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The genesis of austerity (Part 3)

Test tube: The Austria project

With the end of World War I came economic crisis and immense turmoil. In Europe food and raw materials were scarce and famine was rife, even as the "Spanish" flu pandemic added to the war's incredible death toll. Prices soared worldwide, fed by wartime spending and a post-war consumption boom. By 1920, central banks started putting on the brakes, increasing interest rates to rein in the expansion. Determined to prevent the peacetime extension of wartime government interventions to support the economy, the British Treasury with its League of Nations vehicle, the Economic and Financial Organisation, moved rapidly to establish a precedent that would lock nations into a new austerity regime.

An experimental phase of austerity in Britain had been launched immediately at the close of World War I while Germany was being fettered with reparations, but two other states were selected to model imperial designs for a new global financial order: Austria and Italy. Austria was a shard of the Austro-Hungarian Empire, which had disintegrated during the war and, defeated, had been finally dissolved by treaty with the victorious Allies in 1919. Post-war Austria was left with barely one-eighth of the Empire's territory and without the industrial centres in Czechoslovakia that had made Austria-Hungary the world's sixth-largest manufacturer. With its (formerly Imperial) governing institutions in disarray and a collapsing currency, the new Austria faced rising unrest from an impoverished, infirm population. It was desperate for assistance, making it a perfect target for the bankers' plans.

In neighbouring Italy, the population responded to rising inflation and unemployment with strikes, factory occupations, looting and rioting, in the social upheaval known as the Two Red Years (*Biennio Rosso*, 1919-20). By 1921 Prime Minister Giovanni Giolitti did what had been previously unthinkable: in a sign of the austerity to come, he abolished the "political price of bread"—a subsidy of bread that had ensured that even the poorest citizens were fed. In both cases, "reformers" proceeded to demonise any active role of government in the economy, scrap wartime subsidies and dismantle economic regulation in the name of paying back the wartime debt.

Soon after the Genoa financial conference, held April-May 1922 (Part 2), the governments of both Austria and Italy fell, providing the opportunity for the introduction of the new "Genoa Code" of economic austerity—in Austria under an externally directed League of Nations program, and in Italy under Fascism.

The newly installed leaders, Austrian Chancellor Ignaz Seipel and Italy's *Il Duce* ("The Leader") Benito Mussolini, were in the pockets of the British-directed League of Nations, or British Treasury and City of London banking networks. Central banks became a key interface for the League's financial reconstruction schemes, their autonomy having been made a top priority at the Brussels and Genoa conferences. Montagu Norman, who took the reins of the Bank of England in 1920 (having been a director since 1907), made it his personal mission to see all European central banks become fully independent of their countries' governments. Both Italy and Austria revamped their central banks to operate as satellites of the Bank of England. Over the reparations barrel, Germany too was forced to make the Reichsbank, its central bank, more independent. Reichsbank chief Hjalmar Schacht took a trip to London, hosted by Norman, to meet City financiers shortly after taking the reins of the bank in late 1923.

Implementation of the austerity agenda was fast-tracked in Austria by Austrian School economists (about whom more, below) working with Bank of England staff, operating under the authority of the League of Nations, to bypass national control. Austria became a model for the elimination of crucial government functions, slammed as top-heavy "bureaucracy"; the aim was "to make policy independent of parliament and the political parties",[1] supposedly making the economy more efficient. We look at Austria first, but as we will see in the next instalment, Mussolini would push an identical policy in Italy.

Austrian Chancellor Ignaz Seipel (left) and his economic advisor Ludwig von Mises. Photos: Wikipedia

The British role

"Vienna is at the present moment, a place which I should like to call the League of Nations' International Reconstruction Laboratory."

—League of Nations General Commissioner Alfred Zimmerman, 29 March 1923[2]

It was generally feared that the post-war Austrian financial situation would destabilise all of Europe, but rescue loans could not be arranged, despite intensive discussions at the Genoa conference and in other forums. All of Austria's assets were already held as collateral against its war reparations; there was nothing left against which to secure new loans.

Following earlier approaches, commencing in 1921, Austria made a desperate appeal to the Allied Powers at a London conference in August 1922. Seipel begged for a League intervention, without which, he said, "the new Austria which [the Treaties of Peace] created is incapable of existence". Answering his call on behalf of the League Supreme Council, British Prime Minister Lloyd George ruled: "there is no prospect of further financial assistance to Austria from the Allied Powers, unless the League were able to propose such a program of reconstruction, containing definite guarantees that further subscriptions [loans] would produce substantial improvement and not be thrown away like those made in the past".

In his address to the forum, Lord Arthur Balfour blared: "No-one will lend to Austria unless Austria can produce not only what are called good securities for the loan but some clear prospect that the State will be henceforth governed on

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1. University of Notre Dame (USA) historian John Deak's words, from "Dismantling Empire: Ignaz Seipel and Austria's Financial Crisis", in *From Empire to Republic: Post-World War I Austria*, University of New Orleans Press, 2010.
2. Nathan Marcus, *Austrian Reconstruction and the Collapse of Global Finance, 1921–1931* (Harvard University Press, 2018).

those *sound financial principles* on which alone the permanent stability of the State depends, a stability without which no wise lender is going to risk his money." (Emphasis added.) At the time Balfour was Lord President of the British Crown's powerful Privy Council. As Prime Minister in 1904, he had secured the *Entente Cordiale* with France, the British-French alliance which isolated Germany and laid the basis for the war that had wiped out Germany and Austria and set back growth and cooperation on the continent for decades (Part 1).

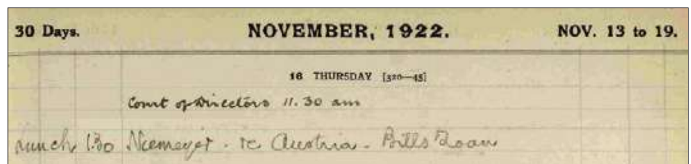
On 4 October 1922 the League of Nations General Assembly agreed to protocols for new loans to Austria, requiring establishment of a new "independent" central bank, the National Bank of Austria, under tutelage of the Bank of England—dedicated to financial stabilisation. In November 1922 the Austrian Parliament passed an Enabling Law to provide government with the powers necessary to implement the program. The League sent a delegation from its Economic and Financial Organisation's (EFO) Financial Committee, thereafter stationing a permanent emissary in Vienna. To achieve the confidence of foreign funding markets, Austria had to accept international control over all matters of finance. It ceded control over budgets, loans, and use of assets, to the Committee's commissioner general.

Britain was the primary player in the post-war scheme for Austria. Montagu Norman personally arranged the League's role and oversaw the set-up of the Austrian scheme, working closely with the Financial Committee and the heads of the US Federal Reserve, Banque de France, and other major banks, particularly JP Morgan. Under Norman's oversight, EFO head Arthur Salter, Jean Monnet (who ran the wartime economic cartels, Part 1) and Basil Blackett (from the League's Financial Committee, Part 2) were key architects of the scheme. A new mechanism for foreign intervention and supranational control was being shaped.

For Britain, "the plan for Austrian financial reconstruction was at least in part a means of reconstructing pre-war financial structures" including the gold standard—a system "with London at its heart".[3] But it was couched in terms of saving the all-but-destroyed currencies of European nations. For Austria, this meant that the "hardships and deprivations of war continued well into the 1920s", historian John Deak noted. Salter, one of the British masterminds of the League and its austerity policies, wrote that Austria lived "pitifully and precariously. She froze in winter, and a large part of her population was hungry throughout the year. Her middle class was almost destroyed.... The mortality was high and, among children, terrible."[4] Hungarian-American political economist Karl Polanyi, who lived through it, said that "small and weak countries", like Austria, "literally starved themselves to reach the golden shores".[5]

Von Mises and the Austrian School

When Seipel signed onto this program he was advised by Ludwig von Mises, who was assisted by his young protégé Friedrich von Hayek. They would both become renowned as leaders of the notorious neoliberal Austrian School of Economics. Von Mises also served the Bank of England's Montagu Norman, through his work for a League of Nations outfit called the Graduate Institute for International Studies in Geneva, largely controlled by Norman and Salter. Von Mises founded and, with von Hayek, manned the Austrian Institute for Business Cycle Research in Vienna; their notions about business cycles as a periodic, long-wave process were explicitly aimed against the American System of directed credit to guide economic and scientific progress. They maintained that the "extension of credit" leads to "overinvestment", resulting in business cycles and crises.[6] Both institutes were funded by the New York-based Rockefeller Foundation. Mises was also secretary of the Vienna Chamber of Commerce, and ran a private seminar for economists; his trainees went on to infect the policy-making of many countries, including the United States, with the neoliberal doctrines.



Diary entry by Bank of England Chair Montagu Norman. That month meetings were also logged with J.P. Morgan "as to Austrian loan", with Monnet and with Zimmerman. Photo: Bank of England Archive

These institutes were forebears of the British Crown-financed Mont Pelerin Society (MPS), a think tank von Mises and von Hayek co-founded after World War II to head off a worldwide resurgence of American System, national-economy policies, which had already been started by US President Franklin Roosevelt to beat the Great Depression and mobilise against fascism in the War. The opening address at the founding 1947 conference of that body would be given by senior League of Nations figure William E. Rappard, a cofounder of the Graduate Institute. At that forum, Rappard would declare: "Most policies all over the world today are in fact illiberal and it is because we believe that they should be liberal that we are assembled here today." Visiting scholars at the Graduate Institute included von Hayek and early supporter of Italian Fascism, Luigi Einaudi. Einaudi was a close friend of Mises who shared many of his ideas. He became president of Italy after WWII (1948-55) and was one of fewer than 40 thinkers invited to the inaugural MPS conference (though unable to attend).

Von Mises was inspired by the original Austrian School of Economics, discovering Carl Menger's *Principles of Economics* at a young age. Menger, a pre-war retainer for the Hapsburg royal family, had founded the Austrian School with his *Principles of Economics* in 1871, and subsequent books which attacked the American System's use of credit and its European supporters such as Chancellor Otto von Bismarck (Part 1). Menger's ideas paralleled those of Alfred Marshall, the founder of the Cambridge school of economics in England and crusader against the American System,[7] who developed notions of modern monetarism based on the concept of "utility" (weighing the benefit of a given policy solely in terms of its costs), updating the doctrine of John Stuart Mill and other British liberals. (Explored in pamphlet cited in Note 6.)

Von Mises devised a new business cycle theory that blamed inflation and depressions on the mere issuance of bank credit. This built upon the 1840-50s British Currency School theory, which rejected credit-creation and insisted currency be 100 per cent backed by gold. Under this theory, extra

3. Barbara Warnock, *The First Bailout: the Financial Reconstruction of Austria 1922-1926* (PhD thesis, Birkbeck College, University of London, 2015).
4. Arthur Salter, "The Reconstruction of Austria", *Foreign Affairs*, June 1924.
5. That is, to meet currency targets to align with the gold standard. Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Farrar & Rinehart, 1944).
6. "Two varieties of monetarism: the Keynesian and 'Austrian' foes of real economic progress", in Citizens Party pamphlet *Who ended the Bretton Woods system and opened an age of infinite speculation?*, 2021, available at citizensparty.org.au/australian-alert-service-feature-articles/economic.
7. Marshall was a cousin of Ralph Hawtrey, who designed the British Treasury's austerity program (Part 2).

spending can only be funded by increased savings, funnelled into investment. Bank credit is akin to "pseudo-savings" and necessitates a recession afterwards "by which the market liquidates unsound investments".[8] This thinking closely mirrors that of British economist Ralph Hawtrey, who also contributed to business cycle theory. Von Hayek elaborated on this thesis, for which he later won a Nobel Prize.

The Austria Protocol

According to the protocols for Allied loans administered by the League of Nations, Austria forfeited control of financial and economic matters to the "independent" central bank, which in reality answered to the League. The Austrian government surrendered the right to issue paper money, or to make loans without special authorisation, and relinquished control of valuable property. It had no control over the disposal of League loans. As his personal diary notes attest, Bank of England head Montagu Norman ensured the precepts of the international conferences were followed to the letter, in order to promptly stabilise the currency and balance the budget. Many of the bankers who had written the proposals for Brussels and Genoa were now in the League's financial unit, orchestrating Austria's new policies. These transnational financiers were well aware that their policy prescriptions could not be imposed upon nations except under extraordinary circumstances; the crisis in Austria provided the perfect opportunity.

Austria was given two years to establish "a permanent equilibrium in her budget", with the 1922 Protocol document repeatedly demanding "drastic reforms". Norman's Bank of England lieutenant Otto Niemeyer, a member of the EFO's Financial Committee, talked about the necessity for "drastic economies in budget expenditure". The Committee described the period of planned reform as "necessarily ... a very painful one". But if the country did not endure "a period of greater hardship than she has known since 1919", it faced "collapsing into a chaos of destitution and starvation to which there is no modern analogy outside Russia." The conditions attached to the initial loan dictated that state industrial enterprises were to be "either suppressed" entirely, "run by the State upon a commercial, i.e., paying basis", or "transferred to private management". The number of government ministries was reduced, budgets were cut, and administrative reforms introduced. The state must "take all measures within its power to prevent an increase of the deficit (such as raising of railway, postal, telegraph, and telephone charges, increases in the prices at which the products of the tobacco and salt monopolies are sold, etc.)".[9]

Deep cuts in government expenditure were made, including lay-offs of nearly 100,000 state employees, close to 30 per cent of the public service (plus more at the provincial level). Railway, postal and telegraph services were slashed. Subsidies on rail travel were reduced and the state rail company was commercialised according to a British plan. Postage rates were jacked up 50 per cent. Grants to provinces were cut. Some taxes were raised. League Commissioner-General Zimmerman played a hands-on role, even personally identifying rail guards whose jobs could be made redundant.

Budgets for public health were cut by a health reform bill mandating hospital closures in working-class areas. Services for war veterans, widows and dependents were cut, affecting up to 8 per cent of the population. These included pensions, healthcare, and education services. Veterans' hospitals and care homes were closed; food subsidies were cut.

The Genoa standard meant putting "stability of the currency"—requiring balanced budgets, reduced national debts, and independent central banks—ahead of the livelihood of the people. An April 1921 League of Nations memorandum mandated that Austria must concentrate "all her forces in a firm and tenacious desire to attain equilibrium in her public finances". A subsequent memo stated that a balanced budget would inevitably "exact considerable sacrifices from the Austrian people". In further communications a 1921 Financial Committee Delegation made clear that the "most stringent measures" it required would "impose [on the Austrian people] CONSIDERABLE PRIVATIONS" (emphasis in original), i.e., slashing consumption of food and other essentials.

The conditions attached to League loans rapidly depressed the economy. Hiking interest rates—to 13 per cent in 1925—to "maintain the value of the currency" cramped investment. Bankruptcies soared, including of small banks, and industrial and commercial companies. These closures drove up unemployment to among the highest levels per capita in the world.

When a League official mooted looser monetary policy—"anathema to the Financial Committee and its supporters, such as Montagu Norman", writes Warnock—the League's leadership quickly quashed the idea. Efforts from the City of Vienna and regional administrations, to solicit loans to invest in the economy, caused conflict.

Although the League's program severely destabilised the Austrian banking system and economy, it was proclaimed a success. By 1931 "Austria [would be] at the centre of a banking crisis" that exacerbated existing "political and economic problems of the 1930s". In fact, the mere announcement of the League's plan touched off an orgy of speculation, even before any reforms were implemented. Bullish investors, both in Austria and overseas, started a stock market boom that continued over the course of 1923. The banks neglected industry in favour of speculation, which inevitably led to a stock market collapse by early 1924. The League's policies "cured" hyperinflation by September 1922, but, absent real investment, half of the country's banks collapsed and disappeared in 1923-27. (This crisis would lead directly to the collapse of Austria's giant Creditanstalt bank in 1931, which in turn triggered the international financial crash of the 1930s.) Nonetheless, Austria had become one of the first countries to re-establish the gold standard after the war, a major goal in the international financiers' post-World War I design of a neoliberal order.

Salter's precedent and the Dawes Plan

Austria formed a precedent for how German war reparations could be enforced. Germany had been perpetually in default on its obligations since reparations were scheduled by the Allied Reparations Commission in 1921. By early 1923, French forces occupied the Ruhr to enforce payments. This region produced three-quarters of Germany's coal, iron and steel. Germany's reaction included printing money to pay the reparations, which quickly led to hyperinflation, leaving the Reichsmark, the German currency, worthless by late 1923. By 1931 the entire scheme would fall apart, leaving Germany's economy wrecked.

The League of Nations' Arthur Salter, head of the Reparations Commission, revelled in what the Austria trial had accomplished.[10] He referred to the effort at Genoa and preceding financial conferences (Part 2) to remove obstacles to

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8. Murray N. Rothbard, "Ludwig von Mises (1881–1973)", Mises Institute.
9. *The Restoration of Austria, Agreements arranged by the League of Nations and signed at Geneva on October 4th, 1922* (League of Nations, 1922).

10. Salter, "The Contribution of the League of Nations to the Economic Recovery of Europe", *The Annals of the American Academy of Political and Social Science*, Nov. 1927.

rebuilding "world economic structures". Referencing the League's programs in both Austria and Hungary, Salter declared victory for their aims—the "permanent reform of the national budget" and permanent "stabilisation of the currency". Those aims did not include "the economic reconstruction of the country", he said. "It confined itself to establishing a sound financial system and a stable currency as an indispensable foundation upon which such economic recovery could alone be surely built." But that economic recovery never came.

The untried economic theories of 1922, Salter wrote, were by 1924 "the axioms of proved experience—so completely accepted as to be regarded almost as platitudes". In a 1926 survey of the project, Salter wrote that the Austrian scheme "tested and proved…. The principles laid down at … Brussels in 1920 and Genoa in 1922."

Salter promoted the results in Austria and Hungary as a model, stressing "the results those first experimental schemes have had upon financial reform in other countries. In particular the close and direct connection between them and the Dawes scheme for Germany has never been sufficiently recognised." Austria demonstrated that reparations could be made to work, indicating that for Germany, with its greater reserves, "substantial reparations payments would not be inconsistent with the maintenance of a sound currency and budget". The noose was tightening around Germany's neck.

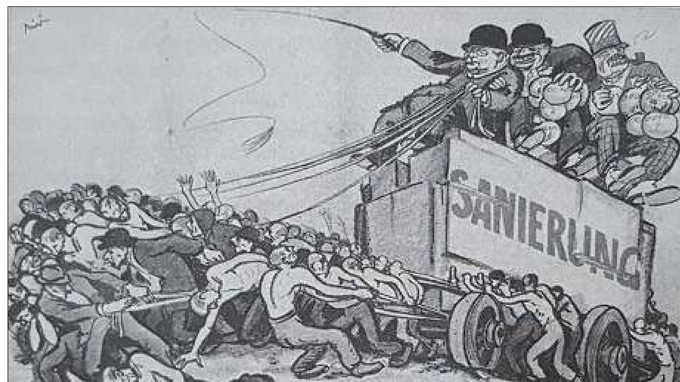
The 1924 Dawes Committee under the Reparations Commission was supposed to get German reparations payments back on track after the hyperinflationary blowout of 1923. Its attempts to reorganise the German reparations, said Salter, faced diverging views and controversy, but "the bridge" was found in the "solution" provided by Austria. In Austria, revenues from specific areas were assigned to go directly to loan repayment, without political interference. Salter laid out this advantage to the Dawes Committee, headed by JP Morgan-allied Chicago banker Charles Dawes (Part 1), which followed the Austria model very closely. Creation of an independent central bank was at the centre of the plan. Germany received an international loan to fund reparations and the Reichsmark was stabilised at the same rate to the dollar as prior to the war.

As in Austria, these stabilisation efforts restricted policy responses that could have improved economic conditions. The American loans that flooded into Germany rapidly increased foreign indebtedness and ultimately destabilised the nation, as they poured into non-productive pursuits, including to bolster the currency and banks' balance sheets.

The 1930s: Descent into fascism

The Austrian model pushed Germany down the pathway to dictatorship and war. At home, it fuelled the instability that hastened the rise of fascism.

European nations, with the 1920s crisis fresh in their minds, responded to the 1929 US stock market crash with further cuts to government spending, worsening economic conditions. With reparations debt being funded by big US loans, Germany was already in a financial vice. By 1931, Europe was in its own financial meltdown, as the collapse of Creditanstalt, Austria's largest bank by far, triggered a crisis of the entire European banking system. Creditanstalt's losses, exposed by a whistle-blower, were greater than Austria's annual budget. A run on the banks quickly spread to other local banks, a run on the currency ensued, and capital fled the nation. This drove Austria further into the clutches of the League (and the



A poster depicting bankers in a cart labelled "the reconstruction", pulled by citizens. Contemporary economist Karl Polanyi noted that "Vienna became the Mecca of liberal economists on account of a brilliantly successful operation on Austria's krone which the patient, unfortunately, did not survive." Photo: *The Meddlers*, Jamie Martin

supranational Bank for International Settlements, which had opened in 1930). In May 1931 there were bank runs and bank collapses in Germany and London. "The unravelling of Austrian banking and financial stability in the early 1930s exacerbated and prolonged the worldwide depression, and deepened the European political crisis that was to culminate in world war and genocide", Warnock writes.

A new Austrian Protocol was issued by the League on 15 July 1932. The same disastrous recipe as the League prescribed in the 1920s was spelled out: the necessity for Austria, without delay, "to maintain complete equilibrium between the revenue and expenditure of the State"; stabilisation of the currency; removal of exchange controls and obstructions to international trade; and a program of budgetary and financial reforms. It specified that the Austrian government appoint representatives to liaise with both the League and the Austrian National Bank, which operated as an external authority. It mandated "permanent economies" (slashing expenditures) to ensure a balanced budget and postponement of capital outlays, with spending for supplies or works to be granted on an exceptional basis only—*if* approved by the League. "No issue of Treasury Bills or other similar short-term operation shall by carried out by the Austrian Government on the home market unless the prior consent of the representative of the League has been given", the protocol declared. Every borrowing or credit operation—*including of a private nature*, if it affected foreign indebtedness—was subject to approval by the League and the National Bank. Every three months the government would report back on the execution of the program, which Austrian historian Siegfried Mattl called *Finanzdiktatur*—financial dictatorship.

Worsened economic conditions increased social instability and division, encouraging paramilitary forces on both the left and right of politics. In 1927 socialist paramilitary forces set alight the Palace of Justice in Vienna, provoking a brutal police response. Chancellor Seipel increasingly clamped down with authoritarian measures, sidelining the elected parliament. By 1934, five more Chancellors had come and gone and the situation had descended into civil war between fascist security forces and workers' militias, intersected by Austrian Nazi Party provocations. Fierce factional warfare marked by coups and assassinations, between the Fatherland Front (the ruling party) and the more radical Nazi Party, culminated in takeover by the latter. It was the Austrian Nazis who signed the 1938 *Anschluss* union with Nazi Germany.