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Who Adjusts?

DOMESTIC SOURCES OF FOREIGN ECONOMIC POLICY DURING THE INTERWAR YEARS

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Chapter 1

INTRODUCTION

WHY WAS international economic conflict so prevalent in the years between the First and Second World Wars? The twenties and thirties have come to be known as a period of rampant economic nationalism, monetary instability, commercial collapse, and "beggar-thy-neighbor" foreign economic policies that shook the fragile international economy. Protectionist policies improverished trading partners, reduced the global welfare, and arguably made the Great Depression even worse than it otherwise might have been. Unilateral devaluation disrupted trade and injected uncertainty into international economic relations. The living standards of millions were at stake in the choice of foreign economic policies; indeed, economic conflict was a prelude to military conflict on a scale unprecedented in modern history. What we need to understand, then, is why individual states chose either to break or to abide by the prevailing norms of internationally accepted economic policy: why some states maintained gold standard requirements of currency stability and relatively liberal trade, while others chose to adjust to balance of payments deficits by devaluing and erecting barriers to trade—in effect, pushing the costs of adjustment onto their trade partners.

Many scholars of international relations have argued that the nature of the international system contributed to economic conflict. The war had been an inconclusive test for hegemonic power in Europe, and brought only a tense transitional period in which states openly prepared to settle accounts. No single economic power had both the willingness and the ability to support a liberal international economic system. The system of alliances was weak and multipolar, arguably lessening states' incentives to "invest" in cooperation. International organizations were thought to be mere fig leaves for the pursuit of raw state interests. Realism, with its mercantilist economic corollary, is nowhere more widely accepted than it is in interpreting the "twenty years' crisis" that reigned between the two world wars of this century.

The interwar years pose something of an anomoly for some of the most powerful explanations of state behavior that have been advanced in the international political economy literature. The spectacle of the most powerful state in the international system refusing to exercise leadership to ensure economic openness poses a puzzle for theories of hegemonic stability. The *variations* in policies over the two decades and from country to country cannot be easily attributed to the uncertainty engendered by systemic multipolarity. Episodic economic cooperation despite the presence of obvious suboptimalities arising in markets for capital, currency, and goods presents problems for functional

theories that focus on the gains to be derived from international cooperation. What these explanations lack is a systematic consideration of the domestic incentives and constraints that states faced in framing their external economic policies during the interwar years.

This study argues that an important part of the explanation for international economic outcomes during the interwar years arose from the internal politics and institutions prevalent within many countries after the Great War. In the face of balance of payments deficits, governments could choose to adjust *internally* by reducing prices and demand, or adjust *externally* with "beggar-thy-neighbor" policies that pushed the problem of adjustment onto a country's trade partners. Is there a political explanation for the choice of adjustment strategy? To answer this question I draw on theoretical work that has developed the logic of strategic behavior—the temptation to dump currencies that are likely to be devalued, the logic of competitive devaluation, the individual rationality of tariff retaliation—but go beyond these by testing for the political conditions associated with the decision to defect from the gold standard and liberal trade. A profile emerges of the domestic political characteristics associated with benign, norm-abiding adjustment during the interwar years: stable governments and quiescent labor movements contributed to international economic cooperation, while domestic political and social instability undermined it. Conservative polities with independent monetary institutions tended to maintain currency stability, but threw up protective barriers to trade, while left-wing governments and governments that could influence their central banks tended to reduce trade protection but sacrificed the gold value of their currency. In short, there is a clear relationship between states' willingness to play by the international economic "rules of the game" and patterns of domestic politics. While this study does not supplant systemic theorizing, it does have crucial implications for the international outcomes with which international relations scholars have been concerned: international economic cooperation and conflict, and the role and durability of international rules or norms.

The Problem: Explaining International Economic Relations during the Interwar Years

Key to understanding economic conflict and cooperation during the interwar years is to understand states' willingness and ability to play by the international economic "rules of the game" on which the gold standard was based. As will become clear in the following chapter, the gold standard had three basic requirements. First, states had to make their balance of payments a higher priority than the condition of their domestic economy. Second, states had to maintain reasonably open trade relations in order that gold standard adjustment could take place. And third, exceptional finance had to be provided by either the central banks or private banking consortia from surplus countries in some cases if fixed rates were to be maintained.

Systemic theorizing alone has been insufficient for interpreting the patterns of national gold standard compliance during the interwar years, and the reason has to do with the indeterminacy of systemic constraints on governments' economic policy choices. Based on systemic conditions (relative size, relative economic productivity, relative degree of trade dependence, for example), scholars have deduced (or sometimes imputed) a set of state preferences that are hypothesized to shape their international economic policy choices and hence systemic economic stability. The classic statement is Charles Kindleberger's interpretation of the collapse of the international economic system during the 1930s as a breakdown in international leadership.[1] He viewed systemic stability and open, liberal economic relations as "public goods" that are best provided by the dominant economic power in the system. He argued that international economic stability could best be provided by one power willing to provide countercyclical international lending and to keep its markets open despite recession, to maintain a stable value for its currency and encourage other states to do the same, to ensure the coordination of macroeconomic policies, which in the context of the gold standard meant to refrain from the sterilization of gold inflows, and finally to act as lender of last resort when other countries were experiencing balance of payments deficits or currency crises.

International relations theorists have tried to test Kindleberger's suggestive insights by exploring the extent to which economic stability and openness are actually associated with a hegemonic system.[2] In some versions, the theory is used to predict more cooperative policies from the hegemon itself.[3] In the last several years, however, several basic flaws have been exposed in the logic that would predict an association of hegemonic structure or position and more cooperative foreign economic policies or stable international outcomes.[4] Fur-

[1] Charles P. Kindleberger, *The World in Depression*, 1929–1939 (Berkeley: University of California Press), 1986.

[2] With respect to international trade, see Stephen Krasner, "State Power and the Structure of International Trade," *World Politics*, Vol. 28, 1976, 317–347; and David Lake, *Power, Protectionism, and Free Trade: International Sources of U.S. Commercial Strategy, 1887–1939*, (Ithaca: Cornell University Press), 1988. The importance of hegemonic dominance has been especially central in the discussion of shifts in international monetary regimes. Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston: Little, Brown), 1977; Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press), 1984.

[3] It is also considered but discounted by two of the most important international political economy studies of the collapse of the Bretton Woods system. See Joanne Gowa, *Closing the Gold Window* (Ithaca: Cornell University Press), 1983; and John Odell, *U.S. International Monetary Policy: Markets, Power, and Ideas as Sources of Change* (Princeton: Princeton University Press), 1982.

[4] Duncan Snidal, for instance, has pointed out that cooperation among a small group of powers is possible; see "The Limits of Hegemonic Stability Theory," *International Organization*, Vol. 39, No. 4, Autumn 1985, pp. 579–614. Conybeare has pointed out that hegemonic powers are more likely to abuse their market size to implement optimal tariffs than to maintain openness; see, John A. C. Conybeare, *Trade Wars: The Theory and Practice of International Commercial Rivalry*; and

thermore, the entire approach is based on the *supposition* that the strongest incentives facing states in the system are indeed external and can be deduced from systemic variables. But it is important to recall that Kindleberger himself was not *puzzled* by the United States' unwillingness to open its markets, maintain a stable currency, and maintain countercyclical capital flows during the Depression. He understood the domestic political incentives facing American policymakers (and deplored these actions nonetheless).[5] The point is quite general: without some information about the preferences of the dominant economic power and the other states in the system, the logic of systemic hegemonic theory is less than compelling.[6]

The same point can be made in the application of game theory to external economic policy choice and international economic outcomes. Game theory provides a framework for understanding states' choices under given assumptions regarding the number of actors, their preference structures, and how much value they place on future interactions. These factors define the strategic setting, and game matrices are usually devised to depict a dichotomous policy choice often generically labeled "cooperate" or "defect." Some very powerful findings have emerged from applications of game theory to international political economy, though the bulk of the work has employed various forms of the Prisoner's Dilemma. The key parameters influencing states' behavior in this context are the probability of future interactions, the length of actors' time horizons, and the number of players involved. Iteration, long time horizons, and small numbers make cooperative outcomes more likely.[7]

The logic is unassailable, as long we make the correct assumptions about the nature of the game, which in turn rests on correctly identifying states' preferences. A Prisoner's Dilemma in international trade means that the participants are conditional free traders: in repeated play they will cooperate only if they believe their trade partners will as well. Once again, this is an empirical issue. Does each state have the same incentives to engage in free trade? What influences the relative value they put on free trade versus protection? The key variable may be systemic or structural (the degree of dependence of a state's economy on international trade), or it may be domestic or institutional (the nature and organization of domestic interest groups). But game theory itself does not assign logical priority to any specific level of analysis in determining state preferences. For the analysis to have any sort of an empirical basis (as opposed to a purely theoretical consideration of the properties of a given game), the researcher must develop a model of state preferences, the determinants of which may be domestic or external.

James Alt et al. have shown that when the costs of enforcement and reputation are considered, the outcome of a hegemonic system need not be stable; see "Reputation and Hegemonic Stability: A Game-Theoretic Analysis," *American Political Science Review*, Vol. 82, June 1988, pp. 445–466.

[5] For example, see Charles P. Kindleberger, *The World in Depression*, pp. 192–196.

[6] A similar point can be made regarding other systemic arguments for states' foreign economic policy choices. Recently, for example, Joanne Gowa has argued that a bipolar international political system is better than a multipolar one in providing for free trade. However, the relationship between bipolar systems and free trade appears to be subject to the domestic political and economic organization of the major alliance partners (contrast the interwar German-led authoritaritan alliance and the Cold War Soviet bloc with the liberal postwar trade principles of Western Europe and the United States). This is not to deny that system characteristics do have an independent effect on the propensity to select free trade policies, but the propensity is likely to be much greater for alliances composed of polities for whom free trade is consistent with their domestic political and economic organization.

[7] Kenneth Oye, Robert Keohane, and Robert Axelrod, *Cooperation Under Anarchy*, special issue of *World Politics*, Vol. 38, No. 1, October 1985.

In contrast to trade policy, international monetary cooperation raises the further problem of what it means to "cooperate," and who the relevant "players" are. This is because currency values are determined not only by governments (their macroeconomic policies, central bank intervention), but by markets as well (their decision to hold the currency or sell it). Few political scientists have offered formal game-theoretical analyses of international macroeconomic policy coordination,[8] but it is inconceivable that macroeconomic preferences—an essential determinant of exchange rates—could be understood without reference to domestic political conditions. On the other hand, the strategic problems underlying the relations between governments and holders of their currency is somewhat better understood.[9] Fixed exchange rate regimes approximate an *N*-person Prisoner's Dilemma among an issuer and holders of a currency. The "dilemma" only grows acute, however, when the *credibility* of the issuer of the currency is in question. What remains unanalyzed in this model are the factors that influence each player's perception of a high risk of defection by the opposing player(s). In other words, what conditions cause markets to suspect that issuers will be tempted to inflate their currency and to devalue?

To answer this question, it is necessary to draw from the scholarship in both international political economy and comparative political economy[10]—two literatures that until recently have remained somewhat distinct despite their common concern of explaining governments' economic policy choices.[11] While the international political economy literature concentrates on external

[8] Economists have done so. See Koichi Hamada, *The Political Economy of International Monetary Interdependence* (Cambridge: MIT Press), 1985. Political scientists representations have often been informal. See Robert D. Putnam and Nicholas Bayne, *Hanging Together: The Seven Power Summits* (Cambridge: Harvard University Press), 1984, which discusses the events leading up to the Bonn macroeconomic agreement in terms that easily suggest a game of chicken between the United States and Germany.

[9] See Kenneth Oye, "The Sterling-Dollar-Franc Triangle: Monetary Diplomacy, 1929–1937," *World Politics*, Vol. 38, No. 1, October 1985, pp. 173–199.

[10] I use this term broadly to include work done by political scientists who have tried to explain economic policy choice/outcomes, as well as economists (fewer in number) who have incorporated political variables—for example, political and social stability, political polarization, electoral and party systems, and domestic monetary institutions—into their analysis.

[11] The reasons for the relative independence of the development of the comparative and the international political economy literature are related to the issue—much debated in international

constraints and opportunities (including retaliation/punishment, greatly expanded joint welfare gains, and the role of international institutions), the comparative political economy subfield provides domestic political and institutional arguments as to why governments might have different preferences over such economic outcomes as rates of economic growth, inflation, and unemployment, and the policy levers they pull to attempt to influence these. Both literatures provide plausible hypotheses regarding a government's ability to make credible commitments to exchange rate stability. A nontendentious approach would examine whatever set of variables from any level of analysis that would speak most clearly to the problem of a credible, noninflationary macroeconomic policy commitment.

Political economists working from a comparative perspective in the 1960s began to address this problem by looking at the influence of class-based political organizations on economic policy preferences. E. S. Kirschen and others discovered systematic differences between parties of the Left and the Right in their macroeconomic objectives: socialist political groupings' dominant policy objective was full employment and improvements in income distribution, center groupings placed price stability above full employment (though both were ranked as significant), and conservatives unambiguously placed price stability at the top of their list of economic objectives.[12] This pioneering study of attitudes spawned a research program, which attempted to quantify the effects

relations theory—of the appropriate level of analysis. Among international relations scholars there is a presumption that the unique contribution of the subfield should be to shed light on how the *systemic* setting in which states operate influences their behavior. Accordingly, systemic theorizing is often viewed as the raison d'être of international relations theory. Kenneth Waltz's exhortation to international relations theorists to avoid reductionism (subunit analysis) reflects such a position. Kenneth Waltz, *Theory of International Politics* (New York: Random House), 1979. International relations scholars also emphasize parsimony: the ability to make significant inferences about state behavior on the basis of limited information. Explanations emanating from a higher level of aggregation, such as the system level, are viewed as an appropriate first cut, and for some theorists are the only acceptable resolution to the trade-off between elegance and accurate prediction. Systemic explanations are viewed as more parsimonious than those from other levels of analysis, hence "We should seek parsimony first, then add complexity while monitoring the adverse effects that this has on the predictive power of our theory," and "initial explanations should seek to account for the main features of behavior at a high level of aggregation—such as the international system as a whole—while subsequent hypotheses are designed to apply only to certain issue areas [or countries]." Robert O. Keohane, "Theory of World Politics: Structural Realism and Beyond," chap. 7 in Keohane (ed.), *Neorealism and Its Critics* (New York: Columbia University Press), 1986, p. 188 and passim. Finally, international relations theorists point to the potential for domestic theories of international political economy to encounter the fallacy of composition. Economic conflict may arise from barriers to communication, information, intractible numbers of players, or the difficulty states have making a credible advance commitment to cooperate, rather than specific attributes of the states themselves. Rational-choice explanations of policy choice and international regime development exemply this approach.

[12] E. S. Kirschen et al., *Economic Policy in Our Time, Vol. 1: General Theory* (Amsterdam: North Holland), 1964. See Kirschen's informative preference chart on p. 227.

of party in power on actual macroeconomic outcomes. Douglas Hibbs's analysis of macroeconomic outcomes confirmed Kirschen's preference mapping: both time-series and cross-sectional data seem to suggest that in periods and nations governed by the Left, generally higher levels of employment and inflation prevailed than was the case under center or right-wing governments.[13] The theory that left-wing and right-wing parties prefer and pursue distinct macroeconomic policies has recently been amended to take into consideration the organization of the labor market and the emergence of neocorporatist structures.[14] But it has also been attacked as irrelevant when international economic interdependence is high and integrated goods and financial markets force a convergence in the macroeconomic policies of competing trade partners.[15]

This last observation has led some scholars to downplay social class explanations in favor of theories that look at the degree of social conflict and political instability themselves. Early sociological interpretations of inflation suggested that it might be a short-term way of containing political conflict among groups and sectors.[16] More recently, theories on the relationship between political

[13] Douglas A. Hibbs, "Political Parties and Macroeconomic Policy," *American Political Science Review*, Vol. 71, No. 4, December 1977, pp. 1467–1487. For a critical review of Hibbs's findings, arguing that they exaggerate the differences between the parties, see Nathaniel Beck, "Parties, Administrations, and American Macroeconomic Outcomes," *American Political Science Review*, Vol. 76, No. 1, March 1982, pp. 83–93. For other empirical tests of the impact of parties on economic policy outcomes, see Paul F. Whiteley, "The Political Economy of Economic Growth," *European Journal of Political Research*, Vol. 11, No. 2, June 1983, pp. 197–213; and Peter Lange and Geoffrey Garrett, "The Politics of Growth: Strategic Interaction and Economic Performance in the Advanced Industrialized Countries," *Journal of Politics*, Vol. 47, No. 3, August 1985, pp. 792–827. For further discussion, see Walter F. Abbott and J. W. Leasure, "Income Level and Inflation in the United States," in Nathan Schmukler and Edward Markus (eds.), *Inflation Through the Ages: Economic, Social, Psychological and Historical Aspects* (New York: Brooklyn College Press), 1983, pp. 804–819. For a sophisticated account that includes union structure and party preferences, see Fritz W. Scharpf, "A Game-theoretical Interpretation of Inflation and Unemployment in Western Europe," *Journal of Public Policy*, Vol. 7, No. 3, pp. 227–257. Other important works on representation of class interests include Andrew Martin, "The Politics of Economic Policy in the United States: A Tentative View from a Comparative Historical Perspective," *Sage Professional Papers in Comparative Politics*, No. 01-040 (Beverly Hills, Calif.: Sage), 1973; Edward Tufte, *Political Control of the Economy* (Princeton: Princeton University Press), 1978.

[14] Philippe C. Schmitter, "Interest Mediation and Regime Governability in Contemporary Western Europe and North America," in Suzanne Berger (ed.), *Organizing Interests in Western Europe and North America* (Cambridge: Cambridge University Press), 1981, pp. 285–327; Colin Crouch, "Conditions for Trade Union Wage Restraint," in Leon N. Lindberg and Charles S. Maier (eds.), *The Politics of Inflation and Economic Stagnation* (Washington, D.C.: Brookings Institution), 1985; Gary Marks, "Neocorporatism and Incomes Policy in Western Europe and North America," *Comparative Politics*, Vol. 18, No. 3, 1986, pp. 253–277.

[15] For a review and partial refutation of these arguments, see Geoffrey Garrett and Peter Lange, "Political Responses to Interdependence: What's 'Left' for the Left?" *International Organization*, Vol. 45, No. 4, Autumn 1991, pp. 539–564.

[16] See Colin Crouch, "Inflation and the Political Organization of Economic Interests," chap. 9 in Fred Hirsch and John H. Goldthorpe, *The Political Economy of Inflation* (Cambridge: Harvard University Press), 1978, pp. 217–239.

instability and inflation have developed two strands: one that emphasizes that weaker governments are *unable* to implement politically costly inflation controls, and another that postulates that weaker governments actually have a shorter time horizon than politically secure ones, and so *rationally choose* to postpone adjustments that would curb inflation.[17] Both hypotheses should have profound consequences for international economic cooperation. In either case, unstable governments can be expected to "defect" from international macroeconomic agreements that require a stable exchange rate, maintenance of balance of payments equilibrium, and debt repayment. One can expect the cooperative outcome of the iterated Prisoner's Dilemma to unravel when a player is domestically unstable, since markets know that unstable governments heavily discount the prospects of future cooperation.

Finally, recent work in the political economy of domestic institutions suggests that the credibility of a state's monetary commitments may depend on the independence of its monetary institutions.[18] Politically independent central banks can carry out a policy of monetary stability, even if to do so would be temporarily politically painful. Lower inflation rates have been found to be associated with more independent banks, although the "optimal" degree of credibility is still debated in the literature.[19] If these models are correct, then central bank independence should not only be interesting from a comparative political economy perspective, but it should also have a direct bearing on the stability of a fixed exchange rate regime—an outcome of central interest to scholars of international political economy.

Scholars concerned with foreign economic policy choice or international economic relations can readily incorporate these testable hypotheses in a way that would be logically consistent with well-developed systemic and strategic paradigms. If it is true that left-wing governments have preference orderings that differ in predictable ways from governments of the Right (or if markets act on the assumption that they do), then these preferences should be reflected in the structure of the game and affect the stability of cooperative outcomes. If a government is politically unstable, this is relevant to the value it will put on present costs versus future benefits of any given policy choice, as well as the value it places on future international interactions (i.e., relatively little). If an international monetary commitment is made by a government whose monetary policies are conducted by an independent central bank, then there would be less reason to expect defection through inflation, severe balance of payments crisis, or devaluation. To artificially segregate international and domestic influences

[17] For a discussion and empirical test, see Sule Ozler and Guido Tabellini, "External Debt and Political Instability," NBER Working Paper No. 3772, July 1991.

[18] Kenneth Rogoff, "The Optimal Degree of Commitment to an Intermediate Monetary Target," *Quarterly Journal of Economics*, Vol. 100, 1985, pp. 1169–1189.

[19] Susanne Lohmann, "Optimal Commitment in Monetary Policy: Credibility versus Flexibility," *American Economic Review*, Vol. 82, No. 1, March 1992, p. 273.

could in fact lead to a misunderstanding of international economic relations. Domestic determinants of preference orderings, time horizons, and credibility should be integrated into an explanation as to why certain states found it difficult to abide by the rules of the gold standard as practiced during the interwar years.

The Argument of This Book

Under what conditions, then, did economic policymakers choose to abide by the rules of the gold standard, and under what conditions did they tend to break the rules? In answering these questions, it is important to keep in mind that governments may be motivated for political reasons to stimulate (or avoid deflating) their domestic economy, and, more importantly, they may be *perceived* by rational forward-looking markets (anyone holding their currency, or any factor of production operating within the economy) as variably subject to such temptation. These governments' problem is that there is no foolproof way to assure markets that they will resist the temptation to try and engineer stimulation or resist the temptation to go back on a commitment to deflate. Rational forward-looking markets search for evidence of a government's commitment. They react negatively to evidence that a government might renege on its commitment to deflate (or to avoid inflation): evidence of political instability, labor unrest, demands of left-wing constituencies. On the other hand, the commitment of a government constrained by an independent monetary authority is more believable to market agents than that of a government which can simply run the printing press. Both quantitative evidence and qualitative evidence for the interwar years suggest that, where governments could not make credible commitments to avoid inflation, the result was capital flight, inflation, and incipient deficit in the current account. The implications for an international monetary regime based on gold were clear: where commitments to avoid inflation and maintain external balance were unbelievable, pressure for devaluation and protection mounted.

Both external and domestic constraints and incentives shaped states' choice of adjustment strategy. Externally, a high degree of economic openness placed limits on the benefits of tariff protection and raised the risk of foreign retaliation, putting a premium on adjustment through the exchange rate. The dominant traders, on the other hand, could exploit their monopoly position to stem balance of payments deficits through protection. Even when these external conditions are controlled, however, the decision of how to cope with deficits is constrained by domestic political factors. Since devaluation cut into the value of investment and creditors' savings, it was avoided by center-right governments and strong independent central banking institutions. On the other hand, trade protection imposed serious costs on the abundant factor of production, labor. The preference of the conservatives was to protect and defend the cur-

rency; that of the Left was to devalue and liberalize trade. Some governments were so weak and unstable, however, that they took virtually no internal adjustment measures; they chose the path of least resistance and protected domestic producers while allowing the currency to depreciate. Ultimately, the gold standard depended on the ability and willingness of policymakers—who faced both external and domestic constraints—to adhere to a stringent set of austerity norms that could be costly in the short term.[20]

Before proceeding further, I should be explicit about what this study does *not* try to do. First, it is not a defense of the gold standard. The argument is *not* that the norms of the gold standard were "good" in any global welfare maximizing sense. Few economists would be likely to argue that widespread protection was anything but welfare reducing, but the case is far from clear for fixed exchange rates.[21] Recent research in economic history has thrown into question the assumption that was widely held by policymakers for most of these two decades: that economic stability depended on monetary stability, and that monetary stability could only be maintained by tying the national currency to gold.[22] However, following contemporary policymakers, I view the gold standard as a

[20] Note that my arguments about externalization are essentially for the short to medium run. No country can adjust to external economic imbalance indefinitely through pure externalization, since protection and devaluation do pose domestic economic costs over time.

[21] See Barry Eichengreen, "A Dynamic Model of Tariffs, Output, and Employment under Flexible Exchange Rates," *Journal of International Economics*, Vol. 11, 1981, pp. 341–359. The welfare-decreasing effects of protectionism are among the few points on which economists are virtually in unanimous agreement. Bruno Frey et al., "Consensus and Dissensus Among Economists: An Empirical Study," *American Economic Review*, Vol. 74, pp. 986–994. For the argument that tariffs worsened the spread of the Depression, see Allen Meltzer, "Monetary and Other Explanations for the Start of the Great Depression," *Journal of Monetary Economics*, Vol. 2, 1976, pp. 455–472; Christian Saint-Etienne, *The Great Depression, 1929–1938: Lessons for the 1980s* (Stanford: Stanford University Press), 1984. I am grateful to Barry Eichengreen for pointing out to me that while devaluation in the thirties may have stimulated the economy of the devaluing country, it tended to have negative transmission effects when taken unilaterally and without a concomitant expansion in the devaluing country's money supply. See also Ehsan U. Choudhri and Levis A. Kockin, "The Exchange Rate and the International Transmission of Business Cycle Disturbances: Some Evidence from the Great Depression," *Journal of Money, Credit, and Banking*, November 1980, pt. 1, pp. 565–574; Barry Eichengreen and Jeffrey Sachs, "Exchange Rates and Economic Recovery in the 1930s," *Journal of Economic History*, Vol. 95, No. 4, December 1985, pp. 925–946; Wallace E. Huffman and James R. Lothian, "The Gold Standard and the Transmission of Business Cycles, 1833–1932," in Michael D. Bordo and Anna J. Schwartz (eds.), *A Retrospective on the Classical Gold Standard* (Chicago: University of Chicago Press), 1984, pp. 455–511.

[22] Barry Eichengreen's recent study carefully and persuasively documents the extent to which adherence to fixed exchange rates actually encouraged the Depression to spread and to deepen. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York and Oxford: Oxford University Press), 1992. Nonetheless, contemporary policymakers clearly viewed the gold standard as the norm for appropriate economic policy choice. Kenneth Mouré's recent history of the franc Poincaré illustrates the excruciating economic distress governments sometimes put their economies through in order to maintain their currency's gold parity. Mouré, *Managing the Franc Poincaré* (Cambridge: Cambridge University Press), 1991.

normative bench mark for appropriate foreign economic policy, and go on to explain the conditions associated with the decision to devalue and to protect. The global welfare implications of the gold standard are a crucial concern of economic history, but do not directly bear on the issue of abiding by the rules that is the focal point of this study.

Second, it is not possible to treat every conceivable policy option designed to address external economic imbalance. Quantitative import restrictions and currency and capital controls are mentioned only in passing, yet they were clearly used to externalize the costs of adjustment by a number of states.[23] Attention is drawn to these alternatives in interpreting the quantitative results and in discussing the cases. The focus here is on devaluation and tariff protection, the two most pervasive means of resisting internal adjustment during the interwar years.

Third, this study does not pretend to supplant systemic international relations theory, but rather to supplement it. Because the study deals with the twenties and thirties, it cannot test for the relative impact of such systemic variables as multipolarity, bipolarity, or hegemony. There is simply not enough variation in the system as a whole during our seventeen-year period to rule these variables in or out. Effectively, the essential nature of the system is held constant. Still, it is possible to test some structural arguments: we can assess the extent to which the policy choices of larger powers, highly trade dependent countries, and net external creditors, for instance, were different from their opposites. But this should not be construed as an effort to supplant broader systemic theorizing.

Toward an Explanation of the Policy Mix: Methodology and Organization

Two methodologies are used here to make the case for domestic sources of foreign economic policy choice: comparative cases and quantitative analysis. A dualist methodological approach has tremendous advantages in unraveling a problem as complex as the political influences on the adjustment policy mix.[24]

[23] There is a sophisticated subset of the endogenous tariff literature that is concerned with modeling the choice between tariffs, quotas, and other tax-cum-subsidy options. See Ronald Findlay and Stanislaw Wellisz, "Endogenous Tariffs, the Political Economy of Trade Restrictions, and Welfare," in Jagdish Bhagwati (ed.), *Import Competition and Response* (Chicago: University of Chicago Press/NBER), 1982; Kent Jones, "The Political Economy of Voluntary Export Restraint Agreements," *Kyklos*, Vol. 37, 1984, pp. 82–101; Wolfgang Mayer and Raymond Riezman, "Endogenous Choice of Trade Policy Instruments," *Journal of International Economics*, Vol. 23, 1987, pp. 377–381.

[24] The prevalent "either-or" debate between methodological schools has been counterproductive, and does not need to be reviewed here. For a good recent review of the strengths of each, see Charles C. Ragin, *The Comparative Method: Moving Beyond Qualitative and Quantitative Strategies* (Berkeley: University of California Press), 1987. For an argument that cases cannot on their own either generate or test theory, see Christopher H. Achen and Duncan Snidal, "Rational

First, descriptive statistics provide some sense of where a particular case fits into a broader distribution of cases. If an argument is to be made that Belgium's trade dependence contributed to its liberal trade policy, it is useful to know just how trade dependent and how liberal Belgium was compared to other states. Secondly, the statistical analysis complements the case studies by parceling out the relative influences of several variables, which is impossible to do convincingly using a small number of cases. The cases, on the other hand, reveal far more about the political *processes* that link the explanatory variables with the dependent variables. Overall, combining methodologies provides a parallax on the problem that is difficult to achieve with a single approach. To choose one method to the exclusion of the other is like closing one eye and trying to make judgments about distance: it is easy to lose perspective. The most convincing conclusions will ultimately be those on which the regressions agree with the archives.

As a first cut, a macroscopic, quantitative, time-series cross-sectional analysis is used that covers from twelve to twenty-one countries for most of the interwar years.[25] The criteria for choosing the countries were that they were part of the European-American economic system during the interwar years, that they were independent countries (colonies and dominions were excluded), and that sufficient data could be found to justify their inclusion into a quantitative analysis. The unit of analysis is a "country-year," and the number of observations could reach a theoretical 357, were it not for the problem of missing data and the inclusion of lagged or moving-averaged variables. For most of the regressions presented, the number of observations ranges between 140 and 300, depending on the included explanatory variables.

The countries that were eventually included in this analysis could fairly be described as constituting the European-American core of the interwar economic system.[26] Thus, conclusions cannot be legitimately drawn about the politics of balance of payments adjustment and the correlates of the policy mix for countries in the non-European periphery.[27] While this is one limitation of

Deterrence Theory and Comparative Case Studies," *World Politics*, Vol. 41, No. 2, January 1989, pp. 143–169.

[25] I originally intended to include twenty-three countries, but as will be seen in the following chapters, Romania and Yugoslavia are almost always excluded from the multivariate analysis due to missing data. The number of countries varies because of case attrition, which in turn depends on which variables are included. Each presentation of the results indicates the identity of the included countries.

[26] With the exception of Japan, which is included because of its economic connections with this core group (the United States was its major trading partner for much of the period).

[27] I have intentionally omitted what many economists have called the (non-European) "periphery"—the semideveloped countries of Latin America, Africa, Asia, and Australasia. There are good methodological and practical reasons for doing so. Economic historians have documented quite well the particular vulnerability of the peripheral regions to the upheavals of the late 1920s and

the study, it may not be overly serious, since there is still a high degree of variation among the included countries with respect to degree of development, industrialization, wealth, and regime type, so that the results may have an acceptable degree of generality. The most stringent efforts were made to avoid selecting these cases on the basis of balance of payments pressures or the policy mix selected to address these pressures. Hence, the United States' balance of payments position was as favorable for the period as a whole as Austria's was dismal. The Dutch florin was as stable as the Greek drachma was mercurial. Belgium's customs averaged less than 6 percent of the total value of its imports for the period as a whole, while the comparable figure for Bulgaria was more than 22 percent. In short, despite the fact that the study is limited to the European-American core, the cases chosen do not artificially truncate the policy choices I am trying to explain. They are delimited only by geography and data availability.[28]

The core theoretical claim is fleshed out in Chapter 3, and a quantitative political/economic model for capital flight and current account deficit follows. This marriage of disciplines raises the question of precisely which variables should be included in a "political/economic" model of external economic imbalance. In the interest of parsimony, my rule has been to include only those economic variables that are reasonably widely accepted as influencing the outcome in question, and *only* those economic variables that the government or monetary authority does not directly control. This means that policy variables—the money supply, bank rate, and fiscal budget—are excluded from the equation. If policy variables were to be controlled, we really would not have an explanation for the relationship between the political variable and the observed outcome.[29] In practical terms, the difficulty is one of multicollinearity: the

1930s. See C. A. Diaz-Alejandro, "Stories of the 1930s for the 1980s," in P. Aspe Armella, R. Dornbusch, and M. Obstfeld (eds.), *Financial Policies and the World Capital Market: The Problem of Latin American Countries* (Chicago: University of Chicago Press), 1983; Barry Eichengreen and Richard Portes, "Debt and Default in the 1930s: Causes and Consequences," *European Economic Review*, Vol. 30, June 1986, pp. 599–640.; H. Fleisig, "The United States and Non-European Periphery During the Early Years of the Great Depression," in H. Van der Wee (ed.), *The Great Depression Revisited: Essays on the Economics of the Thirties*, 1972.

[28] It is possible that the problem of missing data introduces some bias into the analysis. It is frequently the less developed countries within the European core that also happen to be missing data. Thus, it was difficult to find statistics on Bulgaria, Greece, Poland, Romania, Spain, and Yugoslavia—countries whose lesser developed status may be correlated with distinctive patterns on the dependent variables. But data were also missing for Belgium, Canada, and Switzerland in a number of instances, so that it is not obvious that the loss of data introduces serious selection bias.

[29] As an illustration, if we are interested in testing for the impact of the central bank on the current account, it makes little theoretical sense to include the money supply and the bank rate in the equation. My hypothesis assumes distinctive policy patterns among politically independent central banks; the interpretation of the institutional coefficient is questionable if both of its major policy levers are controlled in the equation.

inclusion of both the political variable and the policy instrument washes out the effects of both. The solution has been to control for economic variables, including external shocks, that are largely beyond the control of governments or monetary authorities.

The development of a political/economic model for capital flows, current account deficit, currency depreciation, and tariff policies also raises the contentious issue of the direction of causation. At the risk of oversimplification of their position, economists are often skeptical of claims that political variables have an "independent" effect on economic outcomes. Often they prefer to conceptualize the political variables as endogenous to economic forces, or as epiphenomena of economics, that contribute relatively little to a causal understanding of economic outcomes. To bolster the causal argument, here the political variables are made to compete with lagged economic variables, and successive versions of the model are tested for stability and explanatory power. Where political variables can compete effectively with lagged economic variables in a multivariate regression and where political variables are only weakly correlated with prior economic conditions, a convincing case can be made that politics have an important independent causal effect on economic outcomes. It is an exceedingly demanding test for politics, but the data stand up to the skeptics rather courageously.

The second methodology employed is the comparative case method. Two chapters review selected cases in detail in order to confirm the plausibility of the quantitative analysis. The cases were chosen, first, because they represented deterioriating external economic imbalance, and second, because they contained variations on the explanatory variables that were found to be significant in the quantitative analysis.[30] Hence, the stabilization of the French franc (1923–1926) provides interesting variations over time in three of the variables that were significant to an explanation of capital flight and changes in the currency value. In those few years, France was ruled by a center-right government, a left-wing coalition, and finally by a broad-based (but conservative) coalition of National Union. France experienced a few years of relatively stable government, followed by constant cabinet collapse, and finally again relative stability under the regime of Raymond Poincaré. Finally, while formally independent, the central bank went from extremely weak leadership under Georges Robineau to a strong and assertive posture under Emile Moreau. France during

[30] All of the cases selected for intensive comparison involve countries with pluralist democratic regimes. This has some advantages and some shortcomings: On the one hand, "regime type" is held constant, so that inferences can better be made on the impact of other variables. On the other hand, any observations regarding the impact of other variables, such as instability, party in power, organization of the labor and capital market—must be understood as being contingent on the presence of pluralist democracy. No firm conclusions can be drawn about the way in which other variables may interact with regime type to produce different results. The results of the case comparisons are limited to pluralist democracies.

the 1920s is nearly the ideal case to study three variables that were subjected to systematic testing in Chapters 3 and 4.

Case studies are also employed to compare how states handled balance of payments deficits under the depressionary conditions of the thirties. In Chapter 7, Britain, Belgium, and France are compared.[31] The rationale for selecting these cases, again, is that they represent instances of deteriorating external position and that they provide variance on the explanatory factors revealed to be of importance to the policy mix in previous chapters. Britain was the largest trader in the sample, while Belgium accounted for a much smaller share of world trade. Belgium was the most highly trade dependent country in our sample, while France possessed a highly diversified economy and was potentially self-sufficient. Labor unrest varied over time for each of these countries, with France sustaining the most serious degree of social unrest among the three. Similarly, France was highly politically unstable, while Britain and Belgium enjoyed fairly stable governments during these years. Finally, there is variation within each country over time in the political orientation of party in power. Britain went from a Labour government to a conservative "National" government, while Belgium went from conservative Catholic domination to a coalition that admitted Socialists. France is the extreme case of a swing from center-right government to a far left coalition of Socialists and Communists who cooperated to form the Front Populaire. This trio of cases provides sufficient leverage into the question of the determinants of the policy mix to flesh out the story suggested in the broader statistical analysis.

This study is designed to answer the question "Who adjusts?" in a cumulative fashion. Its design is cumulative on two levels. Within the quantitative chapters (3, 4, and 6), the progression is from a set of simple descriptive statistics of the dependent variable, to a partial regression analysis based on economic variables, and finally to a multiple regression that includes economic and political explanations, as well as some structural control variables. One reason for presenting results in this way is to use the available data to the best advantage. The greater the number of included variables, the higher the case attrition. Simpler presentations take in a larger number of cases. The second reason is that we can assess the impact of adding a political component to the basic economic model. We can look for evidence that the political explanations either increase the proportion of explained variation, reduce the variance of the included variables, or produce fitted variables that are superior to those generated by other models. For these reasons, each chapter is organized *internally* to build

[31] The typical troika for studying systemic breakdown and retaliation during this period consists of Britain, France, and the United States. It would have been inappropriate to select the United States because, while it devalued and threw up tariffs, it was never in a negative or seriously declining balance of payments position. If it is the policy mix we are interested in explaining, then the case cannot be chosen on the basis of this mix. To do so would introduce selection bias into the choice of cases.

toward an estimate of the impact of politics on the balance of payments and the policy mix.

Furthermore, the chapters are organized serially to build a cumulative picture of the policy mix. Chapter 3 concentrates on explaining why countries get into current account difficulties and experience capital flight in the first place. Chapter 4 explores the extent to which the same factors are associated with the decision to devalue or to allow the currency to depreciate. Chapter 5 pauses to check our findings against a historical case in point. The case of the stabilization of the French franc concentrates on the influences on the current account, capital flows, and currency depreciation that have been discussed up to this point. Chapter 6 extends the quantitative analysis to cover the decision to raise tariffs, and Chapter 7 presents three more cases that concentrate on the trade-offs involved in choosing to deflate, to devalue, and/or to protect. This method of inquiry allows us to move easily from economic to political explanations, from quantitative findings to case studies, and from single to multiple policy choices. It provides a reasonably thorough examination of the pressures and opportunities confronting states when they faced the decision of whether or not to abide by the gold standard norms.

Findings

The gold standard required national economic policymakers to place external balance above domestic economic balance, to stabilize and maintain the value of their currency, and to try and maintain a reasonably open market for international trade. Adherence to these norms was the ideal toward which most of the economic conferences and bilateral negotiations of the day were directed. Yet the ability and will to adhere to these norms were highly conditioned in some cases not only by structural features of a country's domestic economy and its relationship to the international economic system, but also by the domestic political constraints policymakers faced and the preferences they held based on their own political objectives.

Countries that were most likely to choose a cooperative policy mix were small, and had highly trade dependent economies. They were led by stable governments and were characterized by a quiescent labor force. When these characteristics prevailed, it was possible to sustain domestic economic policies that were consistent with external equilibrium. Large traders took advantage of their size to implement more restrictive trade policies. Countries that had the luxury of being insulated from the rest of the international economic system were the worst offenders of the gold standard norms: even in the absence of severe balance of payments pressures, they tended to protect and, to a lesser extent, to devalue, forcing the smaller and more trade dependent countries to adjust to these hostile moves.

Unstable governments were also disruptive to international economic relations. By every criteria, they were unwilling—or unable—to cooperate. They tended to overconsume,[32] ringing up larger and larger current account deficits. Political instability shook the confidence of capital, which fled in the face of political uncertainty. Largely as a result of both current account pressure and capital flight, governments with a brief life expectancy allowed their currencies to depreciate much more frequently than did those with a firm grip on political authority. There is even scant evidence, though it is not strong, that unstable governments were also associated with higher tariffs. Governments that were not likely to be in office for long were singularly unsuited to international economic cooperation. Any benefits such cooperation promised in the medium to long term were discounted in the face of the high present costs of internal adjustment.

Finally, there was a distinction in the policy mix favored by conservative polities and that favored by polities in which labor was better represented. The former tended to defend the currency, but raised tariffs. The latter tended to do the opposite. Hence, higher left-wing representation was associated with currency depreciation but also with the alleviation of tariff barriers (which were deemed a "tax on consumption"), while center-right parties defended the currency but protected. Moreover, where the central bank was most independent from government, the currency tended to be stronger, but there was also a slight tendency to restrict imports. The distinct interests of capital and labor are evident in the mix taken. It is difficult to imagine a *selective* implementation of international economic norms that could be more politically driven.

[32] Technically, the correct term here is "absorption," not consumption. In the Keynesian framework, consumption is only one component of total absorption, to which must be added government spending and investment.

Chapter 2

THE INTERWAR GOLD STANDARD

THE INTERWAR gold exchange standard never worked as smoothly as had the international monetary system before the First World War. A crucial reason was that the social and political landscape had changed so radically in so many countries from 1913 on that the commitment to the norms of international adjustment implicit in the gold standard simply were not credible under the conditions that tended to prevail in many countries at the close of the war. This chapter will first provide an introduction to the interwar gold standard, and point out how this system depended on a highly credible commitment on the part of its participants to deflate if necessary in order to defend their currency. It will also show that post–World War I conditions had changed from prewar conditions in ways that undermined the credibility of that commitment in many states. The second section outlines the norms of the interwar gold exchange regime. It first describes the adjustment mechanism, then outlines three implicit adjustment norms, and finally discusses the ways in which states might negotiate so that deficit adjustment might be facilitated by loans or credits from the major lending houses or central banks of surplus countries. The third section discusses theories that shed light on the selection of a policy mix and introduces the explanatory variables that are the empirical core of this study.

THE PREWAR AND INTERWAR GOLD STANDARDS

Expectations during the interwar years about how states experiencing balance of payments disequilibrium should adjust evolved from beliefs about how adjustment had taken place under the prewar "classical" gold standard. Compared to the international monetary chaos that followed, the nineteenth-century gold standard was a model of stability. Without doubt, exchange rates were far less stable in the interwar years than during the gold standard years of the late nineteenth century that preceded them.[1] The only substantial devaluations between 1880 and 1914 were those of Portugal, Argentina, Italy, Chile, Bulgaria, and Mexico. By contrast, almost every European country devalued its currency in the twenties and again, as did the United States, during the Depression.

Why the gold standard worked so well in the earlier period but was so fragile

[1] In his classic account of the prewar international gold standard, Arthur I. Bloomfield wrote, "Only a trifling number of countries were forced off the gold standard, once adopted, and devaluations of gold currencies were highly exceptional." *Monetary Policy Under the International Gold Standard: 1880–1914* (New York: Arno Press), 1978, p. 6

in the twenties and thirties was a puzzle to contemporaries and is still debated today. As a recent study by Barry Eichengreen notes,[2] its robustness did not depend on halcyon economic conditions: the prewar system had survived serious economic downturns in the mid 1890s and the early 1900s. Its stability did not depend on calm capital markets: before the war foreign lending had fluctuated significantly, and financial crises were commonplace. Its workability did not depend on the concentration of financial hegemony in one center: both Paris and Berlin were important financial centers in the nineteenth century, and it is not obvious that the distribution of financial power was any more concentrated than between London, Paris, and New York during the interwar period.[3] Nor could the stability of the prewar system be attributed to a greater willingness on the part of central banks to play by the "rules of the game": in neither period did they consistently contract their money supplies when losing gold reserves or expand it when gaining them.[4]

Where these systems differed greatly was their credibility. "There was no question," Eichengreen writes in reference to the prewar years, "that at the end of the day the authorities at the center of the system would take whatever steps were necessary to defend gold convertibility."[5] When such a commitment was beyond doubt, capital holders would act in anticipation of an unflagging defense of a weak currency, and would ultimately reinforce the authorities' efforts to correct incipient market pressures. But what made the prewar commitment more credible than that of the interwar period? The answer appears to be twofold: minimal domestic political opposition to the gold standard; and prompt and significant international central bank collaboration in times of crisis. In this chapter, I argue that the new political and social conditions unleashed by World War I undermined the certainty that states would be willing and able to maintain the gold standard. And in addition to the oft-cited postwar enmities among the major powers, international cooperation was also hampered by the *expectation of defection on the part of the deficit country*. Where domestic political conditions were not expected to be conducive to maintaining a stable currency, to cooperate was, for the surplus/strong-currency country, to be on the losing end of a one-way bet. While the stability of the system would have been enhanced by international cooperation, international cooperation

[2] Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York and Oxford: Oxford University Press), 1992, chap. 2.

[3] Melchior Palyi, *The Twilight of Gold* (Chicago: Henry Regnery), 1972, *passim*.

[4] See Ragnar Nurkse, who found that central banks in fact tended to offset international reserve flows rather than accommodate them. *International Currency Experience* (Geneva: League of Nations), 1944; and Arthur Bloomfield, *Monetary Policy Under the Gold Standard, 1880–1939* (New York: Federal Reserve Bank of New York), 1959, who found that countries' discounts rates tended to rise and fall together, contrary to theoretical expectations. Surplus countries were in fact reluctant to adjust to the demands of external equilibrium, often for fear of inflation, as evidenced by the reluctance to lower discount rates when reserve ratios rose.

[5] Eichengreen, *Golden Fetters*, p. 65.

was ultimately conditioned by its expected payoff—the best predictor of which was the complexion of the deficit/weak-currency country's domestic politics. Hence, we return again to the question: what conditions contributed to a country's ability to maintain a credible commitment to gold?

Exclusionary Politics and Monetary Stability during the Nineteenth Century

One reason why the international monetary system was stable during the nineteenth century was because of the excellent fit it enjoyed with prevailing domestic political institutions and practices. With little resistance, the gold standard could be managed in most countries between 1870 and 1913 from the top down. Disturbances in the balance of payments, which placed downward pressure on the currency, could be countered by the central bank discount rate or interest rate increases that would constrict short-term finance, discourage investment, and damp down the level of domestic economic activity and depress prices, reducing the incipient deficit and reversing selling pressure on the currency. External balance could then be maintained, though at a cost to the level of domestic economic activity.[6]

Compared to the twentieth century, there was little political resistance during the nineteenth century to the primacy that the gold standard placed on external balance, even when this was achieved at the expense of the domestic economy. This lack of resistance may be largely attributable to exclusionary politics as well as to laissez-faire political philosophies that did not recognize state responsibility for the economic well-being of its citizens. Political systems that excluded, marginalized, or were otherwise able to ignore the widespread economic and social pain caused by the whipsawing of the domestic economy were unquestionably able to maintain a fixed monetary standard. Political philosophies that could justify an exclusive focus on external balance and shun responsibility for economic misery at home buttressed the credibility of the gold standard.

Between 1870 and 1914 there was an increasingly perceptible shift in the balance of power between classes that eventually challenged the institutional and philosophical supports of externally oriented monetary policies. These years of intensified industrialization and urbanization saw a growing demand for the recognition of the rights of workers—a shift that was increasingly recognized by the grudging acceptance of the right of the state to interfere with employers' exploitation of their workers, to regulate conditions of employment, and to develop basic standards of public health. By the 1880s a somewhat

[6] The prewar gold standard was not successful at ensuring either domestic price stability or economic growth. Barry Eichengreen (ed.), *The Gold Standard in Theory and History* (New York: Methuen), 1985, pp. 6–9. The inability of the gold standard to deal with the dual demands of internal and external equilibrium was a major reason for its breakdown under the new political circumstances of the interwar years. Palyi, *Twilight of Gold*, passim.

more positive view of the role of the state in the economic well-being of a nation was gaining currency. Bismarck's policies are often cited as a first step on the road to the "welfare state," but in England as well the need for a more active policy of social reform was making its way into progressive thought about the responsibilities of the state toward the welfare of its citizens. Increasingly, liberalism's earlier tenets were being challenged by new doctrines of state action and responsibility.

Only gradually, as the right to vote was extended to workers and the poor, were these ideas translated into tangible political demands. Universal male suffrage only began to take hold in many European countries after the turn of the century.[7] Among the earliest to extend universally the right to vote were France, Switzerland, and Germany,[8] each of which in 1848 extended suffrage to all male citizens in their twenties and older. Britain maintained various property, tax, and educational requirements and inequalities until 1918, though it is true that these were liberalized in 1868 and again in 1885. The Scandinavian countries were fairly early enfranchisers: by 1900 Norway had virtually universal male suffrage, and by 1907 in Finland all men and women over the age of twenty-four were entitled to vote by secret ballot. Sweden gave up its high economic qualifications in favor of universal male suffrage in 1909. In Austria, landowning and minimum tax contributions greatly restricted suffrage until the abolition of the curial system in the 1907 Reform Law; universal and equal adult suffrage was not extended to all citizens over twenty years of age until 1919. Belgium and the Netherlands also had tax minima that effectively excluded most laborers until 1894, and until the Great War, those who owned property or had a higher-education diploma were awarded additional votes. Denmark prevented workers who did not have their own household from voting until 1915. Italy used a combination of tax and wealth minima, as well as educational requirements, to limit the electorate; in fact, these requirements were tightened in 1894 to reduce the number of eligible voters, contrary to the liberalization trends in other countries. Like most other European countries, however, Italy did extend universal manhood suffrage in 1919, but free and fair elections did not survive the rise of fascism in 1924. In general, it is fair to say that until the turn of the twentieth century—and for some countries, not until after World War I—large portions of working-class persons could effectively be prevented from voicing their political and, potentially, their economic demands via the ballot box. By the beginning of the interwar period, most systems of

[7] For a concise review of suffrage requirements and voting procedures for many Western European countries, see Peter Flora, *State, Economy, and Society in Western Europe, 1815–1975* (Frankfurt am Main: Campus Verlag), 1983, pp. 95–148.

[8] One must be cautious in attributing too much to the extension of the franchise in Germany at this time. First, the electoral law was in fact highly favorable to the Junkers; moreover, the Reichstag was hardly a popularly controlled legislature during this time. See N. Stone, *Europe Transformed, 1878–1919* (Cambridge: Harvard University Press), 1984, p. 184.

exclusion and inequality had been dismantled in favor of universal male suffrage.

Workers were increasingly expressing their demands outside of parliamentary politics as well. Spurred by accelerating urbanization and the depression in agriculture of the 1870s, labor began to concentrate in the cities. During the 1880s, thanks largely to falling food prices, real wages grew (as did profits), muting potential labor disputes for the time being. By the early twentieth century, however, serious social unrest led to demands for universal suffrage in Austria; general strikes in Belgium, the Netherlands, Sweden, and Italy; revolutionary uprisings in Russia and Romania; and nearly to civil war in Hungary.

Italy during the 1890s was a harbinger of the potential for domestic political conflict to undermine international monetary policy commitments. Italy's toehold on parliamentary politics after unification was extremely tenuous, and was further undercut by the depression of the 1890s.[9] Bank failures led to accusations of political corruption, and a violent peasant uprising and tax revolt broke out in Sicily in 1893. Agricultural disasters in 1897 threatened famine in many areas, contributing to the growing strength of the Socialist party. Violent disturbances emanated from the south, and culminated in violent unrest in Milan in the spring of 1898, causing the fall of the government. The election that followed led to a majority for the parties of the Left and the leadership of Giovanni Giolitti, but not without serious monetary crisis. Italy was one of the most politically unstable of the European countries during the late nineteenth century, and one of only three European devaluations between 1880 and 1914. In Italy around the turn of the century, fissiparous domestic politics contributed to monetary chaos and foreshadowed the tensions between domestic politics and gold standard promises that would become all too apparent after the war.

The Great War itself hastened many of the changes that in many countries had begun in the opening years of the twentieth century. In the West, the mixing of classes and income levels in military service, the influx of women into industrial occupations, and the sudden upward surge of trade unionism and participation in industry were clearly altering the political and social landscape on which economic adjustment would fall. The experience of national mobilization for total war legitimized the demands for political equality that had been building since the late nineteenth century.[10]

Political representation of the working classes grew across Europe after the war. Social Democratic party membership made major advances in Austria, Sweden, Denmark, France, and Norway, and membership in the British Labour party climbed over the course of the two interwar decades.[11] And it was only after the war that Social Democratic and Labour parties participated in governments. The British Labour party first contested elections in 1900, but it had only a small representation in Parliament before the war. Labour seats peaked at 47 percent of Parliament in 1929, and Labour governments were formed for the first time in 1924 and again in 1929. In Germany, the Social Democrats had been a significant party since the 1890s, but led democratic governments for the first time in 1919–20 and again in 1928. France experienced its first moderate Left government in 1924 through 1926, and again in 1932 through 1933, and a more radical Socialist-Communist coalition between 1936 and 1938. In Belgium, working-class parties accounted for 14 percent of the seats in parliament in 1914, and the proportion jumped to 37 percent in the first postwar election. The Norwegian Labor party experienced a similar postwar jump: with 18 percent of the parliamentary seats held in 1912, its representation grew to 39 percent in 1927, and it formed its first government in 1935. Though patterns varied across countries, workers undeniably had an unprecedented voice in governance following World War I.

Increased political representation was accompanied by a revolution in labor organization and industrial action. In Britain, Germany, Sweden, Denmark, and Norway, a steady upward trend in unionization had taken off around the turn of the century, and took a gargantuan leap during World War I. The number of union members doubled in Britain and more than trebled in France after the war. Massive strikes erupted across Europe in the early twenties. In Italy, the number of working days lost jumped from 912,000 in 1918 to more than 22 million in 1919 and more than 30 million in 1920. France's pattern was similar. Germany's strikers took their greatest toll in 1924, when more than 36 million working days were lost. The most disruptive of all was the British general strike of 1926, which cost workers and the economy 162 million working days.[12] Organized labor's primary concerns—for political access, employment opportunities, a living wage, and growing demands for a social safety net—were increasingly incompatible with a fail-safe commitment to gold. The old patterns of domestic economic adjustment that were needed to maintain external economic balance and a stable currency would come under increasing stress as a result.

Governing coalitions were far more fragile as a result of the new social and political forces that emerged during the interwar years. For the overwhelming

[9] In Italy, parliamentary politics had come under attack for its "cynical bargains within a narrow clique without much regard for the country as a whole." James Joll, *Europe Since 1870: An International History* (New York: Harper and Row), 1973, p. 124.

[10] For example, for an account of the social effects of the war in Britain, see A. Marwick, *The Deluge* (London: Bodley Head), 1965, and *Britain in the Century of Total War: War, Peace, and Social Change, 1890–1967* (London: Penguin), 1968.

[11] Stefano Bartolini, "The Membership of Mass Parties: The Social Democratic Experience, 1889–1978," chap. 7, in Hans Daalder and Peter Mair, *Western European Party Systems* (London: Sage), 1983, pp. 177–220.

[12] All statistics on strike activity are from B. R. Mitchell, *European Historical Statistics*, Series C2, (London: Macmillan), pp. 181–185.

TABLE 2.1
Average Cabinet Duration for 17 Countries, 1870–1913 and 1923–1939

	Average Cabinet Duration (years)	
	1870–1913	*1923–1939*
Austria/Hungary	2.3	0.93 (Aus.) 1.5 (Hun.)
Belgium	3.3	1.3
Bulgaria[a,b]	1.09	1.2
Denmark[a]	2.15	4.25
France	1.34	0.63
Germany	1.86	1.42
Greece[a]	0.55	0.84
Italy	1.5	1.41
Japan	2.6	1.06
Netherlands	2.26	2.13
Norway	2.26	2.13
Romania	1.16	0.73
Spain	0.86	0.65
Sweden	2.69	1.7
United Kingdom	1.65	1.31
Yugoslavia[a,b]	0.97 (Serbia)	1.13

Source: Arthur S. Banks, Cross-Polity Time-Series Data, Segment 1, Field M.

[a]Countries for which prewar cabinets had longer duration than interwar ones.

[b]1878–1913

majority of European countries, significant cabinet changes were far more frequent during the interwar years than had been the case between 1870 and 1913 (though the United States and Canada do not fit this trend). Table 2.1 clearly indicates the shorter average cabinet duration during the interwar years compared to the decades of the "classic" gold standard.

Even the well-established democracies—Britain, France, the Netherlands, Belgium, Sweden, and Norway—experienced greater political instability during the interwar years than they had prior to the Great War. The war had had even more revolutionary consequences for the political systems of Central and Eastern Europe, of which the Bolshevik revolution is only the most dramatic example. Prewar regimes in Germany and Bulgaria fell. While the former country moved toward an unstable democracy, the latter engaged in economic policies so harsh toward the owners of wealth and capital that economic recovery was paralyzed for several years.[13] Hungary briefly experienced Communist dictatorship under Bela Kun; civil war broke out in Poland and later in Spain.

In short, the interwar period was unprecedented for most countries in the extent to which polities were struggling with the newly organized forces and demands of a broader, more inclusive democracy. Some lost the struggle and abandoned the democratic project. Others persisted and gradually formed a domestic consensus that could support the new demands of the Left. Still others experienced periods of prolonged instability, waivering between competing societal demands and changing governments with alarming frequency. In each case, the way in which competing demands were filtered through the political systems of these states could not help but have a drastic impact on a country's unquestioned commitment to gold.

These social and political changes directly influenced the stability of the gold standard. Whereas during the nineteenth century virtually every European government—and many others besides—had gold standard commitments that were beyond any reasonable doubt, those commitments did not ring true where political and social instability meant politically convenient solutions and where the Left refused to sacrifice labor for the sake of the currency. During the nineteenth century, markets *knew* that governments would defend their legal gold parity. Indeed, it often had been unnecessary actually to do so; market confidence itself had had an equilibratory effect on those rates. But this credibility rested on the widely held assumption that the role of monetary policy was to defend the currency, an assumption which in turn rested on domestic political systems that could ignore economic turmoil. The political reforms of the early twentieth century forewarned that all was not well with this set of priorities, just as they were prescient of the newly emerging demands for an increasingly elaborate welfare state. The nineteenth-century gold standard put a high premium on external equilibrium, often at the expense of internal economic conditions, and it could be justified among the narrow enfranchised classes as a necessary condition for the conduct of international trade and investment.[14] Political marginalization of the working classes ensured unanimity. But the politics of inclusion and the concomitant breakdown in nineteenth-century consensus meant that primacy could no longer unquestionably be given to external balance and currency stability. For the first time, most governments

[13] G. T. Danaillow, *Les Effets de la Guerre en Bulgarie* (Paris: Presses Universitaires de France), 1932.

[14] T. E. Gregory, *The Gold Standard and Its Future* (London: Methuen), 1932. The Macmillan Committee echoed this sentiment just before Britain departed from gold in 1931: "International trade, commerce, and finance are based on confidence. One of the foundation stones on which that confidence reposes is the general belief that all countries will seek to maintain so far as lies in their power the value of their national currency as it has been fixed by law." The Macmillan Report, reprinted in Eichengreen, *The Gold Standard in Theory and History*, p. 196.

faced seriously competing policy goals. In the Western democracies, struggles over income shares between capital and labor led to demands for resources greater than those that could easily be satisfied consonant with the external constraint of a fixed gold parity, creating inflationary pressures within some economies.[15] For the first time in history, workers were more nearly the political match of holders of capital, setting the stage for a "war of attrition"; that is, a period of prolonged conflict over economic policies that arguably contributed to inflation and currency depreciation.[16] The central divide was often not only over which sectors of society should shoulder the heavy fiscal burdens stemming from World War I, but also over the rate of economic growth itself. Deflation would have its most devastating impact on the unfortunate members of the working class who were thrown out of work, but it would benefit creditors and the rentier.[17] As Kindleberger has written, "What was critical was that the postwar position made it necessary for sectors in society to struggle over the income distribution. . . . [T]he issue [was] whether deflation and unemployment would saddle a major share of the load on the working class, as contrasted with the rentier. Keynes observed in 1922 that the choice between inflation or deflation comes down to an agonizing outcome of a struggle among interest groups."[18]

As John Ruggie has pointed out in his discussion of the evolution of the post–World War II economic order, these struggles were not easily digested by an international monetary system fixed to gold.[19] Open domestic conflict undermined the certainty that a government would honor its commitment to defend the currency in light of pressures to inflate. Those with liquid capital, whose decisions constituted the ebb and flow of currency markets, associated political

[15] Colin Crouch, "Inflation and the Political Organization of Economic Interests," chap. 9 in Fred Hirsch and John H. Goldthorpe, *The Political Economy of Inflation* (Cambridge: Harvard University Press), 1978, pp. 217–239.

[16] John Goldthorpe has hypothesized that inflation takes off when conflict between social groups becomes more intense and more evenly matched. John H. Goldthorpe, "The Current Inflation: Towards a Sociological Account," in Hirsch and Goldthorpe, *The Political Economy of Inflation*, pp. 186–216. The phrase "war of attrition" is used by Barry Eichengreen, *Golden Fetters*, and by Alberto Alesina and Allan Drazen, "Why Are Stabilizations Delayed?" Unpublished essay, Harvard and Tel-Aviv Universities, May 1990.

[17] Charles S. Maier believes that it is possible to predict an "inflation prone coalition" that includes (though is not limited to) workers concerned with high wages and full employment. Charles S. Maier, "The Politics of Inflation in the Twentieth Century," chap. 2, in Hirsch and Goldthorpe, *The Political Economy of Inflation*, pp. 37–72.

[18] Charles P. Kindleberger, *A Financial History of Western Europe* (London: Allen and Unwin), 1984, p. 323. See also Manfred G. Schmidt, "The Politics of Unemployment and Labor Market Policy," *West European Politics*, Vol. 7, No. 3, July 1984, pp. 5–24.

[19] John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," in Stephen Krasner, *International Regimes* (Ithaca: Cornell University Press), 1983, pp. 195–231.

instability with inflation, or at the very least uncertainty.[20] More generally, markets tried to anticipate any set of political conditions or government policies that hinted at a weak commitment to gold. Whenever they detected a crack in credibility, they sold the currency in question to avoid exchange losses. These actions were often self-fulfilling prophecies. The turmoil of domestic politics gave holders of liquid capital ample incentive to destabilize the interwar gold standard.

The Role of International Monetary Cooperation

Unfortunately, the gold *exchange* system magnified some of these effects by similarly shaping the incentives of foreign central banks. With the 1922 monetary conference at Genoa, the British had secured agreement on the principle that the smaller countries should hold a portion of their reserves in the currency of the major gold centers (Britain, France, and the United States), and that these in turn would hold gold and make it available upon demand. While this would allow for the expansion of central bank reserves and relieve the deflationary pressures associated with maintaining a strict relationship between gold reserves and the money supply, the risk was that central banks would abandon any currency suspected of weakness. Since sterling, dollars, French or even Swiss francs were all reserve currencies, it was fairly costless to move one's reserves from one to another depending on the mood of the market. An extraordinary degree of confidence was necessary to trust the value of one's own central bank reserves to the monetary policy of a foreign country. Not only was there the temptation to cash in foreign exchange holdings as they grew in relation to a relatively inelastic supply of gold,[21] but there was also the option of purchasing a reserve currency based on its status as "most credible" among the top four. Even central banks were tempted to watch politics and play the market.

This leads to a second important distinction between the prewar gold system and the interwar gold exchange standard. During the earlier period, there was little question that the occasional foreign exchange crisis would be handled cooperatively among the three major money centers of Europe: London, Paris,

[20] For analyses that emphasize the need for political stability in order to achieve economic stabilization, see Thomas Sargent, "Stopping Four Big Inflations," in R. Hall (ed.), *Inflation: Causes and Effects* (Chicago: University of Chicago Press), 1982, and "Stopping Moderate Inflations: The Methods of Poincaré and Thatcher," in Rudiger Dornbusch and Mario H. Simonsen, *Inflation, Debt, and Indexation* (Cambridge: MIT Press), 1984; and Rudiger Dornbusch, "Lessons from the German Inflation Experience of the 1920s," in Rudiger Dornbusch, Stanley Fischer, and John Bossons (eds.), *Macroeconomics and Finance: Essays in Honor of Franco Modigliani* (Cambridge: MIT Press), 1987.

[21] Feliks Mynarski, *Gold and Central Banks* (New York: Macmillan), 1929. This problem applies to any international monetary system in which expanding foreign trade is financed by a "convertible" key currency. Robert Triffin, *Gold and the Dollar Crisis* (New Haven: Yale University Press), 1960.

and Berlin.[22] During the Baring Crisis of 1890, which was sparked by the news of the Argentine rebellion and potential bond default, the Bank of England used its slender reserves to act as lender of last resort, and quickly received short-term loans of £3 million and £1.5 million from the central banks of France and Russia, respectively. Confidence was restored so quickly that gold never crossed the channel.[23] Sterling faced another serious crisis in 1906, due to unusually heavy American borrowing in the London market. The Banque de France offered to support sterling with a loan, and ended up purchasing sterling bills to support the exchange.[24] The following year, a financial panic centered in the United States stimulated a gold drain from the Bank of England that caused the British central bank to raise its discount rate to the highest level in more than thirty years. Continental central banks accommodated the British by allowing their reserves to decline and gold to flow to Britain, where it could be used to finance the increased demand for gold in the United States.[25] These and other episodes of instantaneous international cooperation made the nineteenth-century gold standard stable—if only because publics *believed* the international community's support for the gold standard was virtually inviolable.

The contrast with the interwar period is a stark one. Some of the reasons are well known. The war and the nature of the peace had sown conflicts that were manifest in international monetary relations. Inter-Allied war debts and German reparations poisoned the relationship between France, Britain, and Germany and threw sand into plans to stabilize the mark in 1924.[26] Differing ideas over the merits of the gold standard versus the gold exchange standard retarded central bank cooperation between Britain and the United States from 1928 to 1931.[27] Competition between France and Britain for financial influence on the Continent complicated financial stabilization in Central Europe.[28] To say that international financial and monetary cooperation was not taken for granted is an understatement. It was an uphill battle for most of these two decades.

Publics may have cheered the nationalistic policies of their leaders, but markets were greatly disturbed. When the Federal Reserve Bank of New York, the Bank of England, and J. P. Morgan and Company all hesitated to support the franc in 1924 and 1925, the French franc sank as capital fled. When central bankers could not arrange long-term financing to support the Belgian franc in

[22] Eichengreen, *Golden Fetters*, chap. 2, passim.

[23] Arthur D. Elliot, *The Life of George Joachim Goschen* (London: Longmans, Green), 1911.

[24] Harry White, *The French International Accounts, 1880–1913* (Cambridge: Harvard University Press), 1933, p. 195.

[25] Ira Cross, *Domestic and Foreign Exchange* (London: Macmillan), 1923, p. 217.

[26] Stephen A. Schuker, *The End of French Predominance in Europe: The Financial Crisis of 1924 and the Adoption of the Dawes Plan* (Chapel Hill: University of North Carolina Press), 1976.

[27] S.V.O. Clarke, *Central Bank Cooperation, 1924–1931* (New York: Federal Reserve Bank of New York), 1967.

[28] Competition between London, Paris, and, to a lesser extent, New York is a major theme of Paul Einzig, *The Fight for Financial Supremacy* (London: Macmillan), 1931.

1925, they withdrew their support and the franc lost an eighth of its value in four hours. When negotiations over reparations nearly collapsed in the spring of 1929, markets fled the reichsmark. When the Banque de France hesitated to extend the Bank of England a loan to defend the pound in the waning summer of 1931, speculators and even other central banks delivered the coup de grace. The international climate was uncertain. An international gold standard could not survive without international cooperation, yet for high political and a myriad of petty reasons, such cooperation was notably in short supply.

Yet one of the central reasons for the shortage of international cooperation that hardly ever receives serious treatment is that central banks, treasuries, and private sources of emergency capital were themselves wary to go out on a limb to cooperate with their foreign counterparts who were likely to defect. There was a real hesitation to provide assistance to a deficit country that did not seem ready or able to take action to alter fundamentally its own deteriorating position. One of the primary reasons the French were denied financial assistance between 1925 and 1926 was that there was little confidence that the unstable Cartel des Gauches would implement a financial and fiscal policy that would prevent the hemorrhage of private capital from France. One of the most significant reasons for the breakdown in international cooperation as the British struggled to maintain sterling's parity in 1931 was that foreign central bankers were demanding bigger unemployment compensation cuts than the Labour party could supply. Yes, the interwar gold standard depended on international cooperation for its stability, and indeed, such cooperation was only intermittently forthcoming. But what incentive did the Federal Reserve Bank of New York or the Bank of England have to extend the French emergency credits when French leaders refused to balance the budget?

To summarize, any fixed system of exchange rates requires an extraordinary degree of credibility if parities are to be maintained. One of the starkest contrasts between the operation of the gold standard before and after World War I was the degree of certainty that governments would reliably pursue macroeconomic policies consonant with external balance and fixed rates of exchange, and that in those instances in which a country experienced a run on its reserves international cooperation would be forthcoming. The drastic sociopolitical changes of the First World War undermined confidence in the possibility of internal adjustment. These domestic changes in combination with the animosities that flowed from that conflict created fateful hesitancies with respect to international assistance. The uncertainty these combined conditions placed on financial and foreign exchange markets was overwhelming.

The Norms of Gold Standard Adjustment

In reconstructing the international economic system in the early 1920s, monetary authorities turned to the system that appeared to have served them so well

before the war. The late-nineteenth and early-twentieth-century gold standard constituted a loosely held set of prescriptions about how a country should deal with an incipient deficit or a downward selling pressure on its currency. This system's premise was that individual nations' monetary systems were based on a gold standard regime, which included the convertibility of domestic money into gold at a fixed price, the freedom for private citizens to import and export gold, and a fixed relationship between the money supply (bills in circulation) and the gold reserve. When adopted by a number of countries, these conditions established a fixed exchange rate system between national currencies.

The Adjustment Mechanism

The classic model of gold standard balance of payments adjustment was that described by David Hume in the middle of the eighteenth century.[29] His rendition of the "price-specie-flow" mechanism was based on a stylized economy in which two categories of commodities—goods and gold—were traded. When prices of goods rose domestically, residents tended to substitute less expensive imports for home goods. In the absence of production increases, residents of the foreign country would have to cut their consumption to accommodate increased foreign demand for their goods. Gold would then flow from the country with the higher prices for goods to that with the relatively higher price for gold. In other words, the resulting balance of trade settlement was made by gold shipments from the deficit to the surplus countries.

When opportunities for arbitrage are taken into account (when a capital market is considered in addition to the market for goods and gold), international adjustment will not take place through relative price differences, but rather through interest rate differentials and capital flows.[30] In this case, when domestic prices for securities rise (which is to say, interest rates fall), capital flows from the country in which interest rates are low to the country in which they are high, until security prices and interest rates are once again equalized internationally. Thus, the balance of payments deficit (the sum of the trade balance deficit plus the capital outflow) would not have to be covered fully by an international transfer of gold. If compensating capital flows should fully cover the trade imbalance, there need not be any gold transfer at all.

The critical step in the adjustment process was the effect that incipient gold flows had on the level of economic activity within each country. Central banks maintained gold reserves that were used to back a given multiple of notes, and financial institutions practiced fractional reserve banking that allowed them to

[29] David Hume, *Essays: Moral, Political, and Literary*, Vol. I (London: Longmans, Green), 1898. First published in 1752; recently reprinted in abridged form in Barry Eichengreen, *The Gold Standard*, pp. 39–48.

[30] P. B. Whale, "The Working of the Prewar Gold Standard," *Economica*, Vol. 4, February 1937, pp. 18–32.

"create money" by extending loans on the basis of deposits. A central bank that was losing gold was supposed to raise its discount rate, increasing the cost of funds for financial institutions, which would induce the institutions to hold larger precautionary reserves and reduce the money available to the economy. The central bank might try directly to reduce the money supply by an open-market sale of securities. The point is that gold outflows should be accompanied by efforts to reduce the domestic money supply, which in turn should contract the economy's level of economic activity, lower domestic prices, and improve the balance of payments.

Two points should be stressed about the adjustment mechanism. First, central banks could take measures in anticipation of actual gold flows, which is one reason why the physical movement of gold was often unnecessary. A higher discount rate in the deficit country would attract the capital necessary to finance its deficit, while lower rates in the surplus country would have the opposite effect. Second, in theory, this adjustment mechanism was supposed to operate symmetrically in both surplus and deficit countries, although the norm (and the necessity) for adjustment by deficit countries was much stronger than that for countries in surplus. Thus, gold flows or the central bank's anticipation of incipient flows would set off an increase in the money supply (stimulation) in the surplus country and a decrease in the money supply (a dampening effect) in the deficit country. Rising domestic prices in the surplus country would then encourage foreign purchases (imports or purchases of foreign securities), and falling prices in the deficit country would encourage home purchases and a preference for domestic over foreign investments. Whether the system was stabilized "automatically" via gold flows or was "managed" by central bank policy, the monetary prescription for a deficit country was the same: an increase in interest rates and/or contraction of the money supply was necessary to relieve the external pressure. In theory, equal but opposite policies were to be implemented in surplus countries.[31]

The adjustment mechanism could be severely undermined unless markets were allowed to clear, as described above. In the goods market, price effects had to be able to influence consumption patterns. Trade restrictions or protection efforts were ways of disrupting or delaying the adjustment process. The corollary in the capital market is obvious: if capital is not permitted to move

[31] For a general review of the workings of a gold standard, see Richard N. Cooper, *The Gold Standard: Historical Facts and Future Prospects*, Brookings Papers on Economic Activity, Vol. 1 (Washington D.C.: Brookings Institution), 1982; Kenneth W. Dam, *The Rules of the Game: Reform and Evolution in the International Monetary System* (Chicago: University of Chicago Press), 1982, chap. 2, pp. 15–40. For the historical conditions of its operation, see Leland Yeager, "The Gold Standard Before World War I," chap. 15, in Yeager, *International Monetary Relations: Theory, History, and Policy* (New York: Harper and Row), 1966, pp. 295–309; R. G. Hawtrey, *The Gold Standard in Theory and Practice* (London: Longmans, Green), 1947. On the practical operation of the gold standard, see articles collected in Eichengreen, *The Gold Standard*, especially those by Robert Triffin, Donald N. McCloskey and J. Richard Zecher, and W. M. Scammel.

freely in response to interest rates, the adjustment mechanism will not operate as smoothly as it should.

Implied Norms of Gold Standard Adjustment

The gold standard provides the normative baseline against which this study analyzes the policy choices of deficit and surplus countries. There are two reasons for using gold standard "norms." The first is that present-day economic theory does not speak with sufficient unity or certainty in the area of international macroeconomic adjustment to justify substituting more modern understandings of deficit and surplus adjustment and burden sharing for those that prevailed in the interwar years.[32] The second is that even if economic theory were to converge on a consensus in this area, it would be senseless to impose those understandings on the decisionmakers of the twenties and thirties. Policy choice should be interpreted as far as possible in the context of beliefs and norms that prevailed among contemporaries.[33]

Prewar experiences with the gold standard generally informed monetary and political authorities' conception of external adjustment well into the interwar years. Some fifty nations participated in the interwar gold standard, and there was for most of the period a broad consensus over the economic policies that were needed to maintain the system. Several implied norms were widely shared among those that aspired to reestablish and maintain the gold standard. Not all were equally salient, nor were responsibilities for gold standard maintenance symmetrical for deficit and surplus countries. This is because a country with a surplus does not face an equally finite limit to the reserves it can accumulate, and hence it experiences little economic pressure to alter its policy.[34] The norms listed below reflect those that were broadly accepted by most countries, roughly in the order of importance.

Norm 1: External balance takes priority over the domestic economy. The basic premise of the gold standard was that countries were supposed to pursue macroeconomic policies that were compatible with the maintenance of fixed parities. Currency stability was the first goal of the gold standard. Devaluation was thought to risk the disruption of trade and investment, and was viewed as a

[32] Economists today differ not only on the magnitude of transmission effects from changes in domestic fiscal and monetary policies from one economy to another, but in some cases even differ on the sign of the transmitted effect.

[33] The effect of beliefs and perceptions on policy choice is underscored by Robert Jervis, *Perception and Misperception in International Relations* (Princeton: Princeton University Press), 1976; and Ernst B. Haas, "Words Can Hurt You," in Stephen Krasner (ed.), *International Regimes* (Ithaca: Cornell University Press), 1983, pp. 23–59, although I am not concerned here to develop an evolutionary epistemology that would identify ideas per se as an important independent explanatory variable.

[34] Leland B. Yeager, *International Monetary Relations*, p. 48.

government's default on its obligations. It also caused an immediate loss on the balance sheets of foreign central banks that were holding the depreciated currency as part of their foreign exchange reserves. During the Depression, devaluation was often associated with efforts to "obtain an unreasonable competitive exchange advantage," as it was put in the concurrent declarations of the Tripartite Agreement in 1936.[35] In contrast to post–World War II thinking on the subject, devaluation during the interwar years was not accepted as a legitimate form of economic adjustment.[36]

Because of the significance attached to fixed exchange rates, external balance had to have priority over the domestic economy when these were in conflict. Conflict would arise when a deficit country experienced an economic slowdown (external balance demanded further contraction but domestic conditions justified stimulation), and when a surplus country experienced potential inflationary pressures (external balance would justify further demand stimulation and internal balance the opposite).

The primacy of external balance was clearly stated by the Macmillan Committee during one of the deepest years of the British depression: "[C]ountries which are losing gold must be prepared to act on a policy which will have the effect of lowering prices, and countries which are receiving gold must be prepared to act on a policy which will have the effect of raising prices."[37] In the face of 2.63 million unemployed Britons (some 21.5 percent of the work force), and despite the fact that wholesale prices in 1931 had declined some 12.5 percent and consumer prices had dropped 6.2 percent, the report still called for price compression to improve the declining British balance of payments. The report also called for surplus country (American) price stimulation, as British monetary authorities had been doing for most of the decade. A clearer statement of the priority to be given to external balance over the needs of the domestic economy is difficult to imagine.

There was a notable hierarchy of prescribed actions underlying this general norm. The clearest and most widely understood prescription fell on the fiscal policy of deficit countries. *Deficit countries were entreated to get their houses in order and to practice financial orthodoxy.* The First Interim Report of the Cunliffe Committee (1918) provided the most explicit statement of these policies, but its assumptions were similar to those held in a number of countries in

[35] Tripartite Monetary Agreements of 25 September 1936, printed by the Bank for International Settlements, Monetary and Economic Department, Basel, Switzerland, January 1937.

[36] Devaluation in the postwar period has often been viewed as a necessary part of an expenditure switching policy mix that is designed to encourage the flow of investment and other resources into the traded-goods sector. The interwar norm against devaluation has been criticized as misguided. Kindleberger, for one, considers the 1933 dollar depreciation to have been "useful" in that it raised prices in the United States but did not depress them abroad. Charles P. Kindleberger, *The World in Depression, 1929–1939* (Berkeley: University of California Press), rev. ed., 1986, p. 227.

[37] *Report of the Macmillan Committee on Finance and Industry*, Cmd. 3897, London, HMSO, 1931, paragraph 42.

the twenties.[38] Published on the heels of wartime budgets and outlays for reconstruction, the report came out clearly for financial orthodoxy and balanced budgets within deficit countries in order to reduce domestic demand and stabilize the currency. The need for a return to "financial orthodoxy" in order to facilitate currency stabilization was also a major theme at the International Financial Conference held at Brussels in 1920 and the conference at Genoa in 1922.[39]

The proper conduct of fiscal policy was a norm that fell exclusively on deficit countries. There was absolutely no expectation that surplus countries would "artificially" stimulate their own domestic demand through public expenditures for purposes of influencing their external position. The opportunity to discuss coordinated public works—a form of coordinated reflation—presented itself during the preparations for the World Economic Conference in the spring of 1933, but the idea was made moot by unilateral American action to devalue the dollar, and was in any case vehemently opposed by the French. Had the idea flown, it still would not have amounted to a norm for *surplus* country behavior, since it would have applied to all of the major economies regardless of their external position. The idea of using fiscal policy to influence the balance of payments was an orthodox prescription that applied overwhelmingly to the deficit countries.[40]

The second prescription again fell on deficit countries. *Deficit countries were to pursue stringent monetary policies and to avoid "undue" credit expansion.* The Cunliffe Report linked government borrowing with slack credit policies, noting that "the growth of purchasing power has exceeded that of purchasable goods and services," resulting in balance of payments deficits. The solution was to raise interest rates, which the report reasoned would lessen loan demands, check expenditures and economic activity, and lower domestic prices, with the result that imports would be discouraged and exports promoted. "When the exchanges are adverse and gold is being drawn away, it is essential that the rate of discount in this country should be raised relatively to the rates ruling in other countries," the report concluded.[41]

Although the expectation was somewhat weaker and the norm often resisted,

[38] Eichengreen, *The Gold Standard*, p. 19. *First Interim Report of the Cunliffe Committee on Currency and Foreign Exchanges after the War*, Cmd. 9182, London, HMSO, 1918, paragraphs 6–7.

[39] S.V.O. Clarke, "The Reconstruction of the International Monetary System: The Attempts of 1922 and 1933," *Princeton Studies in International Finance*, No. 33 (Princeton: Princeton University Press), 1973.

[40] Although intentional surplus fiscal expansion for purposes of improving *external* balance was not accepted as an adjustment strategy in the interwar years, after World War II appropriate reflationary policies for the surplus country were expanded to include stimulatory fiscal policies. See chapter 6 in Robert D. Putnam and Nicholas Bayne, *Hanging Together: The Seven Power Summits* (Cambridge: Harvard University Press), 1984, pp. 67–99.

[41] Cunliffe Committee Report, reprinted in Eichengreen, *The Gold Standard*, p. 177.

there was a broad understanding that *surplus countries should accommodate gold inflows by lowering interest rates and expanding the money supply accordingly.* To do otherwise was referred to as "gold sterilization," and surplus countries usually denied that they were engaging in such policies.[42] Relaxing monetary policy in response to gold inflows was meant to be reflationary: to stimulate growth, demand, and prices relative to the surplus country's deficit trading partners. Increased demand was meant to stimulate imports from deficit countries, and lower interest rates were meant to discourage further capital inflows, in these ways correcting an incipient balance of payments surplus.

Overall, the gold standard required that external balance be a higher priority than domestic economic balance. The strongest prescription was that deficit countries should balance their budgets. Next was the demand that deficit countries raise interest rates and implement restrictive monetary policies. Weakest of all was the expectation that surplus countries should accommodate rather than counter gold inflows by relaxing their monetary policies. The primacy of external balance was central to gold standard adjustment, but its prescriptions were much more salient for deficit countries than for those in surplus.

Norm 2: Liberal policies are preferred over external controls. The interwar economic system was far from a liberal international order. Barriers to the free exchange of goods, capital, and currency existed on a wide scale, especially in the years immediately following World War I and during the Depression. Nonetheless, there was an understanding that *external barriers to normal economic intercourse were disruptive to the adjustment mechanism.* Tariffs, import quotas, and capital and currency controls were efforts to improve the balance of trade or to prevent capital flight and currency depreciation *without* fundamentally altering domestic patterns of resource allocation and consumption. It was widely recognized that such barriers often had a negative impact on one's trading partners. These policies were perceived in the interwar years, as they are today, as hostile policy choices.

The preference for liberal external policies was a much weaker norm than that giving priority to external balance. Resistance to liberal trade policies in France, Germany, and Italy often diminished international consensus on the issue. In Britain, Labour supported lower tariffs, but Conservative governments interested in developing and maintaining a system of empire preferences wanted the option of using restrictive measures for this political end. In the United States, the Republicans' high tariff tradition flew in the face of this norm.

While this norm was somewhat weaker than that which gave priority to

[42] The United States did not formally admit to a policy of gold sterilization until 1937, when collapse of the Gold Bloc caused large gold influxes into the United States. Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* (Washington, D.C.: GPO), 1937, p. 1.

external equilibrium, there is still some evidence of a commitment to the ideal of liberal external policies over external controls. Every major economic conference or international agreement during these years, as well as much bilateral negotiation, was aimed at reaching agreements on limiting these hostile adjustment strategies, though often with scant success. International economic conferences held in Brussels in the 1920s, Portorose (near Trieste) in 1921, and Genoa in 1922 strongly opposed stringent trade restrictions. The World Economic Conference held in Geneva in 1927 under League of Nations auspices met to negotiate a convention against import restrictions and to implement tariff reductions. The World Economic Conference held in London in 1933 was supposed to deal with the problem of trade barriers and exchange controls, and the Roosevelt administration proposed a "tariff truce" for its duration. The 1936 Tripartite Agreement indicated the desire of the signatories to dismantle their systems of import quotas and exchange controls.

The norm that liberal policies were to be preferred to external controls applied to both deficit and surplus countries. In contrast to the norms for internal adjustment measures, it was expected that surplus countries would refrain from implementing external restrictions that would disrupt the adjustment process. In fact, when surplus countries contravened this norm, the infraction was considered particularly egregious and elicited a negative reaction from the international community. Thus, the Smoot-Hawley tariff imposed by the United States Congress in June 1930 was a particular object of international invective. In the 1932 election campaign, Roosevelt himself attacked America's tariff policy as unworthy of a creditor nation and blamed it for having forced other countries off the gold standard.[43] Even if we discount the domestic electoral motivation for such an assessment, it indicates a recognition that surplus countries had a special responsibility to maintain reasonably liberal external policies.

Norm 3: Provision of supplementary financing. The third and final norm that underlay the interwar gold standard was as weakly held as the second. This norm recognized that fixed exchange rates had to be supported with international liquidity, and often with exceptional finance, and that the responsibility for providing liquidity was primarily upon surplus countries or consortia organized by surplus countries. When it was available, exceptional finance was usually negotiated between the deficit government and either a surplus government, a multilateral organization, foreign central banks, or foreign bankers.[44]

[43] Kindleberger, *The World in Depression*, p. 124.

[44] Exceptional or compensatory finance is distinguished from market-based or independently motivated finance in that it is not made on the basis of profit-making calculations, but is meant to fill the gap in the demand for and supply of a currency after the market has cleared at a fixed rate of exchange. The distinction between independently motivated and compensatory transactions is made by Yeager, *International Monetary Relations*, pp. 48–51.

In the twenties, Austria, Belgium, Bulgaria, Danzig, Hungary, Greece, and Poland stabilized their currencies with specific stabilization loans or reconstruction loans from the League of Nations.[45] Denmark, Italy, Norway, Portugal, Switzerland, and the United Kingdom arranged temporary forms of credit (usually central bank credits) for stabilization purposes, though these were not always fully utilized. Bulgaria, Czechoslovakia, Estonia, Finland, Latvia, Romania, Yugoslavia, Lithuania, Sweden, and the Netherlands managed their preliminary stabilization without any loans or specific credit arrangements. Germany began its stabilization without credits specifically for that purpose, but within a year had access to capital inflows from the Dawes Loan, which greatly buoyed the mark. France was issued a stabilization credit, but it went unused, and the franc was eventually stabilized without outside assistance. Later in the decade, Poland received credits from a consortium of fourteen central banks to help stabilize its currency, and in 1929, Romania's monetary reform was underwritten by a similar form of external assistance.

Although the provision of external liquidity to support currencies under pressure and balance of payments adjustments was never formally institutionalized, it did receive important multilateral backing from the Bank for International Settlements, which was founded in 1930.[46] Within a year of its creation, the BIS extended credits to the central banks of Austria, Yugoslavia, Hungary, and Germany totaling some 750 million Swiss francs (US$145 million), although such sums were recognized as paltry compared to those in the financial disasters that avalanched throughout Central Europe in 1931.[47] In addition, the BIS organized informal consortia of central banks to extend emergency credits, and by the late 1930s, the BIS had developed facilities for reciprocal credits among central banks.[48]

The norm for the provision of liquidity was weak, especially if one is looking for a Bretton Woods–like commitment to large-scale public finance of balance of payments adjustments.[49] In particular, because it was often done on an ad hoc basis, the provision of liquidity was subject to many of the expectational problems that affected capital flight in general at this time. The problem was twofold. First, ad hoc exceptional financing was difficult to arrange because it was risky for the central banks or firms that made the bulk of the contribution. Furthermore, where the loan amount agreed upon was perceived as insufficient

[45] League of Nations, *Essential Facts About the League of Nations* (Geneva: League of Nations), various issues; Denys P. Myers, *Nine Years of the League of Nations, 1920–1928*, Ninth Yearbook (Boston: World Peace Foundation), Vol. 12, No. 1, 1929, pp. 58–67.

[46] On the origins of the BIS, see Beth A. Simmons, "Why Innovate? Founding the Bank for International Settlements," *World Politics* (Spring 1993), pp. 361–405.

[47] Leon Fraser, "The International Bank and Its Future," *Foreign Affairs*, Vol. 14, No. 3, April 1936, pp. 453–464.

[48] These were designed as much to make credits available for exporters as to support exchange rates. Bank for International Settlements, *8th Report*, Basel, Switzerland, 1938, p. 109.

[49] Dam, *The Rules of the Game*, pp. 69–70.

to salvage a currency under siege, market reactions would often render niggardly assistance packages counterproductive.[50] In the absence of regularized channels and sources, and facing risks that deficit countries would not be able to stabilize even with external support, surplus countries often delayed or shirked adherence to this norm.

Access to exceptional finance was often conditional, although the stringency of conditionality varied considerably from client to client and was often implicit.[51] The most obvious cases of conditionality involved the League loans to the smaller countries in the twenties, where domestic monetary institutions were redesigned and finances administered by League officials. However, even in bilateral cases among the major powers, loans often hinged on specific political and financial undertakings regarding the timing and content of the budget and the independence of the central bank. For example, France was denied American credits after 1923 in part because of its government's failure to ratify war debt agreements with the United States, and a loan to Britain was delayed in September 1931 because the Labour party refused to cut unemployment insurance from the budget. There were no fixed rules, but potential creditors often attached conditions (implied or explicit) to the provision of liquidity.

Overall, there was an expectation that surplus countries would supply financial assistance to help stabilize the economies or defend the currencies of deficit countries. This norm was weak. It was also subject to problems of collective action and uncertainty that prevailed in the absence of institutionalized channels for financial assistance. But it was a customary practice established under the prewar gold standard, and in many cases surplus assistance was critical to the establishment and maintenance of fixed parities.

International Bargaining: Deficit Adjustment and Surplus Facilitation

Implementation of these norms was often negotiable. Whenever a country faced balance of payments pressures that made it difficult to maintain a fixed parity, these norms would provide salient points around which negotiations would center for a resolution of the potential crisis. As a starting point, both surplus and deficit countries would try and maximize the extent to which their counterpart would fulfill the obligations implied by each of the three norms given above. The central goal for surplus countries, in a stylized negotiation over balance of payments adjustment, was for the deficit country to fulfill its obligations implied in the first norm: to balance its budget and to restrict its

[50] Sir Henry Clay, *Lord Norman* (London: Macmillan), 1957, pp. 397–398.

[51] The practice of conditionality evolved much more fully after the Second World War. See J. Keith Horsefield, *The International Monetary Fund, 1945–1960*, Vol. 2: *Analysis* (Washington, D.C.: IMF), 1969, chaps. 18, 20, 21, 23; and Joseph Gold, *Conditionality*, IMF Pamphlet Series No. 31 (Washington, D.C.: IMF), 1979.

monetary policy so that domestic demand would contract and capital would flow inward to help finance the balance of payments deficit. The central goal for deficit countries, on the other hand, was to secure as much assistance from surplus countries as possible and on the most generous terms. Since exceptional finance provided monetary authorities of deficit countries with the foreign exchange necessary to fill the gap between the greater supply and the weaker demand for their currency, it usually spared deficit countries from speculative attacks on their currencies, and gave them some "breathing space" in order to implement more fundamental reforms.

Breathing space was especially important to the process of deficit adjustment because the fiscal and monetary changes demanded by the first norm could entail some fairly severe economic costs in the short term. Balanced budgets usually meant sharp contractions in employment or wage cuts in the public sector, scaled-back public investment for reconstruction, and slashed public services and social benefits upon which many sectors of society depended for their standard of living. The most wrenching domestic debates took place over the importance of budget balancing when unemployment insurance for millions of citizens was at stake.

Balanced budgets also required new taxation, which threw salt into the wounds of social conflict that had opened up in many societies since the conclusion of the Great War. The need to present a balanced budget inevitably raised questions about the incidence of taxation. Socialist parties called for income taxes or, in the extreme, special levies on accumulated wealth. They strongly opposed taxes on the consumption of necessities. Business groups and industries preferred indirect taxes and other nonprogressive tax schemes. The rentier, from the upper social strata, also opposed progressive taxation.[52] The political costs to a government of imposing a revenue-raising solution upon these contending social forces was often so high that the decision did not get made until it was too late.

Restrictive monetary policies also posed problems for deficit countries. The most immediate difficulty was that raising interest rates would complicate the government's ability to finance its debt. To attract funds, governments would have to pay higher yields on bonds, further contributing to the fiscal dilemma. At the same time, credit restrictions would dampen business activity, encourage the drawing down of inventories, and cut into production with inevitable impact on unemployment. In the short run, restrictive monetary policies would usher in recession, the political fallout from which could be great.

Since placing external balance above internal balance could be extremely costly for a deficit country, it was tempting for the country to choose either to

[52] Alberto Alesina, "The End of Large Public Debts," chap. 2 in Giorgio Basevi (ed.), *High Public Debt: The Italian Experience* (Cambridge: Cambridge University Press), 1988, pp. 34–79, especially p. 39.

protect itself by contravening the liberalism norm or, in the extreme, to defect from the basic tenet of the gold standard by devaluing. Surplus countries had a strong preference to encourage deficit countries to continue to comply with norms one and two by offering stabilization financing, and negotiations over domestic orthodoxy in exchange for external financial support took place repeatedly under the gold exchange standard. Surplus countries could also try to encourage the compliance of deficit countries by offering to improve access to their own market by lowering tariff barriers or increasing import quotas. (This was one way France tried to consolidate the Gold Bloc and discourage its members from devaluing between 1933 and 1935.)

In summary, the central bargain between deficit and surplus countries included mutual policy adjustments consistent with the three norms cited above. Surplus countries tried to encourage a policy mix consistent with the first and second norms in exchange for living up to expectations regarding the third. At the margins, surplus countries may also have been willing to offer concessions in the form of increased economic openness. The most cooperative solutions to the problem of international adjustment were those that were most compatible with all three norms. A policy mix taken by the government of a deficit country that placed internal above external balance and bolstered this priority with protectionism and other external controls has been aptly labeled "beggar-thy-neighbor" by historians of the period.

Explaining Policy Choice during the Interwar Years

Despite the social and political changes wrought by the spread of industrialization and the First World War, the vast majority of countries attempted during the 1920s to return to a gold exchange standard, which rested on the adjustment norms sketched above.[53] Yet over the course of the next two decades, states displayed varying propensities to abide by these three norms. Why were some countries better able—or more willing—to live up to the demands of the gold exchange standard, while others more readily defected by allowing their balance of payments to deteriorate, and by devaluing or protecting? This section examines these outcomes and briefly outlines a set of expectations regarding the incentives states face to choose each. (Fuller theoretical reviews are found in the relevant substantive chapters.) In each case, the new political conditions of the interwar years influenced the policy choice taken. The stark contrast with the nineteenth century provides a plausible explanation as to why the interwar monetary system was more fragile than that of the prewar years. But it also explains the variation across countries over the course of the twenties and thirties, which is the primary focus of this study.

[53] The only exception in the twenty-three-country sample used in this study was Spain, which maintained flexible exchange rates throughout the interwar period.

Internal Adjustment

The gold standard entailed a commitment to deflate in the face of an incipient balance of payments deficit, hence reducing economic activity in the short run. If economic agents did not believe that the government would be able to act decisively to keep inflation under control and reverse the incipient imbalance, their behavior alone could frustrate the problem of adjustment, as will be discussed in greater detail in Chapter 3. What conditions signaled markets that governments were willing and able to engage in deflation if necessary? Conversely, what conditions undermined this confidence? I have argued above that the consensus born of nineteenth-century exclusionary politics was beginning to crumble around the turn of the century, and its demise was further hastened by World War I. Democratization, influence of the Left in governance, political instability, and labor unrest were plausible signals to economic agents that monetary policymaking could no longer remain insulated from brewing political demands. Market participants were assuaged wherever central banks could maintain their independence from these demands, but where monetary authority was manipulable by politicians, expedience was expected to prevail.

Regime Type. The shift from exclusionary elite-based politics to inclusive mass politics was one of the most important changes of the late nineteenth and early twentieth centuries. One could plausibly argue that the process of democratization undermined the narrow consensus that gave pride of place to external economic balance during the nineteenth century, yet during the interwar years several states gave up the democratic project in favor of varying degrees of repression. The power to repress demands for growth and to pass austere budgets by decree served to signal governments' potency in controlling popular inflationary pressures. Regimes resting on popular sovereignty on the other hand faced strong incentives to avoid policies that contribute to severe economic contraction in the short run.[54] Indeed, during the years between the wars, many countries found that deflation required some degree of suspension of popular government. Where democracy was not overthrown by authoritarian forms of governance, cabinets were at times empowered to rule by decree until fundamental fiscal reforms were implemented. In short, the new, more democratic politics of the twentieth century raised the possibility that domestic economic conditions would enjoy a far greater priority than they had in the past. Democracy and equality signaled markets that the gold standard was no longer inviolable.

[54] William Nordhaus, among others, has outlined a political and economic logic for expecting democratic systems to have higher than optimal inflation. William Nordhaus, "The Political Business Cycle," *Review of Economic Studies*, Vol. 42, 1975, pp. 169–190. Nordhaus's model is built around the assumption that policymakers can make trade-offs between levels of inflation and unemployment in the short run that will translate into the largest possible number of votes.

Political Orientation of Party in Power. The hallmark of political change across Europe during the late nineteenth century was the gradual organization and representation of the working class into mainstream politics. But this was precisely the class whose interests were most immediately and vitally at stake whenever external balance dictated the need for domestic deflation. Higher interest rates dampened business expansion and reduced employment opportunities. Workers were among the first to experience the burden of adjustment through falling wages or increased unemployment. Furthermore, falling prices would shift the real burden of adjustment away from creditors (or those who saved a larger portion of their income) to debtors. In particular, cuts in government expenditures (fiscal retrenchment) would fall most heavily on low-level public employees and usually involved the withdrawal of support for public social expenditures not deemed "essential." For all these reasons, newly influential political parties that purported to represent the working class after World War I found the practical requirements of internal adjustment especially undesirable.[55] Their pronouncements in favor of balanced budgets and strong currency simply did not ring true given their constituency commitments. Left-wing parties—excluded from governing during the prewar period—were expected to balk at policies by which workers would bear the greatest domestic share of the burden of adjustment. When left-wing parties assumed the responsibility for governing in the twenties and thirties, markets anticipated inflationary pressures and responded accordingly, making it far more difficult to actually achieve the internal adjustment the gold standard required.

Labor Unrest. One of the most painful aspects of internal adjustment is the compression of input prices necessary to improve the competitive position of a country's products on the world market. To make exports competitive, industries must be able to lower their costs, a large part of which is the cost of labor. Where workers resist wage compression, deflation will end in an intolerable level of unemployment rather than in a more competitive economy.[56] An important aspect of the ability to adjust internally is therefore likely to be the degree of labor quiescence in any given society. While labor and social unrest were significant in a number of European countries in the 1890s and after the turn of the century, these protests did not easily translate into improved wages as long as unionization remained low. Labor demands for wage and job security and reduced working hours posed new risks during the interwar years, due to labor's superior organization and political clout. No longer could such demands be ignored; on the contrary, they could be expected to reverberate throughout the economy in the form of inflationary pressure. The new politics of the interwar years shattered the certainty that governments would refuse to accommodate such inflationary pressures in the interest of maintaining low inflation, external balance, and currency stability. And in contrast to the post–World War II period, a well-developed corporatist framework simply did not exist during the interwar years in most countries to contain economic conflict and the threat of domestic inflation. If the politics of the interwar years were newly inclusive, they had yet to develop institutional forms to soften the rough edges of class conflict. In this context, strikes could encourage anticipatory market adjustments that frustrated a program of internal economic adjustment in the face of an incipient deterioration in the balance of payments.

[55] For the post–World War II period, see Douglas Hibbs, "Political Parties and Macroeconomic Policy," *American Political Science Review*, Vol. 71, No. 4, 1977, pp. 1467–1487; Stanley W. Black, "The Use of Monetary Policy for Internal and External Balance in Ten Industrial Countries," in Jacob Frenkel (ed.), *Exchange Rates and International Economics* (Chicago: University of Chicago Press), 1983, pp. 189–225; Andrew Cowart, "The Economic Policies of European Governments, Part 1: Monetary Policy" *British Journal of Political Science*, Vol. 8, 1978, pp. 285–311.

[56] On the relationship between labor demands and inflation for the post–World War II period, see Stanley W. Black, *Politics Versus Markets: International Differences in Macroeconomic Policies* (Washington, D.C.: American Enterprise Institute for Public Policy), 1982; Robert J. Gordon, "The Demand for and Supply of Inflation," *Journal of Law and Economics*, Vol. 18, 1975, pp. 808–836.

Government Instability. While the price of adjustment may indeed be high in the short run, the longer term benefits may be great: a strong stable currency, competitive exports, the ability to disassemble artificial controls, a manageable rate of inflation, and an improved reputational standing at home and abroad are all benefits of reaching a sustainable equilibrium in the balance of payments. Governments that expect to enjoy these benefits may well choose to endure the bitter deflationary medicine required to enjoy economic health. But governments that rest on a politically precarious consensus are highly unlikely to take serious measures to deflate. The practical problem of assembling a consumption-cutting majority with uncertain coalitional support makes it difficult to pass deflationary budgets. Moreover, there is very little incentive for a potentially unstable government to implement unpopular restrictive measures, since their implementation will likely jeopardize the government's prospects of being around to enjoy the benefits of a well-adjusted economy. Unstable governments have notoriously short time horizons. Deflation requires the ability to withstand short-term pain for long-term gain. Unless a government is reasonably sure it will be in power when the price of adjustment begins to pay off, adjustment will be postponed. Growth, consumption, and inflation will continue; political opponents will be left to pay the bills. Unstable governments are only acting rationally when they avoid the restrictive policies needed to correct a balance of payments disequilibrium.

Central Bank Independence. The decision to deflate may not be made by the government alone. While politicians control fiscal policies, they may have much less control over the direction of monetary policy. This is especially true when monetary institutions are designed to be independent of government

control. Central bankers that are not directly appointed or supervised by politicians are in a position to implement tight credit policies that damp down domestic demand and work to lower domestic prices, with relative freedom from governmental pressure. Politically controlled central banks, however, are much more likely to carry out the government's agenda. When the myriad pressures and concerns of governments outlined above are considered, it is highly unlikely that an independent central bank would advocate a monetary policy that is *more* permissive than that preferred by the government itself. More typically, independent central banks will implement monetary policies that are tighter on average than those under political control. Thus, the insulation of the monetary authority from politics may enhance the commitment to monetary stringency, and strengthen the commitment to gold standard adjustment.

Overall, the hypothesis that the policy mix will be pulled toward internal adjustment under specifiable domestic political and institutional conditions can be tested systematically. Internal adjustment should be associated with regimes that are able to keep democratic excesses under control; it may even be the case that authoritarian regimes are better able to compress their economies than are democratic regimes. Internal adjustment is also more likely under center-right governments that place a higher value on price stability than on growth, under polities with a quiescent labor force and a stable government, and in countries with a central bank that is relatively independent of politicians. *In short, the ability to comply with internationally accepted adjustment norms may be conditioned by the domestic political and institutional variables that influence a country's macroeconomic tastes more generally.* Repression, conservatism, and stability are likely to be consistent with gold standard adjustment; their opposites, with defection.

Externalization

MONETARY EXTERNALIZATION: DEVALUATION

The first mode of defection to consider is abandonment of the gold standard's first principle: to maintain fixed currency parity. Because of the central role of market expectations, it is not sufficient to think of international monetary politics in terms of pure reciprocity between *governments.* In an anticipatory model, *official* reciprocity can be undermined by market pressures flowing from expectations that governments will not be able to defend the prevailing parity. When markets act on their beliefs about each government's commitment to the priority of external balance (and exchange stability), their actions can virtually force norm defection, or at least make defection more likely. Under such circumstances, the ability of governments to influence one another's behavior through a calibrated tit-for-tat strategy is highly circumscribed.

For the reserve currency case, Kenneth Oye has analyzed this phenomenon in terms of two sets of *N*-person Prisoner's Dilemmas: one among the central bank of the reserve currency and holders of that currency, and the other among holders themselves.[57] If a currency is under pressure, he notes, dumping it to avoid exchange losses is individually rational. Holders act on their expectations about government policy and about the reactions of other market players. If they expect devaluation they should sell sooner rather than later. If a government foresees selling pressures, it may have an incentive to devalue preemptively, in order to prevent the massive conversion of its currency into gold. Oye concludes that the setting of fixed rates precluded the use of exchange rates for bargaining purposes, undermining the possibilities for reciprocity that might have kept the international economic system from disintegrating in the early thirties.[58]

But intergovernmental reciprocity is not the central issue: the government's *credibility* with any holder of its currency is. The willingness to hold a currency is linked to the degree of confidence that it will not be devalued. In the early thirties, confidence that governments could continue to pursue macroeconomic and monetary policies consistent with fixed gold parities was flagging, partly because it was incredible that governments representing labor would allow their constituents to suffer for the sake of the currency. As Kenneth Oye notes, "Monetary politics in the early thirties were conditioned by recognition of a short term tradeoff between domestic recovery and exchange rate stabilization, and *governments of the left, confronting high levels of unemployment preferred devaluation to deflation.*"[59] Whether or not governments of the Left actually preferred devaluation, markets expected that constituency pressures would encourage the Left to abrogate the first norm of the gold standard. Credibility crumbled, and with it, the international monetary system.

The key empirical question is, *What shattered credibility*? Anything that would lead markets to suspect that Norm 1 was at risk and to expect devaluation could discredit a government's policy. Conditions associated with an expansion in the money supply that were inconsistent with a fixed parity could lead the market agents to rearrange their assets and renegotiate their contracts. Thus, all the variables associated with expected macroeconomic expansion could spark capital flight to the extent that markets anticipate inflation and act on this expectation. The moment deflation appears politically unfeasible, selling pressure on the currency is expected to increase, making devaluation more likely.

Markets are expected to react to political conditions with which they associ-

[57] Kenneth Oye, "The Sterling-Dollar-Franc Triangle," pp. 173–199.
[58] Ibid., p. 180.
[59] Ibid., p. 178 (italics added).

ate a heightened risk of inflation or other forms of confiscation.[60] Governments with working-class constituencies may be perceived as being less willing to deflate and more likely to expand the money supply to protect employment than governments of the center-right. The result will be capital flight and currency depreciation. A similar effect should attend unstable domestic political conditions. Governments that are not expected to be in office for very long are not able to make credible policy commitments, and markets react by seeking more predictable conditions elsewhere. Severe labor unrest could also contribute to capital flight. As strikes spread, expectations of inflation are raised, even if negotiations do not result in higher real wages. Holders of capital, fearing inflation and possible depreciation, will shift their assets accordingly. Capital will flee, and the risk of depreciation will increase. On the other hand, credibility is likely to be enhanced if the central bank is seen as being above politics. Under a more independent central bank, the expansive preferences of the government are perceived as being less likely to influence monetary policy. Holders of liquid capital will prefer to move their assets to markets where the monetary authority is insulated from political pressures to inflate the money supply. Independent central banks are expected to be associated with internal adjustment and with fewer and more moderate devaluations.

To summarize, monetary defection is hypothesized to be conditioned by the strength of a government's reputation for defending the currency. Reputation is heavily conditioned by the economic agents' beliefs about a government's preferences, time horizons, and willingness to accommodate labor demands. The credibility of a monetary commitment will be heightened to the extent that actual control over monetary policy is centered in an independent—and preferably conservative—institution. To answer the question "Who devalues?" we would do well to consider the conditions that contribute to a loss of credibility in monetary affairs.

TRADE EXTERNALIZATION: TARIFFS

The decision to protect is governed by a somewhat different set of factors from those described above. Tariffs more centrally involve the real economy rather than capital markets. Tariffs are also much more directly under a government's control than is the external value of its currency, which in the final analysis is determined by supply and demand. Tariffs also may serve a number of different policy ends: they may be implemented to protect specific producers, to improve the overall balance of payments, or to raise domestic revenue (customs tax).

[60] When inflation is unanticipated, it is "confiscatory" in the sense that it involves an unambiguous transfer of wealth from the private sector to the public sector, resulting in what has been termed an "inflation tax." See, for example, Samuel Brittan, "Inflation and Democracy," chap. 7 in Fred Hirsch and John Goldthorpe (eds.), *The Political Economy of Inflation* (Cambridge: Harvard University Press), 1978, pp. 161–185. Economic agents that anticipate and adjust their portfolios are able to escape wealth losses associated with seigniorage.

Finally, tariffs are legislatively voted rather than determined in the relatively insulated confines of monetary institutions. Tariffs are much more a policy *choice* in the traditional sense than is currency depreciation or devaluation. When governments make monetary decisions, they are primarily involved in strategic interaction with *markets*; when tariffs are contemplated, the primary problem is the strategic reaction of other *governments*. Tariffs are much more usable as international bargaining tools. Considerations of interstate reciprocity and retaliation come to the fore.

Hence, in considering commercial policies it is critical to focus on those factors that shape international economic relations with other states. It would be a mistake to lump devaluation with tariff protection and refer to them generically as "defection," since the strategic actors in each game are distinct. The problem, then, is to explain the conditions that influence the preferred mix of externalization.

In the case of tariffs, the structure and size of the economy are likely to be two of the most important determinants of the decision to protect. The traditional economic literature suggests that the largest states, like monopolistically positioned firms, are able to influence prices and hence may alter the terms of trade in their favor by implementing an optimal tariff.[61] Additionally, states that are relatively self-sufficient can better afford to insulate themselves from the international economy. Highly trade dependent economies, on the other hand, must trade to survive. They will not be willing to engage in protection, both because it raises the price of their own imports and because of the risk of retaliation. There are excellent reasons to believe, as Peter Katzenstein has noted, that the optimal strategy for small, trade-dependent states is to maintain liberal trade policies.[62]

But there may be an ideological or distributional explanation for changes in tariff levels as well. Tariffs are taxes, and tariff protection affords particular domestic producers surplus rents above the value of their production. As with any tax, its attractiveness depends on how the burden falls on different sectors of the society. Tariff protection favors domestic producers and penalizes consumers. Particularly when customs were levied on imported necessities such as food, beverages, and tobacco [*sic*!], tariffs were viewed as consumption taxes that penalized the working class. Despite the fact that consumers were also producers (and hence an argument could be made, as it is often today, that protection has an employment justification), political parties that represented workers were programmatically and ideologically opposed to consumption

[61] Charles P. Kindleberger, *International Economics* (Homewood, Ill: Richard D. Irwin), 1968, chap. 7; Tibor Scitovsky, "A Reconsideration of the Theory of Tariffs," *Review of Economic Studies*, reprinted in American Economic Association, *Readings in the Theory of International Trade* (New York: McGraw-Hill), 1949, chap. 16.

[62] Peter J. Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca: Cornell University Press), 1985.

taxes that raised the cost of living for the working class. More generally, the application of the Stolper-Samuelson theorem—which holds that protection generally benefits the scarce factor of production and imposes a net cost on the abundant factor—might predict that demands for freer trade would emanate from labor and left-wing parties rather than from capital and parties of the right.[63] Furthermore, as the Left gains representation in governance, we might expect a reduction in tariff barriers, both across countries, and over time.

Finally, tariff protection is a mode of externalizing the costs of adjustment, unemployment, and the burden of taxation onto foreign producers, whereas dismantling tariffs or keeping them low forces the domestic economy to absorb the impact of changing economic conditions and to raise taxes internally.[64] One final hypothesis is that unstable governments—those that have low time horizons and that rest on precarious political coalitions—are less likely than more stable ones to take the risks and absorb the costs of maintaining lower tariffs. Less stable governments, on the other hand, find externalization an easy alternative. Unable to resist domestic pressures, they are more likely to take the path of least resistance and protect domestic producers rather than to allow price adjustments to ripple through the economy.

Conclusions

This chapter has laid the groundwork for understanding the sources of instability in the gold exchange standard that prevailed between the two World Wars. The classic gold standard depended not on financial hegemony of one preponderant power, or conducive economic conditions, but rather on the belief that governments were commited to macroeconomic policies with which a fixed relationship to gold would be compatible. The Great War fundamentally changed the political landscape that had been compatible with a credible commitment to gold: political systems in which demands of contending social forces could be marginalized; governments that were stable, if narrowly constituted; and the prevalence of political philosophies that justified a relative lack of governmental responsibility for domestic economic conditions and the welfare of citizens. Although these conditions no longer prevailed after 1920, in reconstructing the international economic order monetary authorities turned to the model of monetary order that had, in their estimation, served so well up to 1913. Some states, for given periods of time, were willing and able to maintain internal macroeconomic policies that were consistent with the demands of the

[63] Ronald Rogowski, *Commerce and Coalitions* (Princeton: Princeton University Press), 1988.

[64] As John Hansen has argued in his discussion of the determinants of American tariff policy, "tariffs were instruments of revenue, and the battles over tariff policy were battles over taxes, over how they should be raised and over who should pay them." John Mark Hansen, "Taxation and the Political Economy of the Tariff," *International Organization*, Vol. 44, No. 4, Autumn 1990, pp. 527–549, especially p. 528.

gold standard; but others, undermined by markets that doubted the sincerity of official commitments to deflationary policies and external balance, found the social and political costs far too high a price to pay for remaining on gold. As the following chapter will show, the political and social factors that distinguished the prewar from the interwar years are also useful in explaining *variations* in the commitment to gold among countries over the course of the interwar years themselves. Thus the stability of the international monetary system had as much to do with internal as with international politics during the two decades between the wars. The distinguishing factors in a country's ability to maintain external economic balance have largely to do with the credibility of its commitment to pursue "moderate" macroeconomic policies, a commitment that came under question in more and more cases with the close of World War I.