The German crisis of 1931: evidence and tradition

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Abstract The German currency was controlled and German banks closed in July 1931. Does it matter whether poor currency management or poor banking practice led to the crisis? This paper argues that it does—because the choice indicates which decisions led to the Great Depression. This issue is so emotional that evidence has been subordinated to tradition in recent academic discussion. Data and economic analysis indicate clearly that the crisis originated in the currency, not the banks. The most useful model for this crisis is Krugman’s first generation model of financial crises.

Keywords Great depression · Currency crises · German crisis

JEL codes N24 · F34 · N44

1 Introduction

The German crisis of 1931 appears to have been a twin crisis, similar to the Asian crises of 1997 (Schnabel 2004). The German mark collapsed in that summer, followed by runs on the British pound and the American dollar in early fall. The ensuing financial troubles turned a bad recession into the Great Depression. Several of the large Berlin banks found themselves in dire straits at the same time, leading the government to recapitalize some and guarantee deposits in others. The traditional view of the German crisis was taken from the preceding Austrian crisis: banking problems caused by over-extended lending brought down the currency. Other work, however, argues that the budgetary problems of the Weimar Republic brought down the German currency, and that the ensuing currency crisis brought down the banks. If banking problems initiated the crisis, then bankers are to blame;
if the currency was key, politicians are the villains who caused the Great Depression. This paper reviews the literature on the German crisis and the evidence on which it rests. It concludes that the evidence reveals that politicians, not bankers, precipitated the 1931 German crisis.

The issue is where instability arose in the international economy. It is clear that instability can come from many quarters, but we may be able to avoid crises if we understand better the origins of instability. It is natural in a time of crisis to blame bankers because they are at the center of modern economies. They also are well paid, and their claims that they are victims rather than perpetrators of economic ills are suspect. Nevertheless, we want to know if fixing the banking system will make the world economy more stable. Since the greatest peacetime economic crises were in the Great Depression, careful examination of these crises is warranted. The German crisis in the summer of 1931 was a key moment in the growing depression. It led to further currency crises and problems and to an ever-deepening crisis (Temin 1989; Eichengreen 1992, 2004).

The German crisis was an important turning point in the depression, although economic policy would have had to change if the avoidance of crisis was to have a major impact (Eichengreen and Temin 2003). The interpretation of events in Berlin during the summer of 1931 therefore colors a view of the whole depression. Investigators may be motivated to present a particular view of the German crisis in order to support a view of depression as a whole. This paper reexamines the crisis in light of recent scholarship, surveying relevant general work on crises in the next section and turning to 1931 in succeeding sections.

2 Crises in general

Kaminsky and Reinhart (1999) surveyed many crises in the 1970s and 1980s. They found that a banking crisis predicted a currency crisis, although the reverse prediction was not observed. They argued for “vicious circles” between banking and currency problems that led to twin crises. This of course is an empirical test of third generation models of financial crises in which banking and currency crises are connected (Chang and Velasco 2001). Several other recent studies have echoed this analysis, and the literature on earlier crises appears to confirm its universality. Schnabel and Shin (2004) found twin crises in 1763, and della Paolera and Taylor (2001) analyzed the 1890 Baring Crisis in Argentina as a twin crisis, suggesting that the Kaminsky and Reinhart story has simple historical applicability.

Grossman (1994), however, found quite a different result in the interwar period. He found that the only predictor of a banking crisis in this period was whether a country was on the gold standard. Not all countries on gold had banking crises, but there were no banking crises in countries off gold. This strong result implies that being on the fixed exchange rate of the interwar gold standard was an important cause of banking crises. In fact, it was the only systematic cause that Grossman found in his sample. It suggests that the first generation model in Krugman (1979) may be more accurate for currency crises in this period. This model adds dynamics to the Mundell–Fleming model, showing how capital outflow can cause a currency
crisis. It does not discuss the source of foreign-exchange losses; instead the model assumes that crises are induced by changing expectations in response to a simple cause.

It is a common-place observation that international economic affairs in the years between the two world wars differed from those before and after (Obstfeld and Taylor 2004). This period thus allows us to test the universality of our current conceptions of the economy. We need to understand the Great Depression both to test the applicability of more recent ideas and to add to our knowledge of how to prevent a recurrence.

Everyone agrees that there was a German currency crisis in June and July of 1931. The open question is whether there also was a banking crisis in the sense that something in the banking system precipitated the crisis. In other words, is a first generation or a third generation model of crises more appropriate? This issue has been worried over and over again in many stories of the Great Depression. It appears obligatory for authors to mention problems of the German banks, and several have detailed their accusations. Since banking data are available with higher frequency than other economic data, economists and historians have been drawn to their analysis. I argue here that there is no evidence that the German banks were acting badly, that is, other than as banks normally do, and that the evidence against banks is illusory. In other words, tradition, not evidence, motivates much of the discussion of the German “banking crisis.”

3 A classic account

Twenty years ago Harold James represented the crisis as a run on German banks. He articulated this view in a paper entitled, “The Causes of the German Banking Crisis,” and reiterated his view in his book, saying that the German banks contained “structural weaknesses” and were “fundamentally unsound” (James 1984, 1986, pp. 294–295). The subtlety of his position is shown in a summary statement from his article: “Here it is argued that the banking collapse was a consequence of weaknesses and difficulties in the sphere of public finance which led to a German loss of confidence in financial markets (James 1984, p. 71, italics in the original).”

This sentence presents two quite separate claims. First, the banking collapse was due to problems of public finance, not banking structure or behavior. In the language used here, the currency crisis produced a banking crisis. Second, the crisis of confidence was among Germans rather than others. The first claim accords with the view expressed here and is supported by the narrative in James’ paper. Given this claim, however, it is not clear what all the detail about supposed bank weakness is about. It may be about the second claim, that Germans were the first to panic. Given that the crisis was in public finance, not banks, does it matter who lost confidence first? It looks from James’ own words as if he focused on the details of the event—in his second claim—rather than the underlying causes—in his first claim.

James presented evidence on the money supply to support his argument. Following the practice of Friedman and Schwartz (1963), he decomposed the money supply into high-powered money, the reserve–deposit ratio, and the deposit–currency
ratio. He used total bank deposits in these calculations: “The deposits include short-
term (under 7 days), medium-term (7 days to 3 months), and long-term (over 
3 months) deposits (James 1984, p. 87).” The deposit–currency ratio typically is 
taken as an index of confidence in banks, since a high-ratio indicates a willingness to 
hold most money in the form of bank deposits (Friedman and Schwartz 1963; 
Bernanke 1995). The deposit–currency ratio in Germany rose substantially from 
1925 until mid 1930 (James 1984, Fig. 2). After that, it fell in the latter half of 1930 
and rose again in the first half of 1931. It fell sharply only in June when the crisis 
began.

By this measure, public confidence in the German banks was higher in the year 
before the crisis than in any other year since the stabilization. The evidence James 
presents reveals German confidence in banks, contrasting sharply with the distrust 
of banks in the United States where the deposit–currency ratio fell steadily in early 
1931. In fact, the steadily declining deposit–currency in the United States in the 
early 1930s—contrasting sharply with its ascending course in Germany—often has 
been taken as a central part of the American contraction. The contrast is shown 
clearly in Fig. 1, which compares the fall in the deposit–currency ratio in the United 
States to the stability in Germany from 1928 to 1931. Two features of this graph are 
worth noting. First, the deposit–currency ratio stayed quite constant in 1928–1930 in 
both countries. The rise in bank liabilities in Germany after the stabilization peaked 
in 1930; the money stock was decreasing in 1931 as the economy declined. This is 
not typical of the approach to banking crises. Second, the United States deposit– 
currency ratio fell steadily in the first half of 1931, reflecting the effects of a rolling 
banking crisis. In Germany, in contrast, the ratio stayed at its earlier level through 
the first half of 1931, above its temporary low in the fall of 1930. It fell only in June, 
after the threat to the German currency had become clear. Comparable data reveal 
different attitudes toward banks in these two countries in the first half of 1931.

It is worth noting for later reference that the reserve–deposit ratio calculated by 
James is very low, in the range of 2%. Again this contrasts with monetary data from 
the United States where banks held much higher reserves. The German banks held 
bills that could be discounted by the Reichsbank instead of reserves. In effect, bank

![Fig. 1 Deposit–currency Ratios for Germany and the United States, Monthly, 1928–1931. Source: Friedman and Schwartz (1963, p. 803) and James (1984, Appendix)](image-url)
reserves were pooled together in the Reichsbank. This had the benefit of minimizing redundant cash in individual banks. It had the disadvantage of placing all the reserves for German banks in a vulnerable place. If one takes the banks’ reserves to include their assets that could be discounted by the Reichsbank, they are near American levels. The ratio of these reserves to deposits stayed constant in early 1931 through the end of May (Temin 1989, p. 66).

The vulnerability of reserves held by the central bank can be seen easily with the aid of the Mundell–Fleming model of an open economy with a fixed exchange rate. Weimar Germany of course had a fixed exchange rate after the stabilization, guaranteed by S. Parker Gilbert, the Berlin agent general agent for reparations, among others. In these conditions, the domestic money stock is endogenous, a result of the demand for money. The reserves of the Reichsbank had to be used to support the value of the mark, and they consequently would vary according to pressures in the international currency markets rather than the market for domestic currency. This institutional arrangement set up a potential conflict between the domestic and international roles of the central bank that was typical of countries on the gold standard.

James showed that he was aware of this potential conflict in his narrative, but the main cause of instability, he kept repeating, was located in the structure of German banks. He stated in his book that the small push that toppled this unsound structure was the withdrawal of foreign—primarily American—deposits, abandoning his claim that Germans were the faintest of heart, but international aspects were secondary in this story. The crisis was the result of unsound German banking that magnified a small shock into a major problem.

James also argued that the Germans had brought the international crisis on themselves by tolerating capital flight in 1930–1931 and by mismanaging their debt. James introduced Weimar’s debt problem into his narrative of the crisis only at the last moment, however, arguing that the budget crisis surfaced on June 9 when revenue figures for April and May became available (James 1986, p. 306). James’
view has become standard; although there are many shadings of this view, almost everyone writing in the past 20 years has echoed James’ condemnation of the Weimar banking system (Ferguson and Temin 2003). Hardach (1976) offered a different view, in which government, not banks, was the cause of the crisis, but his analysis has not affected future research as much as James’ analysis.

4 More recent analyses

Three more recent publications attest to the continuing viability of James’ point of view. I examine them in some detail in order to show that they fail to support the view of a weak banking system, despite their fidelity to James’ historical framework, commenting both on their prose and their use of the available evidence. It is noteworthy that almost all of the banking data come from the same source, the monthly bank reports.

Balderston analyzed the crisis with great attention to the banks. In his words, “The connection between the state’s cash crisis of June 1931 and the banking crisis which had been developing since May is too obvious to need elaboration (Balderston 1993, p. 312).” The ensuing discussion, as well as the analysis in Balderston (1991), indicates that the budgetary and currency problems of the German Reich were the root cause of instability. This conclusion however is masked by Balderston’s focus on the banks and his claim that a banking crisis had been developing of a month before the June crisis. No evidence is presented for this emerging banking crisis, however; the assertion of its existence appears to be obligatory in the analysis after James.

A recent paper by Schnabel (2004) is firmly in the Jamesian tradition, arguing that the German crisis was a twin crisis caused by incautious bank behavior. It follows James’ argument closely by comparing the 1931 crisis to two previous exchange crises and the failure of the Frankfurter Allgemeine Versicherungs A.G. (FAVAG), elevated into a third “crisis.” Two consecutive paragraphs from this paper make the expressed views clear. They are summary paragraphs about three-quarters of the way through the paper:

These observations suggest the following interpretation: As in earlier periods of political uncertainty, foreign and, to a lesser extent, domestic investors started to move their money out of Germany, which showed up in reserve losses at the Reichsbank. The run on the Reichsmark translated into a run on German banks, with the causality running from the currency crisis to the banking crisis. This, in fact, is the preferred interpretation of the 1931 crisis in basically all recent studies on the crisis.

However, there are a number of differences between the 1931 crisis and the earlier episodes, suggesting that this is not the whole story. One important difference is that there was a strong heterogeneity of deposit withdrawals across banks. Moreover, the crisis did not end when the political crisis was settled. Instead, the currency events were increasingly superimposed by problems in the banking sector. Another difference is that the German
government apparently had exhausted its credit capacity, showing up in a refusal of further international loans. International loans had played a major role in calming down financial markets in the earlier episodes. These differences may explain why the outcome of the 1931 crisis was so much worse than in the other crises (Schnabel 2004, p. 855).

The first paragraph argues for a currency crisis. The second paragraph however takes pains to argue that the currency crisis is not the whole story. Schnabel concluded a few pages later that, “it is quite possible…that the crisis of 1931 would not have occurred if the banks had acted with caution in the 1920s (Schnabel 2004, p. 867, italics in the original).” The German financial crisis, in other words, was caused by incautious bank behavior rather than by incautious political acts. Schnabel listed three reasons for this conclusion. First, banks had heterogeneous experiences with depositors. Second, the crisis lasted longer than earlier currency crises. And third, “the German government apparently had exhausted its credit capacity.” Consider these three reasons in turn.

Schnabel pointed to the heterogeneity of deposits at German banks as evidence of the importance of bank behavior in the 1931 crisis. She argued that a currency crisis is “a macroeconomic shock that hit[s] all banks at the same time (Schnabel 2004, p. 862).” But although a macroeconomic shock hits everyone together, not all economic organizations have the same reaction to the shock. To take a mundane illustration, think of the effect of increasing heat on a room full of men in business suits. They remove their jackets due to the heat, but they will not all take off their jackets at the same time. Do we want to say that the men who take their coats off first are to blame for the heat? The Danatbank was the first to feel the pressure on deposits, which may only show that it was the weakest of the great Berlin banks—not an independent source of instability.

Both James and Schnabel make much of the failure of Nordwolle, heavily in debt to the Danatbank, in 1931. Their narratives state that this failure in mid-June set off a run on the Danatbank and then the giant Berlin banks as a whole. Born (1967) reported that Nordwolle was speculating on the price of wool, a losing proposition as things turned out. But Nordwolle’s speculation on wool might have succeeded if the Depression had not deepened and German prices had recovered. Nordwolle’s fate might have been quite different if the German financial crisis had been avoided. Fischer (1999) reminds us that, “When a country’s institutions are subjected to massive pressure by a reversal of capital flows, they may crack, thereby seeming to justify the reversal of flows that produced the crisis.” Only in hindsight does Nordwolle’s strategy look fatally misguided.

Nordwolle’s speculation was going badly in the summer of 1931, and the timing of its failure may have been due to the Reichsbank’s actions to preserve the currency. The real question is not whether Nordwolle was badly run, but whether failure of one company could bring down the entire banking system. The FAVAG “crisis”—described by both James and Schnabel in this context—suggests that this kind of microeconomic event generally does not show up in macroeconomic data.

There is no evidence that undisclosed problems at the Danatbank threatened the Reichsbank before the currency crisis of early June. The Danatbank was not in any
obvious trouble before Nordwolle failed, and it did not lose many deposits before
June. The Danatbank, although possibly unwise to have loaned so much to
Nordwolle, might not have been in trouble, or in trouble at this time, if there had not
been a currency problem.

There were no German bank runs in May. Deposits available in a week or less in
the Danatbank stayed constant in June, despite the Nordwolle failure. Banks were
not calling in loans, there was no run on demand deposits, and only time deposits
were decreasing in June. Acceptances, including many of foreigners, actually were
rising. Table 1 documents this observation with data from the same monthly bank
reports used by James and Schnabel. While they reported total deposits, this table
distinguishes deposits that were available immediately from those that were not.
‘‘Demand deposits’’ (DD) were accessible in a week or less, ‘‘time deposits’’ (TD)
were accessible in a week to 3 months. Demand deposits did not fall at all in the
crisis, indicating that there was no panic among depositors at the great banks even in
June. Time deposits also did not fall before the end of May; they fell only in June.
Changes in time deposits do not signal panic—a rush to the door. Instead, depositors
appear to have been repositioning their assets in anticipation of possible currency
problems as the Weimar government made increasingly rash statements.

Schnabel’s data on foreign deposits confirm this conclusion. At the end of May,
foreign deposits at Berlin’s great banks were at 95% of their level at the end of
March. Domestic deposits were at 99% of their March level. Domestic depositors do
not seem to have been frightened, and foreigners appear to have made only a small
adjustment. The differential decline indicates fear of the currency rather than fear of
banks. It also casts doubt on James’ assertion that German depositors lost
confidence in their banks. The first, relatively faint signs of trouble with the
currency appeared toward the end of May, as word began leaking out that the
Brüning government was contemplating a move on reparations as part of a broader
budgetary retrenchment. In the first week of June, as the rumors turned into fact, the
currency’s problems snowballed. By the end of June, foreign deposits had fallen to

| Table 1 | Grossbank deposits by speed of access (Million RM) |
|---------|-----------------------------------------------|
|         | 2/28/31 | 3/31/31 | 4/30/31 | 5/31/31 | 6/30/31 | 7/31/31 |
| Selected liabilities | | | | | | |
| Demand deposits \(^a\) | 3,756 | 3,819 | 3,657 | 3,626 | 3,626 | 3,891 |
| Time deposits \(^b\) | 4,627 | 4,666 | 4,801 | 4,632 | 3,519 | 2,370 |
| Selected assets | | | | | | |
| Schecks, Wechsel | 2,497 | 2,530 | 2,528 | 2,547 | 1,914 | 1,280 |
| Rembourskredite | 2,006 | 1,894 | 1,828 | 1,781 | 1,748 | 1,599 |
| Total short-term | 5,896 | 5,890 | 5,834 | 5,734 | 5,668 | 5,484 |

Source: Ferguson and Temin (2003), ‘‘Made in Germany,’’ Tables 5 and 6
\(^a\) Available in less than a week
\(^b\) Available in a week to 3 months

\(^1\) Schnabel (2004) reported that deposits in the Danatbank fell sharply in June (Table 7), but the fall was
entirely in deposits not available in a week, hardly an indication of panic.
75%, while domestic deposits stayed at 99% (Schnabel 2004, p. 856). Even with the developing problems of the Danatbank, domestic deposits in the great banks did not fall. There was no domestic crisis of confidence in the great banks, despite James’ (1984) assertion that there was a German currency drain. Only foreigners, reducing their mark assets for fear of devaluation or currency controls, drew down their deposits. The 1931 crisis followed the pattern of the two earlier currency crises Schnabel described, with banks reacting to a currency crisis. This is the story in Ferguson and Temin (2003), and the data in Schnabel’s paper confirm that story. Only the presence of a strong ideology can explain why Schnabel did not see that her data on foreign deposits indicated an external rather than an internal drain, a currency crisis rather than a banking crisis.

Schnabel also argued in the paragraphs quoted here that the crisis of 1931 lasted longer than previous currency crises in 1929 and 1930. This reflects the fact that this currency crisis was larger than the previous ones, but it does not say anything at all about whether the banks were culpable. It confuses causes and effects. Just because the effects were widespread, so—Schnabel seems to argue—the causes must have been so too.

Her third argument is most curious. Schnabel reported that, “the German government apparently had exhausted its credit capacity.” When governments cannot borrow under the gold standard, they have currency crises. This is the point of the Mundell–Fleming model and Krugman (1979). It has nothing to do with banks. The Weimar government’s actions cut off its access to the international capital market and precipitated a currency crisis. Germany ran out of international reserves and could not maintain the value of the mark by market means. The peculiarity of the German crisis of 1931 is the reluctance of the Weimar government to devalue the mark, not bank behavior.

Schnabel argued elsewhere that holding reserves in the form of bills discountable at the Reichsbank was a form of moral hazard. This is odd for two reasons. First, James published the observation about the nature of great German bank reserves 20 years ago; Temin repeated it 15 years ago (James 1984; Temin 1989). It is hardly news. Second, it seems peculiar to blame the banks for the design of the banking system. Under normal circumstances, the Reichsbank was set up to be a lender of last resort. But as the guardian of the gold standard, it was not able to perform this function when the mark was threatened, as noted earlier. Should we blame the banks or the politicians who put the Reichsbank into this position for the conflict of roles?

The Mundell–Fleming model reveals that these roles are only in conflict under fixed exchange rates. As we might expect from this insight, banks only failed in countries on the gold standard during the long contraction of the early 1930s. This correlation of bank troubles and exchange rate regimes is not affected by the structure of banking in different countries. It was the gold standard, not the structure of banking, that made banks vulnerable in the Great Depression (Grossman 1994).

The final example comes from Toniolo’s recent book on the Bank of International Settlements. This is a large book, covering many years and myriad events. The discussion of 1931 is only a few pages in this comprehensive volume. It therefore needs to be seen as a brief representative of current thought rather than as a full-dress investigation like the previous example.
Toniolo’s section is entitled, ‘‘The BIS and the German Financial Crisis,’’ giving both his concern in these few pages and his recognition that the issue was predominantly with German finances rather than German banks. He started his discussion however with the obligatory comment that the large German banks were universal banks, an aspect of banking that does not reappear and is largely irrelevant to the crisis. He then detailed Germany’s financial problems, noting that the Reichsbank raised the discount rate on June 13 from 5 to 7%. The implicit motive is given in the following sentence noting that the discount-rate rise failed to arrest the flight of capital from the mark (Toniolo 2005, pp. 100–101). The Reichsbank, in other words, was defending the mark, not the Berlin banks.

Instead of analyzing the banks further, Toniolo then cited James to the effect that the Reichsbank expected banks to take care of themselves. Toniolo says, ‘‘This was a gross misreading of the situation (Toniolo 2005, p. 103).’’ This simplification of the Reichsbank’s problem is misleading because it does not include the context within which the Reichsbank operated. It certainly is true, as Toniolo said, that asking one bank to help another did not make the original bank’s problem go away. If the problem is small, the new bank may pay the cost of straightening out some awkward finances. If the problem is large, the new bank may find itself in danger caused by its assumption of the other bank’s troubles. But stating the Reichsbank position in this way makes it sound like a perverse mistake.

Their position however was a necessary one. The Reichsbank was struggling to preserve the value of the mark, as shown by the dramatic rise in its discount rate. It could not care for the banks while occupied in this larger process. As a result, the credit banks were left to fend on their own. The Mundell–Fleming model illuminates this problem clearly. Under fixed exchange rates, the central bank has to give its highest priority to preserving the value of its currency. When so occupied, it cannot also help domestic banks; they are left on their own.

5 A new narrative

A new narrative consistent with the data goes like this. The Weimar budget was severely out of balance by 1931. Tax revenues had fallen, and unemployment expenses had risen. It proved impossible to agree on a budget, and Chancellor Brüning governed by decree. Loans from the US and France covered the deficit in early 1931, but Brüning then championed a customs union with Austria and cast doubt on his commitment to pay reparations. His statements exacerbated tensions left over from the First World War and reduced the loans to Germany. Gold reserves at the Reichsbank and deposits at the large German banks nevertheless held up until Chancellor Brüning’s statement on reparations in early June, and then quickly fell.

The Reichsbank tried to replenish its reserves with an international loan, but Brüning’s attempts to shore up his domestic support had dried up international capital flows (Ferguson and Temin 2003). The results of the turn around in Germany’s international lending are shown in Table 2. The French tied political strings around their offer of help that were unacceptable to the Germans, while the Americans pulled in the opposite direction to isolate the German banking crisis from
any long-run considerations. The absence of international cooperation was all too evident, and no international loan was forthcoming.

New evidence in Fig. 2 confirms this interpretation. The graph shows the daily price of Young Plan bonds in Paris and the weekly gold reserves of the Reichsbank from April though June 30, 1931. Young Plan bonds were traded widely, but the most complete series is for Paris. It provides a good index of investor sentiment in the spring and summer of 1931. After rallying early in the year, the bond price stayed remarkably constant from March to May, and then fell sharply during the week of May 27. Gold reserves at the Reichsbank also stayed remarkably constant until the beginning of June, when they too fell. Why? There was no news about German banks in late May, but German newspapers began by May 25 to discuss the rumor that Brüning was likely to ask for some sort of relief in regard to reparations, as he did in early June. This, not phantom withdrawals from banks, was the beginning of the fatal run on the currency that paralyzed the Reichsbank precisely at the moment it needed reserves to foster domestic stability.

Banks appealed to the Reichsbank for help, particularly the Danatbank, which was hard hit when the currency crisis caused one of its major clients to fail. But the

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Table 2  Balances on current account, gold and foreign currency, European creditors and debtors, 1924–1930 and 1931–1937

|                  | 1924–1930 (1) | 1931–1937 (2) | 1924–1937 (3) |
|------------------|--------------|--------------|--------------|
| Europe: creditors|              |              |              |
| United Kingdom   | 1,300        | −4,000       | −2,700       |
| France           | 1,340        | −690         | 650          |
| Netherlands      | 380          | −290         | 90           |
| Switzerland      | 370          | −340         | 30           |
| Sweden           | 180          | −20          | 160          |
| Europe: debtors  |              |              |              |
| Germany          | −4,190       | 1,010        | −3,180       |
| France           | −           | 2,190        | 2,190        |
| Austria          | −860         | −150         | −1,010       |
| Italy            | −710         | −50          | −760         |
| Total Europe     | −3,970       | −2,070       | −6,040       |

a France is included with the creditors for 1924–1932 and with the debtors for 1933–1937, the estimates cover the French overseas territories, except Indo-China for 1924–1930. Source: Feinstein and Watson (1995)

$ million to nearest 10 million

(+) = net capital export, (−) = net capital import

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2 The series also reflects two other processes discussed by Ferguson and Temin (2003). The first is that financial markets briefly held out hopes that Briand could somehow bring off a compromise that would patch up relations between France and Germany after the storm over the customs union blew up. The second is the brief rally that took place in Young Plan bonds in mid-late June, as prospects for international assistance to Germany momentarily brightened, before their final collapse (Ferguson and Temin 2003, pp. 24–29).
Reichsbank ran out of assets with which to monetize the banks’ reserves as its gold reserves shrank. Despite some credits from other central banks, the Reichsbank had fallen below its statutory requirement of 40% reserves by the beginning of July, and it was unable to borrow more. The Reichsbank could no longer purchase the Berlin banks’ bills.

Germany abandoned the gold standard in July and August 1931. A series of decrees and negotiations preserved the value of the mark, but eliminated the free flow of both gold and marks. In one of the great ironies of history, Chancellor Brüning did not take advantage of this independence of international constraints and expand. He continued to contract as if Germany was still on the gold standard. He ruined the German economy—and destroyed German democracy—in the effort to show once and for all that Germany could not pay reparations.

As a consequence of the German moratorium the withdrawal of foreign deposits was prohibited, and huge sums in foreign short-term credits were frozen. As other countries realized that they would be unable to realize these assets they in turn were compelled to restrict withdrawals of their credits. Many other European countries suffered bank runs and currency crises in July, with especially severe crises in Hungary, where the banks were closely tied to those in Austria, and in Romania. More importantly, the German crisis gave rise to a run on the pound and then the dollar.

6 Conclusion

This paper has investigated the nature of one of the most well-known crises of the twentieth century. It contests the popular view of the 1931 German crisis as a twin crisis described by a third-generation crisis model. Instead, I have shown that the data do not support the universal use of this model. The German crisis was in fact a simple currency crisis, best described by a first-generation model. The crisis was caused by government policies incompatible with the fixed exchange rate, not by any actions of German banks.

Two decades ago, James set the discussion of the German financial crisis onto the track of thinking about banks. A generation of scholars has scrutinized the banks, looking for unsound structures and practices. This was the wrong direction for the literature to take. The problem was not in the German or any other banking structure, but in the gold standard. True, banking systems differed, but these differences are second-order concerns. The analysis here confirms that “the commercial banks had little choice about acting as they did in their relations with the government (Balderston 1993, p. 313).”

The dual role of the Reichsbank might be thought of as a structural problem of the Weimar economy. But it was simply the problem of being on the gold standard. It is fundamental macroeconomics that a country cannot have an independent monetary policy when it is on a fixed exchange rate and capital movements are free. Weimar Germany was a typical case of the consequences of a fixed exchange rate, not an exception. If we say that this was a structural problem, then being on the gold standard was a structural problem.
We want to portray history accurately to provide whatever lessons there are for current decisions. And the dominant lesson of the Great Depression is not that bankers will take advantage of any opportunity to exploit moral hazard. It is that poor government policies are the greatest danger to economic stability. The reason that this specific historical issue is worth debating in such detail is to highlight this lesson from the Great Depression for today’s world. Many financial crises now are caused at least partly by bank behavior in the sense of third generation models, but there is no reason to believe that all crises—past and present—follow this particular pattern. In this case, Krugman’s first generation model and the Mundell–Fleming model are more accurate guides.

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