San Giuliano, in *Historical Journal,* vol. XVIII, 1975
55. It should be added that market rates followed a different dynamic. In 1926, when the Albanian franc was introduced but the Italian lira still had a floating rate (being out of the gold standard), the 'theoretical' rate was 1:1, and the market rate was 4.96. At the end of 1927, the return of the lira to the gold standard after considerable deflation entailed a depreciation of its gold content, but an appreciation of its market rate. This explains why the gold parity rate moved from 1 to 3.66 lire per franc (in a depreciation of the lira), while the market rate went from 4.96 lire per franc in 1926 to 3.67 in 1928 (lira appreciation). See Roselli, *Italy and Albania*, p 66
56. Albanian Lek, in *International Currency Review*, July 1977
57. See 'Primo riassunto di massima delle spese e opere effettuate in Albania dal 1925 a tutt'oggi' ('Initial estimate of expenses and works carried out in Albania from 1925 to the present day'), June 1938, ASMAE, 31–45, Albania, 81
58. Caselli, Gian Paolo and Thoma, Grid: La storia economica albanese 1912–1950: lo stabilirsi dell'egemonia italiana e il primo tentativo di pianificazione, in *Rivista di storia economica*, vol. 1, 2003
59. Frasca Polara, Paolo: Il commercio estero e la politica degli scambi in Albania, in *Rivista di politica economica*, 1932

7 The Italian–German Clearing

1. Internal memorandum, no date (but 1932), ASBI, Azzolini, 69
2. Federico *et al.,* pp 4–8
3. Federico *et al.*, Sec 1.3
4. Federico *et al.*, p 42
5. Federico *et al.*, p 37
6. Federico *et al.*, *op cit.*
7. Luther to Azzolini, 11 November 1931, ASBI, Rapporti Estero, 479
8. The official position of Beneduce was president of Istituto di credito per le opere pubbliche-Crediop, a long-term credit institution, created by the government in connection with the banking crises in Italy
9. Schubert to the Italian foreign ministry, 4 December 1931, ASBI, Beneduce, 342
10. Anzilotti to Beneduce, 4 December 1931, ASBI, Beneduce, p 342
11. Jung to Bottai, 9 April 1932, in ASBI, Azzolini, p 69
12. On the bilateral balance of payments, see Tattara, Giuseppe: Power and Trade: Italy and Germany in the Thirties*, Vierteljahrschrift für Sozial- und Wirtschaftsgeschichte*, vol 4, n 78, 1991
13. ASBI, Introna, 22. The INCE had been established in 1927, under the oversight of the finance ministry, as a 'public law institute' (a *de jure* quasi-independent public body) for buying and selling, spot and forward, foreign currencies and the development of foreign trade. Its capital was provided by the Bank of Italy. Its functions were partly similar to the exchange equalization accounts created elsewhere
14. The INCE circular explaining the agreement is in ACS, INCE, 113
15. Antonino Cimino, representative of the Bank of Italy in Berlin, to Ettore Cauli, Director General of INCE, 29 July 1932; table of currency movements 27/6–15/8/1932, ACS, INCE, 113
16. For the text of the Protocol and the INCE circular with the new regulations, 17 October 1932, see ACS, INCE, 113
17. Cimino to Azzolini, 2 July 1934, ASBI, Delegazioni estero, 7
18. Ellis, p 56
19. Child, p 184
20. Federico *et al.*
21. Letters of Cimino to Azzolini, 14, 27 August, 3, 13 September 1934, ASBI, Delegazioni estero, 7
22. See Schacht's speech in ASBI, Beneduce, 326
23. The agreement was signed by Anzilotti and Cerruti, the Italian ambassador, on the Italian side, and by Gerhard Köpke, a diplomat, and Hagemann, on the German side
24. ACS, INCE, 113. In October 1934 a new institution, the *Verrechnungkasse*, was created in Germany for the execution of clearing agreements stipulated by the German government. The Reichsbank would act as the cashier of the *Verrechnungkasse*. In Italy, the Bank of Italy acted as the cashier of the INCE. The governor of the Bank of Italy was president of the INCE. See Tattara, Power and Trade, p 474
25. Gazzetta Ufficiale, Leggi e Decreti, 29 September 1934, in ASBI, Azzolini, 69
26. That is, 25 per cent of that 10 per cent of the value of Italian imports (the 'peak')

27. Technically, that amount would be used to pay the Bank of Italy for the purchase of the coupons which were to be paid to the Italian holders of the two loans. On the clearing agreement and related protocols, see ASBI, Azzolini, 69; Introna, 22
28. However, the Italians were successful in raising from 20 per cent (as originally proposed by the Germans) to 25 per cent of the 'peak' the amount available to service the Reich's loans
29. Fraser to J.P. Morgan, 14 May 1935, ASBI, Rapporti Estero, 458
30. Mühlen, *op cit*., pp 66–69
31. See Pagamento cedole Dawes and Young, 1935, ASBI, Rapporti Estero, 458
32. Decrees of 26 May 1934
33. Note on the control of capital flows and foreign trade, 15 May 1935, ASBI, Azzolini, 70; see also Reitano, p 325 and Guarneri, Felice: *Battaglie economiche fra le due guerre*, Il Mulino, 1988, pp 455–457
34. Guarneri, *Battaglie economiche*, pp 455–457
35. The aim of this measure was also 'to prevent the possibility that the international financial system might have a precise measure of our foreign currency reserve and check our capacity to resist' (Guarneri, p 490). This was perfectly in line with the increasing opaqueness of every country's foreign reserve position in that period
36. Accordo per regolare gli scambi tra Italia e Germania, 16 April 1935, ASBI, Rapporti Estero, 458
37. Federico *et al*.
38. Azzolini to Thaon di Revel, 19 November 1935, ASBI, Azzolini, 69
39. Memorandum, 21 November 1935, ASBI, Azzolini, 69
40. Bank of Italy: internal memorandum, ASBI, Azzolini, 69
41. Azzolini to Thaon di Revel, 27 November 1935, ASBI, Azzolini, 69
42. Cimino to Azzolini, 28 November 1935, ASBI, Azzolini, 69
43. Ciocca and Ulizzi, p 355
44. Cimino to Ricciardi, of the Italian embassy in Berlin, 3 December 1935, ASBI, Azzolini, 69
45. Minute by an official of the Reich Chancellery, 21 October, 1935, DGFP, Series C, vol. IV, 372
46. Guarneri, p 299
47. 'Options and re-options', or 'credit assurance' (memorandum by the state secretary, Bulow, 8 December 1935, DGFP, Series C, vol. 4, 441)
48. Bank of Italy: memorandum, 6 December 1935, ASBI, Azzolini, 70
49. 10 years, according to the Bulow memorandum of 2 December
50. Banca d'Italia: *I bilanci degli istituti di emissione*, p 45
51. 'No information as to what action was subsequently taken has been found in the files' (DGFP, Series C, vol. IV, editors' footnote to document 441)
52. Guarneri, p 500
53. Tattara, Power and Trade, pp 480–484
54. Reitano, pp 321–332
55. Mitchell, pp 821 and 823
56. Federico *et al., Il commercio estero*, pp 108–131
57. Tattara, p 487
58. It must be remembered that the 'peak' was determined as 10 per cent of Italian import payments, but 2.5 per cent was set aside to pay for the coupons of the Reich's loans in Italian hands. The effective free currency portion was therefore 7.5 per cent

59. Banca d'Italia, *I bilanci degli istituti di emissione*
60. As mentioned earlier, during the negotiations for the 1934 clearing agreement Italy had tried to keep that level as low as possible
61. The value of German exports had been steadily increasing
62. Guarneri, p 857
63. Memo by Carl Clodius, deputy director of economic policy, 13 December 1938, DGFP, Series D, vol. IV, 414
64. Memo by the foreign minister, von Ribbentrop, 10 January 1939, DGFP, Series D, vol. IV, 427
65. Memo by the deputy director of the economic policy department of the foreign ministry, DGFP, Series D, vol. IV, 399
66. The embassy in Italy to the foreign ministry, 17 December 1938; foreign ministry to the embassy in Italy, 19 December 1938, DGFP, Series D, vol. IV, 416 and 417
67. Memo by an official of the foreign ministry, concerning a meeting between von Ribbentrop and Funk, 13 January 1939; the German embassy in Italy to the foreign ministry, 24 January 1939, DGFP, Series D, vol. IV, 431 and 438
68. State Secretary Ernst von Weizsacher to the embassy in Italy, 28 January 1939, DGFP, Series D, vol. IV, 442
69. Guarneri, *Battaglie economiche*, pp 860–861; Clodius and von Makensen, German embassy in Italy, to the foreign ministry, 3 February 1939, DGFP, Series D, vol. IV, 446

8 The Funk Plan

1. *Der Wiederaufbau des zwischenstaatlichen Wirtschaftsverkehrs nach dem Kriege (Versuch zu einem wirtschaftlichen Friedensprogramm)*, 8 March 1940, BAB 2501–6612
2. *Die Möglichkeiten einer allgemeinen Währungsangleichung nach dem Kriege*, 30 March 1940, BAB R2501–6433.
3. *Probleme der äußeren Währungspolitik nach Beendigung des Krieges*, 20 June 1940, BAB R2501–7015
4. Such ideas as a continental bloc weighted against Great Britain were seriously considered as a long-term strategy by von Ribbentrop. See Michalka Wolfgang: *Die nationalsozialistische Außenpolitik im Zeichen eines "Konzeptionen-Pluralismus"*, in Funke M. (ed.) *Hitler, Deutschland und die Mächte*, Athenaeum Verlag, 1978, pp 46–62
5. The idea of creating an Exchange Equalization Account with gold obtained by France as war reparations was further developed in a later ERD-memo, *Welche Förderungen, Auflagen usw. sind insbesondere aus währungs- und kreditpolitischen Gründen in den deutsch-französischen Friedensvertrag aufzunehmen?*, 13 July 1940, BAB R2501–7015
6. Speech delivered by Gustav Schlotterer to the High Committee (*Großer Beirat*) of the Reich Industry Group (*Reichsgruppe Industrie*), BAB R9 I–123
7. See *Der deutsche Großwirtschaftsraum*, 15 November 1940, BAB R2501–7018; *Ausarbeitung des Statistischen Reichsamts "Rohstoffversorgung des mitteleuropäisch-großdeutschen Wirtschaftsraumes nach dem Kriege"*, 4 September 1940, BAB R2501–7017
8. The memo included in the greater space Greater Germany, the Protectorate of Bohemia and Moravia, the Scandinavian countries, the Netherlands, Belgium,

Luxembourg, the Balkan countries (excluding Greece): *Probleme der äußeren Währungspolitik nach Beendigung des Krieges*.

9. See Kay, Alex J.: *Exploitation, Resettlement, Mass Murder: Political and Economic Planning for German Occupation Policy in the Soviet Union 1940–1941*, Berghahn Books, 2006. The Reichsbank considered it impossible to achieve autarky even with the crops provided by the Soviet Union, *Zur Möglichkeit, den großdeutschen Fehlbedarf an Getreide in Höhe von jährlich 3 Millionen t aus Sowjetrussland sicherzustellen*, 12 June 1941, BAB R2501–7007
10. *Probleme der äußeren Währungspolitik nach Beendigung des Krieges.*
11. From a memo on monetary unions which retrospectively considered the issue of monetary integration, 9 May 1939, BAB R2501–6427. See also a memo on the Czech crown, *Welche Momente sprechen gegen die Festsetzung einer Wertrelation zwischen Tschechenkrone und Reichsmark, die einer Aufwertung der Tschechenkrone gleichkommt?*, BAB R2501–6959
12. See the minutes of a meeting held on the 21 February 1938 at the office of the Reich Commissioner in Austria, Wilhelm Keppler, BAB R2–14599
13. This decision was imposed by Hitler, who feared that if the old parity were maintained, the Austrian public might feel penalized as its purchasing power would be lower than that of the Germans.
14. *Gutachten über den bei der Einziehung der tschechoslowakischen Währung in den sudetendeutschen Gebieten anzuwendenden Umrechnungsschlüssel (W. Richter)*, BAB R2501–6959
15. For Austria see Moser, Josef: *Oberösterreichs Wirtschaft 1938–1945*, Bölhau, 1995, p 45; for Sudetenland Volkmann, Hans-Erich: *Ökonomie und Expansion. Grundzüge der NS-Wirtschaftspolitik*, Oldenbourg Verlag, 2003, p 193
16. The Protectorate of Bohemia and Moravia was a political entity established by Germany in Bohemia, Moravia and Czech Silesia after the invasion of Czechoslovakia on 15 March 1939.
17. *Aufzeichnung betr. Wirtschaftliche Friedensvereinbarung*, 3 July 1940, PA AA R28372
18. DGFP, series D, vol. X, p 115
19. Schlotterer's Affidavit of the 29 September 1947, Staatsarchiv Nürnberg NI 11374
20. *Punkte für die Satzung der Bank für europäischen Zahlungsausgleich (Europabank)*, 3 July 1940, BAB R2501–6428
21. *Währungsfragen im europäischen Großwirtschaftraum*, 6 July 1940, Berlin 6 Juli 1940, BAB R2501–6428
22. *Währungsfragen im europäischen Großwirtschaftraum*
23. *Der Zahlungsverker im europaichen Großwirtschaftsraum*, 20 Juli 1940, BAB R2501–6428
24. *Währungsumstellung in Nordwesten*, BAB R2501–7013.
25. Letter from the Schnellpressefabrik Koenig & Bauer AG – Würzburg to the director of the Foreign Trade Office (*Außenhandelsstelle*) of Northern Bavaria and Southern Thuringia, *Anregungen für die Gestaltung des deutschen Außenhandels nach Friedensschluss*, 7 August 1940, BAB R9I–123
26. Schmidtbeil, Werner: *Die Standardvolkswirtschaft*, Standard–Verlag, 1939 and *Europa wirtschaftlich neugeordnet*, unverkäufl. Ms., 1941. For the Reichsbank's opinion BAB R2501–6433. On the same book see the discussion at the *Insitut für Bankwissenschaft und Bankwesen*, R2501–6908. A similar criticism was expressed on a proposal launched by Robert Scheu of creating a clearing certificate; see the ERD's report on Scheu's project, 2 September 1940, BAB R2501–7017.

27. See the positive review by the journal of the mine industry, *Deutsche Bergwerks-Zeitung*, nr. 166, 19 July 1940.
28. *Fragen der wirtschaftlichen Neugestaltung Europas*, 15 luglio 1940, BAB R2501–7017
29. As mentioned earlier, the *Deutsche Verrechnungskasse* was the institution that had administered the German clearing until then.
30. Funk's Letter to Göring, 17 August 1940, in Hass, Gerhardt and Schumann, Wolfgang: *Anatomie der Aggression. Neue Dokumente zu den Kriegszielen des faschistischen Imperialismus im zweiten Weltkrieg*, Deutscher Verlag der Wissenschaften, 1972, pp 79–81
31. The multilateralization of the clearing was implemented only in part in the following years. See Fonzi, *La moneta nel Grande Spazio*, p 123ff.
32. *Dr. Schlotterer über Neuregelung des Außenhandels*, 2 July 1940, BAB R2501–7017
33. *Anregungen für den deutschen Außenhandel nach dem Kriege*, Foreign Trade Office (*Außenhandelsstelle*) of Northern Bavaria and Southern Thuringia, 9 August 1940, BAB R9 I–122
34. *Aufbau des deutschen Clearingsystems zu einem europäischen Zentralclearing*, BAB R2–230
35. Ibidem
36. On this, see also *Die Festsetzung der Wertrelationen zwischen den Währungen des deutschen Großwirtschaftsraumes*, 6 August 1940, BAB R2501–7017
37. *Vermerk über die am 22. Juli 1940 unter Vorsitz von Reichsminister Funk im Reichswirtschaftsministerium abgehaltene Chefbesprechung*, BAB R2–230. This has been published in Hass and Schumann: *Anatomie der Aggression*, pp 67–76; English translation in Lipgens, Walter (ed.): *Documents on the History of European Integration*, vol I: *Continental Plans for European Union 1939–1945*, Walter de Gruyter, 1985, pp 60–65
38. *Vermerk über die am 22. Juli 1940 unter Vorsitz von Reichsminister Funk im Reichswirtschaftsministerium abgehaltene Chefbesprechung*, p 121
39. Funk, Walther: *The Economic Reorganization of Europe (Die Wirtschaftliche Neuordnung Europas)*, in Lipgens, pp 65–71. It was a linchpin of official ideology that Nazism had introduced a new monetary constitution in which money was no longer based on gold but on work (*Arbeitswährung*). This idea was rooted in the tradition of German economic thought and had already had many advocates among right-wing intellectuals before the Nazis' rise to power. The regime mainly used this connection to provide a theoretical underpinning to its policy of price regulation and low wages, which only guaranteed the stability of the Reichsmark. For a theoretical discussion of German monetary policy from a Nazi perspective see Bayrhoffer, Walther *et al*: *Deutsche Geldpolitik* [Schriften der Akademie für deutsches Recht 4], Duncker & Humblot, 1941.
40. See the speech delivered by Hermann Josef Abs at the *Reichswirtschaftskamme*r in July 1941, *Europa und USA in wirtschaftlicher Betrachtung*, 17 July 1941, BAB R11–27: '[I]t would be against any rationality if these two parts of the earth did not find a way to join each other again. We hope that this way will be found.'
41. *Die europäische Neuordnung und das amerikanische Goldproblem*, 31 July 1940, BAB R2501–7017
42. *Völkischer Beobachter*, 12 September 1935
43. The role of the Reichsbank during the Second World War has been very little investigated. See Oertel Manfred: *Über die Reichsbank im zweiten Weltkrieg*, 1979, Rostock (Diss.)

44. 'Gesetz über die Deutsche Reichsbank', 15 June 1939, in *Reichsgesetzblatt*, Part I, 1939, pp 1015ff.
45. *Wem obliegt die deutsche Währungspolitik?,* 27 September 1940, BAB R2501–6428.
46. Herbst, Ludolf: *Der totale Krieg und die Ordnung der Wirtschaft: die Kriegswirtschaft im Spannungsfeld von Politik, Ideologie und Propaganda 1939–1945*, Deutsche Verlag-Anstalt, 1982
47. Hachtmann, Rüdiger: *"Neue Staatlichekeit" – Überlegungen zu einer systematischen Theorie des NS-Herrschaftssystems und ihrer Anwendung auf die mittlere Ebene der Gaue*, in John, Jürgen, Möller, Horst and Schaarschmidt, Thomas (eds): *Die NS-Gaue. Regionale Mittelinstanzen im zentralistischen "Führerstaat"*, Oldenbourg, 2007, pp. 56–79; Reichardt, Sven and Seibel, Wolfgang: *Der prekäre Staat. Herrschen und Verwalten im Nationalsozialismus*, Campus, 2011
48. Berger, Helge and Ritschl, Albrecht: 'Die Rekonstruktion der Arbeitsteilung in Europa. Eine neue Sicht des Marshallplans in Deutschland 1947–1951', in *Vierteljahrshefte für Zeitgeschichte*, n 3, 1995, pp 473–519; Fonzi, Paolo: La Großraumwirtschaft e l'Unione Europea dei Pagamenti: continuità nella cultura economica tedesca a cavallo del 1945, in *Ricerche di Storia Politica*, n 2, 2012, pp 131–154
49. An accurate appraisal of Germany's exploitation of the continent during the war in Klemann, Hein and Kudryashov, Sergei: *Occupied economies: An economic history of Nazi-occupied Europe, 1939–1945*, Berg, 2012. According to the authors, Germany drew 30 per cent of the resources employed for war from other European countries
50. *Grundfragen der deutschen Währungspolitik, Vortrag von Emil Puhl in dem Außenhandelsausschuss der Reichsgruppe Industrie am 18 Juni 1941*, BAB R2501–6434.
51. Advocates of this system included, for example, Hunscha, Kurt: 'Gold, Devise oder Clearing. Eine Währungspolitische Bilanz', in *Bank-Archiv*, n 16, 1940, pp 302–306; Meyer, Fritz: 'Zum europäischen Währungsproblem', *Bank-Archiv*, n 22, 1941, pp 439–443
52. Siebert, Friedrich Wilhelm, *Die Stellung der Reichsmark im zwischenstaatlichen Zahlungsverkehr. Eine Untersuchung seit Ausbruch des Krieges 1939*, Diss. Wirtschaftshochschule Berlin 1943, p 98
53. Hohlfeld, Hans Herbert: *Reichsmarkkernwährung und Währungsunion als Lösungsvorschläge für das europäische Währungsproblem*, in *Bank-Archiv*, n 16, 1941, pp 321–323. A similar criticism, based on the fact that the Reichsmark was inconvertible and that this undermined its position as international currency, was formulated by the Reich Group Bank in a secret memo, BAB R 43II–311.
54. Report on a meeting of the Money and Credit Working Group of the Academy for German Law (*Arbeitsgemeinschaft Geld und Kredit der Akademie für deutsches Recht*) held on 17–18 October, 27 October 1941, BAB 2501–7021

9 Money for the World of Tomorrow

1. Attolico to the Foreign Ministry and to the ministry for trade and foreign exchange, 20 June 1939, ASMAE, Gabinetto, 697
2. Guarneri to Attolico, 28 July 1939, and Mussolini to Attolico, 1 August 1939, ASMAE, Gabinetto, 697
3. Attolico to the Foreign Ministry, 3 January 1940, ASMAE, DGAP, 68
4. Italian consulate in Vienna, 10 July 1940; Italian embassy in Berlin to the Foreign Ministry, 11 July 1940; Italian legation in Budapest to the ministry for trade, 11 July 1940, ASMAE, Gabinetto, 1462

5. On the Italian embassy's reactions to the Funk Plan, see also: Mazower, Mark: *Hitler's Empire. Nazi Rule in Occupied Europe*, Penguin Books, 2009, p 128
6. Alfieri to the Foreign Ministry, 12 July 1940, ASMAE, Gabinetto, 1462. The day before, Alberto D'Agostino, the director general at the ministry for trade and foreign exchange, had met Funk in Berlin and, in a sign of non-perfect coordination – or perhaps competition? – with Alfieri, had written exactly in the same terms directly to Ciano, the foreign minister, bypassing the ambassador. D'Agostino also met other officials involved in the plan: Puhl, the number two at the Reichsbank; Schlotter, of the Ministry of Economics, and Landwehr, of the foreign exchange department. See D'Agostino to Ciano, 11 July 1940, DDI, Nona serie, vol. V
7. Funk to Lammers, 30 July 1940, DGFP, Series D, vol. X, 261
8. The Swedish press must observe caution, *The Nation* wrote, lest Sweden's precarious relations with Germany be disturbed
9. Schacht's New Plan, 7 September 1940; Schacht Prepares Plan For Post-War Europe, 7 September 1940
10. Kopper, pp 341–342. There is no trace of his plan in Schacht's autobiography, *My First Seventy-six Years*
11. Alfieri to Ciano, 23 July 1940, ASMAE, Gabinetto, 700
12. Alfieri to Ciano, 1 August 1940, ASMAE, DGAP, 70, 6
13. Report by Renzetti, of the Italian embassy in Berlin, on meetings of count Volpi, president of the Italian Industrial Association, and Renzetti himself, with Funk, 29 July 1940, ASMAE, DGAP, 69
14. Where he had returned after a period at the ministry of trade and foreign exchange
15. D'Agostino to Ciano, 3 August 1940, ASMAE, DGAP, 69
16. State secretary Weizsacher to the embassy in Italy, 8 August 1940, DGFP, Series D, vol. X, 311
17. Einzig, Paul: *Hitler's 'New Order'in Europe*, Macmillan, 1941, p 139
18. Funk to Lammers, 30 July 1940, see above
19. Ciano to the Italian embassy in Washington, 4 August 1940; the embassy to Ciano, 5 August 1940 ASMAE, DGAP, 69
20. He left the United States in the same year, 1940. See Sutton, Anthony: *Wall Street and the Rise of Hitler,* Clairview, 2010, p 82
21. Alfieri to Ciano, 23 August 1940, ASMAE, Gabinetto, 700
22. Adelchi Ricciardi, of the Foreign Ministry, writing to the ministry from the Italian embassy in Berlin, 30 August 1940, ASMAE, DGAP, 68
23. Funk, Walther, Il riordinamento economico dell'Europa, Italian version, 2 September 1940, ASMAE, DGAP, 69
24. ASMAE, DGAP, 68, Italian embassy to the Foreign Ministry, 28 September 1940
25. ASMAE, Gabinetto, 1137, 3
26. Riccardi, Raffaello: Riorganizzazione economica europea, in *Il Messaggero,* 10 October 1940
27. Alfieri to Ciano, 14 October 1940, ASMAE, Gabinetto, 700
28. Fonzi, *La moneta nel Grande Spazio*, p 223
29. Funk, Walther: *Wirtschaftsordnung im Neuen Europa, Sudosteuropa-Gesellschaft Vienna, 12 June 1941*, Sudost-Echo Verlagsgesellschaft, 1941. On Hitler's New Order and List's ideas, see Guillebaud, C.W.: Hitlers New Economic Order for Europe, in *Economic Journal*, December 1940, p 491
30. Riccardi, Raffaello: *La collaborazione economica europea*, Edizioni italiane Roma, 1943. It is a collection of essays. Of particular interest: Collaborazione economica

nel quadro della politica dell'Asse, 1940; L'economia alla base della nuova civiltà europea, 1941; Il terzo fronte, 1942

31. Demaria, Giovanni: Il problema industriale italiano, in *Giornale degli economisti e annali di economia*, vol. 3, 1941, p 539
32. Amore Bianco, Fabrizio: *Il fascismo e il dibattito sul 'nuovo ordine' postbellico (1939–1943),* paper presented at the conference La cultura economica in Italia nel Mezzogiorno fra le due guerre, Naples, November 2013 (unpublished)
33. Steil, Benn: *The Battle of Bretton Woods. John Maynard Keynes, Harry Dexter White, and the Making of a New World Order*, Princeton University Press, 2013
34. See Postwar International Monetary Stabilization. Plan submitted by British experts, in *Federal Reserve Bulletin,* June 1943, pp 507–520.
35. Skidelsky, Robert: *John Maynard Keynes. Fighting for Britain 1937–1946*, Macmillan, 2000, p 194
36. Memorandum prepared by Hubert Henderson for the British cabinet, quoted above
37. Skidelsky, *John Maynard Keynes*, p 197
38. Dated 13 January 1941, BoE, G/16. See also Harrod, Roy: *The Life of John Maynard Keynes*, Palgrave Macmillan 2003, pp 503–505 (first edition Macmillan, 1951)
39. Skidelsky, p 199
40. Norman's notes on the draft, 21 January 1941, BoE, G1/16
41. Dated 22 January 1940, BoE, G1/16
42. James, Harold: Post-war Germany Currency Plans, in Buchheim, C., Hutter, M., James, H. (eds): *Zerrissene Zwischenkriegszeit. Wirtschaftshistorische Beiträge. Knut Borchardt zum 65. Geburtstag*, Nomos Verl.-Ges., 1994, pp 208–209
43. James, Post-war, p 209
44. According to which the 'main creditor centres [would be subject to] an expansionist pressure ... which has been lost since New York succeeded to the position of main creditor' (see the British plan, p 515). Remarkably, this symmetry was absent in the American plan (Plan submitted by United States experts, in *Federal Reserve Bulletin*, June 1943, pp 501–506), and this plan would 'erect a new international monetary edifice based entirely on the dollar'(Steil, *The Battle of Bretton Woods*, p 177)
45. A significantly distorting side-effect in the interwar period was that bilateral trade debit positions did not 'emerge' in the published statistics of the balance of payments: they were hidden commercial debts, which would 'emerge' as a financial debt only if the creditor country, concerned by the potential insolvency of the debtor, wanted a conversion of its trade credit into a financial loan, assisted by adequate guarantees (we have seen such a story with the Italian-German clearing, in the mid-1930s: see Chapter 7).
46. As mentioned in a meeting between Funk and D'Agostino of the Italian trade ministry, 11 July 1940, DDI, Nona serie, vol. V, 211
47. 'Social Product', last available year: see Deutsche Bundesbank: *Deutsche Geld- und Bankwesen in Zahlen 1876–1975*, 1976, tab 1.02
48. As we have stressed in Chapter 6, it is unclear to what extent Germany really exploited this situation, because we have some evidence from archives that the German government actually tried to fill the trade gap by increasing its exports to these countries, albeit with obsolete merchandise which it could get rid of without affecting the efficiency of its productive mechanisms. What is certain, however, is that, when those countries' economies started to pick up in the mid-1930s, their opportunity cost of exporting to Germany rather to other markets grew, and their trade – and clearing – surpluses dramatically shrank,

at least up to the point permitted by their political ties with the Nazi government. As a consequence, in the second half of the 1930s lending to Germany on clearing accounts almost halted.

49. Ritschl quotes, as exponents of this 'orthodoxy', Paul Einzig among contemporary observers and, later, Frank Child
50. Ritschl, Albrecht: Nazi Economic Imperialism and the Exploitation of the Small: Evidence from Germany's Secret Foreign Exchange Balances, 1938–1940, in *Economic History Review*, vol. LIV, n 2, 2001, pp 332–333
51. James, Harold: Post-war Germany Currency Plans, pp 214–216
52. See the above mentioned letter of D'Agostino to Ciano, following his meeting with Funk on 11 July 1940
53. Roger Makins, of the Foreign Office, to Edward Playfair, UK Treasury, 20 October 1940, BoE, G1/415
54. Einzig, *Hitler's 'New Order' in Europe*, p 100

Postscript

1. Plender, John: The Weakest will Win in the Euro Battle, in *Financial Times,* 6 September 2012
2. Goodhart, Charles, and Tsomocos, Dimitrios: *International Monetary Regimes*, paper presented at the conference organized by the Bank of Italy 'Money and Monetary Institutions after the Crisis', in memory of Curzio Giannini, Rome, 10 December 2013, unpublished
3. Hawtrey, *The Gold Standard in Theory and Practice,* p 15
4. For instance, in 1914 the gold content of the Italian lira was 290.3 milligrams of gold; after a long period of suspension from the gold standard and fluctuations of the lira on the foreign exchange market, in 1927 the lira returned to gold with a gold content of 79.19 milligrams, which meant a devaluation in terms of gold of 72 per cent
5. See the above mentioned paper
6. Neuman, Manfred: Monetary Stability: Threat and Proven Response, in Deutsche Bundesbank (ed.): *Fifty Years of the Deutsche Mark. Central Bank and the Currency in Germany Since 1948*, Oxford University Press, 1999, pp 299–300
7. Scope of monetary policy, in www.ecb.europe.eu

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ACS Archivio centrale dello Stato, Roma
ASBI Archivio storico della Banca d'Italia, Roma
ASMAE Archivio storico del Ministero degli affari Esteri, Roma
BAB Bundesarchiv, Berlin (Lichterfelde)
BoE Archive of the Bank of England, London
PA AA Politisches Archiv, Auswärtiges Amt, Berlin
PRO Public Record Office, Kew (London)
Staatsarchiv Nürnberg

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Index