

# **Economics of Nazi Germany**

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Undergraduate Dissertation

November 2, 2024

Words: (4,022)

This paper discusses the extraordinary period of growth from 1933 to 1938 in early Nazi Germany, with a focus on the financial consequences of special paper that came to dominate the currency system. Section one provides a literature review of the prevailing economic theories. Section two focuses on the aftermath of the crises of 1931 and the effect on banking. Section three discusses the preconditions and continued policies prior to Nazi control. Section four discusses Nazi implemented policies with a focus on the banking sector. Section five discusses MEFO bills. Section six discusses the economic impacts of Nazi policy, specifically MEFO bills. Section seven discusses privatization in German economy. Section eight discusses the financial crises of prewar Germany.

## Section 1

The prevailing theory is encompassed by Tooze's 2006 work, *Wages of Destruction*, which attributes the spectacular economic success overwhelmingly to the focus on rearmament. He characterizes the economic landscape of Germany as a dual economy, typical of late industrial societies: in some ways backwards and underdeveloped and in other ways modern. This is contrary to the prevailing consensus that emphasizes the German economic "machine": a

super competent and modern economic system. The German economy faced considerable barriers in their rapid rearmament. They suffered massive shortages in foreign currency reserves (a balance of payments crisis), raw materials, and food supplies because of the insistence on rearmament. This inhibited growth in the consumer sector and eventually the continued expansion of armament. Germany could not sustain self-sufficient growth, and they had to expand trade while the international markets backed away from their support for geopolitical concerns. The modern literature confirms a great asymmetry in the spoils of the economic success which prevailed over this period of Nazi control. The wealth of capital grew tremendously, while the consumer market stagnated as a consequence of the command economy that favored the expediency of capital interests in armament. According to Roth, the favorable business development directly resulted from the subjection of the worker, with the destruction of labor unions and wage freezes, explaining the phenomenon of low inflation that coincided with high growth. But as the war progressed, a movement away from the command economy resulted as the Nazi officials favored privatization in many industries. The extraordinary economic growth ended in crises. It was described as an inevitable outcome of the economic program, stemming from the abuse of financial engineering.

## Section 2

German Banks were in a process of rebuilding their balance sheets after they suffered great destabilizing hyperinflation because of the Weimar republic's currency devaluation. Banks used extreme levels of leverage to make bets on foreign equities, specifically American equities in the pursuit of returns which were not achievable in the domestic economy. Banks, though overleveraged, rebuilt much of their cash reserves until the German financial regulators sought to

curb the rampant speculation by instituting conservative requirements that limited speculation. This coincided with the exogenous crash in the United States equity markets and worsened the crises. German banks were hit hardest as the Great Depression spread into Europe in 1930. Banks faced higher costs and diminished certainty of refinancing at the Reichsbank whilst malfunctions in the securities markets caused German banks to become illiquid (Balderston 573). The rapid surfacing of bad loans, to which German banks were exposed, caused stark withdrawals in deposits and rapid price deflation.

According to Murad, the principal task of the Reichsbank through this period was protecting the reichsmark and obtaining external stability of the currency. The discount rates rose, credit was restricted, and the reserve requirement suspended. The Reichsbank was relatively less important in the German economy than other central banks in their respective economies and the role of central banks in modern economies, therefore had little effect in quelling the instability of the system. The rate remained at 5 percent, comparatively low in historical context, but much higher than other countries. A crisis struck in June. The discount rate was raised to 7 percent, in hopes that it would bring reduced borrowings at the central bank and attract foreign capital. However, it had no effect, and confidence tanked amongst foreign and domestic investors.

The rate was raised to 10 percent in July, but demand for credit continued to grow (1). Currency controls were introduced, making the conversion of marks into hard currencies more costly. To establish stability in the banking system, a general bank holiday was declared from 14 July to 5 August 1931. From 1929 to 1932, the major corporate and regional banks, assets, excluding loans and mortgages, shrunk from 16 billion to 10 billion Reichsmarks, and loans shrunk from nine billion to six billion RM. To prevent total collapse, the government took

effective control of Germany's major banks, forcing consolidation through mergers of regional and national banks. In the wake of the crisis, 69% of the Comers-und Privatbank and 35% of Deutsche Bank were publicly owned, and only one of Berlin's five great banks remained entirely free of state ownership. On July 15th, the Reichsbank suspended convertibility of the Reichsmark into gold and imposed capital controls, which set an end to the gold standard in Germany, which was imposed in 1924 to address the preceding hyperinflation. Yet this legislation, and the Reichsbank's decision to raise rates, failed to prevent the ensuing liquidity crisis. Capital outflows began to undermine the gold standard, it became increasingly clear that the Reichsbank was unable to maintain adequate reserves to back the currency.

The German government's tax revenues fell and left them unable to procure internal and external loans. The conditions of the Treaty of Versailles continued to wreak havoc on the German economy, burdening them with extraordinary reparation debt, among other things. It also enforced a legal cap on interest, at which the government could borrow, at 4.5 percent. Concurrently, the Reichsbank Law of 1926 limited lending to the government with a cap of 100 million Reichsmarks. This prevented Germany's ability to debt finance large scale intervention programs and the German people and government remained wary of the inflationary consequences of monetary stimulus.

Following this crisis, the German government conservatively instituted reforms. The Reich Banking Law in 1933 presented a minimum cash-liquidity ratio of 10 percent. They enforced the separation of savings banks operations and investment activities to limit speculation and promote stability. There were minimum-liquidity requirements and maximum limits on lending. But, the inferior state of German banks continued, as bank reserves and cash dwindled into 1933.

## Section 4

The severe economic troubles and malaise of the German population contributed to the rise in political extremism, resulting in its realization with the election of Adolf Hitler of the national socialist party in 1933. The Nazis extended controls over the economy in general and specifically the banking sector. According to Tooze, the principal goal was to establish military supremacy to combat the rising American empire, whose geopolitical standing grew. The Nazi government decided that rearmament was the superior means to prevent a subversion in geopolitical hegemony.

The Treaty of Versailles imposed severe military restrictions on Germany, limiting its army to 100,000 troops and banning heavy weapons, submarines, and an air force. The Nazis viewed these restrictions as humiliating and sought to overturn them as part of their broader goal to restore Germany's Pre-World War I power. Rearmament was also established as a means toward employment and economic growth, as it would reignite production in the economy towards a national purpose. Central economic planning allowed Germany to favor the armaments industry. They dictated the rationing of raw materials to strategic industries while suppressing the production of goods un conducive to the war effort. Germany emphasized economic autarky, enforcing the adoption of domestic raw material production and consumption. The regime imposed strict controls on the distribution of raw materials and strategic resources like steel, coal, and aluminum were reserved for armaments production. Civilian sectors faced shortages as various resources and materials were diverted from public to military use. This did not change the fact that Germany's raw material resources were limited and often of poorer quality than foreign material sources. Through overwhelming public control of the banks, the regime was

able to efficiently organize their economy around armament and vertically integrate it with minimal waste. While priority was given to armament industry, the Nazi party also had to address the economic malaise of the working class.

In voting for the Nazi party, the German voter displayed his discontent with the previous German economy which left him jobless and destitute of pride. The Nazi party promised work, and pride, and while they succeeded in this promise, the German worker was prioritized far less than the armament program. The Nazi regime was focused on directing all economic capital into the arms industry. This required the suppression of both the worker and the consumer. Two months after taking power in 1933, the Nazi's eliminated collective bargaining rights and unions and replaced them with the German Labor Front. This shift aimed to keep morale high through means of propaganda and other extra-salarial benefits. According to Klein, new laws were passed that gave government appointed labor trustees the ability to relegate wages for whole industries, keeping them low, and promoting the maximum employment within the industry. The purposive consequence was a growing inequality between capital and labor, that suppressed wages while maintaining productivity. Among other things, this policy allowed the Nazi economy to maintain low levels of labor wages, while Germany's productive capacity expanded and the demand for labor rose, calling into question the legitimacy of low inflation and high growth. Unlike a free market economy, where the increase in the demand for labor would result in the rise of wages and propagate into aggregate consumer demand in the economy. Now, suppression of wages was not just expedient for the Nazi propaganda of a no inflation regime, it was also the strategic means to expedite rearmament. The collection of excess profits among industrial firms was purposive for reinvestment into the productive capacities of arms producers. The Nazi government banned the issuance of dividends to compound the excess of capital within

industry. These concurrent facilities created the necessary environment for high and precise velocity flow of capital and reinvestment. This allowed for the effective injection of monetary stimulus to prop up the arms industry, but the main driver of Nazi Germany's economic miracle was the MEFO Bills.

## Section 5

Germany's tremendous armament and its international secrecy was made possible by the extralegal financial mechanism engineered by Hjalmar Schacht called the MEFO Bill. MEFO Bills were bills of exchange drawn by contractors and accepted by the dummy organization called the Metallurgische Forschungsanstalt (MEFO), so that large issuances of debt were hidden off public books. The company had a nominal capital of one million Reichmarks, supplied by the four large armament manufacturers, Krupp, Siemens, Gutehoffnungshütte, and Rheinmetall. MEFO bills ran for six months but could be extended for three months each until their expiry, in five years. The drawer could present the bills to any German bank for discount at any time, and the banks could then be rediscounted for cash at the Reichsbank. With accessible liquidity and the backing of the government, banks gladly accepted these bills as collateral for loans and demand deposits. MEFO Bills offered an annual interest rate of 4 percent, much higher than government treasuries, which were capped at 4 percent, but also higher than the prevailing market rates for commercial bills. Natural demand for MEFO's high rates along with political pressure, resulted in tremendous issuance of MEFO bills. By the end of the program there were 12 billion Reichmarks of MEFO bills outstanding.

The proliferation of bills was in many ways parallel to a standard injection of currency in increasing the money supply, but the mechanism of promissory notes differed starkly in its use and the effectiveness of stimulating industrial production. Bills did not circulate like standard currency that acted as a perpetual claim on goods and could precisely target strategic industry. Because the bills were drawn against government contracts, the government preemptively directed monetary stimulus to industries of their choosing. Also, the monetary injections backed by contractual obligations of production resulted in a symmetric rise in the production of desirable goods. This effect on inflation is twofold: not only was there very little waste and leakage into the wider economy that would stimulate rises in aggregate demand, but currency injections coincided with an increase in available goods. The theory of monetary neutrality explains that any isolated increase in the monetary base gives rise to an equal increase in prices because the other variables, velocity, and output are fixed. The theory also assumes that an economy is at full productive capacity with full employment. But in this instance, multiple assumptions in this model are false. The German economy was far below maximum productive capacity with an idle labor force, unemployment in 1932 at 33%, and idle industrial capacity at near 50%. Therefore, this injection mobilized the productive capacity which matched and possibly even exceeded the expansion of the monetary base. Also, the planned nature of the Nazi economy resulted in the consolidating industry and a greater vertical integration, which resulted in an increase in the velocity of money, further exciting the growth of the Nazi economy. Furthermore, because monetary injections were tied to symmetric increases in  $Y$  through the delivery of goods, the equation was balanced in this sense. Only about 33 percent of the MEFO bills were presented to the central bank for rediscounting, so the bills mostly remained within the

armament industry. They were used as a means of exchange between contractors and subcontractors and were effective in providing capital to expand productive capacity.

Normal currency injections do not have the same precision of affecting productive gains that the MEFO bills had. MEFO bills acted directly on increasing the supply of goods, in turn providing employment and capital to industrial firms. Normal currency injections, providing a more direct expansion of currency, provide a perpetual claim on the nation's productive capacity. While the MEFO bills could be rediscounted prior to their expiry, the currency could then be taken out of circulation once the bill was honored at the date of its expiry. All else equal, no new debt would be issued at the end of this period. This financial mechanism had tremendous impacts on the growth of the economy and the resurgence of healthy bank balance sheets.

## Section 6

From 1929 to 1938 credit institutions, saw an increase of liquid and semi-liquid assets of nearly 80% from 14 billion RM to 21 billion RM and securities rose by 400% from 3 billion RM to 12 billion RM. The growth of banks beyond the pre-depression levels through the expansion of banks' balance sheets which were led by the increase in securities holdings, attributed to their acceptance of MEFO bills. The rise in capitalization allowed the banks to free up customer deposits and resume lending practices that increased the velocity of money through the economy. The Nazi government's control over the economy is displayed by their preference of savings banks to credit banks. State led projects reduced the need for private credit so that from 1929 to 1938 credit bank liabilities fell from 16 billion RM to 10 billion RM, while the liabilities of savings banks increased from 10 billion RM to 21 billion RM. Public expenditures as a

percentage of fiscal revenues, declined from 99% to 57% from 1932 to 1936. From 1932 to 1937 government revenues from tax receipts and miscellaneous increased from 5.8 billion RM to 12.6 billion RM with a return of 13.5% on an annualized basis, and 113% overall increase. However, this economic growth was not accompanied by inflation. The Phillips curve describes the relationship between the rate of inflation and the rate of unemployment in an economy, and suggests that as unemployment decreases, inflation tends to increase, and vice versa. During the great depression, unemployment rose from 7.5% in 1929 to near 35% at its peak in 1933 along with moderate deflation. But, during the Nazi regime from 1933 until 1937, large reductions in unemployment, from 35% to near 9%, did not result in inflation. One explanation is the suppression of accurate unemployment data that resulted from the government's propaganda arm. If unemployment was higher, then the same pressures on the rate of inflation would be weaker. Under this explanation, the points on the chart would shift right the Phillips curve would be right in predicting low inflation. The more convincing explanation is that wage suppression, because of weakened worker rights and stagnant wages, subverted the necessary assumptions of the Phillips curve model. The model attributes this trade-off to changes in wage pressures and production costs, the former being artificially suppressed by policy, though the latter later faced pressure due to shortages in raw materials. This government intervention in the economy was widespread, though later receded.

## Section 7

Although a great deal has been made about Nazi Germany's command economy, it was never as absolute as the soviet economy. The height of government control over the economy reached its peak in the early years of the regime, while an inclination towards privatization

prevailed through the late 1930's. The Nazi government inherited a great amount of public ownership of industry and banking because of the economic collapse during the Great Depression. Through the mid to late 1930's the German government installed a movement of privatization. Nazi government sold its public ownership in several state-owned firms in the mid-1930s. These firms belonged to a wide range of sectors such as steel, mining, banking, shipyards, ship-lines, and railways. According to Bel, whereas modern privatization has run parallel to liberalization policies, in Nazi Germany privatization was applied within a framework of increasing state control of the whole economy through regulation and political interference. According to Bel, financial motivations played an important role in Nazi privatization, since receipts from selling public firms contributed (together with other fiscal measures) towards financing huge public expenditure, particularly attributable to the armament program. The Economist reported that this increase in military expenditure forced the Minister of Finance to look for new resources, which included the sale of public ownership. This privatization was a pragmatic choice, as it raised capital but had little change on the underlying economy or the function of these institutions that were already and would continue to be subject to tight government regulations. This financial source would further fund the war effort which was becoming increasingly inevitable due to impending crises and the need for eastward expansion.

## Section 8

The late 1930's offered more of the same in Germany's strategy, which remained hyper focused on expanding their military arsenal and diverting all resources to this industry which resulted in the shortage of consumer goods. Government spending purposively crowded out consumer spending and the standard of living for German workers stalled. By this time, the

German economy reached full productive capacity, with near full employment and industrial capacity. German finance minister Hjalmar Schacht was eager to sunset the issuance of MEFO Bills, but the program's expedience for raising debt was irresistible to Hitler. They continued the issuance of bills while greatly increasing their spending. In 1939 Germany's deficit reached just under ten billion Reichsmarks, a 180% increase from the year before, and a near 1000% increase from 1933. While wages and consumer consumption remained constant, this spending resulted in a rise in inflation, from negative in 1938 to 19% in 1939.

Throughout the tremendous period of growth, faults began to form that caused underlying instability in the economy. Germany instituted a moratorium on debt payments, in 1933 and a strategic default on the payments a year later. German bond prices began to fall in 1935 as international restrictions caused by Germany's aggressive rhetoric, and the default risk, caused a reduced demand. The New Plan devised by Schacht allowed Germany to avoid the use of foreign exchange reserves, by pressuring weak countries into bilateral clearing agreements. Trade would be conducted through barter or in Reichsmarks. By 1938 these agreements encompassed over forty countries totaling about 80% of Germany's exports. As not to devalue the Reichsmark, Schacht instituted a bond discounting scheme that subsidized German exporters on foreign financial markets. Giving German exporters the benefits of a weaker currency, without affecting exchange rates and the price of imports. The fall in bond prices in 1935 caused the plan to become obsolete, and when the Army's rising demand for materials could not be met, Schacht enacted a tax on armament producers. Annexing Austria in 1938 doubled Germany's foreign exchange reserves to reach about 1.5 billion Reichsmarks. This allowed Nazi government to procure its largest trade deficit, but Austria was also a net importer of raw materials and had little fertile agricultural land and so was not as economically important as the East.

Schacht began to sunset the MEFO bills in 1938 against heavy pressure from Hitler. The MEFO bills, most issued in 1933 were coming due. Hitler, wanting to focus on rearmament and avoid diverting money from production, eventually forced MEFO holders to exchange their bills for long-term treasury bills. Schacht, viewing this as a violation of the contractual obligation, fought this and was subsequently fired. According to Abu, from the start of Hitler's reign to the end of MEFO bill financing, the amount of RMs in circulation rose from 3,560 million to 5,278 million. From March to December 1938, currency circulation rose to 8,223 million RMs, rising more in ten months than in the previous five years. Hitler transferred the position of head financial czar to a loyalist in Walther Funk and directed him to curb inflation by any means necessary. In June 1939 Hitler abolished the Reichsbank limit for adding to the money supply. Price controls and rationing were instituted and prevailed throughout the war economy until German collapse. In current literature, this collapse is presented as an inevitability of the financial wizardry of MEFO bills and the rapid rearmament. The theory of monetary neutrality is confirmed by the rapid increase in inflation in 1938 and the shortages that resulted from the extreme concentration of armament production. The German economy reached maximum employment and productive capacity by 1938 yet continued to abuse the monetary stimulus and fiscal spending.

## Conclusion

The Nazi's economic miracle of extraordinary growth without inflation was not completely valid. It stifled inflation through the suppression of consumer demand and wages and the institution of other price controls and rationing. The immense growth was a function of the large rise in public expenditure on armaments hidden by the MEFO bills, which concentrated

excess capital into reinvestment. This method of deficit financing through special paper reached the end of its viability once full economic capacity was reached, and its continuance proved critical to the crisis of 1939. Further research could investigate whether this method of bill issuance could be viable for expanding investment, without a focus on public consumption.

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