MONEY, MARKETS, AND THE STATE

Social Democratic Economic Policies since 1918

TON NOTERMANS

University of Tromsø

CAMBRIDGE UNIVERSITY PRESS
CONTENTS

List of Tables and Figures  xi
List of Abbreviations  xiii
Acknowledgments  xv
A Note on Terminology  xix

1 Social Democracy in the Macroeconomy  1
2 Politics, Economics, and Political Economy  14
3 Why Was There No Social Democratic Breakthrough in the Twenties?  42
4 The Creation of the Social Democratic Consensus  100
5 The Breakdown of the Social Democratic Consensus  160
6 Social Democracy in the Twenty-first Century  222

Notes  250
References  270
Index  297
TABLES AND FIGURES

TABLES

3.1 British governments during the interwar period 45
3.2 Norwegian governments during the interwar period 46
3.3 Unemployment rates, 1916–26 48
3.4 Dutch governments during the interwar period 57
3.5 German budget deficits, 1919–23 58
3.6 Restoration and decline of the gold standard 69
3.7 German governments during the interwar period 80
3.8 Average annual man-days lost in labor disputes, 1910–69 85
3.9 Swedish governments during the interwar period 90
4.1 Index of national product, 1930–39 108
4.2 Unemployment rates, 1927–37 109
4.3 Central government expenditure and budget deficits, 1920–39 120
4.4 British central government accounts, 1920–38 123
4.5 German public finances, 1926/27–1932/33 124
4.6 The main agricultural price stabilization measures 127
4.7 Gross wages, Germany, 1928–36 137
5.1 Dutch governments, 1973–98 178
5.2 German governments, 1966–98 180
5.3 British governments, 1945–97 194
5.4 Swedish governments, 1974–98 198
5.5 Norwegian governments, 1971–97 202
5.6 Contractual wages and wage drift of Swedish industrial workers, 1971–90 214
5.7 Yearly increase in wages in Norwegian manufacturing of adult males, by contractual increase and wage drift 216
FIGURES

2.1 The Phillips Curve  19
2.2 The neoclassical labor market  20
2.3 Liquidity preference  27
2.4 The credit market  28
3.1 Wholesale price index, 1916–27  63
3.2 Consumer price index, 1916–27  64
4.1 Wholesale price index, 1928–39  106
4.2 Consumer price index, 1928–39  107
5.1 Private consumption deflators, 1970–97  168
5.2 Unemployment rates, 1970–97  171
5.3 General government financial balances, 1973–97  174
5.4 Public-sector employment as a percentage of total employment  199
5.5 The unraveling of the Scandinavian model  208
6.1 Money market rates  238
6.2 Government bond yields  239

ABBREVIATIONS

ADGB Allgemeiner Deutscher Gewerkschaftsbund
AES Alternative Economic Strategy
AfA Allgemeiner freier Angestelltenbund
ARP Anti-Revolutionaire Partij
BdL Bank deutscher Länder
BF Bondeförbundet
BoE Bank of England
BP Bondepartiet
CDU Christlich Demokratische Union
CDU(NL) Christen-Democratische Unie
CHU Christelijk Historische Unie
CSU Christlich Soziale Union
DGB Deutscher Gewerkschaftsbund
DNA Det Norske Arbeiderparti
DNB De Nederlandsche Bank
DNVP Deutsch-Nationale Volkspartei
DP Deutsche Partei
DVP Deutsche Volkspartei
ECB European Central Bank
EEA Exchange Equalization Account
ECU European Currency Unit
EMS European Monetary System
EMU Economic and Monetary Union
FIEF Fackföreningarsrörelsens Institut för Ekonomisk Forskning
KVP Katholike Volkspartij
LO(N) Landsorganisasjon i Norge
LO(S) Landsorganisasjon i Sverige
ACKNOWLEDGMENTS

This manuscript has traveled a long road to completion. I first became interested in questions of economic policy in advanced industrial nations while attending Manfred Schmidt’s seminars at the Freie Universität Berlin during the mid-eighties. At the time, I felt that Schmidt’s emphasis on domestic politics and institutions was becoming less appropriate in an increasingly globalized economy. More than a decade later I realize that Schmidt was right from the beginning: domestic political processes, rather than international economic pressures, were and are the decisive driving forces of economic policy making. That I eventually came to realize this was in no small amount the result of my regular discussions with Lars Mjøset of the University of Oslo. One of my early attempts to make sense of economic policy making drew his comment that it did not seem to apply particularly well to the Scandinavian countries. Lars was right. I hope the present argument will be more acceptable to him.

During my time at the Freie Universität I also regularly visited Hajo Riese’s seminars in macroeconomics. Riese convinced me that any account of economic policy making would have to be centered on money and monetary policy. The years that have passed since then have only made my conviction stronger.

Having finished my master’s thesis at the Freie Universität, I applied to the doctoral programs of several U.S. universities, though with little hopes of being accepted or being able to finance such an undertaking. To my great surprise, the Department of Political Science at the Massachusetts Institute of Technology not only accepted my application but also provided me with a fellowship, hence allowing me to spend some years in what is probably one of the most stimulating intellectual environments in the world.

During my first semester at MIT, I had the great luck of meeting Andrew Martin of the Center for European Studies at Harvard University. Without
Andy’s intellectual and moral support this manuscript probably never would have been written. The argument advanced here has been shaped in more ways by Andy’s comments than he probably realizes himself. Douglas Forsyth of MIT’s Department of History was one of the few who shared my interest in money and finance. During my last years at MIT, we talked almost on a daily basis. His incisive comments have greatly helped clarify my own thoughts on the subject. Another person who provided crucial support in times of need was Helen Ray of the MIT political science department. Without her uplifting presence I probably would not have lasted as long at MIT as I did. It was also at MIT where I met my wife, Simona Piattoni. I am still surprised that she never got tired of carefully reading numerous versions of the same argument. Without Simona the manuscript might have been finished earlier, but it would certainly have been much less fun writing it.

The list of people who at some point or another provided helpful comments would probably fill several pages. In order not to make an already long manuscript even longer I just mention five people who have been particularly helpful: Jos de Beus, Lars Hörgren, Lars Jonung, Charles Sabel, and Richard Samuels. Interviews with policy makers have been of crucial importance, but, as is common in this type of study, I will not mention them by name.

Affiliations with three institutions, in particular, have been most helpful. In Oslo the hospitality of the Institute for Social Research has made my stays both more fruitful and more pleasant. I would like to thank in particular its director, Frederik Engstald, Trond Nordby, Geir Hoegnes, and the staff of the library for their kind assistance. The Swedish Trade Union Institute for Economic Research (FIEF) most probably is the ideal research environment for someone interested in economic policy and social democracy. Without the invaluable assistance of the people at FIEF the Swedish part of this study could not have been written. In particular I would like to express my gratitude to FIEF’s director, Vilho Bergström, and to Anders Vredin and Cesar Fuentes-Godoy. In Germany I greatly benefited from my stay at David Soskice’s Labor Market and Employment Research Group at the Wissenschaftszentrum Berlin.

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

Financial assistance for this study has been received from the Department of Political Science at MIT, the MacArthur doctoral scholarship program of the Center for International Studies at MIT, the Program for the Study of Germany and Europe of the Center for European Studies at Harvard University, and the Social Science Research Council in New York. Finally I would like to thank Johan Olsen of the ARENA Program of the Norwegian Research Council for giving me a chance to broaden my horizon.

This book is dedicated to my father, who finished school during the Great Depression just to join the army of the unemployed, and who died at a time when Western European governments again were doing their best to keep millions of people out of work.
A NOTE ON TERMINOLOGY

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

The social democratic vision of society envisaged a world in which human beings control their circumstances rather than being controlled by them. One essential characteristic of such a society would be that it guaranteed its members a decent livelihood. Rather than large sections of the population being condemned to inactivity by recurring economic crisis, all those able to take up employment should have the possibility of doing so. Those who temporarily or permanently lack the ability to provide for themselves should be able to count on the solidarity of society to provide them with the means for a decent livelihood. The inability to work should not be a condemnation to live a marginalized existence. Sickness should not be an economic catastrophe and the health care received should be determined by need rather than by ability to pay. Likewise, education should be provided according to ability rather than according to social status or wealth. In addition, such a society should be democratic. A society that achieved freedom from economic want by subjecting its members to the whims of an overpowering state would defeat its own purpose. In short, the social democratic program aimed to reform the market economy so as to combine political and economic liberty.

During the first couple of decades after its birth in the second half of the nineteenth century, the social democratic struggle focused primarily on achieving political liberties. Not only was political democracy a goal in itself, it also seemed a necessary and sufficient condition for realizing the economic goals of the labor movement. In a society in which a narrow elite reserved for itself the right to appoint the political leadership, the state would inevitably consider it its task to defend the economic privileges of the few rather than to promote the well-being of the many. After the struggle for democracy was crowned with success shortly after the end of World War I, social democrats had little doubt that their economic program would soon be realized too. Looking back at more
than eighty years of social democratic policies in democratic societies, however, one must conclude that, rather than creating the conditions under which humans can control their own economic fate the social democratic program itself has been subjected to the whims of economic conditions.

At times, it appeared that the social democratic program was the only viable program for the management of the economy in a democratic polity. The economic malaise of the interwar period also convinced center-right political parties that interventionist policies were required to achieve acceptable economic outcomes and that cutting wages, taxes, and welfare benefits was not a promising avenue to economic prosperity. In the decades following the Great Depression, social democrats thus saw much of their policy program realized, even in those countries where they did not manage to obtain a dominant position in government. Yet, this "golden age" of social democracy was bracketed by two periods in which even social democrats found it hard to deny the liberal critique that generous welfare arrangements, a strong union movement, and extensive political management of the economy undermined the well-springs of economic prosperity. During the 1920s and again since the mid-seventies, Western European social democrats proved unable to provide an economic policy program that could effectively address stagnation, unemployment, and inequality. Rather than providing an effective remedy against mass unemployment, social democratic policies seemed to make matters worse. Improving the income of labor and extending welfare state arrangements appeared to threaten the prosperity of the business sector on which the well-being of labor ultimately depended.

This study provides an explanation of the historical vagaries of the social democratic program. It focuses on the economic policies of social democratic governments in five countries. Sweden and Norway boast the strongest social democratic parties in the Western world. Ever since they came to power in the midst of the Great Depression, they have been the dominant political forces in their countries. The Swedish social democratic party (SAP, Sveriges Socialdemokratiska Arbetarepartiet) governed uninterruptedly from 1932 to 1976, and with a three-year interruption in the early nineties, has been in power again since 1982. Interrupted only by the German occupation, the Norwegian social democrats (DNA, Det Norske Arbeiderpartiet) governed from 1935 until 1963. In the thirty-five years since, they have been in office for roughly twenty-three years. German and Dutch social democrats, in contrast, have found themselves in a rather weak position. While the German Social Democratic Party (SPD, Sozialdemokratische Partei Deutschlands) became the strongest political force after the collapse of the German Empire, its fortunes turned with the onset of recession in the early twenties. Except for a two-year period in the late twenties, it was out of office from 1924 to 1966. It suffered a similar fate in the recession of the early eighties, when it was forced to leave office after its liberal coalition partner deserted in 1982. It has only been able to return to office in 1990. The Dutch social democrats traditionally required the consent of the Christian dem-

ocrats to enter government and had to remain on the opposition benches until 1959. They became a regular coalition partner after the war, but their ability to pursue their preferred policies always remained sharply constrained by the pivotal position of the Christian democrats. As economic pressures mounted in the mid-seventies, they had to leave office and were unable to return until 1989. However, as before, since 1989 it, too, has governed on the basis of a coalition in which it confronted parties of equal or greater strength. The British Labour Party occupies a middle position. Due to the absence of coalition governments, it can wield considerable power when in office, yet it managed to govern on a regular basis only during the decades of prosperity after 1945. Apart from two short-lived governments, it was out of office in the interwar period. Mainly due to its inability to handle the economic crisis, it was voted out of office in 1979 and did not manage to return until 1997.

The main argument of this study is that rather than being determined by the political strength of social democratic parties, the success or failure of the social democratic program depends crucially on the institutional and political ability to combine growth with a fair degree of price stability. The economic growth required to achieve the goals of full employment and a well-developed welfare state can only be brought about by an expansionary macroeconomic regime. Macroeconomic policies, however, can concentrate on growth only if labor market institutions can assume a major part of the responsibility for keeping inflation down.

THREE REGIME CHANGES

Three fundamental turning points in the fate of the social democratic policy program in Western Europe can be distinguished since 1918. In the tense political and economic situation following the end of the war, full employment and growth enjoyed top priority. While many wartime regulations were quickly abolished, frequently at the behest of labor, monetary policies remained expansionary so as to promote growth. Within five years after the armistice, however, all governments had come to see the attempts to foster growth and employment by means of discretionary macroeconomic management as a mistake. Full employment was accompanied by rampant inflation, which was perceived to be the result of ill-guided attempts to mitigate domestic distributional conflicts by means of fiscal expansion and the printing press. Accordingly, the resurrection of the fixed exchange rate regime of the gold standard was to provide a "knave-proof" protection against politically caused economic instability, limiting as much as possible the access of domestic political actors to monetary policy decisions. The deflationary policies required to return to the gold standard at the prewar parity initiated a long period of mass unemployment. But, since the experience of high inflation had allegedly shown that macroeconomic policies could not durably alter output, responsibility for growth and employment
apparently could not be placed with the state but instead had to rest with civil society. Especially with respect to demands for employment policies, governments stressed that the unobstructed operation of the labor market was the most promising road to full employment. In this zero-sum situation the accommodation between capital and labor that had started during the war could not proceed.

Although, with the exception of Sweden, non-social democratic governments initiated the return to the gold standard, social democrats saw no alternative. As a result, they found themselves confronting the dilemma of having to agree that the major impulse to growth and employment had to come from domestic cost reduction, while at the same time being unable to politically accept the consequences in terms of social security and wages. Unable to identify a viable policy alternative, many social democrats relapsed into a sort of Marxist fatalism, which postponed all practical policies for the improvement of the lot of the working class to that mythical time when the socialist revolution would arrive.

The liberal policy regime ended abruptly in the Great Depression of the 1930s. The liberal belief in the self-regulating market now came to be widely considered erroneous, and not only by social democrats. The price governments apparently had to pay for their abstention from discretionary policies was the worst economic recession in recorded history and a threat to the legitimacy of liberal democracy. Governments now resorted to widespread regulation of prices and quantities in order to halt what was diagnosed as a process of ruinous competition in unregulated markets. In a full U-turn, independent central banks, which in the preceding decade were heralded as the strong institutions that would restore monetary discipline, came to be seen during the depression as one of the major villains in the piece, who had sacrificed the interests of society in favor of the interests of haute finance. Moreover, Keynes's contention that contracyclical fiscal policies rather than unobstructed wage adjustment were required in order to maintain full employment became a generally accepted dogma for most governments after World War II.

Politically the Great Depression ushered in the golden age of social democracy. The social democratic critique that the liberal management of the economy at best benefited a narrow elite while subjecting the economy to instability and crises now seemed incontrovertible. Social democracy's political opponents on the center and right of the political spectrum also had to recognize the bankruptcy of laissez-faire and accordingly found themselves on the ideological defensive. Moreover, at the moment when market regulation was deemed necessary to prevent ruinous competition, and growth and employment were to be achieved by macroeconomic stimulation, welfare arrangements and organized economic interests no longer appeared as impediments to prosperity but rather could be interpreted as valuable stabilizing elements in an inherently unstable market economy. Accordingly, the polarization between capital and labor gradually gave way to accommodation.
PRECONDITIONS FOR THE SOCIAL DEMOCRATIC PROGRAM

In sociological terms, social democracy traditionally has considered itself the political representation of the working class. Its historical roots lie in the firm-level struggle between workers and owners in an industrial economy. In the labor movements' own understanding of its internal division of labor, trade unions are to represent workers' interests in the bargaining process, while social democratic parties represent their political interests on the level of the state. A potential tension exists, however, between the firm-level conflict of interests between workers and employers and the macrolevel desirability of a market economy. The electoral logic of a political movement, which derives much of its strength from a close association with trade unions, requires that social democrats cannot be seen as wholeheartedly embracing the interests of the employers, while its advocacy of a market economy requires that it must promote conditions under which privately owned business can prosper.

This tension implies that social democracy finds it difficult to thrive in a world where the macrolevel pursuit of workers' interests is considered antithetical to the prosperity of the market economy. Instead, the success of the social democratic program rests on an economic policy regime in which macroeconomic management is considered to hold the key to growth and employment. In technical terms, social democratic policies only come to be seen as constituting a superior mode of managing the economy when macroeconomic policy management is informed by the conviction that money is not neutral, that is, the belief that monetary expansion can have real and not only nominal effects.

The conviction that money is neutral implies that the state, on the macroeconomic level, cannot mitigate the microlevel zero-sum game between business and labor. Expansionary monetary policies per definition only result in higher inflation. The same argument, however, also implies that fiscal management cannot durably alleviate unemployment and stagnation. Without monetary expansion, fiscal expansion requires that increased budget deficits be financed either by increasing taxes or by loans. In either case, no aggregate positive effect can be expected as the funds that the private sector could have employed for expansion are used by the state, and the additional purchasing power is neutralized by heavier taxation. Financing a deficit by creating money does not help because it is the equivalent of expansionary monetary policies. Moreover, to the extent that the desire to prevent inflationary monetary policies has been institutionalized by means of a fixed exchange rate arrangement and the acceptance of unobstructed international financial flows, the possible consequences for the currency will generally be sufficient to prevent attempts at expansionary fiscal management.

In regimes like the interwar gold standard or the present neoliberal one in which macroeconomic policies are primarily assigned the goal of price stability, the low growth and mass unemployment that tend to be characteristic of such periods hence are inevitably attributed to microeconomic causes. Extensive social welfare systems, the trade unions' resistance to more labor market flexibility, cartel agreements, and insufficient innovation come to be seen as the main impediments to renewed prosperity. In such a constellation, social democracy faces the unpleasant dilemma of either supporting trade unions' efforts, thereby risking the loss of electoral support for appearing to lack a policy that can benefit society as a whole, or concentrating on what are considered sound economic policies, thereby sacrificing their conviction that the market economy is not incompatible with the legitimate demands of labor. In practice, such a situation generally entails that social democrats lose the political initiative as they move uneasily between the two sides of this dilemma.

To be sure, during periods when the inevitability of a restrictive macroeconomic regime is generally accepted, the political left tries to regain the initiative by presenting its own version of supply-side theory, which denies that the microlevel interests of the labor force are antithetical to overall prosperity. The leftist version, not surprisingly, inverts the neoclassical contention that a weak labor movement is beneficial for economic performance. Improving productivity and the attractiveness of the product mix, rather than cost cutting, is presented as the key to prosperity. Strong trade unions and high real wages, in this view, promote overall prosperity because they prevent the employers from choosing the low-cost road to competitiveness, forcing them instead to continuously innovate and compete on the basis of quality rather than price. But while this may seem ideologically attractive, social democracy has historically been unable to build an attractive alternative program based on microeconomic strategies, simply because such strategies are economically and organizationally inappropriate.

Just as their liberal (neoclassical) counterpart, social democratic supply-side policies for improved competitiveness have been unable to provide an effective answer to the core problem of mass unemployment because they rest on a fallacy of composition. Competitiveness is a relative term: not every firm or country can improve its competitiveness simultaneously. Even if a firm manages to improve competitiveness, either by cost reduction, improved productivity, or a more attractive product mix, there is no reason to assume that this will lead to an increase of aggregate employment. Aggregate employment increases only if production is increased by more than productivity gains. By itself, increased competitiveness for one firm means loss of market shares for another firm, whereas increased productivity of the economy means that the same level of production will require less labor. Instead of solving the problem of unemployment and stagnation, a policy that relies on microeconomic strategies for employment under a restrictive macroeconomic regime is likely to contribute to increased inequality between a highly paid, highly educated sector of the economy and an increasingly marginalized, underemployed, and undereducated sector.

To avoid confusion, the point is not that supply-side policies are unnece-
sary or ineffective, but that it is inadmissible to treat microeconomic policies as a functional equivalent of macroeconomic policies. It is indeed hard to see how a healthy economy can be based on high wages and low productivity. Especially in an international system in which other countries pursue such policies, neglect of the supply side will have high costs. The level of productivity traditionally had to be an important concern for social democracy because it determines firm-level competitiveness and the feasible real wage. But there is no reason why a high-productivity, high-wage economy cannot be at the same time a low-growth, high-unemployment economy, and vice versa.

Social democratic supply-side policies are organizationally inappropriate because, in the longer run, they tend to undermine the cohesion of organized labor and hence are unable to prevent the cost-cutting policies to which they were meant to provide an alternative. Because they historically have failed to remedy mass unemployment, they cannot provide an effective response to the tendency of the workforce in individual firms, or even individual workers to break away from collective bargaining in order to save their own employment. As will be shown in Chapter 3, beginning in the late twenties the unions started to exert massive pressure on social democratic parties to seek macroeconomic solutions to high unemployment precisely because the existing economic constellation had become an acute threat to their internal cohesion. At present, even the huge German metalworking union IG Metall, which has long been considered the star witness for the argument that high wages can benefit competitiveness by serving as a productivity whip, finds itself increasingly unable to enforce its collective agreements in the face of massive unemployment.

In contrast, the general acceptance of the postulate that discretionary monetary (macroeconomic) management can durably affect growth and employment, from roughly the mid-thirties to the mid-seventies, removed the contradiction between the pursuit of firm-level interest and overall prosperity. Cuts in wages and social security were no longer necessary preconditions for economic prosperity. Rather, stable wages and extensive welfare arrangements could now be argued to play a fundamental role in maintaining effective demand. Hence social democrats could abandon the defensive view that high wages and social security benefits perhaps had some negative economic consequences but were desirable from a social and moral viewpoint and embrace the politically rather more effective argument that such arrangements were beneficial to growth and economic stability. Moreover, the view that markets are crisis prone and that only interventionist policies can safeguard prosperity allowed social democrats to reconcile such policies with their traditional ideological conception that a capitalist system needs to be subjected to social control, while avoiding politically and economically dangerous experiments with socialization of the means of production. Hence, it became possible for social democrats to successfully extend their appeal beyond the narrow base of manual workers. Understandably, social democrats generally consider the period from the end of the Great Depression to the seventies as the golden age.

Social Democracy in the Macroeconomy

The Political Consequences of Price Flexibility

Explaining the historical pattern of success and failure of the social democratic program hence essentially comes down to explaining the dynamics of economic policy regimes. Why have the political consequences of major economic crises of this century differed so radically? Why did the crises of the early twenties and the seventies and eighties give rise to a (neo) liberal policy regime while the depression of the thirties established the ideological hegemony of social democratic concepts? Why was the solution to persistent mass unemployment during the twenties and the seventies and eighties sought in removing obstacles to the operation of the free market, while mass unemployment during the Great Depression came to be interpreted as a failure of free markets?

As most political parties operating under democratic conditions, social democrats have tended to assume that the success of their program depends on the amount of power resources—in particular, votes—they can muster relative to their opponents. Given their roots in the capital-labor conflict, this assumption generally amounts to explaining the success of social democracy in terms of the relative strength of the working class versus business. Indeed, a substantial social science literature attempts to understand the development of Western European social democracy exactly in these terms.

There is good cross-national evidence that strong social democratic parties leave a specific imprint on the political management of the economy. In Norway and Sweden, where social democrats have enjoyed a hegemonic position since World War II, welfare state arrangements came to be more extensive and more interventionist than in countries with a weaker social democracy. Likewise, defending full employment enjoyed higher priority than in the rest of Western Europe. Yet the conclusion that social democracy was simply politically too weak to prevent a change to an unfavorable regime in the early twenties and during the last two decades is obviously inaccurate. Regime changes in most cases do not coincide with a change in governing party. More important, both during the twenties and at present social democrats themselves came to accept the prevailing mode of macroeconomic management as, if not desirable, at least inevitable. The crisis of social democratic policies in both historical instances was not confined to electorally defeated parties but affected all.

Despite its strong position at the end of World War I, the labor movement was not able to prevent the change from the expansionary policies pursued immediately after the war to the restrictive policy regime of the gold standard. Whereas the regime shift of the early twenties was completed throughout Western Europe within a span of five years, it took almost eighteen years, from the Copernican turn of the German Bundesbank to monetarist policies in 1973 to the advent of mass unemployment in Sweden in 1991, for the interventionist Keynesian welfare state policies of the post–Great Depression era to be replaced with a rather more liberal regime. At some point during the eighties, it hence
might have seemed that indeed the crisis of social democracy was confined to those countries where it was weak. Yet, by the early nineties the conclusion could only be that the social democratic policy program was in disarray everywhere. Despite the undeniable, and undeniable important, cross-national differences in economic management, social democratic policies at several instances in history seem to have encountered rather definite limits.

As the crisis of social democratic policies proved to be of a rather general nature, political explanations gave way to structural ones. Social democrats themselves discovered the argument, familiar from the interwar period, that the internationalization of the economy, and in particular the openness of financial markets, frustrated their policies as international investors would rather seek refuge in countries less friendly to labor. Conservatives and liberals in turn came to argue again that the program of an extensively regulated economy simply is economically inappropriate as it gradually destroys those conditions under which a market economic can function well. Yet, the more often these structuralist arguments make a historical appearance, the less convincing they become.

International capital mobility, contrary to what is often argued, is not a phenomenon unique to the present period. The interwar period was equally characterized by highly open, and at times highly erratic, financial flows. Yet, financial openness in most cases did not provide an obstacle to a rather fundamental reorientation of macroeconomic policies once the fixed exchange rate constraint of the gold standard was abandoned. Likewise, in the present period, flexible management of the exchange rate has allowed countries that so desired to pursue more expansionary policies despite open financial markets.

The main liberal explanation for the failures of the social democratic program—namely, that macroeconomic policies only have nominal and not real effects in the long run and hence should be oriented toward the goal of price stability instead of full employment in order to avoid inflationary mayhem—is even less convincing. If money is indeed neutral (i.e., if inflation is stimulating in the short run but has no real effects in the long run), price stability should be a rather irrelevant policy goal. Moreover, the prediction that disinflationary policies would not affect the real economy in the longer run was generally disappointed, as both the policies of the early twenties and the mid-seventies ushered in a long period of mass unemployment. The longer-run result of the disinflationary regime initiated in the early twenties was not a return to full employment but the Great Depression and a shift to more expansionary policies. Similarly in the present period the long-run result of the disinflationary policies of the seventies and eighties does not seem to be a return to prosperity but an increasing doubt concerning their appropriateness.

This study argues that the historical successes and failures of the social democratic policy program have to be explained in terms of the compatibility or incompatibility of governments' macroeconomic policy orientations and the institutional preconditions required for the successful implementation of those policies. A policy regime that successfully promotes growth and full employ-

ment by macroeconomic means has to rely on the ability of labor market institutions to contain inflation by not employing their market power to the full. Tight labor markets inevitably imply upward pressure on nominal wages, and if the central bank is prevented from pursuing consistently tight policies for fear of creating unemployment, inflation can only be contained if unions and employers can be brought to exercise moderation in wage and price setting. Conversely, a liberal regime characterized by mass unemployment and restrictive macroeconomic policies requires labor market institutions that can maintain some degree of nominal wage stability despite an excess supply of labor in order to prevent the price level from falling.

Contrary to what is implied by most standard economic theories, a failure of labor market institutions to show moderation in tight labor markets does not leave the government the choice of either tolerating inflation or increasing unemployment. Nor is it possible for governments to ignore deflation in the longer run in order to pursue restrictive macroeconomic policies. In the neoclassical model world, in which money has no real function, rapid and prolonged changes in nominal prices may be irrelevant. In the monetary economies of the real world, prolonged inflation or deflation undermines the conditions under which a market can function properly.

Major disturbances of price level stability are such a crucial problem because they tend to become cumulative. Expectations of a falling price level increase the attractiveness of hoarding money relative to investing in industry. Consequently, investment and growth decline while unemployment increases. Debt defaults due to the emerging recession further reduce the willingness to finance investment. Prolonged periods of unemployment tend, moreover, to fragment the trade unions' power in wage setting. The resulting drop in the price level prompts further hoarding and a further increase in unemployment, which in turn lead to an additional decrease in nominal wages in a downward spiral. The result is a total cessation of investment and a total collapse of the economy. Inflation is very much a mirror image of this. Expectations of inflation make it unattractive to hold money and more attractive to invest and speculate. Higher investment activity reduces unemployment. As prolonged scarcity of labor fragments the trade unions because employers start bidding up wages in order to attract workers, the labor market amplifies the inflationary impulse. Yet as inflation accelerates, short-term speculation rather than longer-term engagements in productive ventures come to appear as a more appropriate means to safeguard or increase the value of monetary assets. The final stage of such a cycle is a so-called flight out of money— heavy speculation in real estate and other real assets and a collapse of real investment.

If the interaction of policy choices and financial and labor markets comes to cumulatively reinforce price level trends, then the state will eventually be left with no other option than to terminate the old regime. At that point, the question is no longer whether but when policies will change. Rather than operating in a neoclassical or Keynesian economy in which intervention can be
aimed at realizing politically determined goals, governments will first of all have to ensure the conditions under which a market economy can function properly. The progressing loss of control over the economy and the ineffectiveness of traditional instruments may lead governments to stop inflationary or deflationary cycles at an early stage. Alternatively, a regime change may have to await the collapse of the economy. Strong social democratic governments may exhibit a higher degree of tolerance for inflation than their conservative or liberal counterparts for fear of creating unemployment. Yet, if it lacks the institutional means to contain inflation, a parliamentary majority will be of little help for social democrats intent on pursuing their traditional program.

It is the politico-economic dynamic of monetary economies that ultimately determined the political fate of Western European social democracy during the twentieth century. Analyses of the development of social democracy generally centered on the concepts of liberal democracy and a capitalist economy, which automatically directs the attention to issues of political mobilization and the systemic power of the owners of the means of production. Yet, the major problems that have confronted social democracy, and which have driven its political and ideological fate, are rooted in the coordination of a monetary economy.

The failures of social democracy to realize its program cannot be attributed to the systemic power of “capitalists,” nor are social democracy’s successes the outcome of a mobilization of power resources, which enabled it to overcome the opposition of “capital.” The arrangement reached after the Great Depression in which extensive welfare benefits and full employment were combined with private ownership of the means of production was not a temporary compromise that was to be discarded as soon as social democracy had accumulated enough power resources to expropriate the bourgeoisie. Nor can the “failure” of social democracy to establish a socialist economy be attributed to the electoral logic that requires social democrats to water down their program in a situation where the working class comprises less than half of the electorate, or to the electoral unfeasibility of a program that would lead to superior economic outcomes in the long run but cause economic dislocations in the short run.

Being unable both to provide an alternative solution to inflationary pressures and to politically tolerate the unemployment and wage cuts following from the gold standard regime, social democrats during the twenties were structurally unable to govern or advance their goals. And again during the last two decades of the century, the disintegration of institutional devices designed to contain inflation and the subsequent shift to a disinflationary policy regime have marked the loss of ideological and political initiative on the part of social democracy and the acceptance of a substantial part of the conservative or neoliberal policy recommendations. Conversely, as the strategy of tight macroeconomic policies coupled with microeconomic flexibility drove Western European economies into the deflation of the Great Depression, economic liberalism’s ideological shipwreck became inevitable. While social democrats generally did not initiate the new policies, they eventually were to reap the electoral and ideological benefits of liberalism’s failure. After the cataclysm of the Great Depression, liberals now had to pay the price for labeling the interventionist policies of the gold standard a free-market regime, while social democrats could claim that history had shown their postulate of the need for political regulation of a capitalist economy to be correct.

OUTLINE OF THIS VOLUME

The structure of this book is as follows: Chapter 2 reviews the main economic views commonly underlying political analysis and sketches an alternative view in which the general orientation of economic policies (i.e., the regime) is seen to be informed by the need to combat or prevent cumulative movements in nominal prices. The following three chapters provide a historical overview of the three policy regime changes of this century. Chapter 3 argues that the pursuit of expansionary monetary policies in the absence of appropriate institutional and political instruments for the microeconomic control of inflation aborted a nascent social democratic policy regime around the early twenties. Chapter 4 interprets the regime change during the Great Depression as a response to the destructive effects of price deflation. In contrast to a still widespread view, it is argued that the decisive character of the new regime did not consist in a shift to Keynesian counter cyclical policies but rather in the elimination of the need for further deflation by abandoning the gold standard, a policy of cheap money, and a proliferation of institutional devices designed to promote downward nominal rigidity. Chapter 5 argues that the advent of disinflationary policy regimes during the seventies and eighties is ultimately a story about the slow disintegration of the ability to contain inflationary pressures without having recourse to macroeconomic restriction and unemployment. Chapter 6 analyses the prospects for the social democratic policy program at the end of the twentieth century.