

THE INFLUENCE OF FINANCIAL CRISES ON NATIONAL SECURITY POLICIES

A Dissertation

Presented to the Faculty of the Graduate School

of Cornell University

In Partial Fulfillment of the Requirements for the Degree of

Doctor of Philosophy

by

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August 2013

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Cornell University 2013

ABSTRACT

What influence do financial crises exert on states' security policies, specifically crisis-stricken states' military spending, threat assessment, and war prospects? This dissertation finds that, after the start of financial crises, the national security policies of crisis-stricken governments shift towards greater assertiveness or greater caution. Whether greater assertiveness or towards greater caution is realized depends on government exposure to high finance, that is the extent to which crisis-stricken governments rely on the largest transnational financial and business interests to solve the financial crisis. Specifically, the national security policies of a crisis-stricken government will move towards greater assertiveness if the government's exposure to high finance is low, and towards greater caution if the government's exposure to high finance is high. As a result, the national security policies of a crisis-stricken government having low affinity with high finance, namely a low predisposition to include the financial and economic preferences of high finance in its policy agenda, will be *inflated* when the government has a low exposure to high finance and *curbed* when the same government has a high exposure to high finance. Differently, the national security policies of a crisis-stricken government having high affinity with high finance, namely a high predisposition to include the preferences of high finance in its policy agenda, will become *extra cautious* when the government has a high exposure to high finance. The theoretical foundations underlying the argument of this dissertation do not allow determining the character of the national security policies of a crisis-stricken government having a high affinity with high finance and a low exposure to high finance. Relying on archival research, process tracing, text analysis, numerical data analysis and counterfactual analysis, I demonstrate these relationships over a total of 14 instances of financial crises affecting the security policies of a total of six states—Japan, Italy, the United States, Austria-Hungary, Germany and Great Britain—in the period between 1880 and 1940.

BIOGRAPHICAL SKETCH

Maria Sperandei was born and raised in a provincial town in Central Italy (Umbria). Having developed an interest in the mechanics of interstate relations, she completed a B.A. in International and Diplomatic Science at the University of Bologna (Italy). She then moved to Wales (United Kingdom) to earn a Master degree in Strategic Studies at the University of Aberystwyth. In 2005 she came to the United States under a Fulbright to study international political economy at the University of Denver, Colorado. In 2006 she enrolled in the Doctoral program at Cornell University that she will complete by August 2013. At Cornell, Maria cultivated an interest in research at the intersection of political economy and international security, and particularly the process through which perceptions, ideas and emotions about core financial and military values are revised during crises, with profound consequences for states' domestic and foreign behavior. Along these lines, her dissertation investigates the puzzle of why governments that are stricken by financial crisis refuel their assertive or prudent national security policies at times but retreat from them at other times. Maria's previous work on coercive diplomacy and the linkage between alliances and war has appeared in the *International Studies Review* and *Quaderni di Scienza Politica*. In September 2013 she will be a postdoctoral fellow at the Dickey Center for International Understanding at Dartmouth University.

A Diana, Luciano e Laura,

ACKNOWLEDGEMENTS

Ithaca, July 29, 2013

Research for this manuscript originated from a mix of perplexity and fascination with unsubstantiated claims that became popular in late 2007 and early 2008. These claims held that, due to the outbreak of the global financial crisis, sweeping changes in the national security policies of crisis-stricken states were imminent and warranted. The fact that resourceful state authorities and distinguished policy experts endorsed these claims in the absence of systematic theoretical and empirical research on the subject both raised some red flags and made this alleged connection between financial crises and national security policies all the more intriguing. The dust has not settled yet, as similar claims continue to appear—if anything, they have become more numerous. In the meantime, my research journey has left me less perplexed as to how, when, and why national security policies take one sweeping turn or another after the start of financial crisis. By contrast, my fascination with the general absence of a common language to talk about these developments, and with the possible policy benefits and dangers of providing one, has grown. My hopes are that this manuscript can raise awareness on the significance of having this discussion. Despite its risks, not having this conversation will just perpetuate ignorance and misunderstanding.

In the process of attaining less perplexity and more fascination, I have contracted numerous intellectual and personal debts. Starting with the weightiest, I could not have written this manuscript without the groundbreaking work, wise guidance, and firm encouragement of Professor Jonathan Kirshner. Throughout the years, I have marveled at and learnt from the lucidity of his feedback, and his relentless push for improvement and simplicity. Through careful mentoring and precise reading suggestions, Professor Kirshner has helped me avert hazardous blunders, and stop unhelpful theoretical tinkering. At a broader level, I am particularly grateful to him for leading by example, and constantly reminding me of the value of striving for intellectual honesty and meaningful scholarly challenges.

I own earnest thankfulness to Professor Peter J. Katzenstein, whose presence, foresightedness, and generosity have constantly left me speechless. His scholarly and human talents are branches of a tree that stretch towards multiple directions, shatter barriers, and simultaneously reinforce each other's growth. Every academic or life advice that I have received from him has 'stretched,' 'shattered,' and 'reinforced' like one of those branches.

I am also very much obliged to Professor Thomas B. Pepinsky, for the down-to-earthiness, promptness, and intelligence of his reactions, and for having adeptly balanced words of encouragement with the sensible recommendation of handling paramount methodological matters at the best of my ability.

For being a breathtaking source of inspiration as a scholar, mentor, and friend, I am profoundly grateful to Professor Ilene Grabel. She has made a huge difference in my life and continues to do so. I hope she can find traces of her teaching and wisdom in this manuscript.

I have to express a very special thanks to Professor Richard F. Bense, who not only supplied me with a tremendously comprehensive and most ingenious review of this manuscript before my defense, but also shared fresh and exciting ideas at several stages of the process, with exceptional involvement and style.

I own similar thanks to Professor Marco Cesa, for his mentorship, and always finding the time to talk to me since 2001. Without his work, generosity and trust I would not be here now.

Professor George Boyer, Professor Sarah Kreps, Professor Elizabeth Sanders, and Professor Alexander Kuo have either heard a talk on this project or read material related to it.

My conversations and correspondence with them have been precious. I thank them for their time. On a more practical level, most heartfelt thanks go to Tina Slater, Judy Virgilio, and Laurie Coon, for graciously helping me navigate the official procedures, offering grant application assistance, and patiently understanding any unplanned administrative misstep on my part.

For their memorable contributions to my academic and personal growth—contributions that predated the start of this manuscript but widely informed its spirit—I thank Professor Rachel Epstein, Professor Enrico Fabrizi, Professor George De Martino, Professor Martin Alexander, and Professor Riccardo Rovelli.

A big thanks to Deondra Rose, Noelle Brigden, Gaurav Kampani, Jennifer Erickson, Audrey Comstock, and Danielle Cohen, for their candid friendship. I miss some of you already and will miss the rest of you dearly. Call me.

For their insightful feedback on previous drafts of this work, and their great company throughout the years, I must thank Pinar Kemerli, Simon Gilhooley, Don Leonard, Jennifer Hadden, Alison McQueen, Lucia Seybert, Jenny Stepp, Kristin McKie, Simon Cotton, Desmond Jagmohan, Phil Ayoub, Diego Fossati, Michelle Greco, Sinja Graf, Onur Ince, Andrew Yeo, Jason Oaks, Katrina Browne, and Danielle Thompsen.

For their expert assistance with archival documents, data analysis, and editing, whether from Ithaca (NY), Rome (Italy) or Washington (DC), I am especially indebted to Lynn Thitchener, Daniel McKee, Linda McLean, Sarah Tarrow, Annarita Rigano, Stefania Ruggeri, Mariapina Di Simone, the staff of the Banca di Roma, the Staff at the Archivio del Ministero degli Affari Esteri, the staff of the Archivio Centrale dello Stato, and the staff of the Manuscript Division of the Library of Congress.

For having funded this project, having provided forums and debates I highly benefited from, and their gracious help and company, I am much indebted to the Mario Einaudi Center for International Studies, and the Smith-Richardson Foundation, especially Allan Song, Scott Boston, Sydney Van Morgan, Ike Michelsen, Mark Wilson, Walt Baschnagel, Elizabeth Edmonson, and Elaine Scott.

For solidifying my interest and thrill in this research endeavor, many thanks to the 2009 Institute on Qualitative and Multi-Method Research at the Maxwell School of Syracuse University, and to the participants to the 2009 Summer Workshop on the Analysis of Military Operations and Strategy, particularly Professor Colin Elman, Professor Richard Betts, Professor Steven Biddle, Professor Barry Posen, Professor Cindy Williams, Josh Shiffrin, Richard Maas, Diane Pfundstein, and Amr Jossel.

For the bond I have shared with them throughout the years, and for reminding me who I am, and where I am going, I am especially obliged to Christina Bristow, Sian Owen, Gafar Zaaloff, Carlotta Fioramonti, Sadia Tasleem, Sara Sighinolfi, Elisabetta Petrini, Gladys Evangelista, Jody Tong, Joanne Baum, Lia Zaaloff, Andy Mcpherson, Baran Han, Josephine Martell, Marion Luger, Carol Bristow, Michael Marozzo, Anna Goehner, Danielle Corciullo, Bill Kennedy, Claudia Volpe, Gemma Collantes-Celador, Andrew Lui, and Hung-Jen Wang.

Since this project began with a scary medical ride, continued through a few others, and wrapped up with a commitment to prevent more, I must thank Doctor Mark D. Adelson, the staff of St. Josephs Imaging Associates, the medical team of the Fifth Floor of the Crouse Hospital in Syracuse, Doctor Sharon Ziegler at Cayuga Family Medicine, and Doctor Wai Wong at Gannett. I would not be alive without the professionalism and attentive care.

Most importantly, I am thankful to Diana, Luciano e Laura, for showing me every single day what love and happiness are and where to find them.

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CHAPTER I

FINANCIAL CRISES AND NATIONAL SECURITY POLICIES

"It's a global (financial) crisis. [...] I think it will impact on our national security in ways that we quite haven't figured out yet."

Admiral Michael Mullen, Chairman of the Joint Chiefs of Staff, February 1, 2009¹

What influence do financial crises have on national security policies, specifically military spending, threat assessment, and war prospects?² This crucial question remains unasked and unanswered, and yet present and past historical evidence indicates that national security policies are no longer the same after financial-crisis outbreaks, and that the origins of these changes are unclear. After the onset of the global financial meltdown (GFM), the United States, Great Britain, Germany, and France all endorsed deep cuts in their military arsenals, with Germany announcing the biggest reductions in its military forces since World War II.³ Concurrently, Russia, China, and India defended more ambitious military budgets—as did Indonesia, which, interestingly, had responded to the 1997-98 Asian financial crisis (AFC) by pursuing drastic defense cuts. During the AFC, Thailand behaved like

¹ Tom Philpott, "Military Update: Official. Financial Crisis a Bigger Security Risk than War," *The Gazette*, February 1, 2009.

² "Financial crisis," in this work, is a three-dimensional variable having objective, subjective and inter-subjective meaning. Refer to the third section of the chapter for a description of how these different meanings come into being in practice. Military spending refers to national defense allocations; threat assessment refers to the extent to which a potential adversary is perceived as dangerous; war prospects refer to the perceived probability of interstate war.

³ Stephen Fidler and Alistair MacDonald, "Europeans Retreat on Defense Spending," *Wall Street Journal*, August 24, 2011; "Ministers Work to Reassure US Over Cuts in Defense Spending," *Western Mail*, October 16, 2010; Richard Norton-Taylor, "Russia Overtakes Britain and France in Global Arms Spending League Table," *The Guardian*, April 16, 2012; *SIPRI Yearbooks 2004-2009-2011-2012*; <http://www.sipri.org/yearbook>; "Mark Thompson, "The Proposed Defense Budget: 'Shaving the Balloon,'" *Time*, February 14, 2012; Barney Frank, "How to Save the Global Economy: Cut Defense Spending," *Foreign Policy*, Special Report, January-February 2012; "Big Cuts in Store for Bundeswehr," *The Local*, October 26, 2011.

Indonesia whereas Singapore and Australia did not.⁴ Threat assessment and war prospects similarly vary after financial-crisis outbreaks, as both the AFC and the GFM show. In 1998, Russia pulled back from its pre-crisis militant Asian policy while China and the United States strengthened their own conciliatory policies in the region—to the detriment of Japan.⁵ Reversing the cautionary military posture maintained since the late 1990s, Russia responded to the GFM by embarking on an ambitious foreign policy agenda. By contrast, the United States withdrew its forces from Central Asia, moved further away from any presence in European defense plans, and transferred its military and diplomatic focus to the Far East and the Pacific.⁶

Variation in national security policies after a financial-crisis outbreak is not a novel feature in world politics. Before the British financial crisis of 1901–05 (or the South Sea Bubble of 1720), and before the Ottoman banking and debt crisis of 1875–76, Great Britain and Turkey were both engaged in designing and pursuing ambitious

⁴ “Asia Defense Spending to Overtake Europe,” *Financial Times*, March 7, 2012; Keith B. Richburg, “China Military Spending to Top \$100 billion in 2012, Alarming Neighbors,” *Washington Post*, March 4, 2012; Richard Norton Taylor, “Russia Overtakes UK and France in Global Arms Spending League Table,” *The Guardian*, April 16, 2012; “India in Defense Spending Spree,” BBC News April 8, 2012. On the increase in Indonesian military spending during the Global Financial Meltdown see “Shopping Spree,” *The Economist*, May 24, 2012. On military spending in East Asia following the AFC, see Simon (2001: chapter 2), and Hartfield and Job (2007). Cuts to military spending in the West were not uncontroversial or entirely desired by governments. Compare, for instance, Martin Feldstein, “Defense Spending Would Be Great Stimulus,” *Wall Street Journal*, December 24, 2008, with Robert Kagan, “No Time to Cut Defense Spending,” *Washington Post*, February 3, 2009, and with Fareed Zakaria, “Yes, Let’s Cut Defense,” *Washington Post*, August 4, 2011. The French government during a first stage of the crisis attempted to raise defense spending, to no avail; see Edward Cody, “France Boosts Spending on Military,” *Washington Post*, October 30, 2008.

⁵ See Dibb, Hale and Prince (1998); Johnson (1999); Robert and Kelikov (2000); Denoon (2007).

⁶ John Gray, “A Shattering Moment in America’s Fall from Power,” *The Observer*, September 28, 2008; Balkan Devlen, “Geopolitical Consequences of the Economic Crisis,” *Today’s Zaman*, October, 20, 2008; Mark Mazzetti, “Global Economy Top Threat to U.S., Spy Chief Says,” *New York Times*, February 12, 2009; Helene Cooper, Michael Wines and David E. Sanger, “China’s Role as Lender Alters Dynamics for Obama’s Visit,” *New York Times*, November 14, 2009; “Rebalancing America’s Forces: The Downgrading of Europe,” *Economist*, January 14, 2012; Ian Bremmer, “The Recession Won’t Moderate Russia’s Foreign Policy,” *Foreign Policy*, March 25, 2009. See also Friedberg (2010), and Burns and Price (2010).

national security agendas. Yet, Great Britain ditched its expansionist plans after 1905 and 1720, whereas Turkey doubled down on its military ambitions after 1876, waging war on Russia in 1877.⁷ Exhibiting a different national security solution—historically a most memorable one—Japan, Germany, and Italy upturned their military postures from caution to aggression during, and in the aftermath of, the global financial crisis of 1927–33. In contrast, following the outburst of the Latin American debt crisis (August 1982), Argentina’s belligerent national security agenda—which had peaked with the Falklands War just a few months earlier (April 1982)—was quickly overhauled. Overall, evidence shows that, after the outbreak of financial crisis, national security policies change: the pre-crisis national security agenda is either overhauled or accentuated. What explains this variation in post-financial crisis national security policies? Why are some states, or better, governments, after financial-crisis outbreaks able at times to double-down on their pre-crisis assertive or conciliatory national security policies but need, at other times, to pull back from them? More simply, to emphasize once more a question that has long deserved an answer in academic and policy circles: what influence do financial crises have on national security policies?

This study embarks on a systematic analytical and empirical investigation into the national security influence of financial crises. Its main argument is that financial crises cause a severe shock to crisis-stricken governments’ financial *and* security policies—also referred to as financial-security agenda(s)—and that, during the process of crisis response, national military spending, threat assessment and war prospects are

⁷ On the British experience, see Carswell (1960:271–72) and Friedberg (1987:15–37). On the Turkish experience, see Pamuk (1987:72); Blainey (1973:chapter 12).

inflated, curbed, or further softened compared to their pre-crisis equivalents.⁸ Which outcome ensues, this dissertation finds, depends on the relationship between crisis-stricken governments and high finance during the process of financial-crisis response.

A few conceptual clarifications will make these assertions clearer. High finance in this work indicates the largest transnational financial houses and the largest industrial and trading firms that are aligned with them. These houses and firms, due to their profit-seeking objectives, transnational business connections, and resources are primarily interested in the preservation of a fully functioning international financial system and effective and rewarding international financial cooperation.⁹ As demonstrated in the literature—and this is a point that will be developed later in the chapter—because of these preferences, the largest transnational financial houses and the largest industrial and trading firms aligned with them highly cherish international peace and fear the prospect of war. In the years between 1880 and 1940 members of high finance were individuals like London-based banker and financier Nathan Rotschild, German-French banker Mayer de Rotschild, German bankers Gerson Von Bleichröder and Max Waburg, American banker J.P. Morgan, American banker and industrialist Jacob Schiff, Scottish-American industrialist Andrew Carnegie, and German shipping magnate Albert Ballin.¹⁰

⁸ The influence of financial crises on the policies of states that do not directly experience a crisis are discussed in this dissertation only to the extent that they relate to and help illustrate changes in the financial-security agenda(s) of crisis-stricken governments.

⁹ The key element here is that these institutions are privately owned; they are not tied to the fate of any particular nation; are multinational in form; and are “market-oriented,” that is they influence but not dominate markets.

¹⁰ Completing this list were American industrialist and railroad executive E.H. Harriman, American industrialists John D. Rockefeller and Henry H. Rogers, and Canadian-American railroad tycoon James J. Hill. On occasion, the demarcating line separating these business elites from politicians was thin—

At times, high finance has the ability and desire to influence governments' crisis response strategy.¹¹ At other times, this ability can be either dormant or non-existent. The commitment to defend the financial system and international financial cooperation, and the ability and desire to influence governments' strategy of financial crisis response might or might not be included in standard definitions of high finance.¹² Not necessarily included in standard definitions of high finance are also two aspects that are linked to the mentioned components. A first is the confidence of high finance in the virtues of international financial exchange (or at least the prospect of it), and related dislike for, or fear of, international financial instability. A second component is the "fungibility" of high finance across time and space. High finance takes on different forms depending on whether the elites that compose it are located in the crisis-stricken state or outside of it, and whether the crisis-stricken state is either in a position to interact with high finance or instead entirely insulated from it. Thus, for the purposes of this work, high finance is best conceived as a chameleon with the power to filtrate into and out of different domestic political settings, always with the objective of defending international financial stability. This trait sets high finance apart from governments and private, domestic financial actors, although some overlap is occasionally possible.

In agreement with a number of works in political science, national security policies are here classified as *assertive* or *cautious*, and governments—which are

Cecil Rhodes, for instance, is an example of prominent businessman *and* politician—but for the most part major financial/business representatives and state officials belonged to different groups.

¹¹ For an idea of who these financial elites are, see Polanyi (1944), Chernow (1990), Ferguson (1999), and Ahamed (2009).

¹² In standard uses, high finance simply stands for powerful formal or informal cohorts of financial elites or bankers.

understood here narrowly as the main political authorities that decide states' primary economic and security policies—tend to pursue either cautious *or* assertive national security policies and are very often classified as having a *statist-nationalist* or *liberal-cosmopolitan* character or disposition.¹³ Statist-nationalist governments tend to act autonomously from non-state domestic forces and international actors, and resort to rent-seeking economic policies as well as assertive military and diplomatic means to defend the national interest (Krasner 1978:10,313,14; Nordlinger 1988:881; Young 2007:109-111). By contrast, liberal-cosmopolitan governments are generally keen to safeguard the interests or well being of non-state individuals and groups, and, to this purpose, they opt for internationalist policies and commit to the maintenance of international peace (Kant 1789:29; Bull 1977:81; Appiah 2006:xv).

This dispositional diversity also informs government low or high *affinity* with high finance that is low or high predisposition to include the preferences of high finance in their economic and security policies and decisions.¹⁴ After the outbreak of financial crises, statist-nationalist and liberal-cosmopolitan governments tend to respond exactly on the basis of this affinity, *doubling down* or attempting to redouble

¹³ Various expressions of statist-nationalist and liberal-cosmopolitan governments exist in practice. Totalitarian governments and confessional or theocratic governments, for instance, provide two different examples of a statist-nationalist government. Similarly, the welfare-state governments, and the governmental members of an international federation of states are two different examples—or at least two not necessarily overlapping examples—of liberal-cosmopolitan governments. For a simultaneous treatment of both kinds of governments in political science see, in particular, Solingen (1998:18-61). Rather than “liberal-cosmopolitan,” Solingen uses the label “internationalist.” This work offers a more fine-grained approach than Solingen’s to the distinction between liberal-cosmopolitan and statist-nationalist governments by postulating that the affinity with high finance of either kind of government can be high or low. On government affinity with high finance, refer to the following sentence and the rest of the chapter.

¹⁴ Government affinity with high finance therefore tells us how much governments respect high finance, which is, in turn, an indication of governments’ behavioral intentions in the spheres of finance and security.

on their pre-crisis financial-security agenda.¹⁵ Not always, however, governments' *intended* crisis strategy is either possible to implement after the onset of the crisis or possible to sustain until its end. Specifically, the realm of available strategies of crisis response is defined by governments' high or low *exposure* to high finance, that is the necessity or choice to consider the preferences of high finance despite or in addition to national leaders' intended *economic* strategy of financial crisis response.¹⁶ Hence, unlike affinity, exposure is a variable that does not exist without the presence of a financial crisis.

The interplay between crisis-stricken governments' *affinity* with and *exposure* to high finance after the outbreak of financial crises—this work argues—determines whether the crisis-stricken government(s) or high finance leads the process of financial crisis response, and ultimately how pre-crisis national security policies change following the outbreak of financial crises. Explicitly, this work identifies three scenarios of financial crisis influence on national security policies based on three possible combinations between government affinity and exposure to high finance. The security policies of a government having low affinity with high finance are likely to be curbed when exposure to high finance after the start of the crisis is high, and to be inflated when such exposure is low. By contrast, the security policies of a government having high affinity with high finance are likely to become extra prudent when exposure to high finance after the start of the crisis is high. The theoretical foundations

¹⁵ I clarify why this occurs later in the chapter. For now, keep in mind that what I define as “double-down movement” finds its origins in the field of psychology, and particularly the theory of *escalating commitments*, which holds that, after having endorsed a position, one feels compelled to defend it. Stiglitz (2010) recently used this theory for explaining policymaking after the outbreak of financial crises.

¹⁶ Why government affinity with and exposure to high finance are either high or low is clarified later in the chapter.

underlying the argument of this manuscript do not allow determining the character of the national security policies of a crisis-stricken government having a high affinity with high finance and a low exposure to high finance. In each scenario, however, including this latter one, financial crises change state governments' ability or interest in pursuing their pre-crisis policy agendas, resulting in a departure from pre-crisis national security policies.¹⁷

Some clarifications are important. To begin, defining government affinity with high finance in terms of national economic policies *and* national security policies when national security policies is also the variable to be explained is not methodologically problematic because the pre-crisis national security policies that contribute to defining a government's affinity with high finance remain constant throughout each examined financial crisis instance. Pre-crisis national security policies are clearly distinct from the change in national security policies to be explained, which materializes after the outbreak of financial crisis and thanks to the selected economic strategy of financial crisis response. Also, the inclusion of a constant variable on the character of national security policies before financial crisis outbreak is inevitable if the research objective is, like the one of this manuscript, mapping the character of the shift in national security policies over a period of time. Finally, government exposure to high finance is coded based exclusively on the *economic* strategy of financial crisis response that is needed to solve the crisis, and not on the economic *and* security strategy of financial crisis response that are needed to solve the crisis. It is this

¹⁷ See the tree diagram drawn later in the chapter.

economic strategy that explains the changes in national security policies that occur after financial crisis outbreak.

The four scenarios, and the logic and theoretical underpinnings that explain them are the subject of this chapter. The chapter starts with a short account of the national security influence of military-security crises, noting that some pivotal aspects characterizing the process of resolving these crises are also essential ingredients of the influence of financial crises on national (security) policymaking. It then offers a step-by-step explanation of the above-sketched argument. After an overview of the distinctive challenge to national security policies that financial crises pose, by affecting crisis-stricken governments' hold on power and their incentives to respect or close the door to international financial market, the argument develops in three sections. The first section explains the ideal-typical blueprint of financial crisis response recommended to governments by high finance. The second section examines the components of high or low government exposure to high finance during the process of financial crisis response and clarifies how different combinations of government affinity with and exposure to high finance produce three scenarios of influence of financial crises on governments' financial-security agendas. The third section portrays the change in military spending, threat assessment, and war prospects resulting from each of the three scenarios. The national security change that is realized in a fourth scenario, and which the framework cannot capture, is also considered. Case selection, methods, and data are then discussed.

MILITARY-SECURITY CRISES AND NATIONAL SECURITY POLICIES

The literature on crisis decision-making has amply documented that interstate military-security crises are pivotal moments where national security policies—and particularly war prospect, threat assessment, and military spending—are susceptible to fundamental reevaluation and adjustment. Reevaluation and adjustment occur because it is in the nature of military-security crises to threaten a state's position or status in the international system. Specifically, military-security crises present state governments with three concurrent challenges: a threat to one or more basic values; uncertainty; and a shortened shadow of the future (Hermann 1969:414; Hermann 1972:13; Holsti 1972:9; George 1979:104; Bretcher et al. 1997:3–10).¹⁸ Responding to the crisis in this context of emergency, rising insecurity, and pressured decision-making, government officials move towards a new consensus on existing problems as perceptions are transformed, policy options become more limited or more numerous, and different approaches to military spending, threat assessment, and war are adopted (Baddeley 1972:537–546; George 1975:284; Jervis 1976:172–202).

Although threats to basic values, finite time for response, and uncertainty are attributes that all military-security crises share, military-security crises do not affect national security policies equally. For instance, military-security crises have stricken states and governments committed to the pursuit of assertive national security agendas as well as states and governments maintaining cautious national security postures. In either case, crisis response was reached via doubling down on

¹⁸ In the crisis decision-making literature, uncertainty has at times been associated with the surprise provoked by military-security crises. At other times, it has been linked to the heightened probability of war.

assertiveness/cautiousness or withdrawing from it altogether. Four examples illustrate these claims: the Cuban Missile Crisis of 1962; the military crisis of 1914; the Suez crisis of 1956; and the Korean crisis of 1950. In 1962, the resolution of the thirteen-day Cuban Missile Crisis put brakes on escalating Soviet-American military competition, and paved the way for conciliatory national security policies as the United States agreed to dismantle all US-built Jupiter intermediate-range ballistic missiles (IRBMs) deployed in Italy and Turkey, and the Soviets agreed to remove their medium-range and intermediate-range ballistic missiles (MRBMs and ICBMs) from Cuba.¹⁹ The opposite outcome occurred during six critical weeks in 1914, when, fearing for their national survival, governments across Europe gradually abandoned cautious military and diplomatic agendas, and spiraled into mobilization and war.

In contrast to the 1962 and 1914 crises, the Suez crisis of 1956 stirred British and French cautionary (pre-crisis) national security agendas towards greater caution, whereas the Korean crisis of 1950 pushed ambitious American policies of containment towards greater assertiveness. Between July and October 1956, British and French attempts to regain control of the nationalized Suez Canal by supporting an Israeli attack and bombarding Cairo both escalated and faded, with London and Paris eventually resuming a more conciliatory security posture in the fall.²⁰ Vice versa, a few days after the June 1950 crossing of the 38th parallel by North Korea, perceiving a threat to the promise of withstanding aggression recently enunciated in the

¹⁹ Competition had escalated since 1958, following the American deployment of IRBMs in the UK, Italy and Turkey. A similar military-security crisis is the Berlin Blockades of 1948–49.

²⁰ Note that British and French national security policies in the 1950s were “cautious” due to the United States’ power to maintain them so—not necessarily because they were inherently peaceful or conducive to peace. On this point, see Curtis (2007). On the Suez crisis see in particular Kunz (1991).

containment doctrine, the United States intensified its military involvement in the peninsula, embarking on a three-year-long war to repel the invasion.

Since its inception, scholarship on crisis decision-making has been bound to confront a natural question that applies to these examples and many other cases: what does explain the different origins, escalations, and responses to military-security crises?²¹ Why did the Great Powers discard pre-crisis military restraint to adopt an increasingly assertive national security posture in 1914? Why did Britain and France in 1956 end up continuing a policy of non-confrontation? And why were American rearmament policies traded for diplomatic negotiations in 1962, but refueled to wage war in 1950?

A consistent result across much of the literature is that the reconfirmation or curbing of assertive or prudent pre-crisis national security policies hinge on crisis-stricken governments' high or low affinity with or exposure to compromising or non-compromising strategies of crisis response. These strategies are based on a number of factors, which scholarship has identified as dominant beliefs, leaders' personality, civil-military relations, institutions, cultural and historical experience, cognitive assumptions and signaling, technology, and coercive diplomacy. Governments' affinity with and exposure to compromising or non-compromising strategies of crisis resolution after the outbreak of military crises determines the character of the military and diplomatic responses—that is, whether pre-crisis national security agendas are intensified or rebutted. For instance, it is conventional wisdom that throughout the summer of 1914, European government officials became highly exposed to preparing

²¹ See, for instance, Azar (1972), Herek, Janis and Huth (1987), Richardson (1994), Schultz (1998), and Wilkenfeld, Young, Asal and Quinn (2003).

for a major military conflagration (as opposed to diplomatic reconciliation) after developing an affinity, or becoming more and more accustomed with policies that prioritized offensive military weapons and doctrines, the fear of late mobilization, “bandwagoning” behavior, the misperception that the war would be short and limited, and flawed civil-military relations—policies that undermined ongoing attempts to resolve the crisis diplomatically (Hermann 1972:61; Snyder 1984:110; Van Evera 1984:62,68). By contrast, it is commonly acknowledged that nuclear escalation was restrained in 1962 because American and Soviet government officials re-evaluated past historical experience, institutional procedures, and the odds that a surgical strike would succeed in ways that made them more obliged or exposed to conceding military and diplomatic measures, and choked the spirals of nuclear brinkmanship (Sorensen 1963:31; Abel 1964:19; Allison 1969:697-698; Hermann 1972:64,65).

Finally, Britain and France deflected their ambitious strategic plans in 1956 when an exercise in American monetary statecraft made them more willing to embrace international conciliation, and highly exposed to the negative consequences of refusing it (Kirshner 1995:63–80; Andrews 2006:7,19),²² whereas, in 1950, memories of the Munich experience (1938–39), perceptions of growing Soviet nuclear capability, and concerns over the domino effects deriving from the failure to contain a North Korean invasion resulted in a low exposure of the Eisenhower administration to diplomatic compromise, thus enhancing American nuclear “boldness” and affinity with

²² In 1956, a US-sponsored UN resolution called for immediate ceasefire and withdrawal of military forces from Egypt. Both goals were obtained when, in early November, the pound sterling came under sustained market pressure, and the US threatened to block British access to its own reserves in the International Monetary Fund. From the start of the crisis up until November 1956, the exposure of the British and American governments had been low, suggesting that there might be different crisis stages and different vulnerabilities throughout different crisis episodes. I touch upon this point later in the chapter.

confrontational policies, and ultimately accelerating ongoing nuclear races (Dingman 1998:51–54; James and Wells 1993:1–8).²³ In each of these four crisis years, state authorities responded to mounting crisis pressures and tense international climates. Yet, their different affinities with or exposures to compromising and non-compromising means of crisis resolution changed the course of their respective national security policies by virtue of an overhaul or intensification of pre-crisis national security agendas. As the following paragraphs clarify, military-security crises are not the only crises that change the course of national military spending, threat assessment, and war prospects, nor are they the only crises that affect states' exposure to compromising and non-compromising strategies of crisis resolution.

FINANCIAL CRISES: JUST ANOTHER TYPE OF SECURITY CRISES

Financial crises and military-security crises share a number of objective, subjective, and inter subjective attributes. Both crisis contexts are characterized by objective, subjective, and inter-subjective elements—specifically, a material loss or change; a high threat to important values; increased uncertainty, and shrinking decision-making time. Three necessary, specific components of financial crises clarify why, during them, a material loss occurs, important values are threatened, and uncertainty and time constraints prevail. One: as Reinhart and Rogoff (2009) and Bordo (2001) have noted, in any financial crisis some financial assets or institutions suddenly and *tangibly* lose part of their value, signaling the end of a period of

²³ The “limited” character of the Korean War does not change the fact that the assertiveness of American national security policies increased from the summer of 1950.

economic growth or accepted stability.²⁴ Amongst the unpleasant and so-called “deadly” conditions that can appear are GNP growth, liquidity, reserve availability, the value of the exchange rate, deficit and debt levels, credit rating, the rate of bank failure, and price and interest rate levels are all susceptible to significant deterioration (Burton 1910; Fisher 1911; Minsky 1972; Kindleberger 1973; Bordo 1986; Capie and Wood 1986:190-239; Calvo 1995; Bordo et al. 2001; Reinhart and Rogoff 2009). Two: as critical national financial variables deteriorate and the prospect of greater economic damage materializes, national leaderships at the head of the crisis-stricken state (or states) start losing confidence in the workings of the financial system, doubting the validity or desirability of existing policies and institutions, and fearing their removal from power.

Until a solution to the crisis is found, a climate of economic and political uncertainty will remain. Concern or confusion over the status of the affected (national or international) financial system and pre-crisis national agendas increase not only for national leaders or within crisis-stricken governments, but also for high finance. Finally, confidence in status of the financial system declines amongst domestic private financial investors, domestic audiences, and private financial market forces (Eichengreen 1996a). Three: a series of measures involving, at least potentially, governmental and non-governmental actors is undertaken in the attempt to respond quickly to the crisis and restore financial and economic stability, confidence, and growth. As much as the reaction to the sudden fall of financial and economic assets

²⁴ In the datasets assembled by Bordo and Reinhart and Rogoff, financial crises are calculated through a weighted average of changes in exchange rates, short-term interest rates, and reserve availability relative to the United Kingdom or the United States.

above mentioned, the success or failure of crisis response measures hinges upon objective economic changes, and subjective and inter-subjective changes in economic perceptions.

These considerations buttress the existing scholarly conclusion that financial and economic crises produce a “shock effect” or cast a shadow on the value and sustainability of existing state policies while also testing governments’ capacity to survive to the crisis by either holding on to their domestic power and agendas or adjusting them to new circumstances (Katzenstein 1978:15-22; Gourevitch 1986:17,35; Pepinsky 2009:2,3). At times, governments’ crisis response efforts succeed. At other times, they fail and newly empowered domestic forces are installed. There is no difference between the threat that local and global financial crises pose: in either case, government leaders are called to select crisis countermeasures and their affinity with high finance and exposure to high finance—both of them objective, subjective and inter-subjective variables—will drive their policy response.

Systematic thinking and empirical research on the influence of financial crises on crisis-stricken governments’ military spending, threat assessment, and war prospects should take all of the three, described components of financial crises into account. The few, recent scholarly works on the geopolitical implications produced by the AFC or the GFM have focused on the first, objective component, and emphasized the repercussions on international security that financial crises produce by engineering relative, interstate economic gains and losses or balance-of-power-shifts (Dibb, Hale and Prince 1998:5; Devlen 2008; Friedberg 2010:32,35). This approach, which is essentially an application of structural realism to the study of international relations

during financial crises, suffers from two limitations. First, it is inapt to evaluate the character of states' national security policies after the outbreak of financial crises. As Kenneth Waltz (1979) reminds us, interstate balance-of-power shifts have little to say on national foreign policy or diplomatic and military decisions. Second, alterations in interstate economic gains and losses are not, per se, a *distinctive* component of financial crises, since technological innovation or a recession might produce just the same result.

A more appropriate investigation on the national security influence of financial crises starts with examining the shock, collapse of confidence, and crisis response strategies that state and non-state actors experience once that financial assets and institutions have begun to deteriorate. Since government authorities and high finance are at the forefront of these developments, and since they are the main actors that have potentially the ability to resolve the crisis, it makes sense to focus on their relationship to understand the destiny of national security policies after financial crisis outbreak. From this perspective, financial crises, and the crisis-resolution processes that accompany them, are best regarded as moments wherein crisis-stricken governments are called to redefine their participation or non-participation in the international financial system, and to re-establish the credibility of their financial policies vis-à-vis those advocated by high finance.²⁵ Two caveats are in order. One: the enthusiasm with the international financial system of liberal-cosmopolitan and statist-nationalist governments will vary. This variation is displayed in the financial and security policies adopted before, during, and after the financial crisis outbreak by either type of

²⁵ I construct this interpretation based on Kindleberger (1978:17,91,92,94,172), and Eichengreen (1992:3-12).

government. Two: related to the former point, the power between a crisis-stricken government and high finance will vary across financial crises and political contexts. After the onset of a financial crisis, the government's ability to continue its pre-crisis agenda given the increased likelihood of domestic unrest and political realignment alters the relative costs and benefits of pursuing that agenda, as well as those of taking part in or being excluded from a liberalized international financial order. As a result, crisis response is a power game between state authorities and high finance, with variations in the former's financial and security preferences and policies, and the ability of the latter's ability to exert successful policy pressure.²⁶

Elaborating on these caveats, this dissertation makes three claims that are foundational to the framework here developed. The first is that financial crises and the measures undertaken to respond to them affect the destiny of national *financial* policies *and* national *security* policies alike, traditional and interdependent requirements of any government and policy agenda. Having failed to forestall the crisis and the collapse of confidence that is impeding financial and economic stability and growth, pre-crisis national financial policies have lost credibility. Extant national security policies come under scrutiny too, however, because they have jeopardized, or are now jeopardized by a weakened national financial system. Thus, financial crises challenge crisis-stricken governments' financial-security agendas, which are, in turn, re-established or surrendered during the process of crisis response, with inevitable implications on the course of military spending, threat assessment, and war prospects.

²⁶ This project focuses especially on states' responses to financial crises. The immediate effects of crises on national security policies, for instance the fall in military spending deriving from GNP deterioration, are relevant to the extent that they elicit a certain kind of response from crisis-stricken governments.

The second claim that this work advances is that the national security measures that governments having a high affinity with high finance—generally liberal-cosmopolitan governments—and governments having a low affinity with high finance—generally statist-nationalist governments—tend to select after the outbreak of financial crises are likely to be different: the former will be keener on resolving the crisis via further downplaying military ambition in an effort to restore financial confidence and economic stability and growth. By contrast, government having a low affinity with high finance will attempt to defend pre-crisis security agendas, subordinating financial measures of crisis response to those agendas, delinking them from national crisis response measures. The third claim that is foundational to the framework presented in the following pages is that while governments have either high or low affinity with the pressures of high finance *before* the onset of the financial crisis, this affinity can change *after* the financial crisis outbreak depending on crisis-stricken governments' high or low exposure to high finance.

Justifying this distinction (affinity vs. exposure), which goes beyond semantics, are the political stakes with which financial crises present governments and domestic interests. After a financial crisis outbreak government authorities are urged to redefine their pre-crisis financial and security policies. While governments can rely on their control over domestic institutions and societal support to implement their intended crisis countermeasures, the role, power, and success of high finance in the process of financial crisis response can reinforce or weaken those countermeasures. Moreover, governments and high finance hardly have the same economic and security preferences. As a result, their preferred strategies of financial crisis response—and the

strategies of financial crisis response that they will try to implement—will be different. This power game, in turn, tends to galvanize domestic non-financial forces too, and push them towards or against high finance or crisis-stricken governments.²⁷ In sum, after the outbreak of financial crises crisis-stricken governments' autonomy vis-à-vis high finance—and non-financial domestic constituencies, as a result—is fundamentally amended.

The Alarm of High Finance and Its Orthodox Medicine

It is no secret that high finance dislikes financial crises. Powerful members of the transnational financial community—including the Rothschilds, Morgans, Warburgs, Bleichroeders and Rockefellers—are driven by profit and investment opportunities that flourish under conditions of financial stability or, in the language of Hyman Minsky or Charles Kindleberger, the confidence that financial stability will be preserved. Because high finance would not even exist in the absence of a shared international faith in the virtues of capital mobility, and the projection of private financial interests from their home bases, this confidence must hold nationally as well as internationally. By upsetting both financial stability and confidence in financial stability, nationally or internationally, financial crises challenge what high finance most cherishes: high returns on investment, and the prospect that these returns will continue and possibly increase in the near future. Global and local financial crises are

²⁷ Accordingly, this work does not deny the importance of non-financial interests in influencing crisis-stricken governments' strategy of financial crisis response, but rather derives it from the interaction and shifts in balance of power between government authorities and high finance after the onset of the crisis. This primacy of governmental and financial forces in driving the process of crisis response hinges on their greater material and ideological assets to spur recovery compared to the assets of practically any other domestic and international actor.

both sources of concern.²⁸ During such crises high finance loses out, although “losing out” is always preferable to the harsher fate of being “wiped out,” which smaller business is more likely to face.

The recipe for crisis response recommended to governments by high finance is uniform. Crisis-stricken governments should tighten their belts: they should act pro-cyclically to the benefit of the financial sector, defend the value of the exchange rate, lower interest rates, restore a sound (=balanced) budget and credit rating, and deflate the economy by pursuing more stringent or austere monetary and fiscal policies irrespective of the negative implications for employment, wages, and output growth.²⁹ A first justification for this medicine, which derives from classical liberalism, is that declines in demand, prices, costs, and wages will redirect the flow of resources into private hands and reinforce private incentives to invest, eventually bringing the economy out of its downward spiral (Smith 2008). A second, related justification is that deflating prices and the economy, and defending the value of the exchange rate, signal national financial creditworthiness, and foster restoration of an aura of confidence or “seal of approval,” which thriving international financial markets, a sound international financial system, and ultimately prospering national finances need (Hayek 1945; McClosky 1966:122-158; Cooper 1968:148-173; Helleiner 1994:170).

²⁸ Note, however, that financial crises striking states that are popular destinations for international investments are of more concern to high finance than financial crises affecting states that remain rather marginal in the global economy. Also, global financial crises are of particular concern because of the direct threats to the international financial system and to future financial gains—threats that are less serious in the case of local financial crises.

²⁹ Especially following the growth in states’ budgets in the 1940s and 1950s, this recipe has become increasingly compatible with the presence of international lenders of last resort, such as, for instance, the International Monetary Fund, or the European Central Bank, as well as with cooperation amongst foreign central banks and measures of “quantitative monetary easing.” The International Monetary Fund and the European Central Bank can be regarded as institutional improvements on the Bank for International Settlement founded in 1929 to promote the stability of the world’s credit structure.

The ultimate message is that governments should express or restate their commitment to free market principles and international financial cooperation, while creating a hospitable environment for encouraging national and international private investment.³⁰

This pro-cyclical response to financial crises that high finance supports can be regarded as a defense of the rules of the existing international financial or monetary system, rules from which crisis-stricken governments have strayed.³¹ The prescriptions imposed by the International Monetary Fund on the Asian economies following the AFC, and the discipline of fiscal austerity endorsed by most European capitals following the start of the sovereign debt crisis in 2009 are symptomatic examples of the high-finance-style crisis-resolution toolkit.³² Although the appropriateness of the toolkit has already been questioned (Feldstein 1998; Willet 2000; Watson 2002), and although debate over its (un)suitability continues to this day, the final words on the general adequacy of crisis medicine prescribing national financial austerity, and respect for international financial rules favorable to mobile capital, will very likely remain unwritten.

³⁰ In this dissertation, “orthodox” stands for “in agreement with international financial cooperation (=financial orthodoxy), and a liberal international financial order.” Heterodox refers to any financial principle/doctrine that challenges international financial cooperation and a liberal international financial order. With “greater orthodoxy” or “greater heterodoxy,” I intend greater propensity to, respectively, abide by or deviate from the rules of the international financial system. On the use of “orthodox(y)” and “heterodox(y)” see, for instance, Ruggie (1982), Gourevitch (1984:95-129), and Helleiner (1994:181).

³¹ On this response see, for instance, Gourevitch (1986:37-40); Broz (1997:59); Fischer (1998:103-106); Eichengreen and Temin (2000:18).

³² The crisis response unveiled by US Federal Reserve Chairman Ben Bernanke in early 2009 was driven by a similar objective of refueling international financial cooperation and putting national and international credit markets in the position to reverse the sharp slowing in global financial and economic activity. See Ben Bernanke, “The Crisis and the Policy Response,” January 13, 2009, Stamp Lecture, London School of Economics, UK.

<http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm>.

An implication of the use of this toolkit has remained in the shadows. The pro-cyclical medicine requires an extremely prudent approach to national military spending, threat assessment, and war prospects. One could argue that the ideal typical blueprint of financial crisis response desired by high finance comes with a security-conditionality. The carving out of defense funds to face existing or mounting threats would simply backfire on the crisis-resolution efforts that high finance recommends.³³ Similarly, lowering defense spending, downplaying existing threats, and avoiding war entanglements are measures that promise to buttress the success of the fiscal straitjacket that high finance desires of governments during financial crises. In other words, restoring financial confidence and national creditworthiness demands reductions in existing military spending. Reduction in military spending requires, in turn, the downplaying of threats, whereas rising threats pave the way for increases in military budgets and decreasing market confidence. The downplaying of threats implies, in turn, decreased war prospects. Thus, the advice of high finance to governments struggling with financial crises is a universal call to *tame national security ambitions or fears*, no matter the status of existing commitments to national security (or of the economy).

The classical or neoliberal crisis-response medicine suggested by high finance is not far removed from its ordinary, or orthodox, financial and security preferences. It is, indeed, an established finding in the literature that high finance prizes stable macroeconomic conditions and cautious national security policies. In this regard, Karl

³³ Assertive national security policies, particularly wars, have historically been associated with distressed financial markets, weakened financial confidence, and a series of negative repercussions on economic stability and growth.

Polanyi (1944:10,13,14) has noted that, by awarding and renewing loans to governments based on good fiscal behavior and creditworthiness, financial elites significantly contributed to international peace in central Europe during the hundred years preceding World War I. More recently, Jonathan Kirshner (2007:9) has found that high finance is reluctant to risk and initiate war because of its deleterious macroeconomic consequences. And Benjamin Cohen (1986:14) has observed that the firm interest of high finance in peaceful diplomacy has affected the conduct of American foreign policy more than once.

Yet, only occasionally throughout history have the customary financial and security preferences of high finance been translated into policy. In the hundred years of peace that Polanyi describes, states often propped up their military budgets and pursued expansionary colonial policies to the detriment of national macroeconomic variables, thereby escaping from a strict observance of financial orthodoxy. At the height of the gold standard, only Great Britain constantly maintained full convertibility, and even Great Britain itself did not uphold perfectly balanced budgets at all times (De Cecco 1974:1; Eichengreen 1985:2; 1987:16,19; 1996:20; Friedberg 1987:15; Bordo and Kydland 1990; Broz 1997:53). Interestingly, as the Boer Wars demonstrate, British governments were not strangers to escalating defense budgets and military adventures (Friedberg 1987).

Moreover, while governments' policies often deviate from the prescriptions of financial orthodoxy, high finance itself cares more about the existence of heterodox national financial and security policies at certain times than others. For instance, the tendency of high finance to get caught in financial bubbles and economic booms on its

quest for profit maximization (Kindleberger 1978), temporarily losing sight of macroeconomic fundamentals and financial stability, suggests that its commitment to financial orthodoxy is not constantly and staunchly defended. More exactly, financial elites have few incentives to meddle with governments' policies when markets are buoyant. By shattering the expectation of forthcoming high returns to investment, financial crises awaken the demands of high finance. They are not the sole event to do so—security crises and impending wars are others, for instance—but certainly a notable one. Ultimately, financial crises present high finance with extra opportunities to reassert the value of financial orthodoxy and national security caution. Likewise, governments are similarly offered additional chances to show high finance how seriously or poorly they stand for these values.

Crisis-Stricken Governments: Exposure to and Affinity with High Finance

In posing a threat to financial-security agendas, increasing political uncertainty and demanding for an urgent response, financial crises call crisis-stricken governments to redistribute the costs of adjustment between society and the state as well as amongst societal sectors.³⁴ Amongst various societal groups, the role and behavior of high finance versus governments during financial crises are very much acknowledged by existing literature. Several works in international political economy have shown that financial and economic strategies of crisis response are indicative of a variously fought and resolved power-game between crisis-stricken governments and

³⁴ As later pages will acknowledge, and as the literature on the political economy of financial crises has widely shown (Gourevitch 1986; Pepinsky 2009), the domestic political realignment that occurs during financial crises involves societal actors other than crisis-stricken governments and high finance.

international financial markets over the kinds of interests or ideas to be defended or endorsed (Haggard and Maxfield 1996:214-216; Blyth 2003; Helleiner 1994:169-191; Stiglitz 2010). Shaping this game is the autonomy of crisis-stricken governments to undertake and complete their intended strategy of financial crisis response: an autonomous crisis-stricken government will either successfully resist the pressures posed by financial elites or accept these pressures only to the extent that they respect the intended strategy of financial crisis response.

The sources of this autonomy—here defined as high or low government exposure to high finance—have been suggested by existing scholarship on the domestic responses to financial crises, exogenous economic shocks, and international liberalization, and they involve coalitional, institutional, and ideational factors born out of specific domestic, regional, and international contexts.³⁵ For example, the coalitional strength or “embedded autonomy” of governments has been linked to the triumph of the leadership’s intended crisis-strategy, and a *low* government exposure to the pressures of transnational financial markets after the financial crisis outbreak (Pepinsky 2007; Haggard and Kaufman 1992:23–28). Along similar lines, the centralization of domestic institutions (MacIntyre 2001), the limited dependence on international financial markets, the scarce domestic or regional clout of neoliberal mental frameworks (Solingen 1998), and the absence, or extreme political weakness,

³⁵ Amongst these factors are, for instance, coalitional cohesion, the degree of centralization of state structures, the distribution of veto authority, the type of business-government relations, the strength of the army or state bureaucracy, the power of neoliberal mental frameworks, and the degree of capital openness. See, for instance, Katzenstein 1978 and 1985:19-27; Gourevitch 1986; Rogowski 1989; Haggard and Kauffman 1992; Garrett 1995:658; Milner and Keohane 1996; Winters 1999; MacIntyre 1999b, 2001; Kirshner 2006; Pepinsky 2009.

of a domestic financial sector (Frieden 1991), have been associated with greater independence of crisis-stricken governments versus transnational financial elites.³⁶

Building on these findings, this dissertation considers a (crisis-stricken) government highly exposed to high finance when the government's strategy of financial crisis response rests on the following three elements: the domestic relevance of *orthodox* mindsets (1); the *presence* of powerful (private) domestic financial actors (2);³⁷ and the effective mobilization by high finance of the financial and political resources that are needed to respond to the financial crisis (3).³⁸ In contrast, a crisis-stricken government has a low exposure to high finance when its strategy of financial crisis response is shaped by the domestic relevance of *heterodox* mindsets (4); the *absence* of powerful (private) domestic financial actors (5); and the non-effective mobilization by high finance (and effective mobilization by governments) of the of the financial and political resources needed to respond to the financial crisis (6). These two sets of elements tend to "hang together." It is rare, for instance, that heterodox mindsets are popular in a national setting where financial actors are powerful, or that a government having a low exposure to high finance is in power when orthodox mindsets are popular.

³⁶ This point is in line with the widely held conclusion across much of the literature on capital mobility and state autonomy that states have not surrendered to, or retreated from, global finance but maintain significant freedom to maneuver and have often been at the forefront of financial liberalization. On this point, see Katzenstein (1985), Frieden (1991), Goodman and Pauly (1993), Helleiner (1994), Andrews (1994), Quinn and Inclán (1997), and Oatley (1999).

³⁷ Note that while a well-functioning international financial system strengthens the power of financial interests in the crisis-stricken state, the system is no guarantee of the presence of financial interests in the crisis-stricken state.

³⁸ The material assets that high finance has during financial crisis are ample liquidity, and the political endorsement of the major social forces of the crisis-stricken state.

A transposition of the Mundell-Fleming trilemma (Mundell 1963) in the context of financial-crisis response suggests that it is particularly meaningful, theoretically, to consider government exposure to high finance in the process of financial crisis response as either high or low, and with no equilibrium possible between these two extremes.³⁹ One element of the policy triad that the Mundell-Fleming model considers, namely the target of maintaining a fixed exchange rate, can be thought of as equivalent to the objective of financial crisis response. During financial crises, governments may strive for only two of the following three objectives: exchange rate stability or crisis resolution; fiscal and monetary sovereignty; and respect for high finance and capital mobility. Hence, working on a solution to the financial crisis will demand *either* the full exercise of state fiscal and monetary sovereignty *or* the support of high finance and capital mobility. Government exposure to high finance can change from high to low or from low to high during financial crises, like it occurred in Japan in the late 1920s and early 1930s. These episodes are very rare, however.

Financial crises have historically affected statist-nationalist and liberal-cosmopolitan governments.⁴⁰ For instance, the statist-national government of George W. Bush and the liberal-cosmopolitan government of Angela Merkel have both

³⁹ The Mundell Fleming model assumes that a state cannot simultaneously sustain fixed exchange rates, capital mobility, and independent monetary policy.

⁴⁰ An overview of the type of governments that have been affected by banking crises in the last twenty years can confirm this statement. For a list of these crises see Reinhart and Rogoff (2009:345-392). As clarified earlier in the chapter, the statist-nationalist or liberal-cosmopolitan nature of government is based on national financial/economic and security policies. Either kind of government could also be thought of as a large category encompassing various international or statist-nationalist solutions. The Latin American military-populist governments of the 1970s, for instance, and many confessional, Middle Eastern governments, during the same period, offered different expressions of the statist-nationalist ideal-type.

succumbed to the GFM. In the late 1880s, financial crisis hit the statist-nationalist (French) government of Georges Ernesto Boulanger as well as the liberal-cosmopolitan (Dutch) government of Joan Röell.⁴¹ Although the national security principles on which liberal-cosmopolitan ruling coalitions or parties thrive tend to make financial crises a harsher challenge for this type of government than for a statist-nationalist government, both statist-nationalist and liberal-cosmopolitan governments may experience a low or high exposure to high finance during the process of financial crisis response.⁴²

For instance, Suharto's statist-nationalist Indonesian government in financial crisis year 1998 and Berlusconi's liberal-cosmopolitan Italian government in financial crisis year 2011 both became highly exposed to high finance. Neither of them was able to withstand its power against overriding orthodox financial ideas, hold its ground vis-à-vis powerful domestic financial interests, and mobilize the political support and financial resources necessary to resolve the crisis. Both Suharto and Berlusconi lost their battle with high finance: the former was forced to abandon its auspicated plan for a currency board; the latter was compelled to accept the advent a more financially sound ruling party or coalition.⁴³ Differently, Portillo's statist-nationalist Mexican government in financial crisis year 1982 and the American liberal-cosmopolitan government of FDR in financial crisis year 1933 both resorted to monetary and

⁴¹ France experienced a financial crisis in 1889, the Netherlands in 1897.

⁴² For a statist-nationalist government, national financial strain might be a rather common element of the political context in which national agendas are crafted.

⁴³ On Suharto's abandonment of its auspicated plan for a currency board in 1998 see Grabel (2003:43). In 2011, the technical government of Mario Monti replaced Berlusconi's, and the latter's more remarkable commitment to national financial stabilization.

financial heterodoxy as part of the strategy of financial crisis response, indicating low exposure to international financial markets.⁴⁴

While statist-nationalist and liberal-cosmopolitan governments can be highly exposed or minimally exposed to high finance *after* the outbreak of financial crises, *before* crisis outbreak the affinity of each government to international financial markets tends to differ. Government affinity with high finance is discernible from the pre-crisis financial-security agendas of crisis-stricken governments. If this agenda benefits sectors like liquid-asset holders that gain from unprotected international financial competition, government affinity with high finance is high.⁴⁵ Similarly, affinity is high if this agenda envisions the taking of explicit steps towards international peace. By contrast, government affinity with high finance is low if state entrepreneurship prevails domestically over international financial markets. It is also low if the government commits to the sustained extraction and mobilization of domestic resources for increasing military power and national security. Changes in government affinity with high finance obviously occur when a government is replaced with another belonging to a different regime or having a different political orientation.

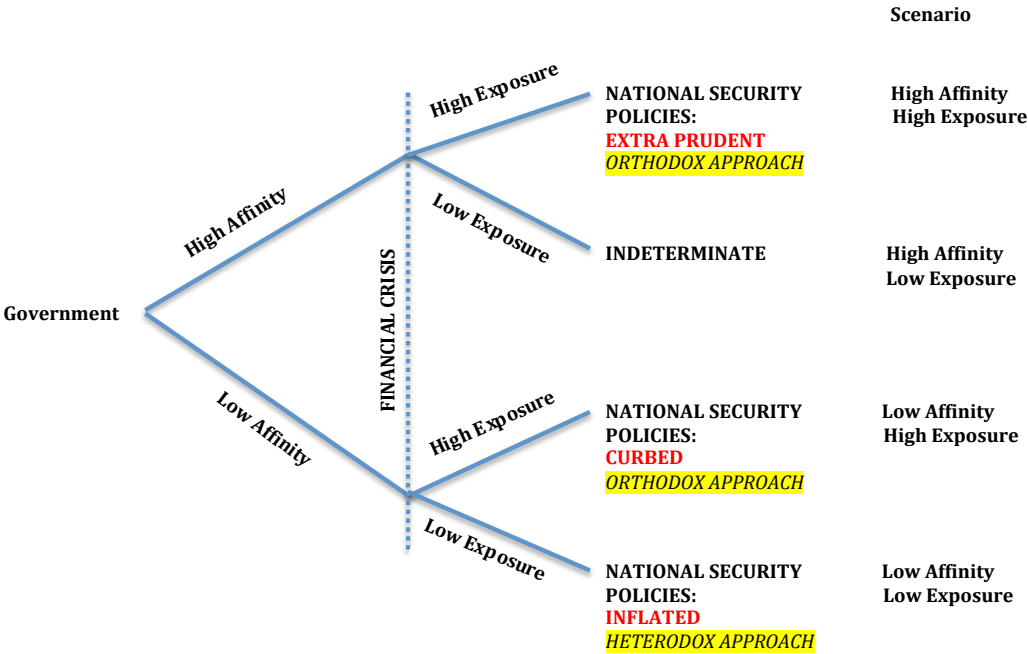
Because of variation in the specific principles and domestic institutional features that filter the relationship between national authorities and global finance (Polanyi 1944; Katzenstein 1978:3–22; Keohane and Milner 1996:16–22), statist-nationalist governments tend to face lesser constraints to pursue assertive national

⁴⁴ Portillo introduced capital controls in 1982. FDR did not need to do that—significant amounts of capital did not enter the United States in the early 1930s—but he similarly undertook a series of heterodox financial policies. See Chapter IV on this point.

⁴⁵ On the domestic distributional impact of the national policies favoring international financial and economic liberalization, see Rogowski (1989:3–21); Haggard and Maxfield (1996:209–236); and Quinn and Inclán (1997:771–813).

security than liberal-cosmopolitan governments do, while, oppositely, liberal-cosmopolitan governments tend to face stronger incentives than statist-nationalist governments to pursue prudent diplomatic and military policies. As a result, the pre-crisis affinity of liberal-cosmopolitan government is likely to be high, whereas the pre-crisis affinity of statist-nationalist government is likely to be low.

Figure 1.1. Three Scenarios of Influence of Financial Crises on National Security Policies



Legend:

Government: Statist-nationalist or liberal-cosmopolitan

NSP: national security policies—military spending, threat assessment, and war prospects;

High/Low Affinity (to high finance): government’s predisposition to include the preferences of high finance in its financial-security agenda;

High/Low Exposure (to high finance): government’s necessity to include the preferences of high finance in its financial-security agenda to solve the financial crisis;

Scenarios: HA-HE → High Affinity and High Exposure; HA-LE → Low Affinity and Low Exposure; LA-HE → Low Affinity and High Exposure; LA-LE → Low Affinity and High Exposure.

For both reasons of simplicity and empirical relevance, the theoretical framework proposed here assumes that the affinity with high finance of the financial and security policies of the same government overlaps. The interplay between government pre-crisis affinity with *and* post-crisis-outbreak exposure to high finance produces four possible scenarios of influence of financial crises on national financial-security agendas that are displayed in Figure 1.1, specifically “HA–HE,” “HA–LE,” “LA–HE,” and “LA–LE.” The four-letter labels refer to the values assumed by government affinity and exposure to high finance in each scenario. Three of these scenarios, as it will soon be clear, imply a shift towards greater or lesser caution in national military spending, threat assessment and war prospects.

Before examining why this is the case and how this occurs, I offer two cautionary notes. First, while the theoretical framework assumes that national financial and security policies express a synchronized affinity with high finance, and that liberal-cosmopolitan and statist-nationalists governments tend to exhibit, respectively, high and low affinity, this synchrony is occasionally absent in practice. The Nordic welfare model, for instance, is a liberal-cosmopolitan government combining a conciliatory approach to military spending, threat assessment, and war prospects, with a financial and economic program heavily weighted towards non-financial domestic groups. High finance is not ostracized, nor it is glorified. Similarly, the statist-nationalist government of George W. Bush (2001–2008) pledged itself to deep, pro-finance tax cuts, financial deregulation, and an explicitly “anti-finance” assertive foreign policy.

Second, in a similar vein, during the process of financial crisis response, there might be moments in practice when government exposure to high finance appears contested, the adopted strategy of crisis response having failed to bring about successful crisis resolution. With little doubt, this occurred during the Great Depression, starting from financial crisis year 1933 (Schlesinger 1957:457)—after that the orthodox medicine had repeatedly failed, and after the power of high finance had shrunk—and it is possibly occurring today, in the midst of the banking scandals that have punctuated the GFM (Gabel 2011; James 2012).⁴⁶ During these moments, crisis resolution strategies are susceptible to change, as are orthodox or heterodox mindsets, the power or weakness of the domestic financial sector, and the ability of governments and high finance to mobilize the financial and political resources needed to respond to the financial crisis.

Before explaining the character of the change in military spending, threat assessment and war prospects that occurs in each scenario, it is important to point out that the three, defined, national security outcomes sketched in Figure 1.1 are a result of the battle between government and high finance during the process of financial crisis response.⁴⁷ Recall that crisis-stricken governments and high finance tend to have different strategies of financial crisis response at the onset of the financial crisis and

⁴⁶ The Ferdinando Pecora investigations of January 1933, so-called after the American lawyer and judge who instituted them, sealed the loss of power of high finance, and a shifting national and international financial consensus. The investigations were part of a large American legal scrutiny into the practice of banking. Today, sluggish recovery, trading fiascos, and scandals like the LIBOR affair might indicate a similar turn of the tide. See, for instance, Heleen Mees, “The Zero Man,” *Foreign Policy*, April 3, 2012; David Rothkopf, “Bleak House,” *Foreign Policy*, April 23, 2012; Rana Foroohar, “How Barclays Rigged the Machine,” *Time*, July 23, 2012; and Jennifer Steinhauer, “Enduring Drought, Farmers Draw the Line at Congress,” *New York Times*, August 12, 2012.

⁴⁷ On describing disagreements over economic beliefs and policies as “battles” see, for instance, Seabrooke (2006:1).

are battling to see their strategy implemented. Whether crisis-stricken governments or high finance will win the battle depends on whether the former or the latter exerts control over the resources that are needed to solve the crisis, and specifically two resources: financial mindsets and domestic financial actors.

Table 1.1 The battle between governments and high finance

		FINANCIAL MINDSETS	
		Orthodox	Heterodox
DOMESTIC FINANCIAL ACTORS	Strong	High Exposure: High Finance Wins (Governments Lose) Low Affinity → NSP: CURBED High Affinity → NSP: EXTRA-PRUDENT [Security Dilemma Lessened]	N/A
	Weak	N/A	Low Exposure: High Finance Loses (Governments Win) Low Affinity → NSP: INFLATED [Security Dilemma is Exacerbated] High Affinity → INDETERMINATE

When orthodox mindsets are dominant, and domestic financial actors are strong, high finance tends to control the resources to solve the financial crisis and obviously governments tend to be exposed to high finance. In this context, governments having *low affinity* with high finance will tend to endorse the orthodox medicine and the security conditionality linked to it, *curbing* their pre-crisis assertiveness. Government with *high affinity* with high finance will be urged by high finance to *go past the point* of redoubling on an agenda based on conciliatory national security policies. National security policies will tend to shift towards greater caution, and the security dilemma will be lessened as a result. Differently, when heterodox

mindsets are dominant and domestic financial actors are weak, crisis-stricken governments tend to control the resources of financial crisis response, and have a low exposure to high finance. Governments with *low affinity* with high finance will inflate their national security policies, and the security dilemma is likely to worsen in this context. The framework does not suggest a specific behavior for the national security policies of crisis-stricken governments having a high affinity with high finance. Table 1.1 sums these considerations.

Scenarios of Influence

Because of the value that they attribute to their pre-crisis financial-security agendas, and because national leaderships' political survival rests on them, governments are likely to respond to financial crises by redoubling on their pre-crisis policies. Namely, governments pursuing assertive national security policies will strive for greater assertiveness while governments practicing conciliatory diplomatic and military policies will attempt greater restraint. They make this choice for at least two interrelated reasons. To begin, while financial crises display a problem in governments' policies and policymaking, denying the existence of a problem based on the validity of a financial-security agenda that has shown to work in the past is an appealing, low-cost strategy of political self-preservation. Moreover, the pre-crisis agenda comes with an ideational baggage over the "best" or "most apt" financial, military and diplomatic policies. Abandoning them and rapidly transitioning towards alternative solutions becomes unfeasible even if the threat to governments' survival, the shortened time-horizon, and the uncertainty posed by financial crises cause

concern. Recent experience with financial crises confirms the doubling-down hypothesis. Following the outbreak of the Asian financial crisis, for instance, policy analysts and observers around the world, members of governments of the affected and unaffected states, and international institutions like the IMF *denied* that a crisis was under way in East Asia. The existing financial policies were pushed ahead with greater strength, as the crisis spread to Latin America and Russia. A very similar response has occurred, and in some regions of the world is still occurring, since the 2008 onset of the GFM. In the early months of the crisis, the Bush administration denied that there was any serious problem, declaring that it was acting pragmatically in rescuing financially bankrupt firms.⁴⁸

Although this “double-down movement” is the strategy for crisis response envisioned by either kind of government, crisis-stricken administrations—for reasons explained in the earlier section—are not always able to implement or pursue it until the end of national financial difficulties. Since the financial and security components of governments’ policy agendas are interdependent, two important implications follow: after the outbreak of a financial crisis, the course of national security policies is likely to change, and this change will depend on the particular scenario within which crisis-stricken governments operate. In each scenario, governments committed to assertive or cautious military spending, threat assessment and war prospects will have to choose, or be forced to choose, between the “compromising” solution of validating (or-revalidating) international financial openness, and the “uncompromising” solution of delinking, or continuing to delink national financial and security policies from the

⁴⁸ On this point, see especially Stiglitz (2010).

imperative of international financial coordination, primarily deflation, implied by participation in an international financial system.⁴⁹ The incentives and constraints to select one route over the other will vary.

Imagine a government in scenario “LA–LE.” The government in question is committed to the pursuit of assertive national security policies when a financial crisis strikes. Government affinity with high finance is low, as pre-crisis financial policies have been adjusted to meet this national security agenda, privileging heterodoxy over orthodoxy. Relatedly, national dependence on the international financial systems is limited or inexistent; a domestic financial sector has not yet developed or is powerless; and neoliberal mental frameworks are absent. The coalition or party in power is statist-nationalist in kind—an acceptable hypothesis in view of the lesser constraints to the pursuit of assertiveness that statist-nationalist coalitions or parties encounter. The government is also well positioned to rely on highly centralized institutions; extract financial resources from the people; minimize the social consequences of political dissonance; and deflect to the domestic private financial sector the adjustment costs of crisis response. In sum, government exposure to high finance is low. In this scenario, government authorities have no incentive to abandon existing national security policies and pursue fiscal and monetary deflation to signal credibility to domestic and foreign investors. The reasons are various.

To begin, responding to the crisis by maximizing domestic resource extraction is possible and in line with existing mercantilist-protectionist frames of mind.

⁴⁹ A state’s participation in the international financial system, a system made by states and for states, will last as long as the state perceives that remaining in the system is beneficial to national financial and economic growth. Financial crises test the value of international financial systems. On this point, see Eichengreen (1996:35).

Secondly, a strong domestic financial sector, and the increasing permeability of domestic borders to foreign capital, are a hindrance to the inward-looking strategy of accelerated economic and industrial development sustaining, and, in turn, being sustained by, a well-oiled commitment to strengthening national defense. Thirdly, redressing the extreme skepticism of high finance towards the status of national finances would require abandoning the ambitious approach to military spending, threat assessment, and war prospects propelling the military-industrial complex that maintains the government in power. Fourthly, the experience of exclusion from the international financial system, and possibly the relevance of a regional context that is similarly insulated from international capital markets (Solingen 1998; Katzenstein 2005), will cement government leaders' belief that rival states will not be deterred from taking advantage diplomatically or militarily of a window of opportunity opened by the financial crisis. The collapse of national financial institutions located abroad could further increase the perception of forthcoming diplomatic and military losses. In this context, the domestic private financial sector, if at all present, will not be capable of persuading the government of the benefits of the orthodox medicine. High finance will not dictate the conditions of recovery, and heterodox financial ideas will predominate. This scenario is popular when military governments are in power, and a state-led program of accelerated development and military prowess captures the hearts and minds of the ruling oligarchy.

Consequently, softening national defense policies is an extremely unappealing strategy, whereas inflating militant national security policies and transferring rising percentages of GNP to national rearmament promises to reduce domestic opposition

arising from the representatives of the military-industrial complex. Government authorities are therefore likely to focus their energies on counteracting the weakening of existing national security policies, and minimizing the potential or real diplomatic or military losses caused by the crisis. Defending and reinvigorating the national financial system, the fiscal and monetary sovereignty of the state, the government's financial bases abroad, and the success of existing national security policies will take priority. Governments will redouble the pace of investment in national defense, and further emphasize the risks of existing threats. The increase in military spending will be decreed in an attempt to resupply existing military plans and activities as well as spurring government-led investment and economic growth. Concern over the solidity of existing alliances will increase and government authorities will deem war prospects to be more likely than before the crisis.⁵⁰ Overall, the crisis-stricken government will adopt a more assertive set of national security policies than in the absence of the crisis (Fig.1), *exacerbating the existing or perceived security dilemma*. Even if the objective of national authorities is to prevent a worsening of the security dilemma and to defend but not radicalize pre-crisis military and diplomatic policies, governments are very likely to inflate their bold pre-crisis national security plans. The national security context proximate to the Russian-Japanese War of 1904–05 exemplified this logic, as both participants embarked on greater assertiveness following the onset of a financial crisis.

⁵⁰ Note that this interpretation of the influence of a financial crisis on war prospects is distinct from the diversionary theory of war, in which economic instability persuades governmental elites to initiate a diversionary war with an opponent in the attempt to divert public attention from domestic troubles that threaten the survival of the regime. In the interpretation offered here, governmental elites might even be concerned for their political survival, but the chief problem lies in diverting the expectation of foreign opponents that the financial crisis has weakened the government and its national security policies.

Imagine now the same statist-nationalist government in “LA-HE.” The government wants to continue its assertive security plans, and might even strengthen them after the outbreak of the crisis. The costs of the maneuver are now politically daunting, however. High finance, a powerful domestic financial sector, members of the opposition, and a majority of domestic forces will oppose unsustainable trends in military spending, threat assessment, and war prospects, pointing at their deleterious effect on national financial creditworthiness or the national economy. Abidance by the norms of financial orthodoxy is presented as essential for crisis response and the restoration of financial stability. As the costs of exclusion from international financial markets and possibly of foreign financial dependence soar, the political and financial resources available to national financial institutions to fend off the crisis decrease sharply. High finance, possibly but not necessarily united with domestic finance, will attach conditions to fund disbursement, and will not lend or stop lending without a stronger commitment to fiscal and monetary deflation and to a conciliatory diplomatic and military agenda.

This scenario is likely, for instance, when the domestic institutional support and ideational drive behind a statist-nationalist government fade away as the crisis unveils no-longer bearable adjustment costs and reveals the increasing advantage of defending national financial credibility, placing national finances on a sustainable path, and upholding the principles of a liberal financial order. Heterodox financial models are likely to be rejected, and emerging domestic financial forces are awarded a stronger role within existing institutions. The crisis-stricken government is likely to reach a political compromise with emerging political forces or be replaced by a

government enjoying the approval of high finance. The timing and character of the transition towards a liberal-cosmopolitan security agenda are likely to vary across politico-institutional contexts. Political debate or unrest resulting from the financial crisis might quickly lead to government rearrangement or replacement. Alternatively, political dissent will find its expression through electoral channels, favoring candidates and parties who support sound finances and a compromising military agenda.

Institutional differences apart, if the financial crisis ushers in an increase in the exposure to high finance of a statist-nationalist government, the national security agenda will tilt towards greater caution or internationalism. Old or new state authorities are likely to recognize that assertive security policies have been pushed beyond the state's financial means, and that greater commitment to strengthening national finances requires overhauling pre-crisis plans. Cuts in military spending will be endorsed. Threat assessment will be softened to signal financial investors at home and abroad that the national economy is on its way to recovery, and that no military ambition or distraction will interrupt it. War prospects will decrease (Fig.1). *The security dilemma will ease*, and national security policies will display greater prudence than in the absence of financial crisis. The peaceful resolution of the 1907 military-security crisis between United States and Japan, for example, was strongly reinforced by the materialization of this scenario triggered by the global financial crisis of 1907.

In "HA-LE" the picture is exactly opposite. A government that has opted for prudent diplomatic and military policies is shocked by financial crisis, but knows or discovers that it is impossible to stop the detrimental effects of the crisis on national

wealth and welfare by resorting to the orthodox medicine in a bid to entice financial markets. In this scenario, a crisis-stricken, liberal-cosmopolitan government acknowledges the costs of domestically unpopular orthodox measures, and gains significant freedom from high finance and domestic financial interests. Finance writ-large is either disinterested in the country either because of the dismal opportunities that it offers to global capital, or because it is weakened by the financial crisis itself. Concurrently, the release of the pre-crisis constraints which international financial markets were posing on the exercise of assertive national security policies empowers domestic groups supporting heterodox financial policies. How important the release of the constraints posed by international capital markets is for the course of national security policies after financial crisis outbreak is highly dependent on how the diminished power of finance modifies specific political contexts. More pointedly, the decreased power of international financial markets—and international economic markets—leaves governments that before the crisis subscribed to a cautionary financial-security agenda with lesser constraints but not necessary more incentives to include financial, economic, diplomatic and possibly military experimentation in their strategy of crisis response, steering away from their conciliatory national security policies. As a result, on the basis of the framework here developed, the change in pre-crisis national security agendas underpinning this scenario is indeterminate and so is the security dilemma in this context (Fig.1).⁵¹ Governments in this scenario face substantial incentives to develop strong ties with the real or non-financial sectors of

⁵¹ It is noteworthy that this theoretical framework would be much less interesting if most financial-crisis episodes in history had resulted in “HA-LE,” and this scenario only. I can state quite confidently that both the empirical evidence gathered in this work and the existing scholarship on financial crises suggest that this is not the case.

the economy, and take on a more active monetary and fiscal role. Both elements, along with the decreased relevance of international financial markets, will likely keep national defense spending much less under check than they had before. Similarly, the decreased power of orthodox mental frameworks will likely encourage government authorities to see the dangers, rather than the benefits, of pursuing an unreservedly dovish foreign policy, and recognize, even amplify, the threats to national security posed by the behavior of other states. Like national financial and economic policies, national security policies will enter a phase of experimentation. This occurred in the United States during the Great Depression: President Franklin D. Roosevelt's approach to military spending, threat assessment, and war prospects injected novel assertiveness into a largely restrained national security posture. Differently, in those politico-institutional contexts where the fall of high finance and domestic financial elites empowers previously restrained confrontational interests, cautionary forces will be silenced, threats enlarged, and war and military spending embraced as an engine of national economic growth and prosperity.⁵² This development decided the international political orientation of Italy between 1932 and 1934, as the constraints posed by financial interests on Mussolini's intentions came off, and so did the exposure of the government to high finance.⁵³

Finally, in "HA-HE," a crisis-stricken, liberal-cosmopolitan government makes prominent sacrifices in its national security agendas because crisis resolution

⁵² This interpretation is distinct from and possibly antithetical to the explanation offered by the diversionary war hypothesis. The matter is not "diverting attention" as much as finding more appropriate tools to resolve the financial crisis.

⁵³ It is also possible that pro-finance governments and their cautionary security policies are trumped by the increase in relative power of national or subnational military forces, like it occurred in Japan in 1931.

must be achieved by rescuing financial confidence and national financial credibility through greater deflationary policies. The government is likely to be at the head of a financially and politically decentralized domestic structure where orthodox financial mindsets are dominant. It is also likely to be limited in its ability and willingness to deflect the cost of the crisis to powerful, domestic financial elites, having long experienced the benefits of subordinating national security ambitions to cross-border capital movements and neoliberal mental frameworks. In this scenario, high finance will play a direct, important role in the process of crisis resolution, as the government will need, in order to solve the crisis, to bend its financial-security agenda under the pressure of unfettered capital mobility.⁵⁴ Pre-crisis national security policies included a military budget kept under watchful observance, the downplaying of threats to national security, and a general commitment to international peace. After the crisis outbreak, however, pre-crisis military spending, threat assessment, and war prospects are pushed to new conciliatory extremes, because the prevailing wisdom amongst domestic political circles is that mobile capital is the key to crisis resolution.⁵⁵ Creating more suitable conditions for the thriving of business impels further disarmament, and the further downplaying of threats and war prospects (Fig.1). Like in LA-HE, *the security dilemma is lessened*.

Notably, intrinsic belief in the virtues of unfettered free markets is not even necessary, although, if present, would explain exceptionally conciliatory national security undertakings by liberal-cosmopolitan governments and their disinterest in

⁵⁴ Note that while in LA-LE government cohesiveness is an asset, in HA-HE domestic support for orthodox financial policies is an advantage.

⁵⁵ The number of parties and political forces involved in, or benefiting from, this decision is likely to vary across different contexts.

their potential consequences. What is necessary is that high finance and financial orthodoxy are considered by government authorities as the most powerful or convenient tools for crisis resolution for the time being.⁵⁶ The military and diplomatic responses by various governments to the 2009 European sovereign debt crisis fit this scenario.

To sum up, when government exposure to the pressures of high finance is *low* after a financial crisis outbreak, (statist-nationalist) governments pursuing assertive national security policies are likely to double-down their pre-crisis agenda, whereas (liberal-cosmopolitan) governments pursuing prudent national security policies are likely to enter a period of uncertainty and policy experimentation. When government exposure is *high*, neither liberal-cosmopolitan nor statist-nationalist governments pursuing, respectively prudent and assertive national security policies are likely to see their optimal strategies for crisis response realized. Liberal-cosmopolitan governments will be urged by high finance to *go past the point* of redoubling an agenda based on financial orthodoxy and conciliatory national security policies. The result is likely to be an extra prudent and super orthodox financial-security agenda.⁵⁷ In contrast, statist-nationalist governments will be impelled by high finance to *pull back* from their intended doubling-down of an assertive, financially heterodox pre-crisis agenda (Fig.1). The inflation, curbing, or extra-cautionary reshuffling of pre-crisis military spending, threat assessment, and war prospects is the influence that financial crises

⁵⁶ For an instrumental understanding of the role of mental frameworks in decision-making, see Goldstein and Keohane (1993), Chapter 1.

⁵⁷ This occurs because increased pressures from high finance to resort to financial orthodoxy are compounded by the shift towards greater financial orthodoxy than government B, a cautionary government with a high affinity with high finance is, already on its own, willing to implement.

produce by requiring crisis-stricken governments to respond to an urgent political and financial threat and redefine their relationship with high finance.

The shift towards greater assertiveness or greater caution does not necessarily affect all three branches of national security decision-making, although this development seems likely to occur in LA–HE, when the pre-crisis security agenda is curbed rather than inflated. More importantly, crisis resolution can entail a number of scenarios. For instance, government exposure to high finance might remain high throughout the first stage of a crisis, when well-known financial and security measures are applied in greater doses and change in fundamental beliefs or perceptions remains difficult.⁵⁸ Yet, repeated strategic failure will induce greater updating in existing beliefs and greater likelihood of policy overturn. In this respect, the American and Italian local financial crises of, respectively, 1893 and 1896–98 first tilted the national security policies of both states towards greater caution. Later, in both states, liberal-cosmopolitan governments realized incumbent threats or severely prejudiced military dreams, and frantically responded to the newly acquired military-diplomatic weakness by slating a cautionary posture. In sum, the process of financial-crisis response is best regarded as developing through a series of stages in which national security decision-making concerning military spending, threat assessment, and war prospects could take a different direction each time.

Shifts towards less assertive and more assertive (or less cautious and more cautious) national security policies can both occur before a new equilibrium in the national financial-security agenda is found. Until then, perceptions of the security

⁵⁸ On the difficulty of replacing existing beliefs see, for instance, Tetlock (1991:27-31).

dilemma, and eventually the real dilemma, will evolve. Notably, the essence of the argument of this dissertation is not that the influence of financial crisis on national security policies is best judged by the degree of disparity in national security policies before and after a financial crisis. Rather, the argument advanced here is that financial crises leave their mark on national security policies; that the characteristics of that mark vary based on the interaction between government affinity with and exposure to high finance; and that the resulting changes in military spending, threat assessment, and war prospects would either not have occurred, or occurred differently had financial crises been absent.⁵⁹ As the chapters of this dissertation show, the direction of the changes is not more important than the very fact that these changes occur. Importantly, while governments undertaking them were induced to affect the security dilemma in a certain way, their perceptions were not always correct, especially when change entailed a paramount abdication to military and diplomatic conciliation.

CASE SELECTION

The bulk of this dissertation rests on the comparative analysis of four large, heuristic case studies.⁶⁰ I call them “large” not because of their length but because they either cover a long temporal span or study the national security influence of financial crises across multiple countries. Three of the case studies apply the theoretical inferences so far illustrated to the national security influence of financial crises in, respectively, Japan, Italy, and the United States between 1880 and 1940. The fourth

⁵⁹ This point has important implications for the research methods used in this work, as clarified later in this chapter.

⁶⁰ Case studies here are “heuristic” in that they are the raw material for the theoretical foundations of this chapter. On heuristic case studies, see Greenstein and Polsby (1975:104-108).

portrays the influence of the 1914 global financial crisis on decision-making concerning military spending, threat assessment and war prospects in Austria-Hungary, Germany and Great Britain. The main cases—Japan, Italy and the United States—were chosen with several aims in mind. To begin with, although the precise influence of financial crises on national security policies differs from case to case as well as within cases, all three states were recognized as significant financial and military powers during the analyzed period. They experienced financial crises—at times the same financial crisis—and they approached decision-making on military spending, threat assessment and war prospects with assertiveness as well as caution. Related to this point, the power of high finance and government exposure to the pressures of high finance varied in each state across the timeframe (1880–1940) as well as across financial crises. Moreover, in each state, financial crises affected statist-nationalist governments and statist-nationalist financial-security agendas, as well as liberal-cosmopolitan governments and liberal-cosmopolitan financial-security agendas.

While these elements indicate that each of the three selected states offers, individually, appropriate terrain for analyzing the national security influences of financial crises in the considered period, Japan, Italy, and the United States are representative candidates for this study even when collectively considered. The national political and financial systems of each case and, more broadly, their cultures, histories, military traditions and geographic locations are significantly distinct. As a

result, Japanese, Italian, and American financial-security agendas rested on different ingredients, broadening the latitude of the theoretical inferences of this work.⁶¹

Three diverse backgrounds also informed the affinity with and exposure to high finance of the Japanese, Italian, and American governments, whatever their international political orientation and national security agendas. Japanese political and financial institutions were strong, centralized, and significantly apt at saving, taxing, and fighting. The Japanese constitutional monarchy legitimized, under divine supervision, the authoritarian rule of an oligarchic cabinet, thrived on the repression or exclusion of dissonant political voices, and rested on a powerful and independent military, directly answerable only to the emperor. The emergence of party government and bipartisan competition, which reached their most satisfactory operation in the 1920s but developed long before then, did not alter the exclusive access and exercise of power to which Japanese rulers were accustomed. Similarly, the Japanese financial system was hierarchically structured around the Bank of Japan and several specialized banks and corporate financing organizations (“zaibatsu”), under the direct regulation and guidance of the government. The system worked by steering household savings to the treasury and national industries to serve the developmental and military purposes of the state (Ranis 1959:440–454; Patrick 1965:187–213; Tsutsui 1990; Francks 1992:29–40; Pauly 1994:351–55; Tamaki 1995:10,62,64; Beasley 2000).⁶² Overall, the presence of a strong army, commonly unconstrained by civilian influences, and the

⁶¹ Some of these different ingredients are widely acknowledged in the literature on comparative political economy. See particularly Gilpin (1975:37–50); Katzenstein (1978:4,20,21,22); Strange (1988:23–34, 64–73); Sakakibara (1993); and Hall and Soskice (2001:88,92,94,100,170,459,461).

⁶¹ On the relevance of this mission for theory development, see Locke and Thelen (1998:11); and George and Bennett (2004:12,19–22).

⁶² This model also informed the Japanese projection of power abroad. On the continuing relevance of this Japanese model today, see Pauly (1994) and Helleiner and Pickel (2005).

commitment to national financial and monetary autonomy rendered Japan a scarcely hospitable environment for *foreign* high finance and the internationalization of financial investments. High finance could only be a force *within* the Japanese government and, even in that case, the traditional power of military authorities often trumped it. No wonder, a group of powerful, private financial and business actors emerged very slowly in Japan.

Differently from Japan, the institutions of the Italian government were moderately centralized (or moderately decentralized), and historically exposed to foreign interference—political and financial.⁶³ Rather than being organized around a small number of oligarchs, Italian governments were commonly coalitional in nature, reflecting political consensus across a diversity of loosely connected forces or parties (Mack Smith 1997:97–103; Verzichelli 2007:2,6,9,10). Consensus amongst different groups was obtained by charismatic and difficult-to-replace leading figures and, occasionally, by the king. Only in 1934 did Mussolini’s totalitarian regime undermine the exercise of consensual or parliamentary politics. The Italian economy was highly reliant on foreign borrowing, and the national financial system was, as much as the political system, only moderately centralized. Specifically, the state’s development and industrialization rested on a few domestically located commercial banks that were private and often in competition with one another. Differently from Japan, a private and politically independent domestic financial sector developed early in Italy.

Relatedly, Italy was never the militarized state that Japan was. The Royal Italian Army

⁶³ It is noteworthy that neither a civil war (United States) nor unification by military conquest (Japan) “made” Italy. The process of Italian unification stemmed from the increasing dissatisfaction with foreign domination and was enabled by diffused social and insurrectionary movements. See, for instance, Ziblatt (2006:chapter 5).

was an expression of the Italian model of moderate centralization. Used only rarely to repress popular unrest, and lacking a solid esprit de corps, the Italian Army remained, until the early 1930s, fairly regularly under civilian control. Its track record made it more popular for its startling military losses than for its modest military victories, or heroic instances of military resistance. Still, Italian armed forces found constant support in the monarchy and enjoyed the respect of an all-but-insignificant share of the political class.

Italy's perpetual position as military alliance partner—albeit a volatile one—also made national armed forces all the more necessary, while the penchant for colonial adventurism never faded, even when liberal forces were in power (Rochat and Massobrio 1987:37,60,128,268; Lowe and Marzani 2002:6,7,22). Although an ambitious foreign policy never lost its appeal amongst Italian elites, the Italian government remained unable to compel the banks (or the public) into coordinated action or resource-extractive plans for national purposes, like Japanese state authorities were able to do. Similarly, neither Italian financial authorities nor Italian private banks had ever the power to join foreign high finance, like it occurred in the United States, or create their own high finance domestically, like it occurred in Japan. Although the Italian government regarded the domestic private banks as the engine of national economic growth, the survival of both entities depended on British, French, German, or American capital (Posner 1978: 225,229,234,235; Serra 1987:611–612; Goodman 1992:142–143; Fratianni and Spinelli 1997:88). Ultimately, Italian borders

were much more permeable than those of Japan, and Italian private or public financial forces not as mighty as their American and Japanese counterparts could be.⁶⁴

Finally, the American political and financial systems were considerably decentralized, although presidential government and a vibrant judicial system counteracted extreme decentralization. Political decentralization found expression, for instance, in the absence of a specialized, politically insulated American bureaucracy; the trimness of the diplomatic apparatus; and the access of American citizens to congressional and presidential representation through regularly held elections (Bensel 1990:5,117; Friedberg 1992; Zakaria 1995:40,46,47). The overturning of a cabinet (as in Japan) or complete government reshuffling with or without government overturns (as in Italy), both expressions of centralized bureaucratic government, were impossible in the United States. The American state was also scarcely interventionist in a variety of spheres ranging from national development to colonial occupation. American military forces were unequivocally under civilian control, and their involvement in foreign lands or share of the national budget was modest in comparison to the immense economic and industrial strength of the American state and the behavior of other states (Graebner 1985:202–203; Hung 1987:16–18,43; Kennedy 1987:202,203; Eloranta 2003). From this perspective, the American state was much weaker than that of Italy or Japan.⁶⁵ Not irrelevantly, it was also much less exposed to external threats.

⁶⁴ Italian financial elites were neither as powerful as their British, French, German and American counterparts—the representatives of high finance—nor as “compact” a front as Japanese financial elites were when they climbed to power.

⁶⁵ It is noteworthy that American institutional weakness did not apply to important spheres of statehood like enforcement. With regard to the latter, for instance, American institutions were much stronger than those of Italy or Japan. On this point see, for instance, Fukuyama (2004).

Financial decentralization accompanied political decentralization. American financial and economic wealth rested on a deregulated market-based system that continued to operate in the absence of a centralized or semi-centralized financial structure until 1913.⁶⁶ Thereafter, a system of weakly coordinated federal banks was in place until 1934 when, finally and thanks to the Great Depression, financial centralization was achieved (Meltzer 1958:55,140–45; Zysman 1983:12,18; Chernow 1990; Gordon 2008).⁶⁷ Because of these delayed, and never completed, efforts at strengthening national financial institutions, and because of the bottom-up nature of American involvement in the international financial system, powerful American private financiers effectively acted as the United States' central bank throughout most of the period between 1880 and 1940. Differently from Japan, high finance in the United States was not a state matter but a private matter. American bankers were high finance. They were high finance always that is the financial officials of the American state could never be high finance. At most, they could be aligned with it. Moreover, a powerful high finance was a constant feature of American politics, not an occasional feature as in Japan. Differently from Italy, high finance in the American case had both a foreign and a domestic component. During financial crises, high finance played its game versus the American government both at home and abroad.

The distinct politico-institutional contexts of Japan, Italy, and the United States, and the specific place of, and interactions between, high finance, governments, and domestic financial actors in each context are especially suited for an application of

⁶⁶ Financial deregulation was not complete in that the federal government maintained firm control of the money supply.

⁶⁷ The American financial system was completely reorganized in 1934. Only thereafter could one claim that the US finally had a central bank with the powers it needed to function.

the “most-different-systems” design (or Mill’s Method of Similarity). If the analytical framework here discussed is correct, the adoption of this research design should lead to the same conclusion that, in all three cases, financial crises were followed by a change in national security policies, and that the character of the change conformed to the combinations of government affinity with high finance and government exposure to high finance outlined in 1.1. These considerations apply not only to the first three Chapters, but also to Chapter Five since the focus of that chapter, once again, is on the national security influence of financial crises in three different politico-institutional contexts.

Data for the case studies consist of primary historical documents, primary and secondary literature on financial, diplomatic, and military history, and numerical series on financial and military indicators. Importantly, excluded from this dissertation are episodes of financial crises that occurred *during* war. Since the “urgent” and “threatening” character that accompanies financial crises in peacetime—making financial crises real “crises”—is diluted or legitimized in wartime, addressing wartime financial crises is outside the scope of the analytical framework that this dissertation proposes. “Wartime financial crisis” might indeed be an improperly used word combination. More apt seems the word choice “wartime financial pressures,” since in wartime “crisis” becomes the permanent operating status of policymaking. As one scholar fittingly described it, “during wartime financial control is inevitably relaxed and the administration of financial departments is marked by a certain lack of grip and strength especially in regard to the control of expenditures. Things have to be done

and done quickly, [with] formulae and conventions brushed aside.”⁶⁸ Not belonging to the category “wartime financial crises” are those financial crises that occurred weeks before crisis-stricken governments’ participation in major war. Those crises are, by all means, like any other military-security crisis, and they find systematic treatment in this work.

⁶⁸ Shirras (1936:5). On the challenge posed by war on state finance and the normal conduct of decision-making, see Keynes (1914:460–486); Blainey (1973) pp.193–194; De Cecco (1974:127–170); Capie and Wood (1986:77–116); Brewer (1988:xx).

CHAPTER II

HOME RULES: JAPANESE GUARDIANS OF PUBLIC FINANCES AND UNTRADITIONAL MILITARY RETRENCHMENT

Financial crisis of 1899-1901:

“The public should take advantage of ongoing military plans to shape [new] bold plans for creating national wealth.”

Midovi Komatse, May 1900.

Financial crisis of 1927-31:

“Japan should lead other nations in the promotion of international peace [and disarmament].”

Saionji Kinmochi, July 1929

For most of the time between 1880 and 1940, Japan earned a reputation for its resistance to foreign interference, its commitment to state-led economic and industrial growth, and its reliance on martial values and prowess in external as much as internal interactions. To a greater extent than cherishing Japan’s entrance and participation in the international (financial) system, Japanese political leaders treasured state independence and development, and the attainment of Japan’s economic sphere and empire. Membership in the international financial system was valuable to the extent that it provided Japan with greater resources to reach these goals as well as equal status with Western nations. The mercantilist slogan “rich nation, strong army” received enormous political support, and Japanese military achievements were remarkable, much more remarkable than any American, let alone Italian.⁶⁹ They were

⁶⁹ On the relevance of the “rich nation, strong army” slogan in Japanese foreign policy, see Samuels (1994), pp.15-18. Note that in the 1930s the terms “national defense state” and “co-prosperity sphere” expressed the same logic. On this point, see Osaka (1941), p.80, and Miwa (1983), p.28. A few notes on Japanese military achievements. In 1894-95, Japanese armed forces crushed China. Ten years later, they defeated Russia. In 1914, the Japanese Army started an unchecked march to acquire territories in China, the Shantung province, and the Pacific. Between 1917 and 1921, Japanese forces took control of Siberia, and, by early 1932, they had extended their authority over Manchuria, threatening further advances in continental Asia.

also the reason why Japan could join the gold standard. Had Japan not defeated China in 1895 and obtained a large pecuniary indemnity for that victory, no gold standard would have been introduced a couple of years later.

In this context, high finance encountered challenges: it could develop only out of the initiative of state authorities; it was more likely to appeal to state authorities under the presence of a party system and the incorporation of the preferences of the rich electorate in governments' agendas; and it was accepted only as a means to increase the prestige and power of the Japanese state. Thus, high finance in Japan originated within state boundaries, and evolved with the Japanese government's efforts to climb the international ladder, and with the development of an increasingly democratic society. It was a creature that emerged from and abided to home rules or needs. It was neither the collection of private financiers characterizing the American experience, nor the powerful, fixed, foreign variable that regularly pierced Italian governments. Japanese governments and high finance were not separate entities: either government officials desired to be high finance, or they were high finance, or high finance in Japan simply did not exist.

For instance, up until the Russo-Japanese War (1904-05), high finance existed in Japan in the form of continuous attempts, on the part of Japanese ruling oligarchy, to join the gold standard and thereby have access to invaluable (foreign) capital to finance Japanese economic and industrial growth, besides obviously enhancing Japan's international status.⁷⁰ Between 1906 and 1931, high finance was present in the

⁷⁰ On the heterodox foundations of Japanese entrance in the gold standard see Smethurst (2007), p.122. Although Japan entered the gold standard in 1897, Western financial circles were traditionally hesitant of lending money to Japan. Between 1897 and 1904, key Japanese financial officials worked hard to

form of non-elected and elected key officials who defended their state's continued access to foreign funds, and, to this scope, understood the value of financial internationalism and the necessity of a "negative" policy of cutting military spending, deficits, and inflation to restore or maintain sound finances.⁷¹ Although tension existed between this course of actions and the classical, "positive" policy of state building through public spending in the industrial and military sphere, the officials of the Japanese state who represented high finance—people like Inoue Kaoru, Takahashi Korekiyo and Inouye Junnosuke—earned abroad similar reputation and respect to Montagu Norman and Benjamin Strong. Their respect for financial orthodoxy could go to incredible lengths, and their ability to obtain foreign capital for national financial and economic growth endowed them, from the late 1900s through the late 1920s, of considerable political fortune domestically. Differently from British or American banking elites, even when the benefits of "negative" financial and economic policies were most appreciated and chased, Japanese representatives of high finance remained skeptical of an excessive reliance on foreign finance and foreign bankers. As one of the fathers of Japanese finance Takahashi Korekiyo put it, it was "not necessary (for Japan) to listen to the opinion of foreign bankers in determining Japan's system."⁷²

From 1931 onwards, Japanese representatives of high finance were brutally murdered,

dispel foreign skepticism over the status of Japanese finances and establish a dialogue with the American and British financial circles. Notably, foreign high finance was persuaded to lend to Japan following Japanese military victories during the Russo-Japanese war.

⁷¹ On the birth and coexistence of the "positive" (or Keynesian) and "negative" (or monetarist) expressions of Japanese economic policy see Smethurst (2007), pp.88-95, and Meltzer (2006), pp.67-90.

⁷² Takahashi's words are from Meltzer (2006), p.32. In the late 1920s and early 1930s, some Japanese financial officials were ready even to be killed while defending financial orthodoxy. Inoue Junnosuke told a trusted official in 1930: "If I am killed, quickly lift the gold embargo." See Meltzer (2006), p.199.

and Japanese politics continued without a thought about high finance until well after World War Two.

The rise, life, and demise of high finance in Japan between 1880 and 1940 is closely related to the influence of financial crises on Japanese national security policies.⁷³ This chapter argues that, like high finance, this influence followed home rules. Financial crises were a fundamental reason of Japanese leaders' attraction to, and disenchantment with the principles of international financial cooperation and the foreign capital that Japan earned (or could earn) by abiding to these principles.

Between 1906 and 1931, financial crises in Japan regularly sparked the abandonment or further distancing from a nationalist agenda aiming at military expansion and assertive empire building. In this period, after financial crisis outbreak, an increasing number of Japanese officials recognized the advantage, for the Japanese state and for themselves, of becoming diligent members of the international financial system because the vital tasks of obtaining foreign capital and the votes of the (rich) electorate required it. One could argue that Japanese financial officials morphed into high finance. Sent to London, Washington and other major European capitals in times of financial need, to win precious capital to finance Japan's economic and military development, Japanese (financial) officials clearly understood the burden of having unsound domestic finances or the mistake of concealing them. They also understood the increasing resistance of the rich electorate, and eventually of part of the *Seiyūkai*

⁷³ The career path of Takahashi Korekiyo, one of the main Japanese financial authorities at the time, give a sense of the rising power of financial interests in Japan between 1880 and 1931. In 1892 Takahashi was an employee of the Bank of Japan; in 1898 he became vice president of a state bank, the Yokohama Specie Bank; in 1904-1905 he rose to a position of political preeminence within the Japanese cabinet by raising foreign loans after the Russo-Japanese war, and by 1913 he had become minister of finance, position that he recovered now and then until 1936, date of his assassination.

and then the *Keinsekai* (later *Minseito*) to increasing military budgets. As a result, during financial crises the power of financial internationalists within Japanese cabinets and the Diet increased, and military retrenchment and peaceful diplomatic means were introduced or doubled down. This occurred not only when crisis-stricken governments were pursuing military and diplomatic caution (1929, 1930), but also when they followed an expansionist agenda (1907, 1920), drastically changing the direction of Japanese foreign policy. Even when financial internationalism and cautionary foreign policies were temporarily suspended because they were associated with the financial crisis (1927-29), the stint away from caution was either brief or unappealing to leading political elites.

Between 1880 and 1906, instead, before high finance and negative policies had become a force to be reckoned with in Japanese politics, financial crises tended to inflate Japanese national security policies.⁷⁴ The ruling oligarchy denied that financial crisis existed, increased national defense spending and empire building plans, and encouraged the public to finance business ventures. During these years, the power of the rich electorate and private domestic financial forces was still limited.

Finally, from 1932 through 1940, no financial crisis occurred. As the international financial system crumbled, Japanese representatives of high finance were assassinated, and removed was also the ability of financial crises to influence Japanese national security policies. Notably, although these findings are in line with the argument that domestic politics shaped Japanese national security policies—argument

⁷⁴ A first movement towards the gold standard and the spirit of international financial cooperation began in early 1880s with the Matsukata deflation, the expedient introduced by the Japanese Finance Minister to restore national finances to a sound basis. Soon afterwards, however, deflationary policies were quickly overhauled.

that has been advanced and defended elsewhere in much greater detail than I do here—the focus of this chapter is on the fact that financial crises were critical to bring about the domestic conditions that led to shifts in Japanese military spending, threat assessment and war prospects by either increasing or decreasing the power of Japanese state custodians of high finance versus the power of their political colleagues or opponents.

The chapter is divided in three main sections that are dedicated to the influence on Japanese national security policies of, respectively, the financial crises of 1889-90 and 1896-1901, the financial crises of 1907-09 and 1920-22, and the financial crisis of 1927-31. Interestingly, financial crises in Japan tended to occur after the undertaking of major positive or negative national security decisions, which is a sign of the deep linkage between the two phenomena.⁷⁵ The financial-crisis sample of this chapter, like the samples of Chapter Three and Four, was selected with an eye to covering as many combinations of government affinity with high finance and government exposure to high finance as possible.⁷⁶ The three main sections of the chapter are preceded by a shorter section that extrapolates expectations on the national security influence of each of the selected financial crises based on assumptions derived from the analytical framework described in Chapter One. Before focusing on what are the expectations

⁷⁵ The financial crises of 1889-90, 1896-98 and 1900-01, 1907-08, 1917-18, and 1920-22 followed, respectively, the rearmament program launched at the beginning of 1889; the ten-year armament program announced in early 1896; the rearmament program of 1906; the six-year naval program launched in 1916; and the launching of the naval rearmament program initiated in 1919. Similarly, the financial crisis of 1914 occurred when past national military debts were falling due; and the financial crisis of 1927-31 worsened (in the second half of 1930) after the start of severe disarmament efforts in the spring of 1930. Although overarching national security decisions were arguably not the *only* factor behind Japanese financial crises, they were undoubtedly a primary one.

⁷⁶ For a list of the total population of financial crises experienced by Japan between 1880 and 1940 (minus those that occurred during a major war, which are excluded from this analysis) see Table 1, in the Appendix.

resulting from the domestic political contest surrounding each of the aforementioned financial crises, it is worth adding a few more words on the peculiarities of the Japanese case.

Between 1880 and 1940, Japan presented many of the features of contemporary rent-seeking autocracies. The affairs of the Japanese state were managed by an oligarchic cabinet that had the task, ultimately by divine right, of building up an economically wealthy and militarily strong nation-state. Rather than a great power “by courtesy,” or geography, like Italy, Japan was an outcast by adversity, being situated far away from the epicenter of the international (financial) system, and in need of substantial catching-up or military success to be recognized as a great power worthy of the name. The Japanese commitment to catch-up rearmament and catch-up industrialization never faded, regardless of whatever government was in power. The introduction of a constitution, restricted parliamentary elections, and, gradually, a partisan system hardly transformed the oligarchic nature of Japanese governments’ economic and military decisions.⁷⁷ When the party representing the interests of high finance, the *Minseito* (later *Keinsekai*) was at the lead of Japan, a “negative” set of financial and military policies was at the lead, and when the *Seiyūkai* was at the lead, a “positive” set of financial and military policies was at the lead. The crafting of Japanese financial and military policies always remained the privilege of very few (which helps to explain the regular resort to domestic violence), and it would always penalize either financial elites or military forces by leaning towards “positive”

⁷⁷ Throughout the 1900s and the 1910s, for instance, the costs of having a partially elected national Diet veto the national budget over and over increased significantly. On the centralization of the Japanese financial and economic system see Lockwood (1954), p.563; Martin (1962), pp.28,29; Patrick (1965), p.198; and Tamaki (1995), p.58.

or “negative” means of state development. As much as Italian politics thrived on compromise, Japanese politics thrived on disagreement.⁷⁸

Military elites or constituencies, particularly Japanese armed forces, were also much more used to inform and benefit from state policies than Japanese private financial actors. In Japan, rich people paid high taxes; armed forces were awarded political independence by the Constitution. That said, while the latter were widely more powerful than the former before 1906, between 1906 and 1931 this power was often curbed by Japanese governments’ conversion to the orthodox cause, which benefited private financial actors—a product of national economic development and of gradual democratization—to a far greater extent than the armed forces.

Examining the influence of financial crises on Japanese national security policies means also analyzing the variation, throughout the process of financial crisis response, in the political advantage of military forces and the “positive” policies they subscribed to versus the political advantage of Japanese private financial actors, and the “negative” policies they benefited from—at least up until the mid-1920s. Ultimately, however, even if each financial crisis triggered a different battle of type of interaction between military forces, Japanese private financial actors, and government authorities, this interaction was always an eminently domestic phenomenon: its result depended on whether most financial mindsets in Japan favored orthodoxy or heterodoxy *and* on whether the power of Japanese financial forces (both public and private) was weak or strong.

⁷⁸ On the importance of controversy in Japanese politics see, for instance, Smethurst (2007), pp.76-95.

EXPECTATIONS

Establishing the affinity with high

*Table 2.1 Japanese financial statistics
1885-1893*

Year	Surp/ Def	nr. of banks	GNP
1885	100	218	649
1886	98	220	712
1887	100	221	692
1888	-73	211	706
1889	-235	218	726
1890	-74	217	983
1891	-77	252	880
1892	-43	270	948
1893	-19	545	988

finance and exposure to high finance of Japanese governments respectively at the onset and throughout each financial crisis episode will allow to derive sets of expectations on whether Japanese plans of empire building and expansion or military retrenchment were propelled with greater intensity or abandoned after the outbreak of each financial crisis. According to the

framework, Japanese governments who have taken on board the preferences of high finance should respond to financial crises by pursuing extra-cautionary national security policies when orthodoxy is the popular financial mindset domestically, and the power of private domestic financial actors is strong throughout the crisis (*HA-HE*). When the opposite occurs, Japanese governments who have taken on board the preferences of high finance should respond to financial crises by replacing cautionary national security policies with others that this work's framework fails to outline (*HA-LE*). On the contrary, Japanese governments who normally dismiss the preferences of high finance should respond to financial crises by inflating their ambitious military agendas when throughout the crisis, heterodox financial mindsets remain popular and the power of private domestic financial actors is weak (*LA-LE*), and by curbing those agendas when, throughout the crisis, the opposite occurs (*LA-HE*).

For about almost three quarters of the Meiji era (1868-1912), scenario *LA-LE* was very popular in Japan. Between 1880 and 1904, Japan experienced three financial crises—the currency crisis of 1880-81, the twin crisis of 1889-90, and the currency, stock market crisis and twin crisis of 1896-1901. All three financial crises were partly engineered by the government’s attempts at maximizing available national financial resources to push forward rearmament and industrialization efforts.⁷⁹ Neither of them nor the process of financial crisis response stopped these efforts. For reasons of space, the inflation crisis of 1880-81 is not treated in this chapter but it is worth noting that the deflationary and retrenchment plan of crisis response realized by newly appointed Finance Minister Matsukata Masayoshi had strong heterodox roots behind its orthodox appearance.⁸⁰ The plan did not apply to military spending, which continued to grow. Matsukata himself recognized the necessity of putting Japanese finances in order to better expand the military budget and fulfill imperialist ambitions. The Japanese door to the gold standard was already partially open, but Japanese authorities continued to deal with state finances in their own way and even eminent financial officials were

⁷⁹ Contributing to the crises were also external monetary shocks, violent fluctuations of silver prices, and poor harvests.

⁸⁰ On Matsukata’s deflation see Allen (1963), p.93, Morley (1974), p.140; Patrick (1965), p.198; and Smethurst (2007), pp.86,87. During that revolution, Japanese oligarchs’ main objective was limited to establishing a solid, centralized national apparatus for funding the country’s security needs and its industrial development. Ironically enough, national finances only needed adjustment to be more efficiently strained. As Matsukata put it, “at this time when specie is scarce, we still must provide for essential expenditures like those of the army and navy...therefore our present duty is to increase exports and provide for the accumulation of specie.” And also: “If we wish to provide ourselves with armaments and not feel ashamed of our independent empire’s military system, there must be an increase in imports.” In Morley (1974), p.140.

contrary to compromising their military ambitions for the sake of international financial cooperation.⁸¹

The financial crisis of 1889-90, Japan's "first capitalistic crisis" in Hugh Patrick's words (1965:203), had a primarily local nature. It started after that, in April-May 1889, the *Times* announced the forthcoming foreign ownership of Japanese land in return for the suspension of the unequal treaties between Japan and the West that the former had sought.⁸² It also started because the Japanese government responded to the scarcity of liquidity and reserves, which fluctuations in world silver prices and the onset of the 1890 (global) Baring crisis compounded, by attempting to form an exchange fund in the London branch of the Yokohama Specie Bank—the Specie Bank instituted by the government to deal with foreign exchange—to facilitate loan disbursement from Europe and finance Tokyo's military build-up and industrialization efforts.⁸³ Between July 1889 and January 1890, panic developed in the domestic money market: banks stopped lending, some failed (Table 2.1), the Bank of Japan found itself uncomfortably placed to finance all ongoing industrial projects, and the deficit reached its highest value ever, as shown in Table 2.1.⁸⁴

⁸¹ On their part, Western bankers in the 19th century were doubtful of lending to Japan. See, for instance, Metzler (2006), pp.46. The first substantial loans to Japan were awarded by the West only at the time of the Russo-Japanese war.

⁸² On this point, see Lebra (1973), pp.86.

⁸³ The Yokohama Specie Bank was one of the several specialized banks created by the Japanese government. The mission of this Specie Bank was to finance domestic and foreign trade. The share of the budget allocated to military expenditures for most of the period between 1880 and 1940 is just an indication of what was inspiring the creation of the exchange fund. With the exclusion of the decade between 1920 and 1931, Japanese expenditures in national defense remained extraordinarily high. Refer to later sections of the chapter for data on Japanese military expenditures over time.

⁸⁴ On the crisis and the economic context leading to the crisis see Patrick (1965), p.203; Tamaki (1995), p.71; Checkland, Nishimura and Tamaki (1994), p.8; Droppers (1998), p.163; and Ericson (1996), pp.126. Data in Table 1 is obtained or calculated from Koichi Emi, *Government Fiscal Activity and Economic Growth in Japan 1868-1960*, Tokyo: Kenkyusha Printing Co. (1963), pp.140-162, and *Hundred-Year Statistics of the Japanese Economy*, Bank of Japan. GNP is expressed in thousand yen.

Before the onset of the crisis, the statist-nationalist governments of General Count Kuroda Kiyotaka (April 1888-October 1889) committed to the preservation of the silver standard, the accumulation of specie, and the pursuit of state development via rearmament, public works, and the protection of Japanese industry (*shokusan kōgyō and kōgyō iken*).⁸⁵ Government affinity with high finance was low at this time. Although Japanese officials—first amongst them Takahashi Korekiyo—travelled to Great Britain and Europe with the hope of strengthening Tokyo’s international linkages and status, Japan was not yet a member of the international gold standard. Also, the democratization process was just starting up (a new Constitution was promulgated in 1890), and protecting private banks’ interests ranked lower than protecting national industries and harnessing non-financial energies for industrial growth.⁸⁶ Finance Minister Matsukata was a strong believer in centrally directed industrialization and pursued a policy of high interest rates that prevented private local investment. Takahashi and Maeda Masana, the most liberal members within the Japanese government at the time, were ordered to scrap any audacious, bottom-up economic plan and dedicate their energies to drawing trademark and patent laws for the protection of Japanese artisans and inventors.⁸⁷

This economic agenda explains the strategy of financial crisis response that the Kuroda government and the cabinets of Sanjō Sanetomi (October-December 1889)

⁸⁵ See, for instance, Smethurst (2007), pp.77,78.

⁸⁶ Takahashi Korekiyo and Maeda Masana had started to develop interesting ideas to unleash the financial and economic power of Japanese regions but the time for the translation of these ideas into policy had not yet come. It is worth noting, however, that neither of them questioned the prevailing conviction that the government had a duty to stimulate economic growth through investment and infrastructural development.

⁸⁷ Ibidem, pp.76, 80 and pp.90-92.

and Yamagata Arimoto (December 1889-May 1891) selected at the time. This strategy—ideated practically in its entirety by Matsukata—entailed higher taxes, increased budget spending, the planning of strict banking regulations, and the set-up of stronger defenses for the Bank of Japan, and ultimately for the prestige and cash needs of the Japanese government.⁸⁸ The Yokohama Specie Bank also became responsible for its own risk. Then, to impede the uncontrolled growth of private bank lending, the government passed the Bank Decree for ordinary banks of 1890—an act strongly resisted by the Tokyo Bank Association and which limited the number and liberties of Japanese commercial banks (Tamaki 1995:76-77). In addition, to restore the balance of payment surplus that the crisis had wounded, the government promoted the export-dumping of Japanese manufactures to neighboring lands, exploiting Japan's comparative advantage in low-priced, durable goods vis-à-vis with the British (Howe 1999:195). These measures, which were selected with the specific purpose of returning to a budget surplus and accumulating specie, are a clear indication that government exposure to high finance was low in 1889-1890. The interests of private financial actors were quickly snubbed in view of the damage that the progress of commercial banks could bring to the Bank of Japan and the State.

Matsukata's crisis policies penalized even big private banks like Mitsui, Mitsubishi and Sumitomo (the Rothschild of Japan), which had recorded a remarkable growth up until 1889. Their lending practices were severely restricted between 1889 and 1890. On their part, Japanese private financial interests could do little to stir the process of financial crisis response towards more orthodox solutions, penalized, as

⁸⁸ All demands for monetary resources had to pass through the Bank of Japan, who responded through special discounting facilities.

they were by inadequate institutional channels to express their opposition.⁸⁹ When the first-time-elected House of Peers complained about the skyrocketing budget in November 1890, obtaining a reduction in the estimated budget, Prime Minister Yamagata left the place to Finance Minister Matsukata and the budget newly escalated.⁹⁰ Similarly, Japanese business could only trust state authorities. Thus, business leader Shibusawa Eichii declared that the panic of 1889-90 was nothing to worry about because monetary tightness was “not caused by a lack of national power,” but occurred “just as national power was increasing.” Similarly, private railroad stockholders urged the fast nationalization of private lines.⁹¹ On the whole, the heterodox medicine of the Kuroda, Sanjō, and Yamagata, and Matsukata cabinets

*Table 2.2 Japanese financial statistics
1894-1902*

Year	nr. of banks	Specie reserves	CGE/ GNP	GNP
1894	700	81,158	0.063	1,226
1895	792	60,370	0.065	1,294
1896	1,005	132,730	0.129	1,305
1897	1,223	98,261	0.142	1,576
1898	1,444	89,570	0.099	2,207
1899	1,561	110,142	0.134	1,892
1900	1,802	67,349	0.135	2,165
1901	1,867	71,358	0.118	2,253
1902	1,841	109,118	0.141	2,047

found no serious obstruction.

The financial crisis of 1896-1901 was also, to a great extent, a local, domestically engineered, financial crisis. The crisis began in June 1896, as a result of a countercyclical reaction, of Japanese markets, to an unprecedented

⁸⁹ In 1889-90, the Imperial Diet was still based on a minute franchise, emerging parties were still mistrusted by the oligarchy, and the Privy Council and the prime minister were both appointed by the Emperor. Along with the cabinet, and the Emperor the Privy Council was a foremost decision-making organ in Japan between 1880 and 1940. The Diet could not question or oppose the cabinet’s decisions until November 1890, when the first general election was held. Even then, and for about ten years, political opposition remained under check. See, for instance, Duus (1968), p.2; Uyehara (1910), pp.216-17.

⁹⁰ The Finance Committee and the government negotiated to cut down 6,130,00 yen n out of a total estimated expenditure of 83,320,000 yen. The government preserved the powers to dissolve the Diet but the costs of doing so were rising. In the general elections of February 1892, the government freely employed police power and repressive laws.

⁹¹ Ericson (1996), pp.126-30.

inflation-led boom that had developed since the end of the Sino-Japanese War (1895).⁹² Having embarked on a large program of state borrowing without the necessary financial instruments (Stein 1937:394; Kobayashi 1922:100), the government of Itō Hirobumi (1892–1896) was firstly responsible for the boom and the crisis. Once again, before the onset of this financial crisis, government affinity with high finance was low. The state-led growth in stock and bond market activity rested on very shaky foundations as 72% of bank emissions was in Bank of Japan notes—a privilege that soon awarded the Bank of Japan with significant profit but private investors with substantial risk.⁹³ Quickly, the supply of capital dried out, specie left the country (Table 2.2), and runs on banks spread. The crisis lasted until June 1898. After a year's break, it resumed in late 1899 and continued until April 1901.⁹⁴

The government's resource-extractive, anti-orthodox, economic philosophy was displayed not only in the post-war boom that Itō and the official, constitutional party (the *Seiyūkai*) endorsed, but also in the means that Finance Minister Matsukata and Japanese financial bureaucrats resorted to, between 1896 and 1901, to terminate the financial crisis. The *Seiyūkai* cabinets of Itō (1896/06–1896/09; 1898/01–1898/06; 1900/10—1901/05), ex-Finance Minister Matsukata (1896/09–1898/01), Ōkuma Shigenobu (1898/06–1898/11), and ex- Navy minister Yamagata Aritomo (1898/11–

⁹² The boom entailed a domestic institution-building flurry to improve Japanese industrialization, agriculture and manufacturing. In 1895 and 1896, respecting this design, the Hypothec Bank and the Agro-Industrial Bank were founded. See Tamaki (1995), pp.98,99.

⁹³ On this point see in particular Tamaki (1995), p.75.

⁹⁴ On the crisis of 1896-1901 see Ishii (1991), Giichi (1922), pp.186-195-197; Takafusa (1983), pp.8; Patrick (1922), pp.187-213; Hiroshi (1962), pp.94-5; Tamaki (1995), pp.74-78;90-96; Nakamura (1938), p.8; and O'Brien (2004), p.14. Data in Table 2.2 is obtained or calculated from Koichi Emi, *Government Fiscal Activity and Economic Growth in Japan 1868-1960*, Tokyo: Kenkyusha Printing Co. (1963), pp.140-162, and *Hundred-Year Statistics of the Japanese Economy*, Bank of Japan. GNP is expressed in thousand yen.

1900/10) responded to the crisis by seeking and obtaining further legitimization of their heterodox medicine of state development.⁹⁵

First above all was the decision, taken in March 1897, a few months into the financial crisis, of joining the gold standard and gaining first-class nationhood *thanks to the indemnity received from having militarily defeated China*.⁹⁶ The decision was taken by Matsukata with the support of the Navy, and annulled the Diet's indecision over Japan's monetary future, as well as the opposition of the Japanese private business community. (Metzler 2006:30; Smethurst 2007:129,130). Unlike from the Navy, who desired a stronger (gold-based) currency to purchase foreign warships and equipment, most of Japanese private business had learnt to capitalize on the export benefits of a depreciated silver currency. Notably, Japan's entrance in the gold standard was neither a way to empower domestic private financial interests and rely on them to drag the nation out of the crisis, nor a bow to the pressures of foreign bankers, who continued to remain cautious and even skeptical of Japan's financial situation.⁹⁷

⁹⁵ Notice that despite differences across the premierships—Matsukata for instance was much more conservative than Okuma—all cabinets abided to an oligarchic, absolutist system of government. Real vestiges of caution regarding Japan's credit status remained amongst foreign investors until 1904,1905. On this point see Hunter (2004), pp.188,189; Sussman and Yafeh (2000), p.442; and Smitka (1998), p.17.

Japanese attempts at obtaining funds from abroad through the formation of a syndicate including the Bank of Japan, the (Japanese) Specie Bank in London, and other financial institutions like the Hongkong and Shanghai Banking Corporation and the Chartered Bank of India, Australia and China, are described in Tamaki (1995), pp.95,96.

⁹⁶ The Chinese money allowed Japan to open an account in London, at the Bank of England, so that Chinese authorities could disburse the debt in chunks, and Japan obtain it in Sterling. The final installment of the Chinese debt was by far the largest check ever drawn on the Bank of England up to that time. Note that the conditions of Japanese entrance in the gold standard were entirely different from those of Italy or the United States. On the Japanese entrance in the gold standard, see Nakamura 1983:4-5; Tamaki 1995:83; Martin 1962:187.

⁹⁷ Real vestiges of caution regarding Japan's credit status remained amongst foreign investors until 1904,1905. On this point see Hunter (2004), pp.188,189; Sussman and Yafeh (2000), p.442; and Smitka (1998), p.17.

A parallel response to the financial crisis that the aforementioned cabinets and Finance Ministers Matsukata and Yamamoto Tatsui selected, as shown in Table 2.2, was a dramatic increase in government spending (CGE), undertaken with the aim of building Japanese industry and empire. This expansionist or “positive” design included the creation of five public-policy banks for long-term industrial financing and protection against foreign control. Amongst them was the Bank of Taiwan (1899), which was meant to further the advance of Japanese commerce and trade into South China and Southeast Asia.⁹⁸ Since raising money abroad was a difficult and time-consuming task,—foreign markets expected, as the *Economist* warned in April 1897, the adoption by Japan of “the same standard of values of first-class powers”—Matsukata, Ōkuma, Yamagata, Katsura and Itō satiated the state’s borrowing needs by introducing domestically unpopular lending regulations and new taxes on land, sake, postage bills and personal income.⁹⁹

The heterodox medicine encountered domestic resistance too. As visible from Table 2.2, the number of private commercial banks or “money-getting spirits,” as the oligarchy called them, continued to grow. Gaining the support of the emerging, liberal (Jiyuto then Keinseitō) or progressive (Shimpoto then Keisehonto) parties to have the

⁹⁸ On these designs see, for instance, Tamaki (1995), p.101; Uyehara (1910), p.242; and Metzler (2006), pp.33-35.

⁹⁹ *The Economist*, April 24, 1897. Between 1896 and 1900, emissaries like Takahashi were sent abroad to raise foreign loans but most approaches to foreign finance failed. On tax increases in these years see Duus (1968), p.10. Notice that despite differences from premier to premier existed—Matsukata for instance was much more conservative than Okuma—all cabinets abided to an oligarchic, absolutist system of government.

Japanese attempts at obtaining funds from abroad through the formation of a syndicate including the Bank of Japan, the (Japanese) Specie Bank in London, and other financial institutions like the Hongkong and Shanghai Banking Corporation and the Chartered Bank of India, Australia and China, are described in Tamaki (1995), pp.95,96.

Diet pass increases in taxation bills was challenging, which explains why *Seiyūkai* cabinets frequently fell during these years.¹⁰⁰

Up until 1900, however, the ruling oligarchy's survival strategy worked. When liberal and progressive forces secured a large number of seats in the Diet, and threatened to mutilate the budget and form a party government—for instance, in December 1897, June 1898, August 1898, and November 1900—Matsukata, Itō, and Ōkuma either resigned to welcome an analogous cabinet or issued Imperial Rescripts. So government-led spending continued to progress, and inflation was let free to increase by 11.3% between 1896 and 1898 alone. Government exposure to high finance was low. However, as national debt skyrocketed and bank runs continued, peaking in May 1900 and in April 1901, Yamagata's late cabinet (1898/11–1900/10), and the cabinet of General Katsura Tarō (1901/06–1906/06) started to fear for Japan's membership in the gold standard and the already difficult access to foreign loans.¹⁰¹ Thus, while in May 1900, in line with the heterodox tradition, Secretary of the Japanese Legation in Washington Midovi Komatse denied the existence of a financial crisis, by April 1901 the Bank of Japan had turned the tables.¹⁰² Applying the orthodox medicine, the Bank raised its discount rates until gold reserves were increased in 1902, even though this was at the price of halting state-led expansionist policies and

¹⁰⁰ On these short-lived alliances and cabinet turnovers see Uyehara (1910), p.232

¹⁰¹ Rapid and sustained domestic industrial growth and equilibrium in the balance of payments under a fixed exchange-rate system were in real conflict.

¹⁰² Midovi Komatse went on saying that, on the contrary, the situation would have produced “a beneficial effect upon the national progress by affording the people a lesson that no good times should be abused by luxury or extravagance of any form.” “Japan's Financial Situation,” *New York Times* (1901): May 3.

economic growth.¹⁰³ Reserves were replenished and in 1902 the deflationary experiment ended.

Based on the described developments, a first set of expectations is easily stated. Since the Kuroda government and the Itō government each faced scenario *LA–LE* during, respectively, the financial crisis of 1889-90 and the financial crisis of 1896-1901, both governments should have redoubled on their pre-crisis assertive policies and intentions after, respectively, July 1889 and June 1896. However, between 1901 and 1902, these policies should have been kept at bay, as demanded by the BOJ’s endorsement of the orthodox medicine of financial crisis.

Table 2.3 Japanese financial statistics, 1904-1912

Year	Govt Debt	Specie reserves	GNP
1904	32	83,581	2,530
1905	49	115,595	2,373
1906	151	147,202	2,863
1907	174	161,742	3,327
1908	177	169,504	3,361
1909	153	217,843	3,268
1910	153	222,382	3,181
1911	147	229,154	3,883
1912	142	247,023	4,509

The financial crisis of 1907-09 resembled the one of 1896-1901 in that it developed in reaction to another war-related boom, analogously engineered from government policies—the boom following the Russo-Japanese war.¹⁰⁴ To a greater extent than the financial crises of the 19th century, this crisis and the boom preceding it had an international character, as the great powers of

Europe and North America were all affected and, for the first time, a coordinated

¹⁰³ See Ono (1922), pp.94,95; and Patrick (1956), pp.206-209. The same had happened in 1880-82 with the Matsukata’s deflation.

¹⁰⁴ After the war, namely from early 1906 to early 1907, a wave of speculation ensued. The wave of enormous speculation resulted in 3,336 newly established firms. All classes of people, even the poorest, engaged in buying unsound subscriptions, particularly those of the South Manchuria Railway Company. The stock market boomed; all classes of people, even the poorest, engaged in buying unsound subscriptions, particularly the stocks of the South Manchuria Railway Company. On this crisis see the *New York Times*, July 29 (1907); Giichi (1922), pp.87, 206-207; Stein (1937), p. 396; Allen (1963), p. 48; Hiroshi (1962), pp.95,103-104; Takafusa (1983), p.8, and Uyehara (1910), pp.256-58; Pooley (1917), pp.191.

international financial response was attempted. In Japan too, as it will be soon clear, the crisis resolution process differed in important ways from previous experiences. Troubles began in early 1907 with a liquidity crisis, an abnormal depreciation of shares and interest rates widespread bank runs, bank failures, a 20% increase in the price of rice, and the looming threat of sovereign default.¹⁰⁵ In March 1909, the price of commodities sank to the lowest level compared to any period after 1906 and the market experienced another wave of panic.

At the onset of the crisis, the Japanese government was in the hands of premier Saionji Kinmochi (1906/01–1908/07) and his party, the *Seiyūkai*. Government affinity with high finance was low.¹⁰⁶ Although it included some liberal forces, the *Seiyūkai* was essentially an alliance of bureaucrats committed to big government and large-scale public spending. These plans were ideated by financial authorities like Finance Minister Sakatani Yoshio and first civilian governor of Taiwan Gotō Shinpei, and made possible by the hard work of financial authorities like Takahashi, financial official at the Bank of Japan and Japan's Financial Commissioner in London, New York and continental Europe.¹⁰⁷ In 1906, the Saionji government still financed its current account deficits by means of massive portfolio borrowing in London and other

¹⁰⁵ On the crisis of 1907-08 in Japan see Nakamura (1938), p.8; Ono (1922), pp.206-207; and Shinjo (1962), pp.97,102-104; the *Economist*, July, 20, 1907.

¹⁰⁶ On the heterodox post-war policies of the Japanese government and its low affinity with high finance, see Meltzer (2007), pp.52-57,82.

¹⁰⁷ On Takahashi support of Japanese foreign borrowing policy and his activities in foreign in Great Britain, United States and Europe, and, more broadly, on the fierce bond policy of the Saionji government, see Smethurst (2006), pp.142-187, and Meltzer (2007), pp.188-89. As Meltzer (2007:46) notices, foreign bankers started to trust Japan's financial abilities during the Russo-Japanese war. This very fact is extremely interesting as it reveals that high finance became willing to finance Japan's debt after Japan had started to defeat Russia militarily. Along these lines, Sussman and Yafeh have advanced the thesis that the reputation acquired by Japan during the war with Russia decisively strengthened foreign investors' confidence about the sustainability of Japanese debt. See Sussman and Yafeh (2000), pp.442-467.

Western capital markets, and, contrary to international financial cooperation, promoted the circulation of yen notes in Manchuria, and set forth to transfer all economic rights there to a single, semi governmental corporation, the South Manchurian Railway Company.¹⁰⁸ These policies contributed to the tremendous increase of Japanese debt between 1904 and 1907 (Table 2.3), which, by spooking investors at home and abroad, contributed to the financial crisis.

Pretending it had a low exposure to high finance, the Saionji government initially addressed the monetary tightness and bank runs by doubling down on the usual “heterodox medicine.” The budget of 1907-08, the first budget of the Saionji government, renewed foreign loans and raised taxes, wholeheartedly shelving the Japanese promise, made after the conclusion of the Russo-Japanese war, of reducing taxation and redeeming the national debt.¹⁰⁹

After the onset of the financial crisis, this heterodox recipe of financial crisis

Table 2.4. Borrowing 1916–1925

Year	GNP	Government Securities
1917	6,834	16,984
1918	10,052	50,355
1919	14,924	19,090
1920	13,125	75,631
1921	12,140	53,032
1922	12,355	26,925
1923	13,053	35,041

response became politically intolerable. Abroad, a systemic financial crisis involving the main Western capitals posed already the conditions for a drastic curtailment of the flow of money to Tokyo.¹¹⁰ Exacerbating them was the Saionji government’s disrespect of agreements concluded with foreign

¹⁰⁸ Technically, American financial magnate E.H. Harriman on the premise that Japan would have allowed direct foreign participation in the Company awarded funds for the creation of the Manchuria Company to Japanese authorities. See Meltzer (2007), pp.55,56.

¹⁰⁹ On these measures see Pooley (1917), p.193; Connors (1987), p.29; Kobayahi (1922), p.102; Hiroshi (1959), p.97; Ishii (1991), pp.220-21; Meltzer (2007), pp.56,57; and “Japan’s financial position,” in *New York Times*, March 14, 1908.

¹¹⁰ Refer to the next chapters for an account of the global financial crisis of 1907-08.

investors. The latter expected direct participation in Japanese financial and economic activities in Asia and, seeing it denied, started to doubt Japanese creditworthiness despite the words of reassurance formulated by the British financial press.¹¹¹ At home, the battle between the supporters of positive or negative economic policies resulted in a schism within the *Seiyūkai*, and the creation of the *Dōshikai* or the anti-*Seiyūkai* party, the party of finance, later named *Keinsekai*. The “negative” front took control of the Diet, and firmly rejected the budget of a government accused to conceal the status of its finances and live to beyond its means.¹¹²

Takahashi too started to call out loudly for fiscal restraint (Meltzer 2007:86; Smethurst 2006:189). When the budget for year 1908-09 was approved, it featured cuts in public works, and the attempt to increase taxation resulted in a cabinet crisis that was solved, in July 1908, with the resignations of the Saionji cabinet and ostracism against its crisis policy. Exposure to high finance was high—the government could see it now—even highly ranked military officials could. By August 1908 a new government, led by general Katsura Tarō (1908/07–1911/08) had committed to reducing the national debt and starting policy of retrenchment to relax the money market, support the stock market, and ultimately restore general financial credit.¹¹³ Between 1908 and 1913 (Table 2.3), floating foreign money and withstanding foreign investors’ concerns regarding the sustainability of Japanese fiscal

¹¹¹ See *The Economist* (1907), p.2072; and “Japan’s Financial Troubles,” in *The Washington Post*, May 13, 1908. See also Meltzer (2007), pp.56-58. Note that after the conclusion of the Russo-Japanese war, Japan had obtained the privilege of carrying on its own shoulders its national debt.

¹¹² See in particular Halliday (1975), p.111; and *The Washington Post*, May 13, 1998, on this point.

¹¹³ Katsura issued a statement on being sworn in, in which he promised to not indulge in further borrowing except for loan conversion. See Pooley (1917), p.201.

deficit and national debt—that is the promotion of an international financial cooperation was a paramount national need.

A situation of high government exposure to high finance despite the crisis-stricken government's positive wishes re-appeared in occasion of the global financial crisis of 1920-22, known in Japan as the Black Monday panic. For Japan and for the rest of the international financial system, the crisis was the result of the collapse of the post-Great War boom.¹¹⁴ In March 1920, Japanese securities and commodities markets collapsed simultaneously. By March 1921 general wholesale prices, silk and cotton prices had collapsed of, respectively, 41, 65 and 73 per cent. Bank runs and bank closures were rampant and industries feverishly formed cartels in self-defense. The wave of bankruptcies stopped in April-May 1921, but resumed in February 1922 (Ishii panic) and continued throughout the end of 1921.¹¹⁵ Once again, a *Seiyūkai* government was in place when the crisis started, although this time the premier (Hara Takashi) was an officially acknowledged party leader.

Before the onset of the crisis, government affinity with high finance was low. Relying on the support and advice of Finance Minister Takahashi and BOJ director Kimura Seishirō, in 1918 and 1919 the Hara government refused to lift the gold embargo introduced during the War, dismissed warnings on the speculative nature of the post-war boom, and passed a grandiose, expansionary thirty-year expansion

¹¹⁴ On the post-war boom and financial crisis in Japan see Nish (2002), p.14; Clark (1920), p.434-35; Inouye (1931), p.69; Lockwood (1954), p.518; Tamaki (1995), p.140; Moulton (1931), p.240; Nakamura (1983), pp.142-153; Meltzer (2007), pp.129; National Archives and Records Service of the United States, "Records of the U.S. Department of State relating to internal affairs of Japan, 1910-1929," (1961), file 0015.

¹¹⁵ The Ishii panic was caused at the end of February 1922 by the bankruptcy of the Ishii Corporation, a lumber company engaged in speculative activities whose collapse triggered bankruptcies in related firms in the Kochi prefecture (Japanese southwest), the Kansai region (Osaka, Kyoto), and, from October through December 1922, Kyushu and Kanto, that is Tokyo and eastern Japan.

program to extend the rail network to every corner of the country, next to boosting public spending on harbors, dams, riverine works and supply-side policies (Duus 1968:136,137; Meltzer 2007:115-121; Smethurst 2006:217,218).¹¹⁶ Although the discount rate was raised twice, in late 1919, once that Inoue became Governor of the Bank of Japan, positive, fast-paced, state-led investment in infrastructure dominated the government's agenda.¹¹⁷ Things changed after the start of the financial crisis as, once again, a violent struggle between supporters of "loose spending policies" (or *Seiyūkai*-style economic policies) and advocates of financial and economic restraint (now gathered in the *Keinsekai*) took hold of the Diet (Silberman and Harootunian 1973:241-44; Meltzer 2007:129,130). *Kenseikai* representatives such as Inoue Junnosuke and Hamaguchi Osachi blamed the policies of the Hara government for the financial crisis, particularly Takahashi's "productionism."

As observable from Table 2.4, Hara and Takahashi initially stood by their supply-side policies, doubling down on the free issuing of government securities to bail out the national credit structure (March-April 1920), and dismissing the relevance of the tremendous rise in Japanese prices. But pressures for bringing down prices coming from the *Keinsekai* and an array of domestic radical forces were too strong to be resisted. Hara paid with his life for the skewed distribution of wealth and domestic political conflict that heterodox financial policies produced.

¹¹⁶ For his part, Takahashi thought that Japan must seize the current, once-in-a-lifetime chance for rapid economic development vis-à-vis the rest of the world. On this point see Meltzer (2007), p.121.

¹¹⁷ For instance, although it had raised its discount rate, the Bank of Japan had also greatly increased its lending to the private sector. On Inoue's The Hara government outlined this impressive plan in October 1918, shortly after taking office, promising to continue the post-Russo-Japanese-war, *Seiyūkai* agenda of state-led improvement of trade, industry, transportation and communication.

In 1921 and 1922, as panics continued intermittently and Japanese exports fell, the Hara government (1918/09–1921/11), and then the governments of Takahashi (1921/11–1922/06), new leader of the *Seiyūkai*, and Katō Tomosaburō (1922/06–1923/08), ex commander in chief of the Japanese Navy, opted for “contracting the currency and lifting the gold embargo on gold exports,” namely an *official* policy of deflation and fiscal restraint in agreement with the orthodox medicine (Meltzer 2007:136-145). As both Takahashi and Hamaguchi acknowledged, “controlled” growth and spending were impellent needs “because of the economic situation” and the “dangerous social climate” that the unprecedented increase in prices (that is the previous policy of financial crisis response) had caused (Smethurst 2006:219,227).

The economic turnaround, it was also believed, would have awarded Japan the status of third economic power after the United States and Great Britain, expectations which Mori Kengo and Fukai Eigo, Japanese representatives to the Washington Conference on international financial stabilization held on to. For the following decade, the restrictive economic line of the *Keinsekai/Minseito*, dominated Japanese politics. Continuing bank failures—the earthquake of 1923 did not help national finances—were also addressed through collusive financial policies reminiscent of a positive line, like the issuing of “earthquake bills” and over lending to prevent bankruptcies.¹¹⁸ There was no question, however, that a turn in economic policy had occurred between 1920 and 1922. Premier Katō even started a “Diligent and Thrift

¹¹⁸ The incentive for moral hazard was significant, and the escalating power of domestic financial interests accounted for the diffusion of pork-barrel politics across the nation. No wonder, banking crises continued to occur throughout the 1920s. As Tamaki (1995:151) put it, Japanese financial history in the 1920s is widely “a history of failed bank management and corruption.” For an account of Japanese financial policies in the 1920s see Allen (1925), p.75; Allen (1934), p.545; Takafusa (1983), pp.140-154; Smitka (1998), pp.103-104; Kirshner (2007), pp.58-88.

Campaign,” in 1924, using traditional Japanese values in the attempt to overcome the nation’s “desperate situation” that policies fomenting high prices and chronic deficit had produced.¹¹⁹

From the Japanese resolution of the financial crises of 1907-09 and 1920-22, a second set of expectations is easily derived. Since in both circumstances governments

Table 2.5. Japanese financial statistics, 1925-1933

Year	Govt Borr	CGE (Real)	Banks (nr)	Bank loans
1925	46	18,245	1,534	6,038
1926	34	19,481	1,417	6,394
1927	61	23,202	1,280	5,864
1928	157	21,313	1,028	5,581
1929	99	15,765	878	5,501
1930	38	29,809	779	5,342
1931	120	23,604	680	5,184
1932	659	23,749	538	4,800
1933	783	25,791	516	4,575

having low affinity with high finance found out to be highly exposed to high finance throughout the crisis, Japanese national security policies should have shifted towards greater caution (scenario LA–HE). In both instances, initial resistance to a turn in economic policy by ruling authorities should have precluded

an immediate shift in security policies.

Throughout the 1920s, the deflationary and belt-tightening policies implemented in Japan and the rest of the world to stabilize price and return to the gold standard did not have the hoped success. In Japan, more than in anywhere else, economic recovery was complicated by a speculative extension of credit and the related overinvestment in finance versus industry and manufacture. Government affinity with high finance had never been higher. In the years leading up to 1927, the *Keinsekai* cabinets of Katō Takaaki and Wakatsuki Reijirō consistently restrained government borrowing and spending (CGE), and nurtured a highly liquid banking

¹¹⁹ On the thrift campaign see Meltzer (2007), pp.154-55.

system, inclusive of numerous banks with unsound finances.¹²⁰ In early 1927, as the problem of the earthquake bills repayment stirred panic within financial markets and conflict in the Diet, Kataoka Naoharu, Finance Minister of the Wakasuki cabinet, stroke a temporary deal with the *Seiyūkai* President Tanaka Giichi.¹²¹

Despite these efforts to keep the lid on a boiling pot, the climate in the Diet remained politically charged and when, in March 1927, Kataoka hinted unwillingly to the unsound status of the Tokyo Watanabe Bank, the latter collapsed, followed by the collapse of Suzuki Shōten, a large Kobe trading company financed by the Bank of Taiwan, and by numerous bank runs across the country.¹²² The financial crisis of 1927-1931, the most severe crisis in Japanese economic history, had so begun, right when return to the gold standard gained renewed legitimation internationally.¹²³ In April 1927, as infighting between the *Seiyūkai* and the *Keinseikai* continued, *Seiyūkai* leader General Tanaka Giichi (1927/04–1929/07) received the imperial mandate to form a new cabinet. Anti-finance economic policies returned. Newly nominated Finance Minister Takahashi depreciated the yen, leaving its value “to nature” (Meltzer 2007:181), refused to lift the gold embargo (which the *Keinseikai* was about to do before the crisis), raised public spending, closed banks first temporarily (April 22, 23, 1927) and then with a moratorium (September 1927), and introduced long-postponed

¹²⁰ On these negative economic policies see Faini and Toniolo (1992), p.130; Tamaki (1995), pp.150-154; Kirshner (2007), p.67.

¹²¹ The thorny issue of relieving “bad” debtors had already caused debate between the *Keinseikai* and the *Seiyūkai* in the lead up to the crisis.

¹²² For an account of the origins of the crisis see Meltzer (2007), pp.178-180.

¹²³ In 1927 and 1928 Italy and France introduced the gold standard.

banking reforms.¹²⁴ Government exposure to high finance turned from high to low, even if American high finance, particularly Thomas Lamont and Russell Leffingwell continued to push Japanese authorities to deflate.¹²⁵

The new phase constituted only a brief parenthesis, however. In July 1929, realizing that large government sterling bonds issued to help finance the Russo-Japanese war were falling due, and observing that Japan was losing ground internationally now that had Europe entered a “new age of currency stability” with all major powers back on the gold standard, Mitsuchi Chūzō, the Ministry of Finance of the ruling *Seiyūkai* cabinet, concluded that lifting the gold embargo—the very policy that the same party had opposed in early 1927 and that had brought down—was now an “urgent necessity.”¹²⁶ This way, Japan would have obtained the necessary international financial cooperation to refinance existing public loans and post-poner payment.

As a result, Tanaka left the place to the *Kenseikai* (or *Minseito*) cabinets of Osachi Hamaguchi (1929/07–1931/04) and Wataksuki Reijirō (1931/04–1931/12), and the 1920s deflationary policies of balancing the budget and returning to the gold standard were resurrected (Allen 1934:547).¹²⁷ Japan seemed to be collecting the fruits of this policy in January 1930, when it newly joined the gold standard. Soon

¹²⁴ In May 1927 the Special Credit Bill and the Financial Relief Bill issued by the Bank of Japan, were passed, and then in January 1928, the Bank Act came into effect. The Bank Act stipulated that ordinary banks and any other style of company were illegal.

¹²⁵ On American pressures to bring Japan back to the gold standard path, see Meltzer (2007), pp.185-191.

¹²⁶ On the unwillingness of the *Seiyūkai* to pay for the existing government loans, and on the new shift towards negative economic policies, see Meltzer (2007), pp.192-193.

¹²⁷ In addressing the Diet, in January 1930 Minister of finance Junnosuke Inoue argued that lifting the specie embargo and returning to the gold standard would have deflationary effects upon the economy, enhance Japan’s international competitiveness, and eventually give strength to the economy. This vision turned out to be too optimistic. See Tamaki (1995), p.166.

afterwards, however, a gold rush and a drastic fall in export began. Showing its high exposure to high finance, Finance Minister Inoue Junnosuke responded to the new financial crisis wave like the Hoover administration did in the United States: by placing the blame on external causes, and reiterating the value of the orthodox medicine, especially now that Japan had managed to enter the gold standard again. But gold outflow reached its worst historical value, Japanese exports continued to fall, the yen depreciated, and by the summer of 1930, much of the Japanese business world was demanding the reintroduction of the gold embargo.¹²⁸ Domestic political struggle and violence flared up again. Later in 1930, Prime Minister Hamaguchi was shot at a station, and in the spring of 1931 Inoue was almost killed by a dynamite bomb that exploded in front of his house.

By December 1931, after the British abandonment of the gold standard and as the international financial order crumbled, infighting within the *Minseito* between supporters of financial internationalism and more jingoistic party members over whether or not to suspend the gold standard had led to the fall of the Wakatsuki cabinet and Inoue's deflationary policies course, and the Privy Council assigning the *Seiyūkai* the task of forming a new government. Under Inukai Tsuyoshi (1931/12–1932/05) government exposure to high finance reverted back to low.¹²⁹ This crisis response recipe ideated by new Finance Minister Takahashi (so-called *Takahashi Zaisei*) included setting a devalued exchange rate for the yen, increasing domestic

¹²⁸ On these developments see Meltzer (2007), pp.228,229.

¹²⁹ The American stock market crash in the fall of 1929 had an almost immediate impact upon Japan. As the best customer of the Japanese, the US was absorbing that year over 40 percent of Japanese exports. By the end of the year the silk market collapsed, and the price of Japan's major export, raw silk, dropped by one-half. On these repercussions see especially Takafusa (1983), p.8; and Warner (1991), p.103; Yamamuro (1932), pp.53,57,58; Smitka (1998), p.113.

fiscal expenditures, introducing capital controls, suspending convertibility, and re-issuing the gold embargo (Takafusa 1973:144; Myung 2003:12; Allen 1963:136; Schiffer 1962:19,20; Meltzer 2007:238-242). The medicine worked remarkably well. In early 1932 Japan's industrial production index resumed growth, and the country escaped economic decline earlier than most countries. No pro-finance party returned to power afterwards, and for the next decade Japanese cabinets did not abandon interventionist economic policies.

Because of the low exposure to high finance of the cabinets of General Tanaka Giichi (1927/04–1929/07), Osachi Hamaguchi (1929/07–1931/04) and Wataksuki Reijirō (1931/04–1931/12), and because of the high affinity with high finance of the Wataksuki cabinet before the start of the financial crisis, the framework does not allow extrapolating specific expectations on the course of Japanese national security policies after the outbreak of the financial crisis. Still, whatever the direction of Japanese national security policies after the outbreak of the financial crisis, Japanese government authorities should face, after the outbreak of the financial crisis, fewer constraints for shifting existing national security policies towards greater assertiveness.

DENYING FINANCIAL CRISES AND BOOSTING STATE POWER AND EXPANSION:
Financial components of Japan's military proclivity

Analyzing the influence on national security policies of the Japanese local financial crises of 1889-90 and 1896-1901 offers a chance to contribute to the debate on the character of Japanese imperialism up until the Russo-Japanese War. The slogan “rich nation, strong army” (*fukoku kyōhei*) is a popular description of Japanese

ambitions throughout these years.¹³⁰ Investing in catch-up industrialization and catch-up rearmament was Japan's strategy for avoiding Western subjugation (as Japan's larger neighbor China had been forced to endure), while at the same time propelling Japan's sway in the East and respect in the West. More concretely, Japan aimed at obtaining a revision of the unequal treaties, and preserving the military and economic independence of the surrounding islands from China and Russia. To Japanese political authorities, building a rich state and a strong army were not only compatible but symbiotic national security goals: improving industrial activity was regarded as a major contribution to military strength while military activities were regarded as boosters of economic and business activities. In the words of Yano Fumio, political adviser to foreign minister Okuma Shigenobu (1888-1889): "if army and navy are the body, national wealth is the food we consume. Without food is impossible to maintain the body. [...] However independent a country may be, the lack of wealth will extinguish it."¹³¹

This section adds a new element to this understanding of Japanese imperialism. The creation of a rich nation and a strong army was born out of the belief that defense and industry preceded finance. Or, better, catch up rearmament and industrialization practically implied weak finance and financial crises: the "rich nation, strong army" program was in truth a "rich nation, strong army, and weak finance" program. This was true not only in the sense that weak finance was functional to the achievement of the rich nation, strong army objective, but also in the sense that the

¹³⁰ See, for instance, Crowley (1966):xv, xvi; and Samuels (1994).

¹³¹ In Samuels (1994), p.37. This interpretation is at odds with the orthodox wisdom for which military activities are hurtful to national finances.

rich-nation-strong-army-weak-finance program was the key to Japanese entrance in the gold standard and rising international status. Accordingly, heterodox solutions to financial crises had the upper hand, even though occasionally Japanese authorities stepped back from them when the latter risked compromising Japan's international rise and future or present membership in the gold standard. This occurred, for instance, in 1881-82 and 1900-01. Even then, however, a short resort to deflation, the orthodox medicine and cautionary international diplomacy did not prevent a return to ambitious military spending, threat assessment and war prospects once that the financial crisis was over. Besides doubling down on catch-up rearmament and catch-up industrialization, up until the Russo-Japanese War, Japanese crisis-stricken cabinets encouraged Japanese industrial to begin new projects, and denied that a financial crisis existed at all. Japan's private financial actors were possibly the clearest victims of this dominant strategy.

Before the start of the 1889-90 financial crisis, the Kuroda cabinet was working on an ambitious foreign policy agenda that transcended the parties and the reformist moment that the country was witnessing (Lebra 1974: 85; Beasley 1991:137; Steel 2004:164).¹³² One third of the national budget was being spent on defense (Table 2.6)—a rearmament program had just been launched in January-February 1889—, and talks with Western capital over the abolition of the unequal treaties and the system of extra-territorial rights had been reopened by foreign minister Okuma Shigenobu, stirring intense domestic opposition.¹³³ Crucially, domestic opposition was more an

¹³² In February 1889 the Emperor promulgated the Japanese constitution.

¹³³ Diplomatic negotiation may appear as a weak, conciliatory card but they were not. Bringing the great power to the negotiating table was a difficult task; Japan was alone against a number of

expression of the existing frustration with the unequal treaties, and an attempt of liberal and progressive forces (the Jiyuto and Kaishinto) to push forward their own interpretation of constitutional government, than an outcry against the government agenda of obtaining one of the world's greatest military-industrial combines (*fukoku kyōhei* and *shokusan kōgyō*) on which the political oligarchy, including Kuroda's erstwhile rivals, substantially agreed. Threats to national security were coming from "all countries," and the national program of nurturing the Japanese industry for

Table 2.6. Japanese military spending 1886-1892 (real measures)

Year	GNP	MS/GNP	MS/CGE
1886	712	0.03	0.30
1887	692	0.03	0.30
1888	706	0.03	0.30
1889	726	0.03	0.30
1890	983	0.02	0.30
1891	880	0.03	0.30
1892	948	0.03	0.30

launching arms production and military build-up was energetically and unanimously directed "against all countries" (Samuels 1994:37). This does not mean that the Kuroda cabinet, like any other Japanese cabinets that preceded it, was set on an inflexible, across-the-board belligerent path. The Japanese army endorsed

the military theory principle that Japan should fight only the battles it could win. And in 1889-90 the nation was not ready to militarily confront China, even less Russia.

Similarly, the civil-military oligarchy composing the Kuroda cabinet committed to avoiding any military or diplomatic maneuver that could provoke Western retaliation:

adversaries, and negotiations were far from being friendly conventions since the powers continued to thwart Japan's revisionist efforts. Unsurprisingly, in Japan treaty powers were perceived as "enemies," and Okuma's negotiation strategies aimed at reducing the number of adversaries at any given time to one showing dignity, aplomb and firmness. On this point see Lebra (1973), pp.85; and Perez (1999), pp.83 and 85.

alienating Western powers equaled to hijacking the ongoing process of unequal treaty revision and jeopardizing Japan's economic and military ambitions.¹³⁴

With these considerations in mind, in the months preceding the start of the financial crisis, Foreign Minister Ōkuma Shigenobu made financial and political overtures to the West, including the offer of allowing foreigners to hold property in Japan, a proposition that did not sit well with the Japanese public—including domestic, private financial actors—and which stirred fears of foreign encroachment even amongst Japanese civil-military elites. Still, Ōkuma's deceptively conciliatory treaty negotiation strategy was at heart only a way to realize the national security agenda of continuous diplomatic and military advancement that Japanese political authorities had pursued since the end of the Matsukata deflation of 1881-82.

In sum, when the financial crisis began, the Kuroda cabinet was advancing an ambitious national security agenda while dealing with the domestic consequences of a newly promulgated constitution and forthcoming Diet elections, and with an escalating anti-revision movement within national borders. Largely a product of ongoing negotiations with the West and not of the financial crisis, the political instability and conflict within the Diet that the movement fostered, and some of its sources—like the treaty negotiation process and particularly Ōkuma's financial concession strategy—fomented the financial crisis. In agreement with what expected, after the start of the financial crisis (April 1889), Japan's foreign policy towards the West shifted towards greater assertiveness. As much as it aimed at preventing a slackening of Japan's catch-up economic development and industrialization, the

¹³⁴ On this point see, for instance, Smethurst (2006), pp.53-44.

heterodox strategy of financial crisis response drafted by Finance Minister Matsukata also aimed at supporting Ōkuma's efforts to obtain recognition for Japan's improved international status. Japanese leadership endeavored as much as it could to keep the financial crisis and the domestic anti-treaty revision opposition both domestically at bay and concealed from foreign eyes.¹³⁵ This explains Matsukata's efforts, in the second half of the 1889 and the first half of 1890, to replenish the Bank of Japan's exchange stabilization fund in London (Tamaki 1995:71), in the attempt to maintain an image of financial rectitude that successful treaty revision negotiations necessitated.

In the summer of 1889, as the financial crisis continued, and domestic anti-treaty revision opposition grew to the point of gravely injuring Ōkuma, the top leadership's security dilemma worsened. As international negotiations proceeded and political acrimony and financial losses intensified, Genrō member Itō Hirobumi warned of the risks of ruining Japan's international reputation by continuing on the

*Table 2.7. Japanese military spending
1894-1902*

Year	GNP	MS/GNP	MS/CGE
1894	1,226	0.11	1.65
1895	1,294	0.09	1.39
1896	1,305	0.06	0.45
1897	1,576	0.07	0.50
1898	2,207	0.05	0.52
1899	1,892	0.06	0.46
1900	2,165	0.06	0.47
1901	2,253	0.05	0.41
1902	2,047	0.04	0.31

existing foreign policy course (McCain 2002:322). High risks existed also domestically, as Japanese public and most of Japanese private economic actors expected a positive response to the financial crisis by state authorities. Finally, backtracking from constitutional government or displaying Japanese financial difficulties and political

struggle was too costly an option (McCain 2002:322). The newly found consensus,

¹³⁵ Financial crisis and political turmoil were hardly appealing developments for a state seeking to improve its international reputation.

within the oligarchy, was to increase the jingoistic character of Japan's treaty revision strategy. This would have healed domestic fears of foreign encroachment, and concurrently reassured domestic private economic actors that national finances were under control. The Kuroda cabinet resigned (October 1889), and, from the fall of 1889 to the spring of 1891, the Sanjō and Yamagata cabinets were much harsher negotiators with the West than the Kuroda cabinet had ever been.¹³⁶

Signaling the shift to a tougher foreign policy stance, in February 1890, in a memorandum to the Western states that held inequality treaties with Japan, Foreign Minister Aoki Shūzō explained that, from then onwards, equality would be a necessary condition of any future treaty negotiation, as the “new Japan,” namely the new Japanese constitutional monarchy would not tolerate anything harmful to the interests of its people or to its dignity as a sovereign state. To show that the new course was a change in policy and not simply a change in tone, the Foreign Ministry retracted the concession, proposed by Ōkuma and the Kuroda cabinet a few months earlier, of giving foreigners the right to hold property in Japan.¹³⁷ Western states were now warned that “if the they did not give in to Japanese demands,” Japan would be urged to “act upon her reserved and inherent right and annul the treaties without [the powers'] consent.”¹³⁸ Finally, in late 1889 and throughout 1890, the Sanjō and Yamagata cabinets shun attacks against their foreign policy and financial crisis

¹³⁶ On these developments see Fraser et al, (2013); Keene (2002), pp.427,428; Takeuchi (1935), pp.94-97; Lebra (1973), p.87; Perez (1999), pp.83,-85,96; Scalapino (1975), pp.161-163; and Two Japanese Statesmen, pp.4,5. It is worth noting that the concession strategy of the Kuroda cabinet did not only entail financial concessions but also jurisdictional ones.

¹³⁷ Keene (2002), p.431.

¹³⁸ Exchange between Mutsu Mutnimitsu and Aoki Shūzō in Perez (1999), p.97.

policies by repeatedly dissolving the Diet and issuing imperial rescripts.¹³⁹ Domestic calls and votes for a reduction of the (military) budget were ignored, and the percentage of total government spending allocated to the defense budget continued to be a full 30 % throughout the crisis (Table 2.6), and in the two years after its end.¹⁴⁰

The fact that the anti-treaty revision movement and the birth of Japan's constitutional monarchy developed or were crowned in financial crisis years 1889 and 1890 does not undermine the role of the financial crisis and the process of financial crisis response in engineering the shift towards a more assertive Japanese foreign policy. Stopping financial losses, reassuring domestic economic actors, and jumpstarting economic growth were fundamental to the program of catch-up rearmament and catch-up industrialization that Japanese government authorities subscribed to. It was exactly the need of reassuring Japanese economic actors and public and preventing an intensification of confrontation and violence within the Diet—confrontation which the combination of financial crisis and constitutional upgrade promised—that created oligarchic consensus around replacing Kuroda's treaty revision policy and its threatening international financial components. Although Japanese public economic actors were too weak to change the course of national (military) spending, let alone the direction of Japanese foreign policy, their fear of foreign financial interference right when their economic action was needed made the oligarchy very hesitant to pursue any strategy of diplomatic collaboration with the

¹³⁹ Fukaya xxxx, p.207; Scalapino (1975), pp.156,157,159; Lone (2000), pp.22-24. On the financial character of the opposition see *Two Japanese Statesmen*, p.6. Rejecting the budget was the only possible instrument that the Diet had at its disposal for exerting an influence on Japanese politics. The Diet had no other constitutional competence to initiate or regulate foreign policy.

¹⁴⁰ Data for Table 2.6 are obtained and calculated from Koichi (1971), pp.140-162. GNP values are expressed in million yen.

West.¹⁴¹ The risk was furthering the financial crisis, allowing greater domestic conflict and violence, and losing the democratization battle at home, as well as the battle for international recognition.

Before the start of the financial crisis of 1896-1901 (June 1896), Japanese military spending and threat assessment were similarly exuding assertive state intentions. Japan had fought and defeated China over the control of Korea (March 1894-June 1895), had extracted territorial and commercial concessions, and concluded revised treaties with Great Britain, the United States, France, Germany, Austria-Hungary and Russia.¹⁴² The military victory against China had also endowed Japan of a colonial empire to defend economically and militarily or, as Yamagata dubbed it, a “line of advantage” beyond the “line of sovereignty.”¹⁴³ To this scope, in early 1896 the Itō cabinet used the war indemnity received from China not only for joining the gold standard but also for financing a new rearmament program, couched in a wider industrialization program.¹⁴⁴ This explains why, as shown in Table 2.7, the high ratios

¹⁴¹ In this regard, there is evidence that in the second half of 1889, “prophets of disaster” frequently raised their voice. They fomented opposition movements against foreign encroachment and against the prospect of cheaper foreign capital driving out Japanese investment. These movements, in turn, promoted the anti-treaty-revision front, and, with it, Kuroda’s resignation and a stalled treaty-revision process. See, instance, Perez (1999), pp.91-92.

¹⁴² With The Sino-Japanese war, Japan gained the Liaotung peninsula, Taiwan and the adjoining islands, the right of navigation on the Yangtze River, the opening of the cities and ports and the treatment of Japan as a most favored nation, and a financial indemnity. On Japanese foreign policy in 1894, 1895 and 1896 see Nish (1966), pp.19,35; Akagi (1936), pp.110-112; Beasley (1963), pp.46; Takeuchi (1935), pp.102-110; Halliday (1975), pp.85,86; Kajima (1976), p.24; Stein (1937), p.393; O’Brien (2004), p.2; Sussman and Yafeh (2000), p.446. On Japanese rearmament see in particular Crowley (1966), p.8.

¹⁴³ On these national security intentions see Akagi (1936), pp.172-174. Threatening Japan’s line of advantage were Russian military build-up in East Asia, revolutionary movements within China, and the possibility of new great powers’ interventions against Japanese interests like the one at the end of the Sino-Japanese war. In short, the Sino-Japanese war gave sudden impetus to the aggressive policies of the European powers towards China.

¹⁴⁴ On Japanese rearmament after the Sino-Japanese war see Ono (1922), p.109; White (1964), p.130; and Ishii (1990), p.219. Had the cabinet not been set on assertive set of national security policies, the Chinese war indemnity could have been employed to repay the national debt.

of Japanese military spending on GNP and total government spending in 1896, equal, respectively, to 6% and 45%.¹⁴⁵ Japanese national security plans entailed investing in doubling the size of the army and the navy by capitalizing on the domestic economic boom and the wave of optimism resulting from Japanese military victory. Russia, Germany, and France had clear expansionist aspirations in the Asian mainland. In 1895, the three powers had intervened to alter the terms of Japanese victory over Beijing, and their incursions in the region, like the entrance of Russian marines in Seoul in January 1896, warned Japanese authorities that they could not let their guard down.¹⁴⁶ The line separating the acquisition of international prestige from international humiliation was thin. Also, the military was in a most favorable political position, domestically.

In agreement with earlier formulated expectations, after the start of the crisis, Japanese military spending, threat assessment, and war prospects underwent an expansionist upgrade. Renewed investment in national defense was part of the economic and military plans, which Finance Minister Matsukata and the Itō cabinet had launched at the conclusion of the Sino-Japanese War. Between 1896 and 1898, after the start of the financial crisis, the assertive agenda informing these plans was further intensified by a newly formed coalition between the Finance Ministry and the Navy (Smethurst 2006: 129). Empowered by Japan's recent military victories, the

¹⁴⁵ Data for Table 2.7 are obtained and calculated from Kōichi (1971), pp.140-162. GNP values are expressed in million yen.

¹⁴⁶ The European powers confiscated Japan's gains on the island by having Japan return the Liaotung peninsula to China for the "peace in the Orient." Also, between mid-1895 and 1899, the Russians seized the Liaotung; the Germans acquired the Shantung province (north China); the French expanded in the Yunnan and parts of Kwangtung and Kwangsi provinces (south China); the British advanced into the Yangtze valley and Weihaiwei (south China); and the Americans occupied Hawaii, Wake, Guam, and the Philippines. See in particular Langer (1960), p.186.

Navy found itself penalized by the financial crisis. Being the state still on a silver standard, the currency crisis made the Navy's budget especially onerous and the gold standard increasingly appealing. In turn, the Navy's support of the gold standard and of a tightened state control over national economic and defense industry was just what the Finance Ministry needed to improve Japan's financial conditions and international status. By March 1897, the Navy and the Finance Ministry had united their forces and decided to enact the gold standard into law, raise taxation, and invest new funds in Japanese catch-up industrialization and catch-up rearmament.¹⁴⁷

Obviously, raising capital abroad *on Japanese terms* was at the core of this strategy of financial crisis response.¹⁴⁸ So when J.P. Morgan and Company refused to accept Japan's war bonds 1898, Japanese authorities moved to the British market where Takahashi managed to place the first really large loan (Meltzer 2007:34-36). London bankers awarded the ¥100 million loan for neutral and non-military purposes only, but the Japanese oligarchy had its military justifications in mind. When General Yamagata was nominated premier in the second half of 1898, and the financial crisis continued, the cabinet responded with new tax increases, the exclusion of liberal forces from the Diet, and the authorization of a new rearmament programs

¹⁴⁷ Complains over taxation and the levels of military spending were popular in the Diet throughout these years but the cabinet's response was, as articulated by Count Katsura, first governor of Taiwan, and by premiers Itō and Matsukata, "carrying through the post-war plans," because "even if [the cabinet is] repeatedly opposed and the Diet repeatedly disbanded," [Japan's] "necessary national defense projects cannot be neglected." See Uyehara (1910), pp.231-255; Lone (2000), p.61; Hackett (1971), pp.179-211.

¹⁴⁸ To this scope, in March 1897, as the gold standard was enacted into law, Takahashi was promoted to Vice President of the Yokohama Specie Bank so that he could investigate into ways to provide access to British and European capital without the danger of foreign control. In the meantime, Kaneko was doing the same in North America.

Overall, between 1896 and 1900, the Navy was greatly increased in size, with the addition of four battleships, sixteen cruisers, and twenty-three destroyers (Beasley 1963:164, 165). Six new divisions were also added to the regular Army, bringing the latter's total divisions to thirteen, while linkages between the government and Japanese heavy industries (weapon, mining and railroad industry) were doubled.¹⁴⁹ As shown in Table 2.7, in early 1896 that is after the issuing of the first rearmament program and *before* the start of the financial crisis, the military budget corresponded to 45% of the total budget. This percentage climbed to 50% and 52% during financial crisis years 1897 and 1898, indicating the cabinet's determination to follow the heterodox medicine and capitalize on the national financial and economic benefits of increasing military spending. In mid-1900, a new rearmament program was authorized.

Similarly, Japanese foreign policy became more hawkish between 1896 and 1900. Before the financial crisis, thinking that it was absolutely necessary to reach an understanding with Russia over Korea, Itō, Yamagata, and Inouye signed with Moscow the Waeber-Komura Memorandum of May 1896, and the Yamagata-Lobanoff Protocol of June 1896. In late 1897 and early 1898, after the start of the crisis, and after the start of the rearmament phase that the financial crisis (and the Finance-Navy alliance deriving from the crisis) had helped fueling, Japanese naval squadrons carried on naval demonstrations in and around Korea against the Russian lease, from China, of the ice-free Port Arthur.¹⁵⁰ Earlier in 1898, British minister in

¹⁴⁹ On the strengthening of government's direct control and linkages with the heavy industry in this period, see Ohara (1963), pp.33,38.

¹⁵⁰ The episode is better known as the Port Arthur crisis or Far Eastern crisis. The Liaodong had first

Japan Satow wrote to Lord Salisbury that the Japanese government was making “strenuous efforts” to upgrade Japan’s military and naval establishments (Satow 1966:120). And in 1899, Japan stopped Russia from acquiring a strategic point on the southern coast of Korea (Masampo) by securing the land military before Moscow could intervene, providing one of the triggers of the Boxer rebellion (Nish 1977:52; Akagi 1936:113). Finally, between 1897 and 1898, an entire Japanese battalion (1,000 soldiers) was stationed in Seoul and a newly established Japanese-Korean central bank, the Dai Ichi Bank, had the task of sponsoring the battalion. Russia and China were the most obvious targets of Japanese military measures, but Japanese financial and economic conditions were also a target. The government’s attempts and propaganda to bolster speculative economic activities and military adventurism in Korea and Manchuria as a means to escape from the financial crisis are amply recorded in the contemporary press.¹⁵¹

In the late 1890s and the early 1900s governor of the Bank of Japan Takahashi encouraged the public to take advantage of ongoing national military activities to “shape bold plans for increasing national wealth” (Duus 1968:144-46), and Japanese private financial actors were drinking this heterodox medicine.¹⁵² As

been given by China to Japan in 1895, after the conclusion of the Sino-Japanese War. After the Triple Intervention of Great Britain, France and Russia, however, the peninsula and Port Arthur were subtracted from Japan. The matter of concern in 1897-98, for Japan, were Russia’s interests in a considerable part of the Chinese Empire (Manchuria plus Mongolia). In mid-1898, an agreement on Japanese and Russian spheres of influence in Korea was reached but the situation remained tense. On these developments, see Malozemoff (1958), pp.106, 110, 111; Beasley (1962), p.73.

¹⁵¹ *Japan weekly mail*, I.V.I., XI (1904), p.18, Harrington (1944), p.305, Malozemoff (1958), pp.220-31, Clyde (1926), p.51; and *Mercury*, I.V.I., VIII (1903), pp. 485-90.

¹⁵² These “bold plans” included obtaining concessions from recently conquered governments (mainly, Korea), and, more generally, complementing past and present military undertakings with industrial entrepreneurship. Giving the example, Japanese cabinets combined accelerated military presence abroad and unprecedented investment in railways, telegraphs, telephones, postal service, and economic

private financial magnate Shibusawa Eiichi reminded to the readers of economic newspaper *Jitsugyō no Nihon*, the Sino-Japanese war had been “a very effective helper for the [Japanese] economy.”

Surely, sources other than the financial crises exacerbated Japan’s security dilemma. Russian incursions into Manchuria after the end of the Sino-Japanese war and the conclusion of a secret treaty between Moscow and Beijing provided Japan with a strategic rationale for redoubling on a muscular foreign policy. But the fact that renewed resort to the military option was made in 1897, 1898, and 1899, that is during the heterodox phase of financial crisis response, is remarkable.

Even more remarkable is Japan’s withdrawal from this renewed militancy between 1899 and 1901. The financial crisis and the understanding that the heterodox strategy of financial crisis response would have compromised Japan’s access to foreign funds, and ultimately Japan’s economic development and military build-up, informed this military caution. Already in 1899, although the existence of a financial crisis was never mentioned in public and denied in foreign exchanges, a concerned premier (Yamagata) wrote to Matsukata that “financial conditions” were rendering difficult to complete the construction of the Seoul-Pusan railway—the railway line on which Japan’s economic strength and national security depended (Hackett 1971:205). In the summer of 1900, British authorities expressed their concern over Japan’s

institutions. A few statistics make the picture clearer. Between 1896 and 1897 the total length of Japanese private railways increased of 1,000 km, about double the increase experienced by said railways between 1893 and 1895.¹⁵² Between 1897 and 1898, the total length of Japanese private railways kept increasing, moving from 3,680 km in 1897 to 4,267km in 1898. Investment in Japanese private railways increased much more modestly but steadily thereafter, with the total length of Japanese private railways reaching 5,070km in 1903. After 1903, railroad building declined dramatically. It reached 5,000km again only in 1926.

budgetary position and warned the Yamagata cabinet that it bore a “heavy responsibility” by delaying to send troops to the relief of Beijing (O’Brien 2004:15-17). British statesmen also offered financial support to Japan, admitted that the latter set it on a suitable diplomatic and military.

Determined to defend Japan’s international financial status and relations with Great Britain and the London money market, the Yamagata cabinet decided to participate in the international intervention against the Boxer insurgents by sending the largest military contingent while repeatedly declining any British financial aid for that purpose (Shigeru 1957:13-19,50-59 and 1987:97; O’Brien 2004:15-17; Davis 2008/09:160).¹⁵³ Notably, Yamagata took the decision to leave Japanese ambitions aside (Beasley 1963:76-77) knowing that Russia had obtained a stronger hold in Manchuria and was determined to exploit the Boxer rebellion to occupy the whole region (White 1964:99,100).¹⁵⁴ Next to being a means to gain international recognition, this resolute refusal was meant to remove the doubts in London that the *genrō* would have used foreign financial capital to finance national security decisions, and served to signal the London market that the required conditions to have a flow of foreign cash to Japan were in place. The flow of capital, in turn, as Itō described in the summer of 1900 while the Japanese Finance Ministry was still seeking financial deals in London, would have solved the ominous financial problem, and facilitated Japanese industry, commerce, and railroad building in Korea and China, and (Matsukata 1901:202). The foundations for a British-Japanese alliance were thus laid. In 1901,

¹⁵³ The Boxer rebellion, which demanded the expulsion of foreign and missionaries from Peking, started in late 1899 and culminated in the attack of Russian railway installations in Manchuria and in the siege of foreign legations from 20 June to 14 August 1900.

¹⁵⁴ By January 1901, Russia had occupied the whole Manchuria.

premier Itō, ex-premier Yamagata and the majority of the genrō, the most influential Japanese statesmen at the time who, until 1900, had opposed closer political and military linkages with Great Britain, now favored them. By November 1901, London and Tokyo were united by a military alliance (Akagi 1963:193-201).

Had Japan not faced a financial crisis and the pressing need of procuring foreign capital for national economic and security purposes, Japanese assessment of the Russian threat, and traditional diffidence for military collaboration with Western powers, including Great Britain, would have worsened, rather the eased the existing security dilemma. Resort to arms was substituted for a strategy of “securing commercial and economic privileges throughout East Asia” (Morley 1974b:17; Ishii 1991:63). The temporary nature and the financial components of this turn were clear soon after the conclusion of the Alliance. In 1902 and 1903, when financial issues stood no longer in the way, the naval budget escalated tremendously as the cabinet of Katsura Tarō now judged Japan’s military expansion in the Far Eastern indispensable (Takeuchi 1935:46; Morley 1974:17). For their part, Japanese capitalist forces had only one option left: relying on the exercise of state power, and particularly military power, to run their business. No wonder, when the Japanese-Russian war started, businessman Ikeda Kenzō (15th Bank) described it as the beginning of “a great commercial advance in the continent.”¹⁵⁵ Differently from the West, in Japan, war and commerce, still continued to be two sides of the same coin.

¹⁵⁵ Duus (1966), p.146; Myers (1984), p.145.

ACKNOWLEDGING FINANCIAL CRISES
AND OVERTURNING EXPANSIONIST DREAMS

Japanese heterodox strategy of financial crisis response suffered of one limit. It thrived on the preservation of a weak domestic financial sector and the limited influence of the orthodox medicine and international financial cooperation on Japanese financial policy. Both objectives were unrealistic to sustain in the long haul, being each incompatible with the parties' increasing control of domestic political life; with continued access to foreign loans (which Japanese governments resorted to from the late 1890s onwards), and, more generally, with the realization of the *fukoku kyōhei* and *shokusan kōgyō* program (of unrelenting investment in catch-up industrialization and rearmament). After the Russo-Japanese war (1904-05), a stronger bourgeoisie having orthodox financial preferences, increasing pressures from foreign investors demanding Japanese respect of the orthodox medicine, and the increasing political need for and appeal of foreign capital created stalemates in the Diet (over the budget) that could not longer be as easily resolved as in the past—namely with the replacement of an oligarchic cabinet with another one similar in kind (Crowley 1966,

*Table 2.8. Japanese military spending
1905-1913*

Year	GNP	MS/GNP	MS/CGE
1905	2,373	0.31	1.76
1906	2,863	0.14	0.88
1907	3,327	0.07	0.40
1908	3,361	0.07	0.38
1909	3,268	0.06	0.38
1910	3,181	0.06	0.38
1911	3,883	0.06	0.39
1912	4,509	0.05	0.38
1913	4,574	0.05	0.38

p.15; Halliday 1975, p.111). The implications for Japanese national security policies of these developments were overriding.

Before the start of the financial crisis of 1907-09, the Katsura cabinet (1901–1905) and the Saionji cabinet (1906/01–1908/07) had pursued an assertive foreign policy that had

culminated, as established at Portsmouth in August 1905, with the conquest of Taiwan, Korea, Southern Sakhalin and Dairen-Port Arthur, and the recognition of a sphere of influence in Manchuria and in the Chinese province of Fukien.¹⁵⁶ Following the conclusion of the peace terms, the Saionji cabinet committed to investing in the military protection and the economic development of the conquered regions (Allen 1936:59; Barnes 1934:55). This included the development of Japanese independent presence in Manchuria as well, to adequately tackle the possible revival of Russian expansion in the Far East.¹⁵⁷

Assertiveness was somehow diluted by the genro's desire to control the actions of belligerent Japanese troops still stationed in Manchuria, which risked to irk Great Britain and deprive Japan of the necessary (financial) support to confront Russia.¹⁵⁸ Counteracting the dilution, however, was the political independence and power of the armed forces, and the cabinet's traditional policy of not interfering with that independence and capitalizing on the positive consequences of post-war national military and economic investment. Thus, the military spending authorized in 1906 had

¹⁵⁶ On the treaty of Portsmouth, and its necessity for Japan see Warner (1991), p.71; Moulton (1931), p.286; Halliday (1975), p.92; Ishii (1931), p.70-73; Hayashi (1915), pp.230-31. Japanese interference in Korean affairs was sanctioned by the Taft-Katsura agreement of July 1905 and the Japanese-Korea Agreement concluded shortly before the Saionji Cabinet was established. Already by then, Korea was at all effects a Japanese protectorate.

¹⁵⁷ Akagi (1936), pp.283-86.

¹⁵⁸ On this point see in particular Beasley (1963), p.95 and Crowley (1966), p.9. Although Japanese army authorities after the war kept regarding Manchuria as the army's special province, the war had drastically altered the position of the Japanese government by disclosing its financial dependence on foreign money. In March 1906, for instance, Saionji, Yamagata, Ito and Matsukata managed to bring about several administrative changes to try to remove the military from the positions of command they had acquired in the Liaotung.

remained at very high levels—14% GNP and 82% of total spending (see Table 8)—in spite of an externally financed and rising aggregate national debt.¹⁵⁹

Also, between March 1906 and February 1907, the Army, the Navy, the Saionji cabinet converged on an ambitious national defense plan that identified the strategic threats posed by Russia and the United States, and recognized the “prime security missions” of “protecting” and “enhancing” Japan’s interests in Korea, South Manchuria, the treaty ports along the Chinese coast, the home islands, and the Western Pacific. In February 1907, along with the plan, the cabinet endorsed an expansionary defense budget which provided exceptional funds for post-war troop establishment in Manchuria and Korea; allowed extensive sums for the development of heavy industry and communications; and, if maintained, would have enhanced the size of the army of 8 divisions (to supplement the existing 17 divisions) and the size of the navy of 12 capital warships by 1912.¹⁶⁰ The financial crisis of 1907-09 started at about the same time (early 1907), possibly triggered, next to the factors considered earlier, by the shock that the decreed military budget provoked amongst domestic financial interests, now represented in Diet.

As expected, Japanese military spending decreased significantly after the start of the financial crisis. As shown in Table 8, the ambitious military budget approved, in early 1907, by the Saionji cabinet thanks to the Emperor’s authorization remained dead letter throughout the year. At the end of 1907, the ratio of military spending over total government spending had more than halved compared to 1906, shifting from

¹⁵⁹ On the effects of high defense spending on Japanese finances in these years see Ono (1922), p.87, Stein (1937), p.396, Allen (1963), p.48, Shinjo (1962), p.95. GNP data in Table 2.8 is in million yen.

¹⁶⁰ See Tatsuji (1935), 162; Crowley (1966), pp.5,6; Morley (1974), p.24-27; Stein (1937), p.395.

88% (at the end of 1906) to 40% (at the end of 1907). Things did not improve in early 1908, as the Diet, the finance ministry, and a growing number of the genro oligarchs refused to champion any of the increases in armament spending which the Saionji cabinet had endorsed in 1906 and early 1907. Back then, the enchantment with capitalizing on the boom resulting from the Russo-Japanese war following the principle “national rearmament and industrialization first, financial policy last,” was still strong. In mid-1907 the old creed no longer united or helped to solve cabinet crises. Unprecedented financial considerations stood in the way. Resorting to foreign borrowing had become increasingly difficult following the start of the global financial crisis.¹⁶¹ Foreign borrowing had also become very expensive, the national debt having reached such dangerous levels that just the repayment of the interests accrued on Japanese war loans amounted to 30% of the budget. This figure upset many members of the ruling class, who looked with worry at Japan’s increasing dependence on foreign loans. Besides its diminished appeal, the traditional, “positive” policy of financial crisis response was losing its old viability: balking at the costs of expansion, the bourgeoisie (now a staple in the Diet’s majority party, the Seiyūkai) repeatedly rejected the military budget, firmly resisted any tax increase, and started to demand a more balanced distribution of the national spending.¹⁶²

¹⁶¹ The next paragraph develops this point in greater length.

¹⁶² Morley (1974), p.27; Crowley (1966), p.11; Ono (1922), p.90. In the late 1900s the Seiyūkai included a significant proportion of urban business interests, even if the Keneihontō, the second party, was the more liberal of the two. In the late 1900s the Seiyūkai included a significant proportion of urban business interests, even if the Keneihontō, the second party, was the more liberal of the two. Only in 1914 the Council of National Defense authorized an increase in the forces stationed in Korea by 2 divisions plus 12 capital warships. In late 1911 heightened demands by the Japanese army led to the army minister and a major governmental crisis lasting into early 1913.

In view of all these considerations, and with Japan's financial conditions worsening, in mid-1907 Saionji informed Emperor Meiji that the ambitious program of military expansion approved by the Emperor in April 1907 would have bankrupted the nation. Thereafter, he adopted a retrenchment policy that forced the army to *post-pone* any military build-up for three additional years and the navy to suspend new ship construction. National security demanded achieving these two objectives before anything else: national financial (and political) stability, and the repayment of the national debt. In the following years—1908, 1909, 1910 and 1911—the Diet rejected the military budget and with it the army's argument that the minimal security needs of the state required an increase in the number of army divisions to be stationed in Korea. Saionji's resignations in favor of the Katsura cabinet in July 1908 and Saionji's return to power in August 1911 after the resignation of the Katsura cabinet did not make any difference. In both circumstances programs of fiscal belt-tightening that cut deeply the army and navy budgets were imposed.¹⁶³

Japanese threat assessment and war prospects similarly shifted towards greater caution after the onset of the global financial crisis of 1907-09. To begin, between 1907 and 1909, Japan's assertive policies in the Far Eastern mainland, preoccupation with the Russian threat, and preparations for a forthcoming war of revenge against Russia disappeared from the national security agenda. In 1906 and early 1907, that is after the conclusion of the Treaty of Portsmouth (1905) and before the start of the

¹⁶³ This decision was particularly frustrating for the army and bred a conviction in the army circles that the government was not abiding to its moral and legal obligations to fulfill the estimates of forces sanctioned by the Emperor in early 1907. On the shift in Japanese economic and military priorities see Crowley (1966), p.11; Halliday (1975), p.111; Ono (1922), pp.89,90; Edward (2009), pp.126-28, and Morton (1980), p.23.

financial crisis, the “forward party,” a group of leading politician composed by forces distrustful of Russia, controlled Japanese politics, determined to assuage the bitter disappointment felt at Portsmouth by pushing their claims concerning Japanese rule in the Far East, and particularly Manchuria and Korea, very far in ongoing negotiations with Russia.¹⁶⁴ Japanese moderates were brushed aside; Japanese military presence in southern Manchuria continued (against the Portsmouth’s peace terms); Imperial ordinances disavowed international railway agreements and made of the South Manchuria Railway Company a Japanese property; and Japanese-Russian negotiations were deadlocked by the unyielding attitude of Japanese diplomatic representatives.¹⁶⁵ It is not without significance, as historian E.W. Edwards (1954:344) has written, that in January 1907 the Japanese Committee of Imperial Defense was occupied in considering the position of India in the eventuality of a war with Russia.¹⁶⁶ Moreover, in early February 1907 the national defense policy of the Saionji cabinet had called for preparing military operations against Russia’s positions in northern Manchuria and the Pacific.¹⁶⁷

After the onset of the global financial crisis, all these policies changed radically—and in agreement with my explanation. In early 1907, as panic spread through the core of the financial system, Japanese financial delegates struggled to raise sufficient foreign funds in the London and Paris markets to finance Japan’s

¹⁶⁴ The Treaty of Portsmouth had left many issues for subsequent settlement.

¹⁶⁵ On these developments, and, more broadly, the political dominance, in Japan, of a tough stance against Russia after the conclusion of the peace treaty, see MacMurray (1921), pp.555-56; Pooley (1915), pp.258-62; and Treat (1928), pp.195-96. A notable agreement that was disavowed at the time was the one signed between Katsura and E.H. Harriman, the American railway magnate, in October 1905.

¹⁶⁶ See also Brett (1934-38:II), pp.217-18.

¹⁶⁷ Beasley (1991), p.100; and Crowley (1966), p.11.

expansionist ventures (and pay the national debt).¹⁶⁸ Eventually, a loan for Japan was found, but the offer, which the French government helped to set up, had the strings of the orthodox medicine attached. Investors and the French government demanded, as guarantee for their lending (and future links with the Paris money market), that Japan pledged to respect the principles of the open door in China, and reached a settlement with Russia to assure peace and security in the Far East (Edwards 1954:348,349).¹⁶⁹

Similarly, throughout the rest of the year, as well as in 1908, international financial circles lectured the Saionji government on the dangers of “concealing the real status of national finances” while pursuing a military and naval expansion program that would “stagger a more populous nation.”¹⁷⁰ Between June and July 1907, the Saionji government did exactly what foreign investors wished. It dropped Japanese claims to Southern Manchuria, committed to preserve the existing spheres of influence in the Chinese mainland, and finally reached an agreement with Russia, settling all questions that had been left open at Portsmouth.¹⁷¹ In 1908, and in 1909, Japan adopted a surprisingly cooperative attitude against China’s defiant policy of secretly assigning railway concessions to British companies in the attempt to checkmate Japan

¹⁶⁸ Refer to discussions of the global financial crisis offered in Chapters III and IV of the dissertation.

¹⁶⁹ The support of the French government to the political preferences of high finance at this conjuncture should not surprise as Great Britain, France, Germany and Russia successfully responded to the financial crisis by embracing the orthodox medicine and international financial cooperation. See the discussion of this crisis offered in Chapter III in particular on this point.

¹⁷⁰ “Japan’s Financial Troubles,” *The Washington Post*, May 13, 1908; “Japan’s Financial Position and the Possibility of a Crisis,” *Wall Street Journal*, March 14, 1908.

¹⁷¹ Edwards (1954), pp.349,50; MacMurray (1921), pp.640-648;657-68; Akagi (1936), pp.289-90. The collusion between the Saionji cabinet and high finance was confirmed in the autumn of 1907, when permanent links between the Japanese government and the Basque de Paris et des Pays Bas were established.

in the construction of its railway enterprise on the Asian continent.¹⁷² These foreign policy decisions occurred in tandem with the earlier described adoption of a program of military retrenchment, and arguably benefited of the atmosphere of international financial cooperation (and restrained assertiveness) in central Europe that ensued after the onset of the global financial crisis.

That a shift in Japanese national security occurred policies between 1907 and 1909 is also evident from the evolution of Japanese assessment of the American threat in this period. Between the end of the Russo-Japanese war and the start of the global financial crisis in 1907, the Yamagata and Saionji cabinets had, respectively, worked towards and approved an ambitious program of naval rearmament against the United States, believing in the political feasibility of the “big navy” agenda. After the start of the financial crisis, the difficulty for Japanese authorities to sell state bonds while committing to the rearmament program, united with the political opposition to

*Table 2.9. Japanese military spending
1918-1926*

Year	GNP	MS/GNP	MS/CGE
1918	10,052	0.07	0.66
1919	14,924	0.07	0.87
1920	13,125	0.07	0.72
1921	12,140	0.07	0.61
1922	12,355	0.06	0.52
1923	13,053	0.04	0.38
1924	14,403	0.04	0.36
1925	15,112	0.03	0.36
1926	14,670	0.03	0.33

increases in budget spending at home, resulted in the dawn of a new financial-security agenda, and the replacement of Japanese-American naval rivalry with Japanese-American cooperation. When, starting in 1907 Japanese navy officials, civilian policymakers, and parliamentary forces clashed in the Diet over the distribution of limited funds, naval

rearmament was blocked (Gow 2004:71-72). The defeat of the military party paved

¹⁷² Akagi (1936), pp.297-98. In particular, China secretly assigned to Pauling and Company the construction of a short line between Hsinmintun and Fakumen, a project that shocked Tokyo.

the way for important diplomatic victories. Between late 1907 and early 1908, after repeated failures during the previous year to find an international agreement over the regulation of migratory flows, the Japanese and American governments signed the “Gentlemen’s Agreement,” a milestone in Japanese-American diplomatic cooperation.¹⁷³ This cooperative attitude was further consolidated later in 1908, when Japan and the United States pledged to share common aims, intentions, and policies in the regions of the Pacific Ocean and would “materially contribute to the preservation of the general peace (Akagi 1936:293,94).”¹⁷⁴ As it will be clear after the reading of Chapter IV, the American government, like the Japanese government confronted scenario LA–HE during the global financial crisis, which, in turn compounded Japan’s turn towards greater caution.

Some of the existing scholarship on Japanese foreign policy seems of the opinion that this shift in Japanese foreign policy was impelled by the absence of a fundamental clash of interests (or a desire of confrontation) between the United States and Japan. Evans and Pettie (1997:150,151), for instance, argue that the ambitious Japanese naval rearmament policy *arbitrarily* selected the United States as a likely opponent in order to justify the scale of naval strength that the navy department or the Imperial government desired, but the United States had no intention to strike Japan. Along similar lines, Asada (2006:47) notes that the United States was nothing more

¹⁷³ As historian Ichiro Tokutomi explains, the agreement marked a watershed in Japanese-American relations, so much so that one could wonder: “Was this a cloak to cover up (Japanese) policy of backing down from the stand Japan had taken towards American up to that time, or was it because Japan believed in it with sincerity?” See Ichiro (1922), p.77.

¹⁷⁴ The pledge is better known as Takahira-Root agreement, based on the diplomats that concluded it. Baron Takahira Kogoro was the Japanese ambassador at Washington. Elihu Root was the US Secretary of State at the time.

than a “budgetary enemy,” a simple target for building a large fleet. The problem that this and similar arguments encounter is that they confuse policy outcomes and intentions. True, a great number of Japanese and American officials believed that there was no fundamental clash of interest between Japan and the United States in late 1907, in 1908, and in 1909. But the embrace of this wisdom, at this juncture, was due to the appearance of scenario LA–HE in both Japan and the United States. In Japan, rearmament intentions encountered too powerful opposition abroad and at home, and could no longer shape Japanese foreign policy as much as they had done in past financial-crisis conjunctures.

As expected, Japanese assertiveness was curbed again during the financial crisis of 1920-22, and this time Japanese authorities endorsed military retrenchment and resorted to conciliatory international diplomacy to a much greater extent. One could say that Japanese national security ambitions were suspended after 1907 and overruled after 1920. Before the financial crisis started in March 1920, the Hara cabinet, like the Saionji cabinet in 1907, sponsored an ambitious national security agenda. With the start of World War I, the Japanese leadership had resumed the imperialist policies that it had abandoned after the 1907-09 financial crisis.¹⁷⁵ These included expanding in previously unclaimed Chinese territories, like the Shantung peninsula; financing Chinese warlords’ military adventures; perpetuating Japanese

¹⁷⁵ The earlier described domestic and international circumstances that had forestalled an augmentation of military spending disappeared when Japan grasped the opportunity of profiting from the war as a major supplier to belligerent countries. Although the intervention in Siberia started as an internationally agreed intervention (amongst the Japanese, American, French, and British governments) on the model of the former intervention against the Boxers, the independent characters of the Japanese expeditions were soon unveiled. On the revival of Japanese military expansionism after World War I, see Crowley (1966), pp.26; Stein (1937), pp.396; Halliday (1975), pp.97; Warner (1991), pp.79; Kawakami (1917), p.39; Morton (1980), pp.28; Dulles (1937), pp.134,35; Nish (1977), p.139; Nish (2002), p.22; “Japanese Imperialism in Siberia,” *The Nation*, June 12, 1920.

presence in the Liaotung Peninsula and around the South Manchuria Railway; sending a military expedition against the Bolsheviks in Siberia, and extracting a series of concessions from China (the 21 demands). At the end of the War, Japan was the dominant military and political power in East Asia.¹⁷⁶

The promotion by Japanese authorities of forceful national security policies continued after the conclusion of World War I. Some cabinet members, including premier Hara, hoped to contain Japanese imperialistic spirits to avoid the worsening of Japanese-American (trade) relations and maintain a “strictly conciliatory attitude” towards the European leaders. Yet, the political weight of the military front, and its abidance by the principles of *fukoku kyōhei* and *shokusan kōgyō* was much greater.¹⁷⁷ In 1919 the renewal of the Anglo-Japanese alliance was in doubt, and the Hara cabinet supported new military operations against the Soviet communists in Siberia, and hugely expanded the Japanese naval budget, bringing the share of national military spending over total government spending to 87% (Table 2.9)—the highest share since the years of the Russo-Japanese war.¹⁷⁸

Early in the following year (1920), before the start of the financial crisis, the Hara cabinet gave its approval to the naval building program approved in 1919, which granted the funds for the construction of 8 battleships and 8 cruisers (10:7 ratio with the United States) to be completed by 1928. Hara even decided to support the advance

¹⁷⁶ See particularly Warner (1991:91) on this point.

¹⁷⁷ The United States was the major importer of Japanese goods. It was also the foremost financial and economic power and the preservation of the Anglo-Japanese alliance required the preservation of good Japanese-American relations. This, in turn, required more cordial relations with China. Premier Hara understood these needs but his understanding was not a game changer before the outbreak of the financial crisis. Also, although more moderate, Hara’s position, in principle, was not against Japanese expansion. See, for instance, Nish (2002), p.16 and Young (1972), pp.125, 141.

¹⁷⁸ The naval rearmament program authorized in 1919 established that Japan reached a ratio of 10:7 with the American fleet by 1928.

of Chinese nationalists into Mongolia, offering military and financial support to Chinese warlord Chang Tso-lin. By the spring of 1920, Japanese troops seized Vladivostok, an action that was a clear statement of the imperialist character of Japanese Siberian intervention, and an action that arguably helped to jumpstart the financial crisis. In the following months, Japan's pre-financial crisis expansionist pathway registered a major setback as the disharmony of interests between the liberal and the military elements of the Hara government grew stronger and a "positive" economic strategy of financial crisis response failed to win the day.

The first indication that Japanese foreign policies were at a turning point appeared in late March, 1920, when the Minister of Foreign Affairs released the policy statement that Japan had no territorial ambition in Siberia and troops would be withdrawn as soon as possible. Two months later, at a conference that Hara had convened to assess the future of Japanese foreign policy, military and civilian authorities failed to achieve a consensus on Japan's military strategy on the continent. Later in the year (summer of 1920), General of the Imperial Japanese Army Tanaka Giichi worked closely with Hara to promote Japanese demobilization in Siberia, and, in October 1920, Japan signed an agreement with Great Britain, the United States and France to support an international consortium of bankers making loans to China. In the Spring of 1921, the Hara cabinet resolved that the country's floundering economy demanded withdrawal from Siberia, and, over the course of the year, as the financial crisis continued, Japanese military and civilian leadership Japan agreed on seeking

some form of diplomatic accommodation with the United States to prevent a naval arms race.¹⁷⁹

By the time that the Takahashi cabinet had replaced the Hara cabinet in November 1921, Japanese leading authorities had endorsed military retrenchment to support deflationary financial policies and the transfer of greater funds to resuscitate the national financial market. Hara Kei, leader of the majority party (Kenseikai) spoke of the emergence of a new (economic) diplomacy—later known as Shidehara diplomacy after the name of the Finance Minister who formulated it. This new diplomacy, or emergent financial-security agenda capitalized on the national security advantages of financial stability, and considered armed competition obsolete and economic competition as the new currency of international affairs.¹⁸⁰ Crucially, the Shidehara diplomacy increasingly appealed to the military leadership and the civilian leadership alike. For instance, during the Ishii panic of 1922, new premier and *ex-Navy commander* Katō praised armament reductions on the grounds that (Japan's) national defense was a composite of capabilities amongst which financial means ranked first.¹⁸¹ Army authorities were not less forthcoming in opting for military retrenchment, as General Tanaka's collaboration with Hara in the summer of 1920 suggests.

Military restraint was further consolidated during the Ishii panic of 1922, when Japan, by signing the Washington Treaty that wrapped up the Washington Naval

¹⁷⁹ For a more detailed account of these developments, see Nish (1977), p.24; (2002), pp.22-28; Morley (1974), pp.46; Crowley (1966), pp.25-26; Young (1972), pp.141-42.

¹⁸⁰ Shidehara's economic diplomacy took its name from Finance Minister Baron Shidehara Kijūrō. The diplomacy relied on the close interdependence between economic and military objectives and policies. On this point see in particular Kirshner (2007), p.68. See also Crowley (1966), pp.29,30; Burns and Bennett (1974), pp.208-210; and Silberman and Harootunian (1974), pp.244,45.

¹⁸¹ Silberman and Harootunian (1974), pp.241-44; Crowley (1966), pp.29-30.

Conference, agreed on giving up the Shantung, returning Kiachow to China, completing Japanese withdrawal from North Sakhalin and Eastern Siberia, endorsing multilateral military cooperation, and accepting a naval ratio of 10:6 between the Anglo-American fleets and the Imperial Navy.¹⁸² In a 1923 top-secret memorandum of the intelligence division of the General Staff, commanding officer and future General Iwane Matsui wrote that, to use old methods of expansion was out of the question. He stated: “We must substitute economic conquest for military invasion, financial influence for military control, and achieve our goals under the slogan of co-prosperity and co-existence, friendship and cooperation.”¹⁸³

A look at Japanese military spending in these years similarly confirms the fast and radical triumph of retrenchment policies, in agreement with what expected. As shown in Table 9, the ratio of military spending on total government spending moved from 84% in 1919 to 72% in 1920, 61% in 1921, and 52% in 1922, and 38% in 1923. Cuts in national military spending continued in the following years as financial crises stroke repeatedly in the 1920s. In 1925, the standing army was even reduced from 18 to 14 divisions against the army’s own estimate that at least 21 divisions were needed.

Looking at these figures and at the contrast between Japanese pre-1920 and post-1920 national security behavior, scholars like Halliday (1975:99), Crowley (1966:29), Nish (1977:141), and Warner (1991:101), have considered the Washington conference as an anti-Japanese operation, emphasizing how Great Britain, the United

¹⁸² The Washington Naval Conference commenced in November 1921 and ended in February 1922. Products of the conference were the replacement of the Anglo-Japanese Alliance through a four-power Pacific Treaty signed by the United States, Britain, France and Japan; the Shantung treaty (for the return of the Shantung and Kiachow to China), and Two Nine-Power Treaties that recognized the territorial and political independence of China. See for instance, Halliday (1975), p.99.

¹⁸³ Silberman and Harootunian (1974), p.244.

States, and France placed the Takahashi and Kato cabinets against a wall and extracted the maximum gain. Differently, Kirshner (2007:68,69) has attributed the watershed change in Japanese national security policies between 1920 and 1922 to the domestic power of Japan's financial forces and their pressures for financial housecleaning—pressures endorsed and encouraged by an increasingly powerful high finance. While all these factors created a ripe political environment in Japan for overhauling existing national security policies, the interpretation advanced here suggests that no overhaul would have been possible without the occurrence of a financial crisis. Western pressures on Japanese national security agenda would have been scarcely relevant without a transformation in the financial-security ideology that the Japanese leadership abided to, and the financial crisis and the process of financial crisis response triggered this transformation. In fact, in 1919, despite the presence of a strong domestic financial group favoring a conciliatory foreign policy, and the existence of international pressures against the use of force, Japanese national security priorities did not exhibit any element pointing to liberal internationalism.¹⁸⁴ The Gaiko Chosakai, the Advisory Council for Foreign Affairs, staunchly opposed the “low posture” foreign policy approach that people like old genro representative Matsukata Masayoshi and future foreign minister Shidehara Kijuro auspicated.¹⁸⁵

Moreover, during the international negotiations of Versailles, ex-premier and genro member Saionji and Ambassador Chinda Sutemi sturdily defended Japan's naval rearmament and military possessions. The Japanese delegation to Paris had been

¹⁸⁴ Belonging to the liberal internationalist front were, for example, Matsukata Matayoshi, Shidehara Kijuro, Makino Nobuaki, and Kato Tomosaburo. Opposition to this group was offered by Inukai Tsuyoshi, Terauchi Masatake, and Ito Miyoji.

¹⁸⁵ Connors (1987), pp.66,67.

firmly instructed to not accept any compromise, and abstain from signing the Covenant unless the powers accepted the principle that any retrocession of conquered Asian land needed to be settled between Japan and China only.¹⁸⁶ The Allies distinctly got the message that Japan would withdraw from the conference had its demands not been met. American President Woodrow Wilson reportedly commented: “[The Japanese delegation] will go home unless we given them what they should not have.”¹⁸⁷ On top of that, in Japan, the military front and the business front were not explicitly at odds.¹⁸⁸

In fact, military advancement in the Chinese mainland, and the financing of Chinese-warlord Chang Tso-lin required the cooperation of Japan’s military and business interests and promised to reward both groups—at least within the frame of mind of catch-up rearmament and catch-up industrialization. Only in the spring of 1920, and in the following months, when the effects of the crisis were patent, the cabinet appeared more uncertain and started to reconsider of existing national security objectives. *Only then* business interests started to strongly ostracize expansionism. *And only from then on*, military retrenchment was increasingly advocated and pursued by Japanese leadership. This timing also rules out the possibility that the Washington Conference—the international disarmament conference held from November 12, 1921 to February 6, 1922 under the wish and direction of the United States and Britain—

¹⁸⁶As Ambassador Chinta Sudemi told the American Secretary of State Lansing: “Regarding the good or bad, or the validity of the Japanese-Chinese Agreement, our government will not permit the meddling of another country [..]. IT is against the objectives of any Peace Conference to try to criticize the agreements existing between nations.” See Connors (1987), p.73.

¹⁸⁷ In Baker (1922), p.265.

¹⁸⁸ Even Silberman and Harootunian (1974:244,245) note that the Japanese decision to reduce military expenditures had not exactly matured out of the Versailles conference.

reversed the course of Japanese military expenditures. The point is the Hara government confronted a solid opposition who urged for reduction in armaments starting from the spring of 1920, long before the idea of an international conference on the reduction of armaments was even entertained by officials in Washington. Along with the banking panic of 1922, the Conference further consolidated the greater political resonance of the orthodox medicine and liberal internationalism—an important effect but definitely not a big enough effect to diminish the catalytic role of the financial crisis.

BRINGING FINANCIAL-CRISIS DENIAL BACK:

Retreat from the orthodox medicine and new conversion to expansionism

In the years following the financial crisis of 1920-22, high finance and financial interests enjoyed an unprecedented position of political supremacy in Japan. Responding to the financial crisis of 1920-22 though military withdrawal from Siberia and defense cuts created the conditions for a tight alliance between Bank of Japan governor Inoue Junnosuke and eminent international financiers like Governor of the Federal Reserve Bank of New York Benjamin Strong and Morgan Chief Executive Thomas Lamont. Captivated by the prospect of placing Japan at the forefront of the international financial order along with the United States and Great Britain, members of Japanese high finance like Inoue urged Tokyo's participation in the "Washington System" and the related endorsement of deep defense cuts and deflationary financial policies to return to the gold standard, abandoned after the beginning of World War

One (Humphreys 1995:44,45,60; Kirhsner 2007:61-69).¹⁸⁹ The realization of this master plan was initially stalled by the emergency, positive financial and economic policies that Japanese political leadership had to embark on to address the widespread devastation produced by the great Kanto earthquake (1923). By mid-1924, however, the political fortunes, for the first time, of the Kenseikai, the party closer to financial interests, rewarded Inoue's financial ambitions, and the master plan could officially start, first under a Seiyukai-Kenseikai coalition government headed by Kenseikai leader Katō Takaaki (1924-1926), and then under an all-Kenseikai government headed by Waktsuki Reijirō (1926-1927).

With a Kenseikai leadership determined to realize profound and urgent retrenchment policies to return to the gold standard no matter what—resignation of the coalition party included—before the onset of the financial crisis of 1927, Japan was abiding by a most cautious national security agenda. Prudence in international diplomatic and military affairs took the name of Shidehara diplomacy, under the name of the Keiseikai Foreign Minister that ideated it as early 1922 (Crowley 1966:29,30; Burns and Bennett 1974:208-10). In the spirit of liberal internationalism, and in the conviction that financial deflation was the key to Japan future economic development, in 1925 the standing army was reduced from 18 to 14 divisions, nullifying the army's own estimate that at least 21 divisions were needed for Japanese development and defensive purpose. Next to budget and military budget reductions, the Kenseikai cabinets sought to promote friendly relations between Japan and China. When in 1925

¹⁸⁹ The Washington System, which the earlier introduced Washington conferences and treaties created, codified and extended a policy of cooperation between Japan and Western powers into the Far Eastern arena through a number of pacts. The Nine Power Pact, for instance, condemned the recognition of spheres of influence in China and upheld the principles of Chinese sovereignty and the Open Door.

and 1926, boycotts and anti-foreign feelings spread through China, Shidehara responded by ordering the withdrawal of Japanese nationals from dangerous areas, and upholding a firm opposition to any use of force.¹⁹⁰ In 1926 and in early 1927, before the start of the financial crisis, the Wakatsuki cabinet continued to abide by the principles of the Washington System castigating anti-Shidehara suggestions, and backing a policy of cooperation with China's Nationalist Government and its political and military leader Chiang Kai-shek. This radical policy of restraint might have contributed to the Nanking incident of March 24, 1927, when ill-discipline units of the advancing Chinese Kuomintang Army deliberately killed several foreigners at

Nanking, including some Japanese residents.

*Table 2.10. Japanese military spending
1925-1933*

Year	GNP	MS/GNP	MS/CGE
1925	15,112	0.03	0.35
1926	14,670	0.04	0.33
1927	14,611	0.04	0.34
1928	14,852	0.04	0.34
1929	14,799	0.04	0.35
1930	13,850	0.04	0.35
1931	12,520	0.05	0.38
1932	13,043	0.06	0.42
1933	14,334	0.07	0.44

Once again, the Chinese Navy held its fire

(Nish 2002:66,67).

Unfortunately, despite the deflationary

efforts and a preponderant military restraint

financial crises continued to occur in Japan

throughout the 1920s, undermining the state's

ability to join the gold standard. In the attempt

to stop them, between 1924 and 1927 the Keiseikai cabinets encouraged merger,

legitimized collusive financial practices, and accommodated national financial markets

with huge sums of liquidity. These expedients only ended up exacerbating moral

¹⁹⁰ In 1925 foreign minister Shidehara expressed the future of Japan's foreign policy in these terms: "Japan must make considerable efforts to maintain the cooperation of the United States and Britain;" it "must strictly refuse any intervention in Chinese domestic affairs;" and it must endeavor "to harmonize the ideal and the pragmatic to bring some kind of compromise," that is compatible "with the real situation in China." See Burns and Bennett (1974), p.201; Morley (1974), p.45; Nish (1977), p.155.

hazard and risky investments in what was already an extremely fragile financial system. Unsurprisingly, the financial crises of the 1920s hit Japan with extraordinary and unprecedented virulence. But no one did so more virulently than the Showa crisis of 1927.

As the Wataksuki cabinet prepared to address it through new disbursements in April 1927, as previously described, indignation at the maneuver escalated within the Diet, bringing the domestic political fracture between military forces and financial forces (which the political conflict between the Seiyukai and Kenseikai fostered) to extremely polarized levels and ultimately causing the Keinseikai leader's resignation. In agreement with my expectations, once that the Emperor awarded the new premiership to General Giichi Tanaka (Seiyukai), Japanese economic and security agenda changed, and Japanese national security policies shifted towards ambiguity or, as Beasley wrote, "incompetence" (1963:122). Tanaka immediately took a number of decisions that conveyed an increased hostility towards China and the great powers. In May 1927, having declared that the cabinet was prepared to act in defense of Japanese special interests in Manchuria and Mongolia as anti-foreign hostility mounted in China, Tanaka dispatched a total of 4,200 troops to Shantung against the terms of the Washington Treaty System. The Shantung Expedition would have become the first step in the forthcoming Japanese military aggression on the Chinese mainland (Tamaki 1995:154).

Despite this renewed assertiveness, powerful domestic political pressures, and an international environment favoring international financial cooperation thwarted the complete abandonment of existing national security policies. As archival records

reveal, Tanaka's efforts to move Japanese foreign policy on a less timid course were counteracted by the dominant pro-Shidehara beliefs of the Kenseikai and the genro, both of which acted to reinstate the China policy by which the Kenseikai stood. The policy results of these parallel efforts were certainly not minimal. In November 1927, with the help of a \$30 million loan from the American Morgan & Co, Japanese financial forces urged and obtained a wide-ranging agreement with Chinese warlord of North Manchuria Chang Tso-lin. The agreement endowed Japan of new railways rights, closer economic cooperation with China and possibly, as the promoter of the agreement Japanese magnate and President of the South Manchuria Railway Company, Jotaro Yamamoto, put it, the indirect "[purchase] of the whole of Manchuria."¹⁹¹ Similarly clashing policies were in place in 1928 too. In April 1928, Tanaka decided to dispatch another expedition to Shantung but, because of the popularity of the Shidehara diplomacy within the government, he ordered the Japanese troops not to intervene, and assured the Diet that no Japanese military or political intervention in Chinese domestic affairs would have occurred.

This ambiguous national security agenda only made the fracture between military and political forces deeper, since the neither of the two groups could obviously be pleased. It also helped to increase the disappointment of Japanese armed forces with the party system.¹⁹² In May 1928, in utter disregard of higher advice from the Tanaka's government, Japanese troops clashed with Chiang Kai-shek's nationalist

¹⁹¹ National Archives and Records Service of the United States, *Records of the U.S. Department of State relating to internal affairs of Japan, 1910-1929*, files 0252, 0324; "The Loan to the SMR," *The North-China Daily News*, December 9, 1927. Jotaro's quote is from Beasley (1991), p.182. See also Connors (1987), pp.114-117.

¹⁹² On the skepticism of the Japanese armed forces towards the party system, despite a slight preference for the Seiyukai versus the Kenseikai see Kirshner (2007), p.80.

forces at the town of Tsinian (Shantung), and in June 1928 Japanese soldiers assassinated Chang Kai-shek. An international storm of protest followed, and Saionji warned Tanaka to “strictly enforce military discipline.” Alarmed, the Tanaka cabinet also issued an official apology to the Chinese government; signed the Renunciation of War treaty in Paris (Kellogg-Briand pact); and authorized Japanese participation in a forthcoming international naval disarmament conference to extend and expand the agreements on practical shipbuilding laid down at the Washington Conference of 1921-22.¹⁹³ By acting this way, Tanaka distanced himself and his party even further from the Japanese army, leaving the latter only one option to pursue: exit, that is exit from bending to a lame foreign policy that tarnished Japan’s interests in Manchuria and jeopardized national security.

Why did Tanaka lapse into the orthodox medicine and cautionary national security policies that he opposed? The answer is most likely that a complete political departure from the orthodox medicine and the attached security conditionality was not feasible yet, as the appeal of participating to the international financial system remained still strong. Of the great powers only Japan was experiencing a financial crisis at this point in time (1927-1928). Also, by 1928 not only Great Britain but also the main European states had returned to the gold standard by 1928, leaving Japan isolated, and giving new impetus to Inoue’s master plan (and the thesis that Tanaka’s feisty policies got in the way).

Relatedly, it is also interesting to observe that the extra prudent national security agenda promoted by Japanese financial forces—which included the pursuit of

¹⁹³ "Records of the U.S. Department of State relating to internal affairs of Japan," files 0348 and 0351.

a “non-military” Japanese foreign policy towards China and a greater investment in international financial cooperation between Tokyo and Beijing and between Japan and the United States—was not a foresighted strategy for preserving international peace. The tripartite collaboration between high finance, Japanese financial parties, and Chang Tso-lin irked not only the Japanese Army but the Chinese leadership too, fostering Chinese military radicalism and the prospects of a Sino-Japanese conflict. Indeed, the Chinese leadership alarmingly saw the tripartite collaboration between the Japanese, the Americans and Chang Tso-lin as an open invitation to all nationalities to participate in the exploitation of Manchuria in the name of improving the railway service. These concerns are well documented by contemporary British and American press and various records of the US Department of State relating to internal affairs of Japan. Alarmed by the agreement, representatives of the Chinese government protested with their American counterparts while the Chinese nationalist forces of Chang Kai-shek quickly initiated their march against Chang Tso-lin. Ultimately, the Japanese Army alarmingly saw the decreasing domestic political utility of their service right when this utility should have increased. The manifestation of Chinese nationalism was escalating and basic requirements of Japanese national security hardly demanded a sheer reliance on economic means—they rather suggested that the Japanese Army stay prepared to prevent incidents involving Japanese nationals.¹⁹⁴ On the whole, Chinese political elites and Japanese military forces each perceived an

¹⁹⁴ "Wang Sees Menace in Japan Loan," *Seattle Post Intelligencer*, December 1, 1927; "Nationalists Also Protest S.M.R. Loan. C.C. Wu Feels America is About to Change Her China Policy." *The Shanghai Times*, December 5, 1927; National Archives and Records Service of the United States, "Records of the U.S. Department of State relating to internal affairs of Japan, " files 0252,0285; Takeuchi (1935), pp.30-31.

increasingly adverse security dilemma, which also meant that there was a clear gap between the behavior of high finance and the outcome that high finance expected that behavior would facilitate.

Domestic and international political opposition to a militant Japanese foreign policy helps to explain why peace was preserved for a few more years. In July 1929, when the pro-Shidehara cabinet of Hamaguchi was appointed, the new cabinet's agenda called, once again, for improving relations with China and promoting multilateral arms controls and arms reductions.¹⁹⁵ In agreement with what expected, greater caution was infused in the existing national security agenda. As Inouye (1931:153) and Kirshner (2007:58-88) have already remarked, conciliatory military measures were conceived by the newly-in-power pro-Shidehara front as *necessary* to let deflationary policies shine and allow Japan to return to the gold standard. Crucially, deflationary policies needed to succeed first of all because Japan's international credibility was at stake, and Japan's international credibility was at stake because of the status of Japanese finances. As influential genro member Saionji précised soon after the appointment of the Hamaguchi cabinet, "since a nation's military preparedness [...] depends first of all upon its financial status and policies, [it is] *especially important now* [that] Japan leads other nations to recognize her earnest promotion of international peace by voluntarily accepting a 60 per cent (ratio vis-à-vis the United States)."¹⁹⁶ In other words, the spread of financial chaos in Japan required a stronger disarmament stance than the one that the country would have normally

¹⁹⁵ On the program of military retrenchment of the Hamaguchi cabinet see Kirshner (2007), pp.70,71,74.

¹⁹⁶ In Harada (1968), p.85.

supported, and also closer ties with the United States, Great Britain, and the signatories of the London treaties.

Hence, Finance Minister Inoue issued new disarmament cuts in the summer of 1929, nullifying the budget that the Tanaka cabinet had passed earlier in the year, and promised more military cuts for the following year, during the naval negotiations taking place in London.¹⁹⁷ Respecting this disarmament schedule, and discounting the hostility that further military sacrifices would have met across the country—even the proponents of arms controls thought that Japan’s share of the world naval forces should be increased by then—, on March 13 (1930), the cabinet helped the works of the Naval Conference by signing the widely appeasing Reed-Matsuidaira agreement. The agreement obliged Japan to remain below the ceiling of 50,768 new naval tonnages and not build a single heavy cruiser in the future. The cabinet ratified the agreement despite the unanimous objection of the Navy and the entire opposition of the Seiyukai. The measure ridiculed the Navy’s aspiration of reaching the 10:7 ratio sometime, and created a profound fracture between Japanese military and political forces, since the linkage between balanced budget and abandoned military expansionism was no secret.¹⁹⁸ More pointedly, the reinstated financial-security

¹⁹⁷ The London Conference was called for extending and expanding the disarmament agenda that the Washington Conference had launched in 1920-22. While the Washington Naval Treaty focused on battleships, the London Naval conference focused on warships and heavy cruisers. On the London conference see Takeuchi (1935), chapter IV; Crowley (1966), p.64; Nish (1977), p.68.

¹⁹⁸ Popular resistance to the signing of the agreement led to critical clashes in Tokyo and the cabinet found itself much more isolated thereafter. Under the terms of the Reed-Matsuidaira compromise, Japan could no build a single heavy cruiser while the US could construct 14 ones between 1930 and 1936. On the results of the London conference for Japan see Beasley (1963), pp.242-244.

agenda did little or nothing to solve the crisis. The financial crisis was also spreading internationally at the time, exacerbating financial conditions in Japan.¹⁹⁹

The new resort to conciliatory measures seemed unstoppable. Complementing the reduction in tonnage with reduction in the strength of the Army, on April 2, 1931, the cabinet decided to decrease the number of its wartime divisions from 32 to 28.²⁰⁰ In September 1931, as the status of Japanese national finances appeared newly jeopardized by the British decision to abandon the gold standard, the Wakatsuki cabinet proposed even more cuts in military spending. Hostility to the cabinet's policies newly exploded, and the Japanese Army took extreme remedies to overrule the ideational and political rationale that was pushing the Japanese military forces to a position of impotence. The statutory and effective independence of the Japanese military made the resort to arms much quicker and far less controversial than anywhere else amongst the great powers. On September 18, 1931, the Kwantung Army, the branch of the Japanese army stationed in Manchuria precipitated the Mukden incident, commenced military action against the Chinese, and, in the following months, pushed into South Manchuria, doggedly and irrespectively of the cabinet's orders to stop. A month later, another incident occurred, while radical military measures were gaining the support of larger sections of the Japanese public, particularly in the rural areas, which had been hit hard by years of financial and economic crisis.

¹⁹⁹ Japanese exports to the US and China collapsed dramatically between 1930 and 1931 due to the internationalization of the financial crisis.

²⁰⁰ Crowley (1966), pp.33; Kirshner (2007), p.73; Morley (1974), p.10;

In the meantime, as the financial crisis spread internationally, and the power of high finance decreased, Japanese society became violent and militarized and disillusion with the orthodox medicine grew within the Diet. Many members of the Japanese leading political class started to reconsider the cabinet's conciliatory financial-security agenda. In two months' time from the Mukden incident, the Inukai (Seiyukai) cabinet was sworn in and, in agreement with expectations, the main ingredient of Finance Minister Takahashi's "positive" economic recipe of financial crisis response was military expansion.²⁰¹ The new budget policy, the new cabinet, and the resounding popular support that the Seiyukai and an autonomous, independent Japanese policy received at the polls in early 1932 offered moral and practical support to the military operations of the Kwantung Army on the Asian mainland. Interestingly, allusions to the interdependence between Japan's financial status and Japan's international credibility were made lesser and lesser frequently.

Between late 1931 and early 1933 Japan's financial-security agenda returned to where it had begun, namely to the denial of financial crises and the promotion of catch-up rearmament and catch-up industrialization. From September 1931 onwards, Japanese national security policies shifted from caution to assertiveness. Proponents of liberal internationalism quickly disappeared from the political arena in late 1931, and the clash of views amongst Japanese political leaders was minor compared to the political dissonance that existed between 1927 and 1929. Two factors explain this discrepancy. A first one is that a tentative foreign policy had been attempted and failed very recently (1927-29), creating a precedent that discouraged repetition. A second

²⁰¹ Military spending increased much more than any other voice of the budget of the Inoue cabinet. On this point see particularly Kirshner (2007), pp.78,79.

factor is the strong political and legal independence and prestige of the military sector in the Japanese society. Although the orthodox medicine had strenuous supporters amongst military ranks up to the late 1920s, when the Washington System started to crumble (1930-1931), disappointed military representatives and new forces joining the army and the navy transitioned towards a more assertive posture.

By early 1932, (Japanese) political and military forces had agreed on a new financial-security agenda. This point is of critical importance because the framework of the thesis concerns military forces and military policies only to the extent that they are a product of political decisions matured in response to urgent national economic needs. It is difficult to say how far into Manchuria the Army would have advanced without the cabinet's support. Although resistance to the cabinet's cautionary agenda had increased compared to 1927 due to the worsening of the global financial crisis (and the negative effects that the crisis had produced on the Japanese rural areas), the increasing incongruence of the official foreign policy towards China, and the precedent that the 1927 expeditions and the London naval conference had set, it is only between February and March 1932—that is only after the inauguration of the Inukai cabinet, the passing of the new military budget, and the approval of the new Japanese foreign policy agenda—that the Kwantung Army reached Harbin in North Manchuria and set up the state of Manchuko. The advance acquired such unprecedented scope and qualities that one can reasonably doubt it would have been achieved had a Kenseikai cabinet been in power. In other words, it would be foolish to discount the importance of the cabinet's "positive" economic and military policies on the successful takeover of Manchuria by Japanese troops.

These developments and the close interdependence between, on the one hand, financial deflation and military retrenchment and, on the other hand, “positive” economic policies and military expansionism are well known. Beasley (1963:122) has possibly offered the best explanation as to why Japanese national security policies, between 1927 and 1932, moved from caution towards assertiveness. As he writes: “Participation in a Western-dominated system set up intolerable contradictions for Japan, and accounted for much of the violent oscillations in Japanese economic and monetary policy between 1929 and 1931. After futile attempts at conciliation, Japan accepted the contradictions as antagonist, launching an assault against the system.”

What this section of the chapter brings to the debate on the reasons that informed Japan’s turn towards assertiveness and away from it in the late 1920s and early 1930s is that the global financial crisis that started in Japan in 1927, and the process of financial crisis response that followed thereafter, first in Japan only and then across the world, informed a move away from national security caution between 1927 and 1929, and from September 1931 onwards—confirming the existence of fewer constraints to the exercise of assertiveness that I expected—as well as a move back to caution between 1929 and September 1931. For instance, in April 1927 Tanaka came to power (and the shift from cautious to assertive in Japanese foreign policy occurred) because of profound disagreement amongst members of the genro, the Privy Council, the House of Peers and the cabinet over the kind of “indulgent” financial crisis response that the Wakatsuki cabinet intended to carry out. Had the financial crisis not occurred, the Wataksuki cabinet and the national security policies of the Wataksuki cabinet would have continued their life, while the extremist measures which the armed

forces undertook in the fall of 1931, after years of financial and economic crisis, would have found fewer proselytes.²⁰²

Denying this argument, some scholars (Imai 1958; McCormack 1977) have argued that there was little fundamental difference between the Shidehara diplomacy and the Tanaka diplomacy. Both cabinets, these scholars note, tried to manipulate Japanese-Chinese relations via economic and security means. This section aligns itself with the supporters of the opposite positions (Connors 1987:113; Kirshner 2007:78-83), who have noted that the swift and dramatic change in Japan's foreign policy following the appointment of the Tanaka cabinet and the Inukai cabinet.

Financial crises and Japanese national security policies in nuts and bolts

With the exception of the last stage of crisis response to the financial crisis of 1927-1933, this chapter suggests that the assumptions of the framework described in Chapter One are correct. In agreement with expectations derived from the framework, financial crises changed the direction of Japanese military spending, threat assessment, and war prospects between 1907 and 1909, between 1920 and 1922, between 1927 and 32. Also, in agreement with expectations derived from the framework, the financial crises that occurred in 1889-91 and 1896-1901 did not change the direction of Japanese national security policies but powered their character, while also drawing deeper political fractures within the government.

Three factors help to explain why the Japanese national security policies moved from caution to assertiveness during the last stage of response to the financial

²⁰² In 1927, for instance, the political supporters of an assertive foreign policy course in Japan were so few that Tanaka himself, who headed the most assertive faction of the Seiyukai, decided to put aside his determination to develop his assertive program and compromise.

crisis of 1927-31, that is from September 1931 until the end of the crisis: a) the particular ordering of the stages of crisis response that the Japanese government went through; b) the power and institutional prestige of Japanese armed forces; and c) the timing of the spread of the financial crisis across the globe. The transition from what was regarded as a corrupted government due to its questionable financial policies to a government far less committed to the orthodox medicine and national security caution that occurred during the first stage of crisis response (mid-1927-mid-1929) “failed” to herald a new financial-security agenda. The new members of the cabinet remained hesitant to embrace the ambitious dreams of new premier General Terauchi, and the Japanese military conceded. An uncomfortable precedent was created, however: to bring about a significant change in Japanese policies, awarding the premiership to a General would not suffice. With a cosmopolitan leader newly in power from July 1929 onward, an orthodox medicine that continued to disappoint, and the weakening of domestic financial interests and high finance, the political and military opposition to financial orthodoxy and military restraint became both more popular and fierce. In late 1931, the military incidents of organized by the Kwantung Army suggested that any element pointing at political moderation had become extremely unattractive.

On the whole, the examined shifts in Japanese national security policies illustrate how financial crises have marked the evolution of Japan’s relationship with the international financial system. In the pre-1900 period, this relationship is defined by exclusion, and the determination to place catch-up rearmament and catch-up industrialization before any financial variable (including financial crises). In the period between 1906 and 1927, Japan increasingly participates in the existing international

financial order, and financial factors are now recognized as a priority for Japanese security. Neglecting financial crises is now politically suicidal. Finally, disenchantment with the international financial and domestic order is what shapes, gradually, Japan's response to financial chaos from 1927 onwards.

Some traits of the distinctive influence of financial crises on Japanese politics and national security policies shall be recognized. A first one is that, in the pre-1900 period, this influence did not originate from or produce any change in premiership, cabinet, or ruling coalition—a development that does not find an equivalent in Italy or the United States. Both in Italy and in the United States, a change in the governing coalition or ruling presidential team followed the onset of *any* financial crisis between 1880 and 1940.

A second and related trait of the influence of financial crises on Japanese security policies is that the channels through which this influence was exerted changed across time. The debt-repayment mechanism, for instance, which was a constant in the Italian context, was not always at play during Japanese financial crises. In 1889-91 and 1896-1901, for instance, a rising national debt posed little pressure on the national security agenda of incumbent cabinets. But the pressure had exponentially increased by 1907. Similarly, foreign financial dependence was irrelevant to the process of financial crisis resolution in 1889-91 and 1896-1901, but it was paramount in the early 1920s and late 1920s.

A third trait that sets the Japanese experience apart from Italian and American experiences, is that the influence of financial crises on Japanese national security policies was highly modulated by the incentives that the international financial system

and participation in the gold standard offered to Japanese financial officials. Another important variable is the gradually increasing political voice of domestic financial interests. These two variables were the main drivers of the studied changes. As shown in the next two chapters, neither Italian nor American financial officials were as powerful as Japanese financial officials.

Evidence collected in the chapter further suggests that local and global financial crises did not exert a substantially different influence on Japanese national security policies. The permanence in power of a statist-nationalist government throughout the financial crises of 1889-1891 and 1896-1901, for instance, had little to do with the fact that both crises were local, and much more do with the disinterest of foreign investors in Japanese finances (and Japanese economy more generally), as well as with the absence of a democratic system of party politics in Japan. Foreign investors and foreign capital required, first of all, the local presence of a political opposition that could hold the crisis-stricken government accountable. Once that government accountability and a party system were assured, financial crises and Japanese financial officials' response to them significantly contributed to the dawn (1907-09) and success (1929-1931) of the liberal internationalism. This "peaceful" effect lasted only as long as the orthodox medicine remained a trusted instrument of financial crisis resolution internationally, and as long as the domestic political forces bearing the main costs of the medicine could tolerate it.

Another interesting finding of the chapter is that implementing the orthodox medicine of financial crisis response, and shifting national security policies towards greater prudence might not have the peace-inducing effects internationally that one

might think it would have. Between 1929 and 1931, for instance, the undertaking of drastic military retrenchment measures by the Japanese cabinet in response to the financial crisis increased the prospects of a Japanese-Chinese war. Japanese military forces had, until then, respected political authorities' decisions to a much greater extent than at any other time in the past. But drastic military cuts, at that point in time, after a decade of significant military restraint, were regarded as an irreparable setback to national security. Countermeasures were quickly taken. The finding that the pursuit of greater prudence in national security policies might not be peace-inducing is in line with the existing knowledge (Kirshner 2007) that powerful financial interests desire international peace not as an end in itself, but only as a means to an end, which is the set up and preservation of the necessary conditions for lucrative investment. Greater awareness to this simple rule by crisis-stricken cabinets promises to benefit their intended financial strategies as much as their desired national security goals.

CHAPTER III

RULES MADE ABROAD: CURBED FOREIGN LENDING AND REGULARLY FETTERED ITALIAN IMPERIALISM

“Italy faces a difficult moment for the anguish of national finances [...], but we’ll recover from it [...]
We will lift up our credit [...]
We will demonstrate [to London, Paris, and Berlin] that Italy has no aggressive intentions.”²⁰³

Antonio di Rudini to the Chamber, 1891

Italian military and economic involvement in Northern Africa between 1880 and 1940 remains a puzzle. Although the dream of founding an Italian Empire never faded from the political horizons of Italian leadership, its realization was often tenaciously pursued only to be put on hold shortly afterwards, and then resumed. This dragging out of the Italian imperialist desire for a “place in the sun” is generally explained by a number of factors, including the frequent turnover of Italian governments, the fragility of Italian institutions, the lack of financial and economic resources, and geopolitical pressures of more powerful neighbors. The importance of all of these factors emerges from the works of scholars in pre-World War I, post-World War I, and contemporary Italian politics, such as Lowe (1975) Putnam (1994), Fabbrini (2011), and Giacomello (2011).

This chapter argues that there is one particular factor, financial crisis, that had (and has) the power to set in motion these variables (and a few others, too), and that yielded critical repercussions on Italian military spending, threat assessment, and war

²⁰³ Speech by Prime Minister Antonio di Rudini to the Chamber delivered on February 14, 1891, after the denial of foreign credit to Italy from France, and the fall of the government of Francesco Crispi. AEM, Serie Politica P, busta 319, pos.54: Programma della Politica del Governo Italiano 1891-1900.

prospects—and ultimately the course of Italian imperialist ambitions. Relatedly, not only has the primary causal role of financial crises been neglected but also post-financial-crises shifts of Italian national security policies away from or towards assertiveness have been misattributed. Financial crises altered the balance of power between Italian political leaders and domestic financial interests thanks to the leverage that foreign financial markets gained on the former. To rescue their jeopardized credit rating, Italian leading authorities—generally the expression of a rearranged governing coalition after the outbreak of a financial crisis—either shifted Italian national security policies towards greater caution or desisted from inflating them.

The chapter proceeds as follows. The next couple of pages situate the Italian case vis-à-vis the American and Japanese cases. Next, expectations about the national security influence of financial crises based on the framework explained in Chapter One are drawn from relevant Italian financial and military history. Then, the chapter is divided into three main sections dedicated to illustrating the expected national security influence of the financial crises that hit Italy in 1889-1890, 1893-94, 1907-08 and again from 1931-33.²⁰⁴ Statist-nationalist governments—governments having low affinity with high finance—were in power at the start of the first two financial crises. Conversely, cosmopolitan governments led the nation when the latter two crises began.

The Italian security context differed from the Japanese and American ones in significant ways. As much as the Japanese military was impressive, the

²⁰⁴ Financial crises also hit Italy in 1914, 1921-22, and 1935-36. For reasons of space, only four financial crises are treated in the chapter. The discussed crises have been selected with an eye to discussing each of the four branches of the analytical tree presented in chapter 1.

disorganization and institutional weakness of the Italian army were notorious. Since Italian colonial ambitions and geopolitical pressures continued between 1880 and 1940, military inadequacies translated into recurrent and abysmal military fiascos.²⁰⁵ Similarly, Italian alliance politics was amongst the most volatile and unreliable in Europe. The political stances of Japan and the United States were less ambiguously defined even when Tokyo and Washington did not belong to any international alliance.²⁰⁶

The capriciousness of Italian alliance politics found an equivalent in the multifaceted character of Italian parliamentary politics and governing coalitions.²⁰⁷ Both traits were also a function of whether British, French, German or American high finance could fund Italy's economic, industrial, and military development. Although the largest Italian private banks had close political ties with Palazzo Chigi, and these ties prevented the financial decentralization characteristic of the American environment, the Italian government and Italian bankers were constantly in need of foreign funds. Italy did not have an effective tax collection system—like Japan had, and Italian private financiers were a shadow of Wall Street's titans. As a result, financial dependence on foreign banking houses characterized Italian politics to a much greater extent than Japanese or American politics.²⁰⁸ High exposure to high finance soon after financial crisis outbreak was also very likely.

²⁰⁵ Rochat and Massobrio 1987:37,60,128,268; Lowe and Marzani 2002:6,7,22.

²⁰⁶ *Ibidem*.

²⁰⁷ On the coalitional nature of Italian governments see Mack Smith 1997, pp.97–103 and Verzichelli 2007, pp.2,6,9,10.

²⁰⁸ On the Italian financial system see Posner 1978, pp. 225,229,234,235; Serra 1987, pp.611–612; Goodman 1992, pp.142–143, and Fratianni and Spinelli 1997, p.88.

Financial crises changed the direction of Italian national security policies by altering the relative importance or desirability of obtaining the support of German, French, British, and American capital instead of investing in military preparedness and expansion. During financial crises, the Italian government lost a large chunk of its loan-repayment ability and financial credibility, and high finance could effectively use the threat of withdrawing its financial support to steer the Italian national security policies towards greater caution.²⁰⁹ Differently from the American case, change in partisanship and governing coalition was part of the historical equation through which financial crises exercised their influence on Italian military spending, threat assessment and war prospects. For the Italian case to a greater extent than the Japanese case, changes in partisanship and governing coalitions were expressions of parliamentary reshuffling and bargaining amongst different groups rather than the replacement of a party-led government with another. Italian parties were fluid aggregates in which political identities were reshuffled rather frequently. Rescuing the financial credibility of the Italian political leadership after financial crisis outbreak necessitated the formation of a new parliamentary majority committed to place national finances on a sounder track. The consensual nature of Italian politics and the organization of political consensus around one leading figure made coalitional adjustments with the replacement of prime ministers more common than Japanese-style cabinet overhauls. Finally, national financial dependence from abroad increased

²⁰⁹ Italian financial dependence was significant between 1885 and 1900. It drastically decreased between 1900 and 1907 due to the favorable circumstances such as a booming economic growth and related easy access to financial capital and a temporarily favorable capital account in the national balance of payment. It swiftly climbed up during WWI and it was extreme between 1919 and 1934.

the power of the domestic financial sector—at least during a first phase of response to the financial crisis.

EXPECTATIONS

The framework discussed in Chapter One is valid if, after financial-crisis outbreak, an Italian government having low affinity with high finance curbed its pre-crisis (assertive) national security agenda under high exposure (*LA-HE*) and enhanced it under low exposure to high finance (*LA-LE*). Conversely, an Italian government having high affinity with high finance should, after the outbreak of financial crisis, push its national security policies towards extra-prudence under high exposure to high finance (*HA-HE*). This section formulates more specific expectations after discerning which of the three aforementioned scenarios was realized after the start of financial crises in 1889-91, 1893-94, 1907-08, and 1931-33.

Two financial crises rocked Italy between 1880 and 1900: the local-turned-global financial crisis of 1889-91, and the local financial crisis of 1893-94.²¹⁰ The first crisis started locally (in 1889) due to a credit-fueled overexpansion of the building industry. It was then compounded in late 1890 by the failure of the Baring Brothers (the world's largest merchant bank), which brought to an end the international speculative excesses and investment mania that had developed throughout the 1880s across the major European markets. The inflow of capital from London and Paris to

²¹⁰ Other countries in other continents also experienced a financial crisis in 1893—namely the United States, South Africa and Australia. However, there was no direct connection amongst the crisis episodes that Italy, the US and Australia experienced, although it can be said that the deflationary effects of the 1889-91 crisis were still present in 1893 and were not irrelevant to the Italian, American and Australian financial crises of 1893, even if these crises had a local breadth.

Italy stopped, and the Italian economy suffered a deficit and debt crisis as a result (Table 3.1).

*Table 3.1. Financial Crisis Statistics 1880-1897 (in million lire)*²¹¹

Year	Deficit	Debt/GNP	Gross Investment
1886	-213	1.07	1915
1887	-219	1.164	1521
1888	-386	1.22	1391
1889	-488	1.22	558
1890	-222	1.123	1203
1891	-206	1.11	1552
1892	-129	1.23	887
1893	-48	1.20	1190
1894	-175	1.27	724
1895	-95	1.22	707
1896	-98	1.24	909
1897	-36	1.29	546

In 1889 the withdrawal of French capital cut gross national investments in half compared to 1888; the state deficit reached the never-seen-before peak of 488 million lire; and the national debt climbed to the exorbitant level of 122% of GNP.²¹² After 1891, national finances struggled to sustain recovery, and between 1893 and 1894 the nation was caught in another financial crisis.²¹³ This time the crisis was triggered by the discovery in 1892 of widespread irregularities in the administration of key domestic financial institutions, and the eruption of scandals involving eminent governmental figures. Between 1893 and 1894, banking scandals and the collapse of leading national banks such as the Credito Mobiliare and Banca Generale brought the

²¹¹Data obtained or calculated from Ercolani, pp. 442-448; Serra, p.235, and Mitchell, pp.907-922.

²¹² On the Baring crisis see Mitchener and Weidenmier (2007); Eichengreen (1999), pp.249-270; Fern (1992), pp.241-273; Ford (1956), pp.127-150; Ferguson (1998), pp.863-73; and della Paloera and Taylor (2001). On the crisis in Italy see Toniolo (1973), pp.17,18,87-88; Mitchell (1975), p.375; Kindleberger (1984), pp.142-43; Repaci (1962), p.29; Webster (1975), p.18; and Warglien (1987).

²¹³ The Banca Romana had over-issued and falsified its balance sheets to conceal bankruptcy for years. Overnight, the Bank's practices became public knowledge. For an in-depth account of the Italian financial crisis of 1893-94 see Toniolo (1990), p.93; Fratianni and Spinelli (1990), p.91; De Rosa (1997), pp.252-253; Forsyth (1993), pp.9-10; and Warglien 1987, p. 403.

national banking system down, while the national debt exploded, reaching its worst value ever (at 127% of GNP).

Original documents I accessed at the Archives of the Italian Foreign Ministry display the anxiety that the withdrawal of foreign capital caused Italian state authorities, as financial intermediaries were regularly sent to London, Paris and Berlin to raise loans “in the best interest of Italian affairs,” and to reassure investors of the country’s “financial rectitude.”²¹⁴

A statist-nationalist government having low affinity with high finance was in power at the start of both crises. In 1889, the Historical Left—a conservative coalition that united the interests of the great industrial oligopolies of the Northwest with the landowners of the South—was led by Francesco Crispi and combined an audacious foreign policy of military conquest in Eastern Africa with a protectionist economic agenda.²¹⁵ The heterodox character of the financial policies promoted by the Crispi government in the late 1880s was manifest in its determination to pursue a tariff war against France and condone bank-note circulation vastly exceeding any legal (and orthodox) credit limit to cover up repeated failures in the private banking sector.²¹⁶

The mounting levels of national deficit and debt that the security agenda of the Crispi

²¹⁴ ASMAE, Serie Politica P, busta 448, fascicolo “Finanze Italiane: notizie, manovre ostili, missioni;” and ASMAE, Serie Politica P, busta 319, pos.54, “Programma della Politica del Governo Italiano.” See also Toniolo (1898), p.287.

²¹⁵ Quite counter intuitively, the “Right” was much more progressive than the “Left” in 19th century Italy. The (conservative) Historical Left favored the expansion and strengthening of national defense industries, an assertive national security policy line, and commercial protectionism. By contrast, the (liberal) Historical Right encouraged social services, middle-sized national industry, and very moderate defense budgets. On the distinction between the two blocs and their different financial and security preferences see Manacorda (1968), pp.21,22,23,94,141-149; Barone (1972), pp.568-69; Kogan (1963), pp.29,30;

²¹⁶ On the Italian tariff war against France and the government’s lifting of legal restrictions on credit see Mack Smith (1997), pp.143-148. Crispi regularly intervened in the national financial market to persuade the larger domestic financial houses to cover the costs of failing banks.

government demanded during these years snubbed high finance and financial orthodoxy. The Historical Left was newly in power at the start of the 1893-94 financial crisis. This time, the coalition had appointed ex-Treasury minister Giovanni Giolitti to the premiership, in the hope of convincing high finance of the financial trustworthiness of the Italian political leadership. Government affinity with high finance continued to be low, however. Premier Giolitti remained committed to the same economic policies he had backed as Treasury minister. As Crispi had done, he condoned heterodox free printing by Italian national banks, and illegal printing and fraudulent activities by a number of Italian commercial banks.²¹⁷

After the onset of the financial crisis of 1889-91, the Crispi government found itself highly exposed to the pressures of high finance. The Left intended to preserve its access to foreign capital and keep domestic markets afloat by strengthening collusive relationships between the cabinet and Italian banks of issue and bailing out domestic financial institutions that began to suspend payment.²¹⁸ The spread of the financial crisis across the major financial capitals—for reasons other than the Italian financial crisis—and the leaking out of irregularities within the Italian banking system thwarted these intentions. In the late 1880s, international liquidity had started to shrink, and, up until 1891, high finance was involved in international rescue efforts to save the Baring

²¹⁷ On this point see in particular Webster (1975), pp.20,21; Giolitti Memoirs, pp.76-77. More broadly, on the heterodoxy of the Left see Tattara (2003), pp.122-142. It is interesting to note that the financial heterodoxy of the Left did not impede it from receiving the political support of eminent *domestic* bankers. The Banco di Roma, for instance, was a

²¹⁸ The Italian banks of issue in the late 1880s and early 1890s were private companies with shareholders who sought profit. For an account of the collusive practices through which the Crispi government persuaded large Italian banks to keep the system afloat see Fratianni and Spinelli (1991), pp.90; Mack Smith (1997), pp.148-49; De Rosa (1963), pp.375; Barone (1972), p.584.

Brothers and the international financial system.²¹⁹ Securing foreign credit by selling large quantities of state bonds became more and more difficult for the Italian leadership but still remained a priority. In the meantime, domestic banking difficulties increased, revelations of wrongdoings continued to surface, and Italian bankers defended themselves from accusations by implicating the Crispian leadership. Political opposition was galvanized, private commissions of inquiry were instituted, and, in February 1891, the government fell to the advantage of the more financially virtuous (or orthodox) Historical Right. Its frontrunner Antonio S. M. di Rudinì subscribed to drastic “economies” to stop the decline in popularity of Italian state bonds abroad.²²⁰ Only then did fears dissipate, albeit only temporarily.

Government exposure to high finance was high even during the first phase of response to the financial crisis of 1893-94, even if a conservative government was newly in power, this time its affinity to high finance was high. The resolution of the 1889-91 financial crisis had increased the domestic power of Italian financial and economic elites, and the ability of foreign state leaders to control Italian financial policies. After the start of the crisis in early 1893, the further loss of Italy’s international financial prestige became intertwined with a domestic ethical, financial and political crisis conducted on the battlefield of real or presumed scandals. The Giolitti government was powerless in the face of the crisis, and had to resort to foreign capital to resurrect the collapsing national banking structure. German financiers quickly came forward in early 1893. The localized nature of the financial crisis gave

²¹⁹ The international intervention to bail out Baring Brothers is described in Kingleberger (1978), pp.184, 185, 210, 219; Frieden, p.36.

²²⁰ Battaglia (1958), pp.339-45; Haywood (1999), p.161; and Toniolo (1990), p.90.

them an advantaged position and plenty of financial resources.²²¹ In the following months the Italian banking system was entirely rebuilt using mostly German funds. The balance of power openly swung towards high finance.

This extent of foreign financial dependence was not an ideal outcome for any Italian government, let alone a coalition representing the Historical Left. Yet, the correspondence of Italian Treasury minister Sidney Sonnino indicates that the cabinet outmaneuvered as much as it could to reach this outcome and prevent a worse one.²²² As Giolitti wrote in his memoirs, “The conditions of our budget were such that [...] we were obliged to have recourse to foreign credits [to maintain] a fixed exchange.”²²³ In November 1893, Giolitti and what had become liberal attempts to overcome the crisis were replaced by Crispi’s return to leadership and a strategy of financial crisis response that brought back financial heterodoxy and strong state intervention in the national economy. The program of economies-alone had failed, and the nation had dangerously increased its dependence on foreign bankers without successfully reducing the national debt. Taxes and customs duties on imported agricultural products were raised. Gold reserves were immobilized (so-called “Corso Forzoso”), and the banks of issue were permitted to enlarge their circulation. In December 1893, a unified, state-regulated, central note-issuing bank, the Bank of Italy was born.

²²¹ In 1893-94, financial crisis remained limited to Italy, the United States and Australia, which were at the margins of the international financial system. Alberto Acquarone, “Italia Giolittiana 1896-1915. Le Premesse Politiche ed Economiche,” pp.39-41.

²²² ACS, DDI, Seconda Serie 1870-1896, vol.XXVI, Sonnino’s letter to Blanc, 25 December 1893. On the reconstruction of the Italian commercial banking system with the help of foreign capital see Acquarone, pp.39-41; Kindleberger 1993, p.143; Hertner, pp.69-101; and D’Alessandro (1968), p.459.

²²³ Giolitti, Memoirs, p.62.

Giuseppe Marchiori, the chief of the old and less powerful Bank of Italy took the place of Giacomo Grillo, as desired by the Treasury Ministry.²²⁴

These developments allow for formulating the first set of expectations on the influence of financial crises on Italian national security policies. If the framework advanced in Chapter One is correct, this is what should have happened to Italian national security after the two financial crises just described. Since Crispi and his conservative government found themselves in scenario LA–HE after the start of the financial crisis of 1889-91, the agenda of foreign policy assertiveness that the Historical Left had pledged Italy to under Crispi should have been curbed. Similarly, after the start of the financial crisis of 1893-94, and during most of financial crisis year 1893, Italian military spending, threat assessment, and war prospects should have become extra—since the Giolitti government was in scenario HA–HE. However, the failure of the orthodox medicine to resolve the crisis, and the materialization of scenario HA–LE in late financial crisis year 1893 and in 1894, should have removed some of the existing constraints for shifting Italian national security policies towards greater assertiveness (HA–LE). In due course, this new phase of crisis response should have allowed the Crispi government to revert back to its original, ambitious security agenda.

The Italian financial system was hit again by a financial crisis in 1907, when panic and crashes spread through world markets, impelling a halt to foreign lending.

²²⁴ The government refused altogether to consider the right of emission of currency as a privilege given to a group of private capitalists. As Sonnino stated to Parliament in June 1893, “while respecting the interests of the private, the State needs to defend the interests of the State!” On this second phase of response to the 1893-94 financial crisis, see Manacorda (1986), pp.141-145; 174; Sonnino, *Discorsi Parlamentari*, Camera, June 29, 1893, p.37.

Like the main powers in Europe, before the crisis Italy had experienced unforeseen levels of economic prosperity, booming investment, and an abundance of liquidity (Table 3.2).²²⁵ Although the gross national product continued to grow, in 1907 and 1908 a sudden and drastic reversal in credit lines brought many on-shore and offshore banks and investment projects to a standstill, causing price deflation, cut backs in employment, industrial overproduction, and a worsening of the budget.²²⁶

Between June and October 1907, major commercial banks like the Società Bancaria Italiana (SBI) and the overextended Banco di Roma were temporarily paralyzed in their ability to repay their debts and function as financial lenders. Industrial sectors were brought down too, as a result.²²⁷ Witnessing the beginning, development, and end of the financial crisis in Italy was the second Giolitti government, in power between 1903 and 1905, and then again from June 1906 until December 1909. Between December 1909 and March 1911—after the end of the financial crisis on Italia soil—the premierships of, respectively, Sidney Sonnino and Luigi Luzzatti replaced the Giolitti leadership. Both premierships had a liberal character and their majority in parliament remained essentially the one that Giolitti had shrewdly assembled.

²²⁵ The national deficit had disappeared altogether by 1905.

²²⁶ For an account of the 1907-08 financial crisis see Frieden (2006), pp.36-39; Kindleberger (1978) pp.132,133,171,185,186; and Sayers (1936), p.111. See also the description of the crisis offered in chapters two and three of this work. On the crisis in Italy during these years see Forsyth, (1993), p.7; Bonelli (1971); Bonelli (1982); Toniolo (1990); Ciocca e Toniolo (1999), pp.194-98.

²²⁷ Entire national industrial sectors—the steel, cotton, and mechanic industries in particular—were paralyzed. On the industrial dimension of the crisis see especially De Rosa, *Storia del Banco di Roma*, pp.180-181.

Table 3.2. *Financial Crisis Statistics 1904-11(in million lire)*²²⁸

Year	Surplus/ Deficit	Gross Investment	Banknote Circulation	Real GNP	Inflation
1904	46	1839	445	13650	0.0109
1905	63	1889	442	14421	0.0054
1906	72	2130	438	15156	0.0161
1907	92	3668	437	16460	0.0510
1908	52	2942	436	16773	-0.0103
1909	22	3754	433	18593	-0.0319
1910	-10	2697	442	17351	0.0259
1911	-35	3644	485	19215	0.0252

Giolitti had broken ties with the Historical Left of the 19th century. Gathering forces from the left, the right and the center through a strategy later known as “transformismo,” he had assembled a coalition that, up until World War I—and quite singularly in the Italian context—faced no serious political competition.²²⁹ The coalition had an unwaveringly liberal character. Before the onset of the financial crisis, the Giolitti government had demonstrated its high affinity with high finance by favoring the free-trade interests of small and medium-sized industries, promoting social reforms, assuring the development of ordinary credit institutions and economic opportunities at home and abroad, and opposing high military spending and expansion.²³⁰

²²⁸ Data obtained or calculated from Ercolani; *Sommario di Statistiche Storiche Italiane*, pp.163,164,447,448; Serra, *Il Debito Pubblico Italiano*, p.235; and Mitchell (1975), pp.907-922.

²²⁹ In Giolitti’s governing coalition, socialist, republican, and radical forces would coexist with catholic forces of the Right. See, for instance, Webster (1975), pp. 24-26; Kogan (1963), pp.31-32; and Haywood (1999). The stunning economic and industrial development of this period clearly explains the anomalous and almost uninterrupted regnum that the coalition enjoyed. On the lack of a serious political alternative to the liberal front see Haywood (1999), pp.267-394; Rochat and Massobrio (1987), p.164; and Whittam (1977), p.180. From December 1909 to March 1911, Giolitti’s premiership went to Treasury Minister Sidney Sonnino and then to Treasury Minister Luigi Luzzatti. Both governments were liberal, like their predecessor. Conservative forces gained power only in March 1914.

²³⁰ De Rosa (1997), p.255; Haywood (1999), pp.267-394; Rochat and Massobrio (1987), p.164

After the onset of the crisis, the government was highly exposed to high finance—by choice more than by necessity. Treasury minister Paolo Carcano had excellent relations with Governor of the Bank of Italy, Bonaldo Stringher, and left him in charge of saving the national financial system. In the spring of 1907, while resisting pressures for the indiscriminate financing of firms whose financial conduct had been irresponsible, the Bank of Italy began to grant several lines of credit to rescue the SBI. As fears of panic spread across the national system in the fall of 1907, the Bank of Italy organized a consortium to assist a number of troubled financial institutions, providing liquidity in all directions. The increase in circulation was exceptional compared to any increase recorded before that time.²³¹

The government helped the success of this infusion of liquidity by limiting paper money printing and preserving its creditor position (Table 3.2). Distancing himself from the behavior of conservative leaderships on occasion of the financial crises of 1889-91 and 1893-94, Carcano recognized the existence of “a temporary state” of financial tension and reassured national markets of the “solid foundations” of Italian credit, the presence of a substantial cushion of reserve cushion, and the enduring “prestige” of state bonds.²³² The Bank emerged from the crisis-response process as the effective lender of last resort, endowed with greater political strength and freedom of movement in the national money market.²³³ The stabilization of European financial markets through similar bailout efforts spearheaded by the Central Banks of Britain, France, Germany and Russia, and by the transnational cooperation of

²³¹ Bonelli (1971), pp.58,62,93,124; Toniolo (1990), pp.115,253; Forsyth (1993), p.43.

²³² Quoted from Carcano, Annual Financial Exposition to the Chamber, Biblioteca del Senato, AP, Legislatura XXII, Discussioni Camera, 7 December 1907.

²³³ See in particular Bonelli (1971), p.63.

tycoons of high finance such as J.P. Morgan and Nathan Rothschild indirectly helped the resolution of the financial crisis within Italian borders.²³⁴ Much less successful was the response to the spread of the crisis to Italian offshore colonial possessions. Assistance to subsidiary financial and industrial firms located in Northern Africa was not forthcoming.

Since the Giolitti government had a high affinity with high finance before the start of the financial crisis of 1907-08, and a high exposure to high finance after the start of the crisis, Italian national security policies should have become extra-prudent according to the framework. This shift should have taken place as a result of the greater reliance on financial orthodoxy demanded by the process of financial crisis resolution.

The last set of expectations is derived from the response by the first regime of Benito Mussolini to the global financial crisis of 1929-33, which hit Italy between late 1931 and early 1932, peaking between mid-1932 and early 1933.²³⁵ Differently from what occurred in 1907-08, international financial cooperation and the orthodox medicine did not work this time, and a wave of bank failures spread through North America and central Europe. By the time the crisis reached Italy, gold convertibility had already been suspended in London (September 1931). Between 1931 and 1933, the condition of Italian finances changed radically. Following the cancellation of American loans and the suspension (and then cancellation) of German reparations,

²³⁴ On the resolution of the global financial crisis of 1907-08 at the center of the financial system see De Cecco (1987), pp.103-26; Frieden (2006); pp.106-07; Kenney (1989), pp.202-49; Kindleberger (1978), pp.185-86; Withers (1911), pp.288-89.

²³⁵ On the global financial crisis of the early 1930s see Eichengreen, *Golden Fetters*, op. cit., pp.268-91; Barry Eichengreen (2008) pp.72-92; Claven (1996); Strange (1988), p.101; Frieden, *Global Capitalism*, pp.182-194.

five large Italian banks that had long sustained excessive risk-taking activities failed. Next to the credit crunch and bank failures, the national economy faced the explosion of deficit and debt levels, a sharp contraction in industrial production and GNP growth, and a currency and exchange rate crisis (Table 3.3).²³⁶

Table 3.3. Italian financial statistics 1929-1937(in million lire)²³⁷

Year	Real GNP	Debt/GNP	Lira E.R. vs. \$/average	Gross Investment	Deficit
1929	111543	0.693769	100/100	27705	1525
1930	189453	0.770744	100/101	19527	1858
1931	125415	0.896783784	99/105	16446	2532
1932	109578	0.968009346	98/111	16355	5968
1933	105706	1.091553986	125/119	14399	5615
1934	105344	1.132054108	164/128	15335	8458
1935	110564	1.049267857	158/121	23252	6040
1936	110977	1.084823529	135/100	21738	15000
1937	129606	1.005468085	100/84	30285	19000

As in 1907-08, a government having high affinity with high finance was in power before the onset of this crisis, too. Mussolini's *quota novanta* policy, which implied a commitment to maintaining a fixed exchange between the lira and the US dollar (and the lira and the British pound), was one indication of the respect which financial orthodoxy enjoyed within the Italian government in the late 1920s.²³⁸

Although reasons of prestige and strategic revenge undoubtedly informed Mussolini's fascination with his *quota novanta* policy, in the late 1920s the regime exhibited its commitment to international financial cooperation by participating in debt-

²³⁶ See, for instance, Battilossi (2009), pp.101-134; Ciocca and Toniolo (1976), p.22; Ciocca (1999), pp.277-288; Catalano (1969), pp.4,5; De Cecco (1993), p.625. On the cancellation of American loans to Europe refer to the chapter four.

²³⁷ Data obtained or calculated from *Ricerche per la Storia della Banca d'Italia*, vol.I, p.358,359; Ercolani, pp.442-43; *Sommario di Statistiche Storiche Italiane*, pp.163,164; Serra, *Il Debito Pubblico Italiano*, p.235; and Mitchell (1975), pp.907-922.

²³⁸ With the "quota novanta" policy, which was kicked off in December 1927, the exchange rate was pegged to lire 92.46 versus one British pound and lire 19 versus one dollar. See Toniolo (1990), pp.327-350.

restructuring agreements to save financially endangered European governments, and by continuing to negotiate financial loans with high finance on behalf of the Italian government. The same 1927 stabilization of the lira at the heart of the *quota novanta* policy was achieved through a loan granted by J.P. Morgan. Moreover, fascist forces shared their hold on power with Italian financial interests.²³⁹

After the spread of the global financial crisis in central Europe and in Italy, Italian leaders trusted the power of liberalist crisis policies—the same policies that had saved Europe from financial collapse throughout the 1920s. Showing its high affinity with high finance, in June 1931, when the crisis had spread through Austria and not yet affected Italy, Italian minister of foreign affairs Dino Grandi offered the support of the Italian government to the international stabilization loan for saving the Viennese banking system; expressed hostility about the German project of economic custom union with Austria; and reiterated the necessity of condoning war debts and reparations during international financial conferences in Paris and London (in July 1931).²⁴⁰ Concurrently, Mussolini praised the “high moral meaning” of the Hoover initiative, and took on shareholdings weighting heavily on the Italian banking system, in an attempt to bring financial relief to domestic financial markets while auspicing the international success of the orthodox medicine.²⁴¹ The cabinet even completed a domestic custom reform dominated by liberal principles. In 1932, Italian finance

²³⁹ MAE, Ufficio Trattati, Anno 1929.

²⁴⁰ Grandi (1985:I), pp. 393-4.

²⁴¹ ACS, DDI, VII Serie, 1922-1935, t.650; ACS, DDI, Settima Serie, 1922-35, volume X, pp.541-676. ACS, DDI, Settima Serie, Serie 1922-35, volume X, Appunto di Grandi, 19 June 1931, and ACS, PCM, Anno 1934-36, 1.1.7/4236. See also Ciocca (1999), pp. 276; ACS, SPD, CR, Busta 1 (De Stefani), March 24, 1931. To the extent that it pledged to a cancellation of war debts and reparation, the Italian position was even more “orthodox” than the American-British line.

ministers Antonio Mosconi and Guido Jung promoted deflationary policies and harsh budget cuts, with deleterious consequences on GNP growth (Table 3).²⁴²

State finances gave no visible sign of improvement, however. Italian large commercial banks struggled and failed. Between 1932 and 1934, the exposure of Italian state authorities to international financial cooperation and high finance was evident in the declining fortunes of domestic financial actors and in the increasing international resort to heterodox policies by other nations, Great Britain included. During the London Monetary Conference of June-July 1933, Italian representative Alberto Beneduce reported to the Italian delegation and the Italian government that President Roosevelt's proposition to delink the Italian exchange from its gold parity value promised to heighten the financial crisis rather than solve it.²⁴³

In Rome, the Duce continued to be faithful to the deflationary “quota novanta” policy (and the international gold bloc), but he also produced the Italian version of the American New Deal by establishing two mercantilist institutions, the Istituto Mobiliare Italiano (IMI) and the Istituto per la Ricostruzione Industriale (IRI), to reorganize and return to the market the national industrial enterprise—particularly the mechanic and metallurgic sectors.²⁴⁴ In January 1934, the government turned towards financial heterodoxy with the decision to issue large quantities of treasury bonds to be absorbed by the “revitalized” domestic market. Italian deficit and

²⁴² ACS, PCM, Anno 1934-35, Mosconi's communication, October 6, 1932.

²⁴³ Beneduce's message and other correspondence can be accessed at De Cecco (1999), pp.454-58.

²⁴⁴ Until 1933 the Italian industry was dominated by the textile sector. The mechanic and metallurgic sectors expanded by leaps and bounds between 1933 and 1935. See *Indici delle condizioni economiche e finanziarie dell'Italia dal 1922 al 1930*, Roma (1940), *Compendio Statistico Italiano*, 1940, Vol.XIV, cap. XX, ISTAT. See also *L'Economia Italiana nel Sessennio 1931-36*, parte II, vol. II, a cura della Banca d'Italia, Rome 1938, pp.1268-69 and ASBI, *Rapporti con l'estero*, cart.108. Dattiloscritto: “Appunto anonimo sulla costituzione dell'oro.”

debt increased but not by much and not for long (Table 3.3).²⁴⁵ A few months later, the Italian ambassador in Washington, Rosso, notified American authorities that Italy would not pay its debt disbursement before everyone else had done so.²⁴⁶ By 1935, the state intervention in the Italian economy was reflected in GNP growth.

Because of the high affinity with high finance of the Mussolini government at the time of the financial crisis, and because of the same government's low exposure to high finance throughout the crisis, expectations on the influence of the crisis on the course of Italian national security policies cannot be extrapolated from the framework.

FROM CURBED TO SUICIDAL MILITARY MOVES TO SALVAGE FINANCIAL
CREDIT: *Financial crises and Italian 19th century imperialism*

Italian military strategy in Eastern Africa during the Victorian Age earned intense domestic criticism and significant international mockery for the “incredible incompetence,” to quote Giovanni Giolitti, in the “organization and direction” of the enterprise.²⁴⁷ How did the Italian political and military leadership achieve this miserable record? Existing literature answers this question by recognizing that the systemic and domestic pressures shaping Italian national security policies combined to create a recipe for abrupt changes and military disaster. Systemic pressures originated from Britain, France, Germany and Eastern Africa. For instance, Webster (1975:47), Whittam (1977:121), and Mack Smith (1997:113,120) have observed that Italian assertiveness originated from wake-ups calls such as French expansionism in

²⁴⁵ ACS, AP, Camera dei Deputati, Legislatura XXIX, 1a sessione, Discussioni, May 18, 1935.

²⁴⁶ ACS, DDI, VII Serie, 1922-35, vol.XV. On the role of international pressures in shaping Italian national security decisions see Webster (1975), p.47; Whittam (1977), p.121; Serra (1987), p.611; and Mack Smith (1997), pp.113, 120.

²⁴⁷ Giolitti as quoted in Mack Smith (1997), p.168.

Morocco; British welcoming of an Italian presence in Africa as background support for the British campaign against Sudan; German fears that a shaken Italy might throw herself in the arms of France, Russia, or Britain; and the arming of Ethiopian forces by Emperor of Ethiopia Menelik.²⁴⁸ Domestic pressures originated from money scarcity (or abundance), and the related necessity to pursue stringent financial policies (or privilege not to do so).²⁴⁹ Stressing the role of domestic constraints and diversionary motives in explaining changes in Italian national security policies, Mack Smith (1997:133, 167-68), Romano and Bosworth (1991:128) and Serra (1987:612) have also noted that factors such as production gluts and surfacing episodes of financial distress and corruption fueled the charm of an Italian African Empire and infused the false appearance of Italian military strength.²⁵⁰

As a result of these pressures, Italian national security policies experienced two major and bizarre changes in the Victorian age: in 1891 the Italian leadership abandoned an ambitious, expansionist foreign policy and embraced cautionary military spending, threat assessment and war prospects; in 1893, the opposite occurred.

²⁴⁸ In the late 1880s and in the early 1890s interstate relations indicated a growing rapprochement between France and Russia, and a deterioration in British-German relationships. On British reasons for supporting Italian military expansion in Northeast Africa see Mack-Smith (1997), p.164. On German (and Austrian) reasons see Pribram (1920:II), p.54 and Serra (1987), p.611.

²⁴⁹ See also Lowe and Marzani (1975:66). Arms trade in Western weapon had allowed Menelik to arm its forces and increase Ethiopia's military power. Other sources of domestic pressure have been identified in nationalism and changes in national political leadership. Structural- and domestic-level explanations of changes in Italian national security policies are not incompatible. Historians have often combined explanations at both levels to enlighten Italian national security decisions.

²⁵⁰ Other domestic factors include nationalism, Italy's questionable status as a great power, regional unrest, and political competition. See also Whittam (1977), p.124; Lowe and Marzani (1975:57); Seton-Watson (1967:18); and Rochat and Massobrio (1978:109,115-16). On the forward-jump in European economic growth of the first half of 1880s see Toniolo (1973), p.87; Mitchell (1975), p.375; Kindleberger (1984), pp.142-43.

This section updates existing interpretations of the causes of Italian petty colonial adventures in the late 19th century from the perspective of the overlooked role of financial crises and the process of financial crisis responses on Italian national security decisions. Existing accounts on the domestic economic foundations of the change in Italian national security policies that was realized in 1891 or 1893 leave some puzzling questions. To begin, why would financial stringency become an imperative specifically in 1891 and again in 1893? Second, why would Crispi refuse to provide the army with the means necessary to win the war against Ethiopian forces in 1893? Third, if it is true that in 1893 Crispi was “anxious” (as Mack Smith put it) about the status of the state’s finances, why did he not act to impede an assertive Italian African policy? This section responds to these questions by illustrating that the financial crises of 1889-91 and 1893-94—and related processes of financial crisis response—shifted Italian national security policies towards greater cautiousness. What accounted for the different character of the shift was the different scenarios (or different balance of power between government authorities and high finance) that came about in the context of each financial crisis.

The section suggests that, in financial crisis years 1889-91 and 1893-94, money scarcity (or abundance), financial corruption and distress, and overproduction were intermediate variables taking different values or becoming consequential depending on the affinity-exposure scenario that Italian governments faced.

Relatedly, the findings of the section challenge both the power of the diversionary theory of war and the overproduction thesis in explaining changes in Italian national security policies in the Victorian age. These results are in line with available findings.

Interestingly, while financial distress and corruption have been described as the trigger of expansionist turns in Italian foreign policy—along the lines of diversionary war theory and overproduction-fueled expansionism—economic factors have also been linked to the playing down of jingoism and the pursuit of cautionary military spending, threat assessment, and war prospects. Mack Smith (1997:133, 168), Rochat and Massobrio (1978:131) and Haywood (1999:161), for instance, have argued that, in 1891, the shift towards caution in Italian national security policies matured or emerged out of the growing conviction that financial stringency was an urgent and imperative necessity.²⁵¹ Mack Smith even went as far as to claim that financial stringency would explain why Crispi refused to fund the Italian army exactly when military operations against Ethiopia were resuming (in 1893) after that they had come to a halt in 1891.

Before the outbreak of the financial crisis of 1889-91, the Crispi government unabatedly promoted military expansion in Northeast Africa while widely condoning financial heterodoxy via massive foreign borrowing, economic warfare, and the breaking of money printing rules.²⁵² Ministerial documents from the archives of Francesco Crispi and then Army General Secretary Luigi Pelloux show that, up until 1889, the Italian dream of founding an Eritrean colony in Eastern Africa enjoyed widespread support within the cabinet and in parliament. In the pursuit of this dream, the governing Left joined the central powers in the Triple Alliance in 1882, thereby abandoning its pre-1882 military restraint, opposition to colonialism, and diplomatic

²⁵¹ The literature is in agreement that a major shift in Italian national security policies occurred in 1891.

²⁵² In 1881, much to the surprise of the Italian government, the French established a protectorate over Tunis. Soon afterwards the Italian government ditched military restraint. For an account of Italian colonial policy in East Africa in the 19th century see Crispi, *Memoirs* II, pp.390-91; Kogan (1963), p.4; Mori (1972), pp.152-53; Whittam (1977), p.121; Rochat and Massobrio, (1987), pp.109,114-116; Mack Smith (1997), pp.114-120,132-149; Barone, (1972), pp.595-596; Ferrari (1986), p.162; Sonnino, *Discorsi Parlamentari*, pp.474, 485; Lowe and Marzani (1975); and Monzali (2008), pp.369-416.

whitewashed.²⁵⁴ Not even Italy's military defeat against the Abyssinian forces in Dogali (January 1887) stopped the government from supporting an Italian war of conquest. In July 1887, Italy's imperial plans were favored by 332 votes against 40 in the Chamber and, from 1887 onwards, Prime Minister Crispi kept propagandizing the glamour of imperialism amongst larger and larger segments of state decision-makers. Military spending skyrocketed, as shown in Table 4. In December 1888, Crispi approved a bill that allocated 127 million lire of extraordinary military expenditures, causing an increase in real military spending, compared to 1887, of almost 15% (4% of real GNP) while real government spending increased only 5% and real GNP decreased about 4% (Tab.3.3).²⁵⁵

Between 1889 and early 1890, Italian military boldness encountered its first challenges. As expected, after the onset of the liquidity crisis and debt and deficit crisis of 1889-91, Italian state leaders, despite their intention to renew their financial-security agenda (and some initial, partial successes in defending these intentions), gradually found themselves in scenario LA-HE. Previously stifled criticisms of Crispi's national security policies were brought to light in April 1889 as ministers from both the Chamber and the Senate expressed serious concern over the increasing difficulty of selling Italian public debt in London and Paris, and the uncomfortable financial dependence on foreign bankers or high finance. Since national treasury bonds sales and foreign financial dependence served primarily to fund Italy's

²⁵⁴ These motions and their lack of success even between May 1888 and December 1888 as new investments in military plans were discussed—is well evident from ACS, Crispi DSPP, b.57, 58, and Biblioteca del Senato, AP, Legislatura XVI, sessione III, tornata del 17 Giugno 1889.

²⁵⁵ This massive increase in military spending is described in Barone (1972), pp.595-596; Ferrari (1986), p.162; Rochat (1978), p.114; Mack Smith (1997), p.132.

expansionist foreign policy plans, the practice and philosophy of expansionism came under attack.

*Table 3.4. Italian real military spending (ME), GNP and government spending (CGE) in 1886-1897**

Year	Real ME	Real CGE	Real GNP	ME/GNP	ME/CGE
1886	337	1433	11200	0.0300	0.24
1887	369	1478	10521	0.0350	0.25
1888	424	1547	10128	0.0418	0.27
1889	552	1707	10328	0.0534	0.32
1890	416	1586	11141	0.0373	0.26
1891	398	1617	12000	0.0331	0.25
1892	370	1588	10919	0.0338	0.24
1893	356	1605	11250	0.0316	0.22
1894	354	1617	10600	0.0333	0.22
1895	332	1618	11125	0.0298	0.21
1896	439	1699	11000	0.0399	0.26
1897	375	1624	10800	0.0347	0.23

* Data obtained or calculated from Ercolani, pp. 445, 446 and Mitchell, pp. 907-911.

Concurrently, the need to implement a “stringent policy of economies” took on a sense of unprecedented urgency. Crispi’s archival collection revealed that on April 5, 1889, the prime minister suffered a major defeat over Italian foreign policy and military conduct in Eritrea: when the Chamber discussed potential ways to square the circle between Italian Eritrean policy and the anticipated national fiscal adjustments for the year 1888-1889, many members endorsed Finance Minister Federico Seismit-Doda’s plea for redressing the deficit and adopting a more prudent financial conduct, in line with the preferences of high finance.²⁵⁶ A process of reassessment of the financial and military measures endorsed by the Crispi government had just started—as Treasury Minister Giovanni Giolitti noted on the same day.²⁵⁷

²⁵⁶ ACS, Crispi DSPP, b.58.

²⁵⁷ Besides ACS, Crispi DSPP, b.58, see Plebano (1902), pp.102-112.

In agreement with the framework, the transition to another financial-security agenda was not immediate. Archival documents show that the Crispian leadership attempted to double-down on its military and financial measures by announcing the establishment of the Italian colony of Eritrea (January 1890), closely watching international markets' reactions to Crispi's statements, and sending emissaries to the continental financial capitals to assure the placement of Italian debt and keep the cash rolling in.²⁵⁸ The strategy functioned for awhile and on November 18, 1890, Crispi was reconfirmed to the premiership—even if the new mandate was not as broad as the former one. Between November 1890 and February 1891, however, as the news of the Baring Bank's insolvency uncovered the global nature of the crisis, and as international competition for liquidity intensified, international and domestic political pressures on the Crispian leadership mounted. Bending only slightly to these uninviting circumstances, in December 1890 and January 1891 Crispi continued to send loan-raising Italian missions abroad while promising the introduction of economies at home—in all sectors except those serving national defense.²⁵⁹ The main international banking houses with headquarters in Britain, Germany, and France did not buy the promise and refused to take in new Italian treasury bonds. Italy's international doors to liquidity were being shut. Correspondence already gathered by Marcello De Cecco (1993:760-67) documents the many disappointing messages sent by high finance to Palazzo Chigi.

²⁵⁸ ACS, Crispi DSPP, b.58.

²⁵⁹ ACS, Crispi, DSPP, b.54; ACS, Giolitti, Archivio Cavour, b.1, fasc.3; and ASMAE, Serie Politica P, b.448.

At home, Crispi's financial and military strategies started to meet the overt ostracism of several ministers. Documents from the Central State Archives and the Bank of Italy elucidate that, in late 1890 and early 1891, several members of parliament judged Crispi's national security policies and foreign loan requests as excessively onerous for being comprised within his new electoral mandate.²⁶⁰ In early December 1890, Treasury minister Giovanni Giolitti resigned.²⁶¹ Interestingly, opposition to the government's financial and military policies arose even from the Director of the National Bank, Giacomo Grillo, who, in the 1880s, was one of Crispi's firmest supporters and friends.²⁶² This indicates that political perspectives were changing because financial developments were redesigning the lines of battle. The correspondence between Crispi and Grillo and between Grillo, and Treasury Ministers Giolitti and Luigi Luzzatti further illustrates the growing strength, within the Italian government, of a policy line centered on rigid fiscal measures and a prudent military stance. As Luzzatti pointed out, continuous efforts at selling Italian treasury bonds on international markets took economic opportunities away from private Italian citizens and industrialists—the same constituencies that had supported Italian economic growth for the previous ten years.²⁶³ By early February 1891, high finance and the orthodox medicine had gained enough proselytes across the peninsula to induce the

²⁶⁰ ACS, Giolitti, Archivio Cavour, b.1, fasc.3; ASBI, Studi, cop.16.

²⁶¹ ACS, Giolitti-Cavour, s.1, fasc.3.

²⁶² As Grillo warned, a radical change in Italy's fiscal and military policies was warranted because capital was being drawn away.

²⁶³ ASBI, Studi, cop.16.

collapse of the Crispi government and coalitional rearrangement in favor of the Historical Right.²⁶⁴

As expected, the new leadership adopted a cautionary approach to military spending, threat assessment, and war prospects, as archival documents from the ASMAE and the ACS reveal. Between 1891 and 1893, the Right played down jingoism and colonial expansion, and committed to placing Italian foreign policy “back in the middle road.” Italian authorities in Eritrea were warned that the governing Right was “adverse to any further attempt at colonial expansion.”²⁶⁵ In the spring of 1891, the government of di Rudini brought Italian military expansion in Eastern Africa to a halt by signing agreements with Paris and London that limited Italian military occupation to the triangle Massaua-Asmara-Cheren (Map 3.1). Italian financial situation, not Italian neighbors, was now the real threat. Not only was a military agreement with France signed but the Right also resolved to put a decade of trade wars to an end, significantly improving diplomatic relations between Paris and Rome.

It should not be a surprise that the most radical shift in national security policies concerned national military spending.²⁶⁶ Overall, the Right’s ascent to power rested on the Italian foreign indebtedness and the related promise of implementing “all-ranging” budget reductions. Between February and March 1891, Minister of War Luigi Pelloux was ordered to reduce army expenditures in Africa “to the lowest possible sum,” and to introduce “economies” in many items or tasks of the military

²⁶⁴ Diplomatic exchanges between di Rudini and Italian embassies in London, France, Vienna and Berlin reveal the new government’s intent of “lifting up the status of Italian credit abroad” in order to obtain “greater independence from foreign bankers” and relieve “the anguish of finances.” ASMAE, Serie Politica P, b.448.

²⁶⁵ ACS, DDI, Seconda Serie, 1870-96, volume XXIV, p.22,64,65,112.

²⁶⁶ ASMAE, Serie Politica P, b.319, pos.514; ACS, Pelloux, b.45.

budget.²⁶⁷ As the encircled data in Table 4 indicate, in 1891 and 1892 military spending cuts were far-reaching. Military appropriations were slashed both in their absolute value as well as in the proportion of budget spending. Also, so quickly was the reduction in military spending happening that, in November 1892, the King ordered the government to reach annually a minimum military ceiling of 246 million lire.²⁶⁸ The ceiling was compatible with the policy of stable military quota advocated by high finance but also impeded the outflow of military funds.²⁶⁹ Although in May 1892 the Left had returned to power under the lead of Giolitti, without the King's intervention cuts would have most likely continued.²⁷⁰ The consolidated figure of lire 246 million represented, as Giolitti declared in November 1892, what was strictly necessary to maintain the efficient functioning of the army and the state's national security and independence.²⁷¹ Giolitti had come a long way since 1889, and, by 1892, the state's deficit had been significantly contained, as shown in Table 4.1.

Existing explanations of the change in Italian national security policies that occurred in 1891 rightly link it to the perceived necessity of pursuing stringent fiscal

²⁶⁷ ACS, Pelloux, b.45.

²⁶⁸ Table 3.4 suggests that the actual military spending for 1892 significantly overcame the established ceiling. That there were substantial reductions in military spending throughout these years is an established finding. See, for instance, Whittam (1977), pp.126,127.

²⁶⁹ For a description of this policy and the change in Italian national security policies between 1891 and 1893 see also Sonnino (1892), p.596; Battaglia (1958), pp.339-45; Whittman (1977), pp.126,127; Mack Smith (1997), pp.166,67; Haywood (1999), p.161.

²⁷⁰ ACS, Pelloux, b.45, Giolitti's statement of November 3, 1892. It is not surprising that the new set of fiscal and military ideas legitimized by the financial crisis encountered the resistance of the King and the war ministry. Both of them were the guarantors of conservatism. Notice that the ceiling of "246" million lire would be incorrect according to Tab.4. There are two possible explanations to this discrepancy, both of them plausible. The first is that actual military spending for 1892 significantly overcame the established ceiling and Giolitti's estimates. The second is that part of the military spending previous to 1892 was computed in the military spending of the following years (included 1892). This practice was for instance extremely common during the Great War years. That there were substantial reductions in military spending throughout these years is certain nevertheless. See Whittam (1977), pp.126,127.

²⁷¹ Ibidem.

policies, a conduct which the Historical Right embraced much more readily than the Historical Left. Rochat and Massabrio (1978:124) even acknowledge that a debate over whether budget parity or defense was a priority was taking place at the time. Yet, current explanations discount entirely the catalytic role of the financial crisis of 1889-91. Implicitly, these explanations advance the alternative hypothesis that the 1891 change governing coalition and Italian national security policies would have occurred even without the global financial crisis of 1889-91. Such an hypothesis, however, fails its hoop test.²⁷² The Left bloc would have not been dethroned from power (and the Italian African campaign would have not been stopped) had the Crispi government not been paralyzed in its ability to sell the Italian debt by the 1889-91 financial crisis. Crucially, despite the defeat suffered by Crispi's conservative coalition in early April 1889, before April 1889 and during the remainder of that year, Crispi's financial-security agenda was still rather popular. Many renowned government members—including future Treasury Minister Sidney Sonnino—were positively passionate about the Italian colonial mission in East Africa, and so was the Italian military. In early May 1889, Italian troops occupied the East African high plain. In the following months, they continued to march from Massaua to the conquest of Cheren, Asmara and Agordat, in perfect alignment with Crispi's foreign policy objectives and flagrantly outstripping the allocated military budget. Further, in July and August 1889,

²⁷² On the use of hoop tests to exclude alternative hypotheses see Van Evera (1997), pp.31-32; and Bennett (2008), p.706.

even Grillo defended the purchase of Italian Treasury bonds on international financial markets. During those months, Grillo was still a “Crispian.”²⁷³

Grillo’s stance radically changed in correspondence with the financial squeeze of 1890 and 1891 and, as earlier seen, his stance was not the only one to change. Sidney Sonnino was a strenuous supporter of Crispi before 1891. After 1891, he declared his full support for reducing the number of the armed corps (from 12 to 10), and implementing military cuts and reforms in the army. Like Sonnino, many within the government became convinced that a stringent policy of economies was an urgent necessity.²⁷⁴ The evidence so far provided not only rejects the alternative hypothesis advanced earlier but it also makes clear that had the crisis been “local” or “Italian,” the debate would have likely been tamed—as it indeed occurred between April and July 1889—and Crispi’s policies would have continued.

As expected, more cautionary national security policies—indeed extremely prudent military spending, threat assessment, and war prospects, as per HA–HE, were embraced by the Italian government during the first stage of response to the financial crisis of 1893-94. Before the onset of this crisis, and differently from the pre-1889 period, the military ambitions of the Giolitti government (May 1892 – December 1893) were kept at bay.²⁷⁵ Military activities in Northern Africa had been curbed as a result of the financial crisis of 1889-91 and the above described response, and had been on hold since. After the start of the crisis in early 1893, as financial operators

²⁷³ During the summer of 1889 Grillo, contacted international banking houses on Crispi’s behalf to allocate the Italian debt. The Italian Rendita was the main government security traded in international financial markets—These letters are found in Marcello De Cecco (1993), pp. 688-757.

²⁷⁴ On Sonnino’s rethinking and on the growing governmental awareness between 1891 and 1894 that Italy could not afford its grandiose foreign policy see Whittam (1977), p.126; Plebano (1902), pp.102-112; and Haywood (1999), p.163.

²⁷⁵ The (first) Giolitti government was formed in May 1892.

across Europe fretted over the prospect of an Italian bankruptcy, British and German authorities demanded that the Giolitti government bend even further to the dictates of the orthodox medicine.²⁷⁶ British premier William Gladstone alerted Italian Ambassador in London Count Tornielli of the need for a more serious Italian commitment to balancing the budget.²⁷⁷ Along the same lines, German and Austrian state officials provided Minister of Foreign Affairs Alberto Blanc with instructions regarding how to reorganize the Italian army to allow for “additional,” and “necessary” reductions in the military budget.²⁷⁸

Both government and parliament took unambiguous and extreme national security measures to rescue the nation’s banking system and restore financial credibility. The Chamber and the Senate introduced more radical economies in the military budget to reach budget parity, redress any unbalance between the military and other items of the budget, and defend the country’s financial independence and credit status.²⁷⁹ As shown in Table 4, military spending moved from 24 percent of total government spending in 1892, to 22 percent of total government spending during financial crisis years 1893 and 1894. In an unprecedented reappraisal of the financial-security agenda of the 1880s, military budgets were explicitly recognized as the crux of existing economic evils. In his speech to the nation in October 1893, Prime Minister

²⁷⁶ It was rumored that Italy could very likely end like Portugal and Greece (or many Latin American states) and be forced to declare its inability to continue to serve the payment of the interests on its foreign debt. ASBI, Studi, cop.66; ASMAE, Serie Politica P, b.319, pos.54 and b.448. See also Théry (1893).

²⁷⁷ ASMAE, Serie Politica P, b. 319, pos.54. Correspondence of January 1894 between the Italian Embassy in London to the Ministry of Foreign Affairs in Rome.

²⁷⁸ ACS, DDI, Seconda Serie, 1870-96, v. XXVI; ASMAE, Serie Politica P, b.448. Blanc shared the German instructions on the reorganization of the Italian army with war minister Mocenni and treasury minister Sonnino in March 1894.

²⁷⁹ See Biblioteca del Senato, AP, Discussioni Camera, Legislatura XVIII, 10-16 June, 1893 and May 1894. See also ACS, Pelloux, b.45.

Giolitti stated that the ongoing national financial crisis, which threatened both Italian financial security and the Italian ability to provide for national and allied defense, rested entirely upon a previous financial policy of excessive military spending via foreign debt.²⁸⁰

As the financial crisis continued and after that major banking scandals swept Giolitti out of power leading to the reinstatement of Crispi to the premiership in December 1893, the discrediting of assertive military policies (and financial heterodoxy) was moderated. From mid-December 1893 onwards Italian troops resumed the military activities that they had halted in 1891, and advanced east and south of the triangle Massawa-Asmara-Cheren (Eritrea), reviving the aggressive foreign policy stance and the ambitious military plans of General Oreste Baratieri—governor of Eritrea and commander of Italian forces in Africa. The Army conquered Kassala, at the border with British Sudan, and occupied Aduwa and Macalle' in northern Ethiopia (Map 3.1), fueling the resentment of Menelik, the Ethiopian Negus, and his military forces.²⁸¹ Archival documents on the exchanges between Baratieri and Crispi in the second half of December 1893 illustrate the General's expectation of receiving the desired, daring military instructions and completing the unfinished business of conquering Ethiopia.²⁸² Crispi himself, as existing explanations have rightly pointed out, did not resolutely oppose military advance, perhaps still convinced that military conquest could have lifted its popularity at home. Yet—and this is where a crucial aspect that existing explanations fail to account for—while the Italian army

²⁸⁰ ASMAE, Serie Politica P, b.319, pos.54.

²⁸¹ Italian military expansion in the 1890s is described in Battaglia (1958), pp.716-720; Seton-Watson (1967), p.181; Whittman (1977), pp.134,135.

²⁸² ACS, Crispi, DSPP, b.143, fasc.1066.

was advancing and meeting a powerful Abyssinian resistance, the military budget for the Italian campaign was not increasing but rather decreasing. As confirmed by the official collection of the Laws and Decrees of the Italian Kingdom, and by existing military data (Table 4), between 1893 and 1895 Italian military spending shrank in both its absolute value and as a share of total government spending.²⁸³ The “minimum ceiling” of 246 million lire to be allocated to the army was lowered to 233 million in May 1894 and kept declining in the following year. Crispi himself avoided asking parliament for funds and denied Baratieri the military reinforcements he demanded.²⁸⁴

Overall, headstrong military forces could do little to change a prevailing political atmosphere of ostracism towards the conservative dream of imperialist expansion in Northeast Africa. Between December 1893 and late 1895, the Italian government was split into two fronts, one represented by Finance Ministers Giuseppe Colombo (1893) and Sidney Sonnino (1894-1895), and the other heralded by War Ministers Luigi Pelloux (1893) and Stanislao Mocenni (1894-95). The Colombo-Sonnino front drew the greater majority of deputy members, enjoyed the particular favor amongst the main European financial houses and their governments, and favored further reductions in the allegedly consolidated military budget of 246 million lire. Using words that illustrate the relevance of the financial crisis in shaping national security policies, Minister of Public Works Ascanio Branca justified the Treasury’s position in these terms:

²⁸³ Biblioteca del Senato, Raccolta Ufficiale delle Leggi e Decreti del Regno d’Italia.

²⁸⁴ So Branca expressed himself in May 1894. On the discrepancy between military spending and military activities see especially Rochat and Massobrio (1987), pp.135,136; Mack Smith (1997), pp.167,168.

“If [Italy], at this very moment, had stable national finances and a florid economy, none in the Chamber would propose to make economies in the military budget [...]. Military expenditures have left us 2 milliards of debt and, if there were two milliards less of public debt, the issue would be practically solved.”²⁸⁵

This situation according to the Colombo-Sonnino front had also decreased the value of the Triple Alliance because an ally who is “financially in ruins” [like Italy] is also a “cumbersome military help.”²⁸⁶ Hence, military restraint was the sensible way ahead.

War ministers Luigi Pelloux (1893) and Stanislao Mocenni (1894-95) led the other front. Pelloux and Mocenni, too, understood the impellent necessity of responding to most difficult financial circumstances, and the increased power of foreign bankers. Yet, further economies in their view would have weakened the army and created a precedent for inexorable reductions in the military budget. As a result, their plan was to maintain the army budget to 246 million while introducing further army reforms to improve military efficiency.

Between 1893 and 1895, right when Italian military forces were renewing their efforts to conquer Ethiopia and achieve the dream of an Italian Eastern Africa Empire, the Colombo-Sonnino front was committed to ensure the success of the orthodox medicine of financial crisis response and this effort shaped the destiny of Italian military spending. Although Baratieri’s military plans were arguably not very distant from the premier’s aspirations, Crispi could not actively support them. In due course, this divergence between political circles and military forces culminated in the

²⁸⁵ See AP, Discussioni Camera, Legislatura XVIII, Tornata del 7 Maggio 1894.

²⁸⁶ AP, Discussioni Camera, Legislatura XVIII. The observations by deputy member Giovanni Bovio on May 12, 1894 best capture the essence of the discussion. On Sonnino’s rethinking and on the growing governmental awareness between 1891 and 1894 that Italy could not afford its grandiose foreign policy see also Whittam (1977), p.126; Plebano (1902), pp.102-112; and Haywood (1999), p.163.

disastrous defeat of Aduwa (1896), where 6,000 Italians died in one battle against the Ethiopians. After Aduwa, Eritrea was placed under civilian rule, and Italian plans of military conquest in Easter Africa were shelved for the following fifteen years.²⁸⁷

Archival evidence confirms that, between 1893 and 1895, the resort to international financial cooperation by members of the Crispi government to stop the financial crisis obstructed the resumed military operations in Eastern Africa. As both Treasury Minister Sonnino and Foreign Minister Blanc knew, successful negotiation of the foreign loan from German bankers that would have rescued the country from the financial crisis required the restoration of parity in the national balance of payment. Budget parity would have been reached only by virtue of a more serious commitment to the security conditionality of the orthodox medicine, and therefore the abandonment of offensive military policies in Africa and the adoption of a strategy of passive defense.²⁸⁸ Accordingly, in late December 1893, Italian Ministry of Foreign Affairs Blanc and Italian Under-Secretary for Foreign Affairs Antonelli ordered General Baratier to restrict Italian military operations in Africa to the triangle Massauwa-Asmara-Cheren. Similar instructions were repeated in a telegram from Blanc to Baratieri in early February 1894.²⁸⁹ The measures—available minutes on record reveal—were taken “in consideration of existing financial risks and the available financial means.”²⁹⁰

²⁸⁷ For an account of the change in Italian national security policies that stemmed from Aduwa see Bosworth (1979), p.12.

²⁸⁸ DDI, Seconda Serie, 1870-1896, personal letter by Sonnino to Blanc of December 25, 1893; DDI, Seconda Serie, 1870-1896, telegram by Italian ambassador in Berlin, Lanza, to Blanc of July, 2, 1894. See also Biblioteca del Senato, AP, Discussioni Camera, Legislatura XVIII, 7 Maggio 1894.

²⁸⁹ DDI, Seconda Serie, 1870-1896, vol.XVI, telegram 347 sent by Blanc on February 5, 1894.

²⁹⁰ DDI, Seconda Serie, vol. XVI, ‘verbale’ from the meeting of the Consulta of December 23, 1893; ACS, Crispi, DSPP, b.143, Baratieri’s letter to Crispi of December, 26, 1893.

Archival evidence also confirms that, between 1893 and 1895, Prime Minister Crispi remained faithful to giving new impetus to Italian military operations in Africa and so did General Baratieri.²⁹¹ Confident of Crispi's support, Baratieri organized and launched the military conquest of Cassala after having communicated to Blanc, in early February 1894, that, "in spite of the stringency of [Italian] finances," the Eritrean colony could be best preserved "by defending the outposts of Cassala and Agordat rather than by restricting [Italian] forces to the triangle Massauwa-Asmara-Cheren."²⁹² In the spring and fall of 1894 Italian troops advanced in defense of the newly gained outposts.²⁹³ Ethiopian resistance increased in the meantime.

In 1895 and 1896, the clash within the Italian government between the orthodoxy of international financial cooperation and Crispi's pursuit of military expansionism resulted in the utter estrangement of political authorities from the course of events on the battlefield and an ensemble of disastrous national security policies. To General Baratieri's requests for new troops, the Sonnino-Colombo front responded with retrenchment. Not only were military reinforcements to East Africa denied, but military disengagement was also ordered and massive military cutbacks performed. The Eritrean budget was lowered to less than lire 10 million lire—a sum that, as Baratieri explained in the spring of 1895, demanded the winding-up of several Italian battalions, encouraged Ethiopian aggression and paralyzed any Italian response.²⁹⁴

Erasing any doubt over the primary reason that impelled this radical restraint, Blanc

²⁹¹ ACS, Crispi, DSPP, b.143; Baratieri's letter to Crispi of December, 26, 1893.

²⁹² Historical Office of the Armed Forces, Baratieri's report to Blanc, r.154; and DDI, Seconda Serie, 1870-1896, vol. XXVI, telegram sent by Blanc sends to Baratieri on February 5, 1894.

²⁹³ ACS, Crispi, DSPP, b.143.

²⁹⁴ DDI, Seconda Serie, 1870-1896, Vol.XXVII. Telegrams were sent to Baratieri on April, 10, 23 and 25 and May 21 and 25, 1895.

informed Baratieri that the government in Rome was “mostly focusing on trying to limit any public spending to redress the balance of payment deficit and the enormous debt from the of abyss of which [the country had been] lightly saved.”²⁹⁵

Sonnino kept stating and restating his opposition to raising the defense budget until mid-December 1895, when Italian troops were defeated in Amba Alagi. From then onwards, Italian national security policies moved resolutely towards greater assertive and scenario HA–LE. The Colombo-Sonnino front was now convinced that restoring budget parity had endangered the State’s defense and national integrity. Crispi passed a bill that added lire 20 million to the African budget and sent an urgent telegram to Baratieri that read: “We are sending you more than you have requested. If any damage occurs now due to lack of resources or improvidence it will not be our fault.”²⁹⁶ It was a couple of months later that Italian troops experienced the massive defeat of Aduwa.

The conflicting character or confusing nature of Italian military conduct between 1893 and 1896—character which an explanation of the influence of financial on Italian national security policies significantly enlightens and that existing explanations ignore—could hardly have played little role in the “incompetent organization and direction” of the Italian African campaign during these years. At the root of this ambiguity was confusion over whether the financial crisis should have been addressed following the rules of international financial cooperation or following national military independence and autonomy. In an interesting update to the

²⁹⁵ DDI, Seconda Serie, 1870-1896, Vol. XXVII. Telegrams exchanged between Baratieri, Blanc, Mocenni, and Crispi on April 1, 2, 3, 4, 5, 10 1895.

²⁹⁶ Ibidem. Notably, the funds were awarded for the defense of Eritrea and not for pursuing a policy of foreign expansionism.

framework, when Italian military defeat by Menelik's forces came about, its strongest domestic advocates abandoned subscription to the dictates of the orthodox medicine.

On the whole, the gathered archival information offers a more nuanced explanation than the ones which financial stringency or "military ineptitude" would offer about why the Crispi government and why the Italian military failed so badly, between 1894 and 1896, to provide a decent African military strategy and campaign. Financial stringency, or "military ineptitude," do not per se explain why Italian military activities in East Africa between 1893 and 1895 were first initiated, then stopped, then initiated again, or why the military budget was harshly cut first and then increased radically at the last minute. The explanation offered here does arguably a better job. Crucially, the riskiest and most ambitious Italian military advances in East Africa occurred while the greatest attempts at exercising financial stringency were being implemented at home. The Crispi government (1893-96) was paralyzed for two years since its installment by the transnational power of orthodox ideas and policies. Throughout this time, Menelik put together an impressive army. For the Italian army, reaching a comparable level of preparedness when financial retrenchment was the dominant crisis response strategy at home became extremely difficult—perhaps impossible.

FINANCIAL CRISIS IN THE PERIPHERY AND
CHANGES IN FOREIGN POLICY AT THE CORE:
The Origins of the Libyan War (1911-12)

The Italian decision to wage war to Libya in 1911-12 is more puzzling than existing explanations have credited it to be. A cosmopolitan government that had an established record of commitment to disarmament and to the preservation of

international peace decided, rather out of the blue, to wage a war against an international peer—Turkey and its Ottoman Empire—for reasons that involved Italian spheres of (colonial) influence in Northern Africa. Between 1896 and 1911, the rejection of colonial aggression and the defense of international peace were the staples of Italian foreign policy. Militarism and colonialism were replaced by the pursuit of financial and economic interdependence and the expansion of Italian business interests in North Africa and the Balkans. National military spending did not surpass the fixed ceiling of 20-22% of total government spending (Table 3.5).²⁹⁷ The low investment in military spending is apparent when it is considered that the GNP kept growing throughout most of the period. Similarly, between 1896 and 1911, the Giolitti government renewed the Triple Alliance and defended its policy of alliance with the central powers while simultaneously promoting friendly relationships with France based on the assumption that Franco-Italian cooperation would have helped the interests of European peace.²⁹⁸

These policies changed drastically in September 1911, when, overturning its previous policy of pacific financial and economic penetration in Northern Africa, the Giolitti government began military operations in Libya against the Ottoman Empire.²⁹⁹ Italian military spending, too, underwent a massive increase between 1911 and 1912. Why did this happen? That is, why did Italian colonial possessions in Northern Africa

²⁹⁷ See Whittam (1977), pp.146,156; and Rochat and Massobrio (1987) p.153-54.

²⁹⁸ These policies are described in Bosworth (1979), p.136; Lowe and Marzani (1975), pp.92,102; Whittam (1877), pp.146,156; Rochat and Massobrio (1987), pp.153-54.

²⁹⁹ For an account of existing perspectives on the Italian war in Libya see Malgeri (1970); De Rosa (1984); Mori (1952), pp.102-118; Giolitti (1922), pp.249-260; Giolitti (1962), p.57; Whittam (1977), pp.156,157,167; Bosworth (1979), pp.143-44; Mack Smith (1997), p.245; Rashid Khalidi (1991), p.22; Herrmann (1989), pp.332-356; and Haywood (1999), p.342-45.

become an issue of political contention with the Ottoman Empire? Some scholars have explained this drastic change in the foreign policy of liberal Italy with the more threatening international security context and war-like atmosphere that developed in Europe from the First Moroccan crisis (1906-07) onwards.

*Table 3.5. Italian (real) Military Spending (ME), GNP and Government Spending (CGE) between 1904 and 1911**

Year	Real ME	Real CGE	Real GNP	ME/GNP	ME/CGE
1904	358	1709	13650	0.026	0.21
1905	375	1757	14421	0.026	0.21
1906	368	1831	15156	0.024	0.20
1907	385	1766	16460	0.023	0.22
1908	426	1905	16773	0.025	0.22
1909	482	2168	18593	0.026	0.22
1910	486	2149	17351	0.028	0.22
1911	563	2333	19215	0.029	0.24

* Data obtained or calculated from Ercolani, pp. 445, 446 and Mitchell, pp. 907-911.

Between 1904 and 1911, a number of systemic shocks were reshaping international relations in the region. These included, for instance, the Anglo-French entente, the Tangier incident, the Anglo-Russian entente, the intensification of Anglo-German naval rivalry, Austria's expansion in the Balkans, and the Agadir crisis. Along these lines, Haywood (1999) and Whittam (1977) have observed that calls for a more assertive Italian military policy intensified after the Austrian occupation of Bosnia-Herzegovina in 1908. The most convincing structural explanation of the Italian policy towards Libya in 1911-12 is possibly the one advanced by Khalidi (1991) and Anderson (1993). Both scholars have noted the detrimental implications on Italian colonial possessions in Libya—and therefore the policy pressures for a military intervention—that the spread of the Young Turk revolution (1908) across the Ottoman

Empire was bringing about, and the related growing local opposition against foreign encroachment.³⁰⁰ This interpretation is very close to the one that the Giolitti government accredited. Prime Minister Giolitti, in fact, justified the decision of taking military action against Libya by noting that the Turks had provocatively resisted Italian economic penetration, denying franchising opportunities to Italian nationals and forestalling Italian economic supremacy in Libya.³⁰¹

Giolitti's defense of Italian military intervention in Libya is buttressed by Marxist explanations of the Italo-Turkish war. Identifying the roots of the Italian foreign policy towards Libya (and Turkey) in the capitalistic system of the domestic economy, Marxist accounts (Webster 1975:193-94; Mori 1978:672-73) hold that, in the year preceding the military intervention, Italian business firms at home and abroad encountered closing windows of opportunity, critical financial conditions, and a recession. Because of their strong connections with national leadership—Romolo Tittoni, Vice President of the Banco di Roma was the brother of Italian Minister of Foreign Affairs Tommaso Tittoni—, Italian business interests dictated a shift towards greater national security assertiveness to deflect the costs of domestic economic adjustments.³⁰² The economic imperialism thesis is supported by available evidence that the Banco di Roma, the primary vehicle of Italian economic penetration in Libya,

³⁰⁰ The revolution replaced panislamic sentiment with political turmoil, regional loyalties, and hostility against European encroachment. Since Italy had the largest number of business ventures in Libya, panislamic hostility was essentially directed to the Italian rule.

³⁰¹ Giolitti (1922), pp.250-260, especially p.257; Giolitti states that “by means of concessions offered to other powers,” the Ottoman government “rendered the Italian military occupation inevitable.” See also Mack Smith (1997), p.245.

³⁰² On these developments Haywood (1999), pp.343-44,380; Webster (1975), pp.193-94; Mori (1978), pp.672-73; and Bosworth (1979), pp.13, 141. The Italian leadership, the Marxist argument goes, had systematically resorted to its connection with Italian business elites to advance its strategic interests in Northern Africa and the Balkans.

blackmailed the Italian government by threatening to sell its considerable assets in Libya to Austrian and German banks if the Italian government did not intervene to protect the interests of Italian business in Northern Africa.³⁰³ Ultimately, whether the economic imperialism thesis or the systemic, great power politics explanation is a more accurate understanding of the Italian war in Libya boils down to a matter of emphasis more than substance, namely whether it was mostly business interests or mostly strategic reasons (and the Giolittian leadership) that were responsible for the intervention.

This section reconciles these two sets of explanations on the Italian decision to move war to Turkey by reconstructing the role that the global financial crisis of 1907-08 exerted on Italian political leadership and business elites. The crisis exacerbated international economic competition, and made a shift towards assertiveness in Italian foreign policy much more likely than would have been otherwise. Whichever their take, existing portrayals of Italian military intervention against Libya are incomplete without considering the pressures unleashed by the financial crisis of 1907-08. Their incompleteness, as the section will show, has kindled mistaken conclusions. Notably, while the linkage between the global financial crisis of 1907-08 and the change in Italian national security policies remains ignored by the existing literature, some accounts have recognized the relevance of the social and economic distress in 1911 in inciting Italian nationalistic ambitions.³⁰⁴ In particular, historian Richard Bosworth (1979:143-44) has documented the existence of a “social

³⁰³ The threat posed by the Banco di Roma is well documented by a letter sent by Italian foreign minister Antonio di San Giuliano to Giolitti on August 9. The letter is contained in Giolitti (1962), p.57. See also Mack Smith (1997), pp.238-39, 244.

³⁰⁴ See Albertini, I, p.343; Malgeri (1970), pp.54-55; Bosworth (1979), pp.143-44.

and economic crisis” in Italy in 1911. Yet, this 1911 crisis is nothing like the global financial crisis of 1907-08 discussed here. Moreover, the role that Bosworth bestowed upon the 1911 crisis in explaining the origins of Italian intervention in Libya is rather marginal.

More importantly, the section unwraps interesting material for updating the framework as the expectation that the Italian government pursued extra-prudent conduct in national security policies after the onset of the 1907-08 global financial crisis is disproved by existing evidence. As previous paragraphs have made evident, Italian threat assessment and war prospects did not exude extra prudence after 1907. Military spending, too, as data in Table 3.5 demonstrate, did not decrease. If anything, it increased slightly. Rochat and Massobrio (1977:153-54) have found that Italian military spending increased from 22% to 27% of total defense spending in 1907—a finding that is not matched by the evidence here gathered (cf. Table 3.5). Rochat and Massobrio themselves have observed that this increase did not correspond to a calculated or intentional policy shift but was mostly a result of the decreased incidence of interest rates on state finances following the national debt conversion of 1906.³⁰⁵ Still, Rochat and Massobrio are not the only ones to have noted the presence of a few percentage points increase in Italian military budgets during or after the financial crisis of 1907. Consider, for instance, that historian Geoffrey Haywood describes the 1907

³⁰⁵ See Rochat and Massobrio (1977), pp.153-54. On Italy’s national debt conversion in 1904 see Giolitti (1922), p.194 and Lowe and Marzani (1975), p.96. The Italian Rendita was lowered from 5 to 3%.

military spending increase as part of the context of the factors that heralded the shift in Italian national security policies that culminated in the Libyan war.³⁰⁶

As known, the Giolitti government remained firmly in power throughout the financial crisis, and the governments that followed in the years following the end of the crisis shared a liberal set of fiscal and military preferences not different from the previous, long Giolittian era. In the months and years leading up to 1907, the national security agenda of Giolitti's ruling coalition recognized and defended the preferences of private financial interests and the principles of international financial cooperation. A popular opinion in Parliament was that increasing the military budget was equal to "subtracting the nation's vital forces from productive employment."³⁰⁷ As the circled data in Table 5 indicate, year after year before the outbreak of the financial crisis, national military spending as a percentage of gross national product kept decreasing year while GNP growth kept increasing several percentage points. The Italian standing army had already been reduced to 200,000 soldiers—half the size of the Swiss army—, and the Italian Parliament had refused greater investment in national defense for "fear that it could compromise Italian financial future."³⁰⁸ Moreover, in March 1906, Italy signed an international agreement with Great Britain and France, which de facto paralyzed Italian military expansion in Eastern Africa.³⁰⁹ One year later, the Italian Minister of Foreign Affairs claimed in Parliament and during various international disarmament meetings that Italy saw no threats to national security, rejected the use of

³⁰⁶ Haywood (1999), p.342. Refer to the following paragraphs for a discussion of the factors leading to the increase of Italian military spending in 1907.

³⁰⁷ ACS, AP, Discussioni, Camera, Legislatura XXI, 2a sessione, June 21-22, 1904.

³⁰⁸ ACS, Atti Parlamentari, Discussioni Camera, Leg. XXI, Sessione June-July 1904;

³⁰⁹ On this agreement see Monzali (1999), p.425.

military force, and pledged to peaceful international economic competition in its primary regions of interests—Northern Africa and the Balkans.³¹⁰

After the onset of the crisis, and even after the end of the crisis, the Giolitti government found itself in scenario HA-HE, but rather than courting an extra cautious military stance, it moved gradually towards assertiveness. For instance, between June and December 1907, and despite reiterated pressures by Treasury Minister Carcano and a majoritarian front in parliament to restrain national spending, specifically the military budget, attempts by government forces to stop steady decreases in national military investment appeared just as resolute. In July 1907, freshly concerned about the risk of condemning the national defense sector to “complete inaction,” Premier Giolitti attempted to pass a law, drafted by War Minister General Viganó, to freeze the extraordinary component of the war budgets for three years.³¹¹ Exposure to high finance was high, and republican and socialist forces blocked the measure. But opposition to the “progressive and disturbing impoverishment of the army,” as Viganó defined it, weakened in the following months. A commission was set up for verifying the necessity and effectiveness of Viganó’s plan; several pleas were made in Parliament for the introduction of extraordinary measures—for instance the disbursement of 200 million lire over 10 years to strengthen the Italian standing army; and, in late 1907, a war budget that did not entail additional military reductions was approved.³¹² Since GNP decreased as a result of the financial crisis, the military share

³¹⁰ MAE, Archivio Riservato, 1906-1911, fascicolo 63; Atti Parlamentari, Leg. XXII, 1a Sessione, Discussioni, Camera Deputati, June 1907.

³¹¹ ACS, AP, Discussioni Camera, Legislatura XXII, discussion from June 1907 to June 1908.

³¹² ACS, AP, Discussioni Camera, Legislatura XXII, discussions from June 1907 to June 1908 and on 28 November 1907.

of the budget increased. By December 1907, even the fiscally prudent, ex Treasury Minister Sidney Sonnino bemoaned Italy's chronic unpreparedness, while Giolitti nominated a civilian, Baron Severino Casana, to the War Ministry, in the hope that the latter could better persuade the Chamber to start military preparations.³¹³

The evidence just presented dismisses the expectation that the financial crisis paved the way for extra-cautious military spending. If anything, a less cautionary approach ensued between the onset of the crisis and the end of year 1907. Afterwards, the shift away from extra-cautiousness was even more evident. In 1908 and 1909, Italian national security policies moved gradually towards greater assertiveness. In March 1908, several voices in the Chamber recognized that it was necessary to pass more audacious military budgets, and "prepare the army for harder times." Two months later (June 1908), Premier Giolitti expressed his determination to avoid arresting "the military machine" and creating "disaster in the administration of war."³¹⁴ Due to "ongoing financial difficulties," it was established that the increase in the military budget would not be "immediate" but take place the following year.³¹⁵ In June 1909 the Pollio-Spingardi program was approved: it promised substantial increases in the military budget and the reorganization and reinforcement of the army between 1909 and 1913.³¹⁶

³¹³ Sidney Sonnino, *Scritti*, II, 21 December 1907 and 25 June 1908. See also, Haywood (1999), pp.344, 45.

³¹⁴ ACS, AP, Leg. XXII, 1a sessione discussion, June 25, 1908.

³¹⁵ AP, Discussioni Camera, Legislatura XXII, 6 Marzo 1908.

³¹⁶ AP, Discussioni Camera, Legislatura XXII, 6 Marzo 1908; see also Whittman (1977), pp.151,157; Mack Smith (1997), p.238-39; and De Rosa (1984), pp.216-217. By then Austria-Hungary had already annexed Bosnia-Herzegovina (December 1908).

Similar to military spending and contrary to what would be expected according to the framework, Italian threat assessment reflected greater assertiveness and *not* greater cautiousness after the financial crisis. The shift, however, was much more gradual. In 1907, 1908 and 1909, the Giolitti government remained faithful to the same foreign policy agenda that it had subscribed to before the start of the crisis. This agenda included the defense and expansion of Italian economic opportunities in Northern Africa and in the Balkans, and the preservation of international peace.³¹⁷ Minister of Foreign Affairs Tommaso Tittoni declared, in a speech to the Chamber in December 1908, that Italy was committed to “preserving [its] traditional alliances”—the Triple Alliance and the informal alliance with Britain—and “respecting the interests of Ottoman and Russian Empires in the Balkans.”³¹⁸ As a result, Italy had “no intention of dragging the country into a war,” as the Premier had stated even after the approval of the Pollio-Spingardi Program (June 1909).³¹⁹ After the ministerial crisis that developed in December 1909 over the potential introduction of a progressive tax, the like-minded leaderships of Sonnino (1909-1910), Luttazzi (1910-1911), and Giolitti (1911-1914) showed greater awareness of the diplomatic and military dangers of cautionary conduct. In December 1909, Minister of Foreign Affairs Count F. Guicciardini informed Vienna that further Austrian expansion in the Balkans be

³¹⁷ ACS, AP, Discussioni Camera, Legislatura XXII, discussions from June 1907 to June 1908; ASMAE, Archivio Riservato, 1906-11, b.63.

³¹⁸ ASMAE, Archivio Riservato, Casella 4, b.152; Tittoni’s speech to the Chamber; DDI, Quarta Serie, 1908-1914, Vol. V-VI, memorandum by Di San Giuliano to Giolitti, July, 28, 1911. See also Malgeri (1970), pp.100-101.

³¹⁹ Giolitti (1922), p.207.

accepted only with adequate “compensation.”³²⁰ At the same time, the Foreign Ministry writ-large believed that only the acquisition of a stronger Italian position in Northern Africa and the Balkans would have improved Anglo-Italian relations and dissipated British doubts over Italian “incapacity as a colonial power.”³²¹ Accordingly, and as revealed by Italian diplomatic correspondence throughout 1910, efforts by the Foreign Ministry to sustain Italian private enterprises in these regions intensified.³²² In the meantime, war prospects worsened compared to a few years earlier. As Minister of Foreign Affairs Di San Giuliano informed Premier Luzzatti in “most urgent and personal letters” in October 1910, Italian firms located in Libya risked to undertake actions that could foment violence and escalate out of control.³²³

Crucially, as much as the decreed increase in military spending, these developments were very subtly related to the financial crisis that had developed in Italy and at the center of the international financial system in 1907-08, and which the National Banks and high finance had cooperatively and effectively addressed. These developments were more directly related to the financial and economic crisis that had spread at the periphery of the system during the same period, and which international financial cooperation between the Italian government and the Libyan authorities, the Ottoman Empire, and Austria-Hungary and Germany had not resolved.

³²⁰ ACS, DDI, Quarta Serie, 1908-14, vol.V-VI, December 15, 1909. The Italian notice to Austria had more the character of a reminder than an ultimatum. Overall, Austro-Italian relationships did not deteriorate. On this point see, for instance, Bosworth (1979), pp.130-131.

³²¹ ACS, DDI, Quarta Serie, 1908-14, vol.V-VI, December 15, 1909.

³²² ACS, DDI, Quarta Serie, 1908-14, vol.V-VI. See in particular telegram 371, June 26, 1910, Minister of Foreign Affairs San Giuliano to Italian Ambassador in Constantinople; exchanges of June 19, 26, 28; July 8 (384); August 28 (469).

³²³ ACS, DDI, Quarta Serie, 1908-14, vol.V-VI, October 16 and 20, 1910, communications 591 and 606.

More exactly, the global financial crisis of 1907-08 buttressed speculative dynamics in the periphery, which, united with the developments above, and local factors such as the growth of panislamic sentiment and the decreasing Ottoman military might, increased the Italian leadership's fears of incurring economic and strategic losses in Libya. This, in turn, fueled a perception of altered military stakes in the region, increased Italian leaders' suspicion about their European peers' intentions, and paved the way for the military intervention of 1911-12.

Between 1905 and 1907, driven by the international economic boom, Italian private firms peacefully expanded throughout Northern Africa and the Balkans. In Libya—thanks to the strategic endorsement of the Italian government and helped by the favor of the locals—the Banco di Roma established commercial, industrial, and agricultural agencies.³²⁴ The diffusion of these agencies escalated between February and June 1907, and continued till 1911.³²⁵ Archival material shows that, during this period, because of the development of the financial crisis in the periphery, Arab populations no longer responded positively to the industrialization process.³²⁶ Liquidity dried up, industrial production fell, and prices and wages collapsed.

These events fomented local hatred and violence against Italian capital and institutions and, by implications, Italian strategic interests, impelling a change in the peaceful character of Italian penetration in Northern Africa.³²⁷ The situation is portrayed in a long and secret report that Italian Consul in Benghazi Bernabei sent to

³²⁴ ACS, Carte Giolitti, Gabinetto, b.25, and AP, Legislatura XXII, 14 Giugno 1907; Malgeri (1970), p.19; Luigi De Rosa (1997: vol.I), pp.260-61.

³²⁵ Mori (1952), pp.102-118; Luigi De Rosa (1997: vol.I), p.256; Francesco Malgeri (1970), p.19; Webster (1975), pp.204-44.

³²⁶ On the initial atmosphere of positive collaboration between Italian entrepreneurs and local authorities see Mori, p.107.

³²⁷ On the damage experienced by Italian firms in Northern Africa see De Rosa (1997: vol.I), p.227.

Prime Minister Giolitti in September 1911, just a few days before the start of Italian military operations in Northern Africa.³²⁸ In the report, Bernabei explicitly ascribed the changed local context in Libya to the period of financial and industrial speculation that had developed in the wake of the 1907-08 financial crisis, escalated throughout it and then continued in its aftermath. Italian industrial enterprises had grown too swiftly and precipitously, Bernabei noted. They had incurred severe financial losses and industrial difficulties, had missed to live up to their promise of offering a better future to local people, and had inspired local hatred and violence against Italian capital and institutions, compromising the originally positive disposition of the locals.

This evidence updates systemic and Marxist or imperialist explanations of the Italo-Turkish War of 1911-12. To begin, systemic factors like the 1908 Austrian annexation of Bosnia-Herzegovina, the spread of pan-Islamic sentiment in Libya following the Young Turks Revolution in Turkey, and the French occupation of Morocco in July 1911, were not *sufficient* to cause a change in Italian national security policies. Had these factors been sufficient to envision a change, Italian leadership's statements would have reflected it. While systemic factors stirred Italian nationalism and increased Arab resistance to foreign invaders, the unchecked pressures that the global financial crisis of 1907-08 unleashed in the periphery significantly compounded Italian nationalist fervor. A case in point: as Gaeta and Bosworth have shown, Italian nationalists and nationalist associations were highly concentrated in Libya, and they used the running clash between the local and Italian authorities to encourage their

³²⁸ ACS, Giolitti, Gabinetto, b.12. The report was sent sometimes in the first half of September 1911, before the start of the Libyan war. The accurate date is uncertain.

growth within Italy.³²⁹ In short, the systemic factors of “global financial crisis and financial crisis response across the world” mattered.

Moreover, the spread of the crisis in the periphery, and its impact on the fortunes of Italian firms in the region and on the Banco di Roma in particular, reorganize Marxist or imperialist interpretations of the origins of the War. Because of the successful resolution of the financial crisis at the core of the system, closing windows of opportunity *at home* were arguably not a paramount issue behind the Italian decision to wage the War. By contrast, the damage that the global financial crisis provoked *at the periphery* of the international system—damage that was not successfully addressed—was paramount. The Bank of Italy’s rescue efforts did not extend to the Libyan financial apparatus. Left to handle this damage on its own, the Banco di Roma begged for the intervention of the Italian government. When the government hesitated (up until July 1911), the Banco resorted to blackmail and threatened to sell its agencies in Libya to foreign interests. The threats were credible given the greater extent of British, German, and Austrian economic (and military) involvement in the territories of the Ottoman Empire.³³⁰ As the authorities of the Banco di Roma had forecasted, the news greatly alarmed Italian Ministry of Foreign Affairs di San Giuliano, who, in early August 1911, in a private letter to Prime

³²⁹ F. Gaeta, Naples (1965), p.94; Bosworth (1979), p.142. Enrico Corradini, Italian most prominent nationalist figure, argued that Libya was “the fulcrum” of Italian foreign policy.”

³³⁰ ACS, DDI, Quarta Serie, 1908-14, Volume V,VI, pp.384-87, correspondence between the Italian foreign minister di San Giuliano and Prime Minister Luigi Luzzatti.

Minister Giolitti, solicited preparations for a military intervention because Italy “could not afford that Italian affairs in Libya went to foreign hands.”³³¹

Ultimately, when the role of the 1907-08 financial crisis and its response is considered, explaining the change in Italian military spending, threat assessment, and war prospects between 1909 and 1911 from a systemic or imperialist perspective becomes much easier. The final explanation cuts across systemic and domestic levels of analysis.

Finally, the evidence in this section updates the framework presented in Chapter One by suggesting that high exposure to high finance (at home) does not preclude the possibility of more assertive national security policies when the crisis-stricken country in question has vital strategic interests (i.e. colonies) in the periphery, and response to the crisis in such territories does not develop along the same lines as at home. This finding is compatible with other conclusions in other chapters of this manuscript that denote the greater complexity of global financial crisis compared to local financial crises.

WAGING WAR TO SOLVE FINANCIAL CRISIS:

Italy's latest bet for colonial ambition and the limits of diversionary war theory

Compared to the influence of financial crises on Italian national security policies, so far described in the chapter, the economic roots of Italian imperialism in the 1930s are no secret. Between 1932 and 1936, Italy went from being a status-quo power that subscribed to the post-war order established at Versailles and renegotiated

³³¹ ACS, Giolitti, Archivio Gabinetto, b.25 and DDI, Quarta Serie, 1908-14, Vol. V-VI. Giolitti received di San Giuliano's letter on August 9, 1911. Di San Giuliano's concern over the potential loss of Italian affairs in Libya is also reported by Bosworth (1979), p.141. Notice that although Giolitti claimed in his Memoirs that he had returned in office in March 1911 “with the firm intention [..of finding..] the solution to the Libyan problem,” military preparations and military intervention were only decided between August and September 1911. See, once again, Bosworth (1979), p.150.

throughout the following years, to a revisionist power committed to the conquest of Ethiopia and the utter dismissal of international treaties. Before 1932, the intrinsically subversive nature of the fascist regime and Prime Minister Benito Mussolini's territorial ambitions had been restrained by the pact that the Prime Minister had to strike with financial and industrial forces—the regime's support base.³³² These forces favored the promotion of international peace and national and international financial stabilization. From 1932 onwards, in concomitance with the worsening of national and international economic conditions, Italian national security policies became more militant, and expansionism in Eastern Africa moved to center stage. The first thoughts of an invasion of Ethiopia were advanced between mid-1932 and early 1933. In December 1934, plans were crystallized in a secret memorandum that set forth the first stage of Italy's new expansionist program. Then, while being intent on sending directives and actions plans to address the Italo-Abyssinian question in view of this newly changed context, Mussolini noted that the process of reinforcement of Ethiopian armed forces against Italian interests had been irresistible, that Italian foreign policy of pacific penetration in Abyssinia was failing, and that the use of force was therefore mandatory.³³³

³³² On the constrained nature of the regime up until the early 1930s see Montenegro (1990), pp.73-76; Pirelli (1984); Melograni (1980), p.149; De Felice (1966); Carocci (1969); *Relazione* (1980), pp.93-112; Burgwyn, pp.35-36. The main point here is that if Mussolini wanted to remain in power, he needed to endorse some of the preferences of his supporters and contain his national security ambitions. He also needed to collaborate with Britain and the United States in enforcing the terms of the post-war international treaties because financial assistance from Britain and the United States was indispensable for gaining relief from the immense wartime debt and the chronic balance of payment deficit that threatened the interests of Italian financiers and industrialists.

³³³ On these developments see Lowe and Marzani (1975), pp.221, 248; Burgwyn, pp.74-75; Baer (1967); Catalano (1969), p.7; Mori (1978), pp.663-776; Rochat (1979); Mori (1972), p.681.

Several analysts (Baer 1967; Catalano 1969; Rochat 1972; and Lowe and Marzani 1975) have identified the roots of this aggressive shift in Italian national security policies in diversionary as well as non-diversionary pressures. For instance, scholars like Bauer (1969:43) and Rochat (1972:191) have argued that Mussolini embarked on rearmament and war in order to deflect public attention away from grave and urgent domestic economic difficulties, re-launch the regime, and ensure his political survival. Scholars like Catalano (1969:7), instead, have concluded that unleashing Italian national security ambitions served to revive the broken national economic engine through war-related industries and commissions.

These interpretations of the domestic economic roots of Italian foreign policy are clearly at odds: the former credits the predictions of diversionary war theory; the latter refutes them.

The findings of this section support the non-diversionary hypothesis: the Italian government embarked on an assertive set of national security policies not to *escape* from internal difficulties but to *solve* them. This does not equal to stating that the non-diversionary hypothesis is the only sensible explanation for the changed Italian national security policies of the 1930s. The relevance of systemic factors, such as the growing Ethiopian threat to Italian possessions in Abyssinia; British provocative policy and increasingly uncooperative attitudes vis-à-vis Italy; the failure of ongoing discussions on European disarmament; and the rise of Germany, is well recognized. So is the role of nationalism, reasons of *décor* or prestige, and Mussolini's

unscrupulous behavior.³³⁴ In this spirit, Mori has explained the Italian conversion to the Ethiopian enterprise by uniting the imperialist aspirations that had haunted Italian politics since the defeat of Aduwa (1896) with the feeling of urgency that the Ethiopian violent expansion demanded, and the desire to prove that the fascist corporative system was not less worthy than Anglo-American liberalism.³³⁵

While being compatible with a multiple-cause approach to the study of Italian imperialist resurgence in the 1930s, the explanation offered here addresses an important question which scholarship has left unanswered, namely, why did the Italian transition towards overt imperialism and national security assertiveness take so long? Relatedly, why did Italian relations with the status-quo powers deteriorate radically in the mid-1930s and not before? It is worth recalling that up until late 1935, the Italian leadership made specific efforts to defend international cooperation and the existing international order. Between late 1931 and 1932, Italy joined international efforts at armament reduction and proposed the formation of a Directorate between Britain, Italy, Germany and France to bring about “orderly treaty revision.”³³⁶

Throughout the following two years, the Italian government undertook serious diplomatic efforts to maintain the status quo in Europe and offset German ambitions. It signed the Four Power Pact with France (June 1933), the Little Entente with Yugoslavia, Czech Republic and Rumania (July 1933), and the Tripartite Agreement with Austria and Hungary (March 1934). On top of that, the Italian government exerted pressure on Engelbert Dollfuss for a resolution of Austro-German political

³³⁴ On these factors see, besides the mentioned works, De Felice (1974); Chabod (1961); Lowe and Marzani (1975:290) and Mallett (2000:161).

³³⁵ Mori (1972), p.668.

³³⁶ Lowe and Marzani, pp.48, 223-24;

disputes that defended Austrian integrity.³³⁷ Finally, it opposed German revisionism by signing the Rome protocols with French foreign minister Laval (January 1935), and by participating in the Stresa conference (April-May 1935) with French and British delegations (April-May 1935).³³⁸

It was only between mid-1935 and late 1936 that Italian national security policies shifted from tamed revisionism to complete revisionism.³³⁹ In June 1935, Anglo-Italian discussion concerning a settlement over the Ethiopian question failed, and, thereafter Mussolini began to lay the groundwork for the establishment of the Rome-Berlin Axis, and a full-scale military intervention in Ethiopia.³⁴⁰ Both events shaped international politics dramatically, setting the context for World War II.

As the following paragraph will clarify, an analysis of the influence of the financial crisis of 1929-33 on Italian national security policies accounts for this delayed, two-stage Italian transition towards revisionism while also providing a validation of the scenarios and expectations derived from the framework.

³³⁷ The defense of Austrian independence and integrity had been a staple of Italian national security policies since the early 1920s and the intensification of the German menace in the early 1930s had made it even more vital.

³³⁸ At Stresa, the Duce communicated to the British and French delegations that Italy was prepared to form a common front against the Hitlerian threat to European security. See *Opera Omnia di Benito Mussolini*, Florence and Rome, 1951-80, XXVI, pp.8-79; Goldman (1974), p.111; R.A.C. Parker (1933), p.29.

³³⁹ On this shift in in Italian national security policies see de Felice (1981), chapter 4; Mack Smith (1997), p.385; Lowe and Marzani (1975) p.254; Burgwyn, p.102; Mallett (2000), pp.157-87; Quartararo (1980), p.336; Lefebvre D'Ovidio (2000), pp.1-55; Ara (1989), pp.301-319.

³⁴⁰ A very detailed account, based on Italian DDI, of the worsening of Italo-British relationships in the fall of 1935 is offered in Mallett (2000) pp.169-72. British foreign minister Anthony Eden remained firm in his position that Italian expansion in Ethiopia constituted a threat to the British Empire (a statement that the British conservative party refused); he offered the Duce the scarcely appealing Ogaden region of Southern Ethiopia and denied Italy the port of Zeila, which was instead offered to Abyssinia. Mussolini presented a report, the Maffley Report, which illustrated the absence of any threat to the British Empire that would come from an Italian occupation of Ethiopia. See ACS, DDI, Ottava Serie, vol. I, discussions between Mussolini and Eden; and Renato Mori, *Mussolini e la conquista dell'Etiopia*, p.35. See also de Felice, *Lo Stato Totalitario*, pp.451-62, and Quartararo (2000).

From the mid-to-late 1920s, the Mussolini government combined international financial cooperation and reliance on the loans of high finance, with diplomatic and military prudence. In the mid-1920s, key declarations by Mussolini reveal that the Italian government committed to cultivating diplomatic and military cooperation with all great powers—Great Britain in particular—, and considered Austrian independence a vital international interest.³⁴¹ In defense of this cautionary line, in 1925 and 1927 Italian leadership signed diplomatic agreements with Britain and France for both the preservation of peace in Europe and the division of spheres of influence in Eastern Africa and on the Red Sea.³⁴² In Europe the Italian government aligned itself with the Kellogg-Briand pact of war renunciation (1928), and participated in the London conference on armament limitation (1930). In Eastern Africa, Mussolini and Ethiopian Negus, Ras Tafari, concluded a treaty of friendship and non-aggression (1928).³⁴³ Admittedly, as much as the earlier discussed financial policies, Italian security policies were not completely detached from nationalistic aspirations. For instance, at the London conference, the Italian delegation refused to accept any agreement that would have stipulated Italian naval inferiority to France.³⁴⁴ Along with French obstinacy, this position stalled the possibility of reaching an international agreement on armament reduction. On the whole, however, a cautionary approach to military spending, threat assessment, and war prospects far surpassed any revisionist undercurrents.

³⁴¹ ACS, SPD, CR, Busta 1 (De Stefani), May 20, 1925. See also Lowe and Marzani 1975, p.220; Burgwyn 1997, p.36, 45.

³⁴² ACS, SPD, CR, Busta 97 (Volpi), December 3, 1925. See also Quartararo (1979), pp.849-50. The Locarno agreement on European security was part of these agreements.

³⁴³ On the prudence and moderation in Italian national security policy in the late 1920s see Montenegro (1990), pp.55-90; Di Nolfo (1960), p.262; D'Oviodio (1978); and Lowe and Marzani (1975), pp.244.

³⁴⁴ ACS, DDI, Settima Serie (1922-35), vol.VIII, October 7, 1929.

Naval parity between Italy and France had been one of the cardinal points of the post-Great War order, and, as shown in Table 6, between 1926 and 1930 Italy made no clear rearmament effort.³⁴⁵ Moreover, in the spring of 1929, Mussolini handed over the foreign ministry portfolio to Dino Grandi, and his “peace program” of cooperation with Great Britain, respect for the principles of the League of Nations, and disarmament.³⁴⁶ After the onset of the global financial crisis *abroad*—in 1929 and 1930—, Grandi combined his defense of the orthodox medicine advanced by high finance, with a pledge to accept any reduction in Italian naval power—supposing that France and Italy preserved parity. Archival correspondence and the Grandi’s diaries reveal that, as a result of the onset of the financial crisis abroad, the cabinet expected an increase in American cooperation with Europe. Italy, it was believed, needed to be at the forefront of this cooperation.³⁴⁷

In early 1931, on the eve of spread of the financial crisis in Italy, the Italian government continued to commit to a peaceful policy of economic penetration in Ethiopia, and expressed satisfaction over the disarmament agreement reached by Great Britain, France, and Italy in March 1931.³⁴⁸ Diplomatic exchanges within the cabinet inform that the 1930-1931 increase in military spending as a percentage of total

³⁴⁵ Italian military spending fluctuated between the Duce’s condemnation of France’s refusal to recognize naval parity with Italy with Grandi’s peace offensive.

³⁴⁶ ACS, DDI Settima Serie, 1922-1935, volume X, March 4, 1931. Fascist forces in Italy described Grandi’s foreign policy as “renunciatory.” See in particular Burgwyn (1997), pp.57-59; Lowe and Marzani (1975), pp. 219-20. The naval agreement reached by France, Italy and Great Britain in March 1931 was a result of these efforts. Italian authorities were extremely satisfied at the time.

³⁴⁷ ACS, SPD, Busta 1 (De Stefani), February 9, 12, 14, 1930; ACS, Carte Schanzer, busta 29 (Grandi), May 1930; Grandi (1985), pp.280,282.

³⁴⁸ ACS, SPD, b.1. Exchanges between Italian minister of foreign affairs Grandi, Italian minister of colonies De Bono, and Italian minister in Addis Abeba Paternó. DDI, VII Serie 1922-35, vol.X. March 4, 17, 1931. On March 4, 1931, in a telegram to British prime minister Mac Donald, the Duce expressed its deep satisfaction for the recently signed Italo-French naval agreement and praised the contribution of British intermediation.

government spending and of GNP had no revisionist purposes but rather served to quell a rebellion in Libya before it could become a more serious threat to the stability of Italian protectorate rule there.³⁴⁹ In early 1931, on the eve of spread of the financial crisis in Italy, the Italian government continued to commit to a peaceful policy of economic penetration in Ethiopia, and expressed satisfaction over the disarmament agreement reached by Great Britain, France, and Italy in March 1931.³⁵⁰ Diplomatic exchanges within the cabinet inform that the 1930-1931 increase in military spending as a percentage of total government spending and of GNP had no revisionist purposes but rather served to quell a rebellion in Libya before it could become a more serious threat to the stability of Italian protectorate rule there.³⁵¹

*Table 3.6. Italian real ME, GNP and CGE between 1929 and 1937**

Year	Real ME	Real CGE	Real GNP	ME/GNP	ME/CGE
1926	5163	19481	149677	0.035	0.265
1927	6899	23202	153479	0.045	0.297
1928	5849	21314	152444	0.038	0.274
1929	4535	15765	111543	0.041	0.288
1930	8668	29809	189453	0.046	0.290
1931	7085	23604	125415	0.056	0.300
1932	6267	23749	109578	0.057	0.264
1933	6482	23217	105706	0.061	0.279
1934	5771	25791	105344	0.055	0.224
1935	5233	20579	110564	0.047	0.254
1936	5733	30828	110977	0.052	0.186
1937	6173	37624	129606	0.048	0.164

*ME and CGE data are from Paolo Ercolani 445, 446; data on GNP are from Mitchel, 907-911

³⁴⁹ ACS, SPD, CR, Busta (De Stefani), March 1930; DDI, Settima Serie, 1922-35, volume X, February 18, 1930. Note that the Hoover moratorium made the increase in Italian military spending possible.

³⁵⁰ ACS, SPD, b.1. Exchanges between Italian minister of foreign affairs Grandi, Italian minister of colonies De Bono, and Italian minister in Addis Abeba Paternó. DDI, VII Serie 1922-35, vol.X. March 4, 17, 1931. On March 4, 1931, in a telegram to British prime minister Mac Donald, the Duce expressed its deep satisfaction for the recently signed Italo-French naval agreement and praised the contribution of British intermediation.

³⁵¹ ACS, SPD, CR, Busta (De Stefani), March 1930; DDI, Settima Serie, 1922-35, volume X, February 18, 1930. Note that the Hoover moratorium made the increase in Italian military spending possible.

As expected, after the start of the financial crisis in Italy in late 1931, and during the first stage in the crisis response process (1931-32), the Italian government intensified its cautionary posture. Relying on both the (meager) financial cushion awarded by the Hoover moratorium and the (less meager) hope that ongoing international financial meetings would succeed, the Italian government sacrificed considerations of national defense to help keep the nation's banking system afloat.³⁵² While a much greater percentage of national public spending (which increased in 1931-32, as Tab. 3.6 shows) went to the founding of a credit-awarding institution and another institution for the reorganization of national industry (IRI and IMI)—see Table 3.6, figures in red, bold—funds awarded for military spending decreased in their absolute value and as a share of total spending. Italian Financial Ministers Guido Jung and Antonio Mosconi ordered the implementation of an austere financial policy that included budget cuts in the military sector.³⁵³ Military cutbacks meant a severe blow to Italian plans of economic penetration in Africa. Italian operations for resisting rebellions were suspended, and, since the existing colonial policy established that the majority of available resources be allocated to sustain peaceful plans of foreign economic policy, the military share of the budget of Italian African colonies decreased even more quickly than did the civil share.³⁵⁴

³⁵² Italian hope in the working of financial orthodoxy is well confirmed by Italian loans awarded, throughout financial crisis year 1932, to the rescue of various European states. ACS, DDI, Settima Serie, Vol. XI, March 7, 22, 23 and May 5, 31 1932; MAE, Ufficio Trattati, Anno 1932, pos. T. 26/2, June 15, 1932.

³⁵³ ACS, PCM, Anno 1934-35; Mosconi's communication, October 6, 1932; ACS, Fondo Graziani, b.11: April 1, 1932; ACS, AP, Camera dei Deputati, leg. XXVIII, Discussioni, vol. III, May, 10, 1932; *Ricerche per la Storia della Banca D'Italia*, pp. 196, 197. As an example, Libyan military spending moved from 230 million lire in 1928-29 to 131 million lire in 1932-33.

³⁵⁴ ACS, Fondo Graziani, b.10: 27 July 1933.

Not surprisingly, correspondence throughout 1932 between Mussolini, Grandi, Minister of Colonies De Rubeis, and Governor of Libya General Emilio De Bono illustrates that the Ethiopian Negus was taking advantage of Italian military disengagement to reinforce the Kingdom and threaten Italian colonial possessions in Eastern Africa.³⁵⁵ Downplaying the security risks that the financial crisis and the orthodox medicine of response created for Italian colonies, between 1931 and 1932 the Mussolini government participated in international bailout agreements as much as it joined international disarmament meetings in Geneva. Showing an ever more prudent security stance (and more orthodox financial philosophy), Italian authorities proposed the formation of a Directorate among Britain, Italy, Germany and France, to bring about an “orderly treaty revision,” and cancel forever the economically suboptimal legacy of war debts and reparations.³⁵⁶ As foreign minister Grandi stated several times after the failure of the Creditanstalt (May 1931), Italy strongly sided with the United States in the resolution of the global financial crisis; offered its cooperation to solve German and Austrian financial difficulties; and praised the contribution of British intermediation in the Franco-Italian naval negotiations.³⁵⁷ In June 1932, the Hoover government repaid the regime by renegotiating the Italian-American debt agreement

³⁵⁵ ACS, DDI, VII Serie, 1922-35, vol.X, January 14, 22, 1932.

³⁵⁶ Lowe and Marzani (1975), pp.48, 223-24.

³⁵⁷ ACS, DDI, Settima Serie, 1922-1935; Grandi's notes and telegrams of June, 15 and 22, 1931. A few months later, Grandi reported to the Senate his “extremely friendly discussions” with Washington and was applauded within the cabinet for his speeches in favor of disarmament in occasion of the preparatory works to the Genève conference on disarmament that were held in late 1931. ASMAE, Carte Grandi, b.11; Carte Schanzer, b.29.

(June 1932), in view of the exchange rate crisis of the lira and Italian difficulties in meeting the payment.³⁵⁸

Confirming previously formulated expectations, Italian softened threat assessment, diplomatic patience, and military restraint changed between 1933 and 1934, as the conditions of European and Italian finances continued to deteriorate—the collapse of Italian GNP was halted only in 1934 (Tab.6)—, and orthodox measures continued to fail to address the problem at its root.³⁵⁹ Although German reparations were canceled by an Anglo-American ad hoc understanding with Berlin (Lausanne, July 1932), nothing was done internationally to relieve Italy from debt repayment or ease its foreign borrowing. In December 1932, Mussolini was only able to provide the United States Federal Reserve with \$1,245,437 (rather than the required \$1,800,000), and in February 1933 an even smaller amount could be put together.³⁶⁰ The regime's *best* orthodox prospect seemed to be one of signing debt agreements with the United States every six months to temporarily excuse Rome's crippled ability to honor its external payments, or postpone the day of an Italian bankruptcy. Throughout 1933, however, this prospect worsened, as Italian GNP kept falling, and financial crisis

³⁵⁸ Italy had concluded a war debt agreement with the United States on November 14, 1925. According to the terms of the agreement, the Italian government owed the United States the amount of \$14,706,125. The payment of this amount was to be realized in six-months disbursements until 1957. The agreement was renegotiated before the congregation of the Lausanne Conference in June-July 1932. The major European powers convened at the conference to discuss, amongst other things, the future of the debt and reparation question after the outburst of the financial crisis and the issuing of the Hoover moratorium. According to the new financial agreement stipulated on June 3, 1932, the payment of the June 1932 disbursement was postponed to the fiscal year starting in July 1932 and set equal to approximately \$1,800,000. ASMAE, Ufficio Trattati, Anno 1932, pos. T.26/2.

³⁵⁹ Compounding Italian finances was the American decision to cancellation of public loans to Italy, preserve the repayment of international debts and cancel German reparations (Lausanne, July 1932). See, for instance, De Cecco (1993), p.625.

³⁶⁰ ACS, DDI, VII Serie, 1922-35, vol.XII, Mussolini's telegram to Italian business representative in Washington; December 15, 1932.

continued both at home and abroad.³⁶¹ Italian-American diplomatic relations deteriorated. In June 15, 1933, Finance Minister Guido Jung informed US President Franklin D. Roosevelt that Italy could not meet the expected disbursement (\$1,800,000) but would nevertheless offer \$1,000,000 to demonstrate “(Italian) good will.”³⁶² Fearing the formation of a debtor coalition against the United States, the new American leadership questioned the credibility of the Italian “excuse.” Exasperated, Mussolini replied that “the United States should better consider the conduct of the Italian government,” and that Italy no longer wanted “to speed up” but rather desired to “hold back as much as possible the beginning of bilateral negotiations.”

With Italian GNP and the exchange rate in free fall, unemployment climbing, and debt and deficit levels skyrocketing, the Mussolini government could see fewer and fewer reasons for accepting the American privilege of deciding whether the Italian state *was in default* or not.³⁶³ This was especially true because by mid-1933, the power of domestic financial interests that were part of the governing coalition was far weaker than it was just a couple years earlier. Deprived of such political counterweight, and deprived of faith in the orthodox medicine, the fascist regime could now manifest its intrinsic revisionist character more easily, and it did not take too long to do so.

The overhaul of existing Italian-American relations was only one expression of the diplomatic and military shift the new path of crisis response demanded. From mid-

³⁶¹ The installment of a new American government with a heterodox financial-security agenda did not ease the conclusion of an agreement between Washington and Rome. Refer to Chapter IV for more details on the change in American financial-security agenda during the Roosevelt’s presidency.

³⁶² See ACS, DDI, VII Serie, 1922-35, vol. XII; telegram to Mussolini, May, 7, 1933; ASMAE, Carte Grandi, b.67 and DDI, VII Serie, 1922-45, vol. XIII.

³⁶³ DDI, VII Serie, 1922-35, vol. XIII, XIV, XV. Exchanges between Mussolini and Italian ambassador in Washington Rosso in 1933; exchange between Rosso and Mussolini on May 27, 1934 in ACS, DDI, VII Serie, 1922-35, vol. XV. On the worsening economic conditions in Italy see Guarnieri (1988), p.242.

1933 onwards, Mussolini abandoned his alliance with the Western front, adopted an assertive foreign policy towards Ethiopia, abandoned the League of Nations, and found an ally in Nazi Germany. Italy embarked on a war of conquest (1935-36), became a target for international sanctions, and was excluded from the Tripartite Agreement of 1936.³⁶⁴

As outlined in a memorable speech delivered by Mussolini to the Chamber in the spring of 1934, the financial crisis and the ineffective process of crisis response had pushed the country to a point of no return. A new foreign policy was required to solve the unemployment and industrial stagnation that financial austerity, deflation, and international cooperation—the orthodox medicine—had been unable to solve. Thus, although a collapsing GNP could not offer sustained military increases (Table 6), national military spending was left free to grow in 1933, and in 1934 the regime initiated military preparations for launching the Italian conquest of Ethiopia. Relatedly, saving Italy's African Empire and saving the national economy from a never-ending crisis were portrayed as inextricable goals.³⁶⁵ Supporters of orthodoxy were summarily removed from power, and Italian workers and soldiers were sent to Africa.³⁶⁶ As Mussolini unambiguously stated in a communication to Italian State

³⁶⁴ ACS, DDI, VIII Serie, 1935-39, vol. IV; Rosso's telegram to Ciano, June 19, 1936; ACS, DDI, VIII Serie, 1935-39, vol. V; telegram by Attolico to Ciano regarding Italian talks with German finance minister Schacht, October, 1, 1936. Excluded from the Tripartite agreement of July 1936, Italy was naturally drawn to the financial policy and concerns of German finance minister Schacht.

³⁶⁵ Biblioteca del Senato, AP, Leg. XXIX, 26 May 1934. "No state—Mussolini argued on May, 26, 1934—can live by continuously contracting debt" as "debt payment [...] subtracts money from the national economy" while impeding creating jobs for "the highest possible number of Italian workers," and jeopardizing the maintenance of existing Italian possessions in Africa. The scenarios were two, "remaining on the bottom" or "starting to live again" by launching a "continental policy next to the continental policies of the United States and Japan."

³⁶⁶ The first to go was finance minister Guido Jung. ACS, SPD, CR, b.86. Mussolini's letter to Guido Jung, January 24, 1935.

Secretaries for the War and the Navy in November 1935, “jumpstarting Italian labor market” was a major purpose of Italian military commissions.³⁶⁷ To a possibly greater extent than it was a military enterprise, the Ethiopian war of conquest was a “construction enterprise.” A disproportionate quantity of soldiers and civilians was employed and massive road and railway works were initiated.³⁶⁸

These developments and declarations seem to negate the diversionary war hypothesis. The problem that Italian leaders faced in the mid-1930s was not as much “distracting the country from the ongoing economic crisis,” as diversionary theory postulates, but rather performing one last candid attempt at rescuing the nation from bankruptcy. Symptomatically, Mussolini’s speech occurred soon after the exchange of a series of telegrams between him and Italian ambassador in Washington Rosso on the subject of Italy’s war-debt payment capacity. Moreover, counter to the prediction of diversionary war theory, the Duce’s control over the cabinet increased between 1933 and 1935, as the fortunes of the domestic financial sector dwindled.

In sum, Catalano’s non-diversionary explanation about the roots of Italian foreign policy in the early 1930s seems the most accurate understanding of the origins of the Ethiopian war. Because of its focus on the global financial crisis of 1929-33 and the shifting power of high finance during and soon after it, the explanation proposed here has the advantage of capturing not only the domestic financial and political developments informing Italian African policy but also the systemic pressures that prompted the regime’s assertiveness. The failure of high finance and the orthodox

³⁶⁷ Guarnieri (1988), pp. 508,9.

³⁶⁸ ACS, SPD, CR, b.3 and b.67; ACS, Fondo Graziani, b.45; ACS, DDI, Settima Serie, 1935-1940, vol.II; SPD, CR b.4.

medicine to check the spread of the financial crisis in the United States and Great Britain compounded the Italian transition towards scenario HA-LE and the prospect of assertive Italian action. While the influence of the financial crisis of 1929-33 on American national security policies will be discussed in Chapter IV of this manuscript, and the influence of the same crisis on Italian national security policies has already been described, a few words should be said on the influence of the crisis on British national security policies, and particularly British African policy. Evidence shows that the financial crisis and the British process of financial crisis response led to the liquidation of the Bank of Abyssinia and to Britain's financial and political disengagement from central Africa. These events, in turn, wiped out the most promising attempts at institutional cooperation that the great powers had set up in Africa; crushed the Italian expectation that the British would have helped Italian economic expansion in the region; and paved the way for the strengthening of an autonomous Ethiopian force.³⁶⁹

As Italian foreign minister Dino Grandi told the Italian ambassador in London in June 1931, the British withdrawal from Ethiopia was a recipe for causing a financial catastrophe there, and, inevitably, for producing a drastic change in Italian African policy.³⁷⁰ Financial catastrophe did not occur, but the Negus was able to exploit ongoing financial and commercial speculation in East Africa for achieving the military restocking of Ethiopia.³⁷¹ The trend continued throughout 1932, and in late August

³⁶⁹ ACS, DDI, Settima Serie 1922-35, vol. X, Director Guariglia to Italian minister of colonies De Bono, May, 9, 1931 and Grandi to Italian ambassador in London, June, 8, 1931.

³⁷⁰ ACS, DDI, Settima Serie 1922-35, vol. X, June 8, 1931. This was Italian last attempt to convince the British government to organize a financial rescue of Ethiopia.

³⁷¹ ACS, VII Serie, 1922-35, vol.X.

1932, Italian director of political trade affairs Raffaele Guariglia reported to Mussolini that Ethiopia was “arming up and getting much more centralized, posing a much greater obstacle than it was five years [earlier]” and “endangering [Italian] bordering colonies.”³⁷² It is difficult to believe that these events did not inform the shift in Italian national security policies towards Ethiopia, which took place between 1933 and 1934.³⁷³ Arguably, these events also point to the more numerous channels of national security influence that a global financial crisis unleashes compared to a local financial crisis. When the crisis is local, this influence originates locally. But when the crisis is global, it originates both locally and globally, making the analytical efforts of tracking down all the channels of influence, and particularly the interaction between them, much more challenging.

Finally, the Italian abandonment of the orthodox medicine did neither occur suddenly nor irreversibly. In the spring of 1934, Mussolini had clearly lost his patience with financial diplomacy and the regime embarked on a more assertive foreign policy vis-à-vis Ethiopia. Yet, throughout 1934, the regime refused to enter into an alliance agreement with Germany and in January 1935, Mussolini and French Prime Minister Pierre Laval even concluded a military agreement against the prospect of German mobilization for the Anschluss. Months later, at Stresa (May 1935), the Italian government renewed its support against a rearming Germany. Only in October 1935 did Italy begin a war of conquest of Ethiopia and fully embrace revisionism.

³⁷² Quoted in Guariglia (1949), p.769.

³⁷³ Italian rearmament and the first war plans against Ethiopia, for instance started in the fall of 1933, after international financial cooperation in Ethiopia had lost any hope. ACS, SPD, CR, b.86. See also De Bono (1937), pp.8,9; Catalano (1969), pp.4,5.

Financial crises and Italian national security policies in nuts and bolts

With the exception of the 1930s, the influence of financial crises on Italian national security policies has been generally ignored. This disregard—the chapter has shown—has produced either inaccurate or incomplete explanations of paramount Italian diplomatic and military decisions that were made during or in the aftermath of the financial crises that swept through Italy between 1880 and 1940. Financial crises shaped the course of Italian military spending, threat assessment, and war prospects, both when governments having high affinity with high finance were in power (1907; 1929), and when governments having low affinity with high finance led the country (1889; 1893). At times the national security influence of financial crises was realized in one stage of crisis response (1889-91; 1907-08); at other times two stages were necessary (1893-94; 1931-33).

A consistent finding for the Italian case is that always, during a first stage of the crisis response process, the domestic balance of power shifted to the advantage of high finance, and therefore to the domestic financial sector, and to cautious (1907-08) or extra-cautious (1889-91; 1893-94; 1931-33) national security policies. As will be clear after reading the chapter on the American case, the pressures of high finance on the Italian government came from abroad and not from within. Similar to the American case, the heightening of these pressures resulted in a retreat from imperialist agendas (1889-91; 1893-95; 1931-33) or a rescheduling of military build-up (1907-08). Also, similar to the American case, and arguably to a greater extent than the American case, diplomatic and military retrenchment was revisited and overturned when it failed to

address the financial crisis and/or critically jeopardized Italian military position. For instance, the decision to perform further cuts in the military budget between 1893 and 1895 was followed by the decision to increase military spending (1895-1896) to face Menelik's incessant military advances. Similarly, the decision, during the financial crisis of 1907-08, to restrain military build-up and continue a foreign policy of pacific economic penetration in Libya, was followed by the start of military operations (1911) to avoid dangerous financial, industrial (and strategic) losses in Northern Africa. Finally, resort to the orthodox medicine and military restraint (1931-1933) was replaced, between 1933 and 1935, first by an ambiguous mix of military spending, threat assessment, and war prospects, and then by a full conversion to economic, diplomatic and military revisionism when national financial conditions failed to turn around.

This "evolution-bounded" effect of financial crises on Italian national security policies points to the fact that the *real* national security implications of Italian financial crises were very often obscure to existing governments, and that a process of trial and error, including parliamentary debates, political defeats, new financial expedients, and exposure to the side-effects of no longer satisfactory financial and security ideas was often the rule in responding to financial crises.³⁷⁴ The same could be said with regards to the national security influence of financial crises on Japanese and American national security policies, although some channels of influence were

³⁷⁴ Learning from previous financial crisis experience was rare but it has occurred at least once. In accepting British and French liquidity in 1914, Treasury minister Sidney Sonnino, a strong supporter of the Italian alliance with the central empire, was very much reminiscent of the cost of liquidity shortages for Italy between 1893 and 1896 and this consideration arguably contributed to the political shift towards the Allies.

much more typical than others. The Italian government mastered the “art” of coalitional reshuffling and repositioning around a new financial-security agenda flexibility to *please* foreign moneylenders. One could argue that geopolitical pressures made Italian politics less domestic and more international than were American or Japanese politics.

Thus, when Crispi did not bend to the orthodox medicine in 1889-1890, but behaved as if he were in scenario LA-LE, his government and financial-security agenda fell under the pressures of high finance and a much stronger domestic opposition. This boomerang effect came into play again during the financial crisis of 1920-22, which, for reasons of space, has not been treated in this chapter. On that occasion, fascist forces with their assertive security agenda were compelled to tie a pact with powerful domestic financial interests. The successful resolution of the financial crisis by high finance informed Mussolini’s thwarted national security agenda throughout the interwar period, as well his first response to the global financial crisis of 1929-33.

Interestingly, archival material indicates that the Italian government struggled to resist the slippery slope of withdrawing from an expansionist agenda once a new parliamentary majority around a new financial-security agenda had been established after the outbreak of a financial crisis. In the spring of 1892, without the King’s intervention and the issuance of a decree imposing to preserve a minimum ceiling of investment in national defense, cuts to the military budget would have continued irrepressibly—a decision that from a strategic point of view (and possibly even a financial one), was entirely foolish.

Suggesting a potential problem with the analytical framework of this work, the findings of the chapter on the national security influence of the global financial crisis of 1907-08 seem to support scenario HA-LE rather than scenario HA-HE. However, the shift towards assertiveness in Italian national security policies following the 1907-08 financial crisis appears to be a response not to the domestic manifestations of the crisis—on which the framework is based—but to the manifestation of the crisis in Italian colonial possessions in the periphery. It should also be noted that the Italian-Libyan war was neither conceived as a war against the status quo nor was it against the interests of the main powers in the international (financial) system. If anything, the war helped preserve international peace at the core of the system.

Also, evidence shows that Italian leadership did not “jump” into a war against Turkey, but abstained from doing so for several months and years, until it could no longer avoid it. Even then, the Giolitti government made sure to defend his pro-status quo stance with the great powers. The possibly discrepant resolution of financial crises that is offered at the center and at the periphery is surely an interesting avenue for further research. On the whole, the findings of the chapter indicate that changes in Italian national security policies during or soon after financial crisis might have been misattributed to factors or theories—like the diversionary war theory—that do not seem to explain historical events more powerfully than our financial crisis-based explanation.

CHAPTER IV

ABROAD IS AT HOME: WALL STREET CRIES, AMERICAN SECURITY SHIFTS

February 4, 1895, The White House:
“If that \$10-million draft is presented, you can’t meet it. It will be all
over by 3 o’clock.”

Pierpont Morgan to President Grover Cleveland

October 31, 1936, The White House:

“Never before in all our history have these forces been so united against one candidate as they stand today. They are unanimous in their hate for me — and I welcome their hatred.”

*Radio Address by President Franklin D. Roosevelt to the Nation*³⁷⁵

What should we make of American imperial understretch in the 1880s and 1890s? Why did a Japanese-American war not occur in 1907-08? And were the national security agendas of Herbert Hoover and Franklin Roosevelt fundamentally similar in the early 1930s? This chapter answers these questions based on financial-crisis outbreak and the interplay between American governments’ affinity with and exposure to high finance during the process of crisis response. In the United States, differently from Italy or Japan, government exposure to high finance pitted Washington elites against the financial titans of New York, or Wall Street. Between the 1880s and the early 1930s Wall Street titans were some of the world’s most prominent private financial houses, with no equivalent in Japan or Italy.³⁷⁶ The chapter argues that financial crises altered the balance of power between American

³⁷⁵ Chernow (1990:75); FDR Presidential Library, <http://docs.fdrlibrary.marist.edu/OD2NDST.HTML>

³⁷⁶ As seen in chapter II, Japanese financial elites remained significantly weak throughout most of the period under analysis. In the 1920s they achieved short-lived political prominence domestically. As seen in Chapter III, the power of Italian financial elites was usually inferior or subordinate to that of Italian authorities and wealthier international banking houses.

governments and Wall Street, causing the inflation or curbing of American pre-crisis financial-security agendas and changing the course of American military spending, threat assessment, and war prospects in the Gilded Age, in the late 1900s, and in the 1930s. Discussion proceeds as follows. After a brief overview of the specific traits of this case compared to previous ones, expectations on the national security influence of financial crises are extrapolated based on the interplay between the financial-security agenda of American governments stricken by financial crisis, and the exposure of the same governments to high finance throughout the process of crisis response. Then, three major sections illustrate how the foundational hypothesis of this study is a potent device to understand the change in American military spending, threat assessment, and war prospects caused by financial crisis. Of the three sections, the first discusses the national security influence of the local gold crises of 1884 and 1893-96. The second and the third sections are dedicated to the global banking crisis of 1907 and the worldwide financial crisis of 1929-33.³⁷⁷

Financial crisis hit the United States in 1884, in 1893-96, in 1907-08, and again in 1929-36.³⁷⁸ Statist-nationalist governments were in power when the 1884 and 1907-08 crises started, whereas cosmopolitan governments experienced the outbreak of the crises of 1893-96 and 1929-36. Ultimately, it was impossible for American cosmopolitan governments, and politically suicidal for their statist-

³⁷⁷ On these crises see Barnes (1931:230-31), Sobel (1968:207,222-24,250-66,297-321), Friedman and Schwartz (1971:99-100,108,156-163,254-255,299-308,324-28), Dewey (1968:415,444-447,481,536), Kindleberger (1978:132,173-74,189-195); Myers (1970:211,218,317-318,335), Chernow (1990:71-77,122-124), Brownlee (1979:270), and Rockoff (1990:742).

³⁷⁸ This sample does not include the financial crisis of 1914, which is treated in Chapter V.

nationalist counterparts, to avoid relying on the political sway and recommendations of Wall Street in response to financial crisis. Interestingly, during or in the immediate aftermath of each financial-crisis episode, Wall Street interests were able to punish statist-nationalist governments who attempted a crisis response that penalized the orthodox medicine. Thus notwithstanding, only after 1884 and 1907 did the power advantage gain by Wall Street versus Washington outlast the end of the crisis.

American national security policies differed from those of Italy and Japan in three major ways: they were less driven by the quest for vital spaces or colonies; they relied on a weaker state apparatus; and their creation and destiny rested on two solidly civilian institutions, the Presidency and the Congress. As the chapter will show, the United States was never disinterested in the projection of diplomatic and military power abroad, and American administrations expressed this drive well (May 1961; Kennedy 1987:202-203; Campbell 1976:40; Graebner 1985:314-315). Yet, to provide for national defense in a dangerous world, American leaderships needed much less vital space to conquer than did their Italian or Japanese counterparts. Geopolitical factors, American civil war experience, and a liberal political tradition also discouraged war enthusiasm and colonial dreams.³⁷⁹ It is also well known that the American offshore projection of diplomatic and military power relied on a feeble bureaucratic structure and a commonly thin financial apparatus.³⁸⁰ While Japanese and Italian leaderships worked on reinforcing the national financial

³⁷⁹ Note that until 1890, the American army ranked fourteenth in the world, after Bulgaria's, and the American navy was

³⁸⁰ See Bense (1880:106); and Zakaria (1998:40).

system between 1880 and the mid-1890s, American leaders remained without a solid system until 1913, when the Federal Reserve System was established.³⁸¹

This explains why, in times of financial crisis, Wall Street titans could often act as the United States' central bank—as will be clear later in the chapter.³⁸²⁸ However, American governments were not defenseless against the power of high finance, nor were their institutions fragile. The steady control over American military forces that the Presidency and the Congress enjoyed, for instance, found no parallel in Italy or Japan.

To augment its domestic power and kick-start shifts towards greater national security caution after financial-crisis outbreak, Wall Street could operate through two or three channels. Namely, it could provide the administration with the liquidity and creditworthiness necessary to impede a worsening of the financial crisis, and it could attempt to stir support for its cause during presidential races and congressional political majorities. Backing an “honest” defender of financial orthodoxy—a gold-standard-friendly presidential candidate—promised to usher in more cautionary national security policies. Similarly, Wall Street could affect the administration's agenda by compacting a solid Congressional majority behind a stricter adherence to international financial cooperation. Presidential races and mid-term

³⁸¹ Even then, the state's financial apparatus was not wired to bail out, regulate, or enforce. The New York Federal Reserve never acted as the national lenders of last resort nor capitalized on the nation's financial assets. American leadership steered away from reinforcing domestic financial institutions even when, in the 1920s, the US was financially the most powerful nation on earth.

³⁸² A “strong” financial apparatus does not mean a “moral” or a “just” one, as Japanese and Italian experiences well exemplify. Note that the defeat of the titans in the early 1930s allowed for a systematic strengthening of the practice of American central banking. The levels of centralization of Japanese finance were never reached, however.

elections were also the channels through which American leadership, Congress, and, as a result, national security policies could withstand the pressures of high finance. Notably, to a greater extent than their Japanese or Italian equivalents, American debates over finance and national defense cut transversely across parties or administrations.³⁸³ Consequently, neither partisanship nor, more obviously, regime type was *ever* part of the historical equation through which financial crises influenced American national security policies.³⁸⁴

EXPECTATIONS

The overarching expectation of this chapter is that the relationship, postulated in Chapter I, between the four scenarios of influence and American military spending, threat assessment, and war prospects is accurate. Particularly, the framework is correct if the following propositions hold. The national security policies of a government having low affinity with high finance tend to be curbed when exposure to high finance is high (*LA-HE*), and to be inflated when such exposure is low (*LA-LE*). The security policies of a government having high affinity with high finance are likely to become extra prudent when exposure to high finance is high (*HA-HE*). More specific expectations regarding the character of the change in

³⁸³ For instance, from 1880 to 1896, a bimetallic financial system and the build-up of a strong navy were goals that Presidents Chester Arthur (R) and Grover Cleveland (D) shared. In a similar vein, the administration of Theodore Roosevelt (R) exposed a kaleidoscopic set of financial and security policies, while those of President F.D. Roosevelt (D) evolved drastically between 1929 and 1936. On the relevance of institutional factors other than partisanship in the scrutiny of American politics or foreign policy, see Bensel (1984), Lake (1988), Trubowitz (1998), and Kirshner (2007:122-153).

³⁸⁴ By contrast, shifts in national security policies in Japan are highly correlated to shifts in partisanship, regime type, or regime change. Although less markedly than in Japan, similar conclusions can be drawn for the Italian case. See Chapters II and III.

American national security policies during financial crises can be obtained by discerning the particular scenario or scenarios coexisting with each crisis. It is to this task that I now turn.

In the Gilded Age, the United States experienced two financial crises: the local silver scares or gold crises of 1884 and 1893-96.³⁸⁵ The latter crisis was significantly compounded by the global financial crisis of 1890-91, which the United States escaped but Europe did not.³⁸⁶ In 1884 as well as between 1893 and 1895, European and American investors threw back American securities upon the US market and recalled their credits in copious quantities, resulting in an intensification of current gold and capital outflows and the most significant GNP contractions between 1880 and 1900 (Table 4.1). Congressional documents and newspapers of the time reveal that both American state leaders and Wall Street financiers felt grave anxiety, between 1884 and 1895, over the “financial emergency” derived from the loss of ongoing projects to European markets and the risk of an American gold default.³⁸⁷ Gold crises meant not only a drastic fall in profits on Wall Street but also a curtailed capacity of the American government to

³⁸⁵ The crisis of 1884 started after the introduction of the heterodox Tariff Act of 1883 and Treasury Secretary Hugh McCulloch’s decision to coin 200 millions silver dollars. The crisis of 1893-96 started after McCulloch’s successor, Charles Foster, had issued the ultra-heterodox McKinley Tariff Act and Sherman Act of 1890. See “Is this a Mystery?” *The Daily Register*, March 23, 1891; Myers (1970:211); Dewey (1968:440); Chernow (1990:72); Sobel (1968:242); and Friedman and Schwartz (1971:106).

³⁸⁶ Differently from Great Britain and most of Europe, the United States escaped the Baring crisis of 1890-91 via export increases to the old continent (Tab.1). By 1892, however, the Treasury gold supply was down to only \$14 million over the reserve limit.

³⁸⁷ Congressional Record, 53rd Congress, 2nd Session, August 7-September 6, 1893; “Getting All our Gold: Treasury Officials Anxious to Stop the Drain Made by Europe,” *Washington Post*, December 19, 1892; “On the Verge of Panic. Wall Street Alarmed by a Succession of Failures,” *New York Times*, May 17, 1884; “Is this a Mystery?,” *The Daily Register*, May 23, 1891 in *The Papers of Grover Cleveland, 1859-1908*, Library of Congress (1931), Series 2, General Correspondence, 1846-1910, Reel 69; “Nothing But Money,” *Chicago Daily Tribune*, December 19, 1892; and “American Nation in Jeopardy,” *Chicago Daily Tribune*, December 18, 1892.

harness necessary state funds and political support to push forward ongoing nation-building ventures.³⁸⁸

Table 4.1. American Financial statistics 1880-1898 (in million \$)

Year	Real GNP	Capital Account	Gold Stock Increase	(Exp – Imp)	Net Liabilities on GNP
1881	11483	65884	99.2	235	0.13
1882	12343	145544	84.7	264	0.13
1883	12590	132879	2.1	77	0.13
1884	12348	104394	41.3	127	0.15
1885	11656	63464	10.3	92	0.16
1886	12113	93957	37.2	157	0.17
1887	12162	103471	26.9	83	0.18
1888	12420	111341	64.1	15	0.20
1889	13315	87761	----	-41	
1890	13524	85040	-16.5	24	0.21
1891	13742	26839	16.5	55	0.22
1892	14081	9914	-16.5	122	0.22
1893	14390	2342	-35.1	196	0.23
1894	13937	-61170	16.5	76	0.24
1895	14330	-31466	-41.3	251	0.23
1896	14044	-14037	-26.9	81	0.24
1897	15065	-18052	95.1	232	0.22
1898	15869	-38047	51.7	333	0.19

For the statist-nationalist government of Chester Arthur (1881-84), who fully subscribed to silver-friendly financial policies, national building ventures included naval rearmament and the pursuit of an ambitious national defense strategy. For the cosmopolitan government of Grover Cleveland (1893-1896), instead, the national financial-security agenda entailed establishing and maintaining naval plans and a security profile that were compatible with strengthening American commitment to the gold standard.

Before the onset of financial crisis in 1884 and again in 1893, the Arthur and Cleveland governments had, respectively, low and high affinity with high finance.

³⁸⁸ As the greatest borrower in international financial markets, the US needed foreign funds and depended on a good credit rating. See, for instance, Myers (1970:22).

The assertive national security program of the Arthur administration rested on a financial policy of sustained silver printing at home and encouragement of international bimetallism abroad. Cleveland repudiated this platform during the later stages of his 1892 presidential campaign, when he praised the financial benefits of participating in the gold standard and renouncing to an international bimetallist agreement.³⁸⁹

As a result, in 1893 the affinity of the American government with high finance was low. After the onset of either financial crisis, the American administration found itself highly exposed to pressures of Wall Street titans and financial orthodoxy. Neither the Arthur nor the Cleveland government possessed the necessary resources to strengthen American international financial credibility and stop either crisis—these resources being either gold reserves or the ability to obtain, as US Treasury Secretary Foster acknowledged in 1892, the cooperation of the principal European countries to save American commitment to gold.³⁹⁰ By contrast, J.P. Morgan and his friends had plentiful gold assets and were the earnest receivers of international respect, as demonstrated by their key role in the transnational rescue of the Baring Brothers in 1891. Between 1884 and 1885, and again between 1892 and 1895, Wall Street financiers bailed out the Treasury and

³⁸⁹ Until the spring of 1892 American administrations remained interested in establishing bimetallism domestically and internationally. Cleveland too tried incessantly to bring Great Britain and Germany into an international bimetallic agreement with the United States. See “Parity is maintained: Secretary Foster Discusses Relations of Gold and Silver,” *Washington Post*, November 18, 1891; and “The Silver Conference,” *New York Times*, December 31, 1892. See also LaFeber (1963:108); Grenville and Young (1966:41-45); Sobel (1968:242); Dewey (1968:460); Myers (1970:207-208); Rockoff (1990:739-760); Frieden (1997:367-395); and, more recently, Wilson (2000).

³⁹⁰ “Getting All our Gold: Treasury Officials Anxious to Stop the Drain Made by Europe,” *Washington Post*, December 19, 1892.

prevented an American gold default by cosmopolitan and nationalist statist administrations.

Practically, in 1884 Morgan and his banker acolytes purchased stocks from alarmed American and European speculators and silver from the Treasury in exchange for gold. Scares about an impending silver standard and doubts about the nation's commitment to gold disappeared. Identifying the causes of the crisis in the pro-silver financial policies pursued by the Arthur administration until 1884, Wall Street took advantage of the ongoing presidential campaign to give its full support, successfully, to the more explicitly pro-gold—although not exclusively pro-gold until late 1892—presidential candidate Grover Cleveland. Thus, an administration that had low affinity with high finance and scarce sympathy for the gold standard was relatively quickly replaced with one that promised greater virtue. Rescue efforts similar to those performed in 1884 were undertaken between 1893 and 1895, albeit unsuccessfully this time.

By late January 1895, the US Treasury was \$10 million away from gold default, and, in a tremendous display of the change in government exposure from low to high following the outbreak of financial crisis, Morgan was able to play a game of “chicken” against the administration. With a signature by the financial magnate on a \$10 million draft that he reserved the right to present to US Treasury Secretary Carlisle, American participation in the gold standard would have ended (Chernow 1990:75). Backed against a wall, the President had no choice and, without Congressional approval, he gave Morgan the green light to bail out the

Treasury.³⁹¹ Crisis resolution efforts failed, Congressional opposition exploded, anti-Wall Street forces gained popularity, and the exposure of American administrations to high finance moved to low. This second stage of crisis response, which lasted at least until 1897³⁹² under the succeeding Cleveland and McKinley administrations, saw the emergence of a financially stronger and more independent American Treasury, the defense of silver circulation as much as the gold standard, and a commitment to national financial reform—although the contours of that reform remained ambiguous.³⁹³

A first set of expectations is thus formulated. After the start of the financial crisis in 1884, the Arthur administration should have found itself in LA–HE. Instead, the Cleveland administration should have been, from the start of the crisis in 1893 to the end of a first stage of crisis response in early 1895, in HA–HE and, after early 1895, in HA–LE. According to the framework, both the Arthur administration and, until 1895, the Cleveland administration should have faced

³⁹¹ Morgan set up a private syndicate between the Morgan and Rothschild houses in New York and London and the dollar-gold peg was saved. On the financial rescue efforts during both crises, see Dewey (1968:447); Sobel (1968:250-52,266); and Chernow (1990:74, 75).

³⁹² Trade reversal was achieved by 1896, and quite unexpectedly so; American financial policy remained confused thereafter, while bank failures continued and industrial growth stalled. The resumption of a steady inflow of gold from Europe in 1898 significantly eased the recovery process.

³⁹³ See US Treasury Secretary Carlisle, *Annual Report for 1896*; and McCulley (1992:40-55). Under the McKinley administration, a financial reform movement that knew no precedent started. Notice that the policy platform of William McKinley defended the interests of high finance only on the surface. The Republican Party was deeply divided over the optimal national financial policy, and the McKinley administration developed an approach to monetary issues that avoided precise definitions and was in practice very consonant to bimetallism. In late 1896, Wall Street only fooled itself by thinking that a staunchly orthodox President had been elected. The first proposals for establishing a national banking system started during these years, and lasted until 1907. With high finance having failed to restore financial and economic stability and growth, the American government was next in line to try out, challenging the limited financial role that the state and the Treasury had occupied since the Civil War.

pressures to endorse, and eventually endorsed, more cautious national security policies—that is, policies signaling greater American commitment to the dictates of the international gold standard. The outcome should have been, following 1884, the curbing of Arthur’s agenda of military and diplomatic assertiveness, and, after 1893, the inflation of Cleveland’s diplomatic and military prudence. The failure of orthodox medicine and the partially related mounting of Congressional opposition from early 1895 onwards should have freed the Cleveland administration first, and the McKinley administration thereafter, from the former constraints of avoiding assertive national security policies to solve financial crisis.

*Table 4.2. American Financial statistics 1900-1913 (in million dollars)**

Year	Real GNP	Public Debt	Total Bank Assets	Gold Stock Increase
1900	18694	1263417	4115	93
1901	19991	1221572	4897	68.2
1902	21180	1178031	5420	70.3
1903	22099	1159406	5905	68.2
1904	22828	1136259	6382	31
1905	25043	1132357	7217	74.4
1906	27171	1142523	7820	167.4
1907	28443	1147178	8390	16.5
1908	28765	1177690	7954	49.6
1909	31647	1148315	8780	-16.5
1910	31792	1146940	9432	70.3
1911	33712	1153985	9941	88.9
1912	35502	1193839	10638	80.6
1913	37609	1193048	11024	39.3

The global financial crisis that spread across Great Britain and Europe between late 1906 and 1907 did not fully reach the United States until the late

summer/fall of 1907.³⁹⁴ Before then, as the growth in total bank assets between 1900 and 1907 shows (see Table 4.2), the fortunes of Wall Street titans had been swelling while the nation had transformed from a peripheral, highly dependent financial borrower into a financially creditworthy world frontrunner in manufacturing and trade.³⁹⁵ Wall Street's soaring financial fortunes had not stalled Theodore Roosevelt's statist-nationalist agenda, however. Denoting low affinity with high finance, the Roosevelt administration between 1901 and 1907 crafted a foreign policy of unprecedented ambition while remaining firmly committed to strengthening financial regulation and trust-busting policies, thereby stirring the anger of American financial elites who blamed primarily the American government for the spreading of the global financial crisis.³⁹⁶ Embittered Wall Street titans John Rockefeller and E.H. Harriman squealed and staged pro-business protests but were unable to change the course of Roosevelt's financial policies for most of 1907. Early that year, the

³⁹⁴ Global financial crisis started following the San Francisco earthquake of April 1906. It spread in Great Britain and the rest of the world following a massive gold outflow to the United States. British companies had underwritten most of the fire insurance policies in San Francisco. In October 1907, the collapse of the copper shares of the Knickerbocker Trust Company in New York brought the crisis to the United States. As shown in Table 4.3, official gold reserves decreased, stock market and security prices fell, bank runs and a credit crunch seized the nation, and a sharp drop in output and employment occurred. On the crisis of 1907-08 and its causes, see in particular Odell and Weidenmier (2004); Bruner and Carr (2007); H.D.S. Greenway, "The Panic of 1907," *New York Times*, 09/23/1908; and Chernow (1990:122-124).

³⁹⁵ From the world economic boom that took place between 1899 and 1907, the United States benefited more than any other member of the international financial system. The financial gap between Uncle Sam and Great Britain shrank fast throughout this period. See Dewey (1968:469); Myers (1970:243); De Cecco (1974:26-29); Lake (1988:120); Bensel (1963:40-54).

³⁹⁶ *Theodore Roosevelt Papers* (1967), Library of Congress, Series 1, Reel 78, 79 and Series 2, Reel 347, October, November 1907; George B. *Cortelyou Papers*, Manuscript Division, Library of Congress, DC, Box 62, "General Correspondence," November 1907; *The Papers of William H. Taft*, Secretary of War, "Correspondence with Roosevelt," reel 321, March 1907 through November 1908. These were also the years when the powers of the Executive were significantly expanded, greatly but not exclusively by the hand of Teddy Roosevelt. On these developments, see Sundquist (1973:155-164); Schulzinger (1984:24-25); Leuchtenburg (1952:483-504); and Chessman (1969:143).

American government remained visibly absent from ongoing British and European attempts to save the international gold standard. Ultimately, joint rescue efforts between the Bank of England, the Bank of France, the German Reichsbank, and the Russian State Bank—efforts in which Wall Street titans and other major transnational financial houses participated—succeeded in bringing relief and restoring confidence at the core of the international financial system. By the spring of 1907 European states had overcome the crisis, leaving the United States to face its own, by then much accrued, financial troubles.

Table 4.3. American financial statistics 1924-1937 (in million dollars)

Year	Real GNP	Number of Banks	Investments Income Receipts of US Assets Abroad	Government Deficit/ Surplus	Real Gov Spending	Number of Unemployed (in Thousands)
1924	87115	20908	762	963367	2908	2341
1925	88315	20376	912	717043	2842	2115
1926	96735	19770	953	865144	2916	1321
1927	97187	18860	981	1155365	2899	1808
1928	99113	18113	1080	939083	3005	2235
1929	103900	17440	1139	734391	3127	1383
1930	94359	16432	1040	737673	3405	4340
1931	85562	14854	766	-461877	3970	7721
1932	67011	12598	527	-2735290	5274	11468
1933	59786	9310	437	-2601652	4849	10635
1934	64291	9931	437	-3629632	6443	8366
1935	71945	10063	521	-2791052	6342	7523
1936	83000	9961	569	-4424549	8321	5286
1937	89189	9801	577	-2777421	7472	4937

Mistrusted and attacked by high finance, Roosevelt had a difficult time creating national financial and economic recovery once the crisis hit full bloom in the United States in the summer and fall of 1907: government exposure to high finance

was high.³⁹⁷ As archival evidence indicates, without the cooperation of high finance, national remedies such as the issuing of Panama bonds and the deposit of customs receipts in national banks were failing. Once again, the pressures of Wall Street on the Roosevelt administration tilted the domestic balance of power to the former's advantage. Although the Treasury took on a more active role compared to the previous crises, the intervention of a Morgan-led clique of American bankers became crucial to legitimating the Treasury's injection of liquidity into the system, organizing a private pool to collect extra funds, and ultimately restoring faith in the creditworthiness of the administration at home and abroad.³⁹⁸

The administration's need to preserve a well-functioning capital market to push forward its agenda rendered it highly exposed to high finance shortly after the outbreak of the financial crisis at home. In the summer of 1907, as animated discussions between the President and Secretary of War William Taft illustrate,

³⁹⁷ Letters sent to and received from Emlen Roosevelt (October 29, November 22, 1907; January 13, 1908); Douglas Robison (November 16, 1907); American Ambassador to France Henry White (November 27, 1907); financial magnate Andrew Carnegie (February 15, 1908) Presidential Papers Microfilm, *Theodore Roosevelt Papers*, Series 1, reels 78, 79, 80,81; Series 2, Reel 347. Exchange between the President and US diplomat Cecil Arthur Spring Rice on December 21, 1907 in John M. Blum, Alfred D. Chandler, Jr., and Sylvia Rice, eds., *The Letters of Theodore Roosevelt*, Cambridge: Harvard University Press (1952), vol.6, Madison Library, Library of Congress; "Power of the Treasury," *The Wall Street Journal*," April 25, 1907; "Rothschild Scouts Panic," *Washington Post*, March 26, 1907; "Causes of Declining Prices," *Wall Street Journal*, March 30, 1907; "Remedy Found," *Los Angeles Times*, November 19, 1907; "Power of the Treasury," *The Wall Street Journal*," April 25, 1907; "The Secretaryship of Mr. Shaw," *Wall Street Journal*, September 13, 1907.

³⁹⁸ Within a few weeks from the spread of the crisis in New York in October 1907, J.P. Morgan rallied some of the titans of Wall Street, organized a pool of \$35 million and came to the rescue of several trust companies, stopping further stock price declines. Concurrently, Cortelyou deposited an equal amount of currency with the reserve city banks of New York. Panic subsided. Letter of Cortelyou to Teddy Roosevelt, November 16, 1907, in Theodore Roosevelt Papers, Series 1, reel 78; Roosevelt's reply to Cortelyou of the same day in Series 2, reel 347. "Issue of Panama Bonds Might Bring Out the Hoarded Cash," *Wall Street Journal*, November 18, 1907; "Ghost of 'Panic' Vanishes in Air," *Chicago Daily Tribune*, November 19, 1907. On Shaw's effort to bolster national bank circulation see Timberlake (1963:41).

Roosevelt's trust-busting policies came under harsher scrutiny in the face of their seemingly unrelenting "harm to business." President Roosevelt distanced himself from his "middle-of-the-road" policy by asserting, in late 1907 and again in 1908, that American "businessmen" had done an "invaluable service" to the country "in checking the panic" and bringing the nation into "excellent financial standing."³⁹⁹ The Anti-trust Act was also bent on a few occasions between late 1907 and 1908.⁴⁰⁰ This trend was further strengthened by (and arguably contributed to) the victory, in the presidential elections of 1908, of William Howard Taft, by then the paladin of high finance.

In view of these observations, the Roosevelt administration should have confronted LA– HE. As the financial crisis reached the United States between the summer and fall of 1907, pressures on the administration for endorsing greater caution in military spending, threat assessment, and war prospects should have escalated, while the Roosevelt government should eventually have settled on a more cautionary national security path. Pre-crisis, ambitious national security policies should have been curbed as a result. The pull back from diplomatic and military assertiveness should be even more evident after the election of the cosmopolitan administration of Howard Taft.

³⁹⁹ TR to Cortelyou, October 25, 1907, *Theodore Roosevelt Papers*, Series 2, reel 347; letter to Jacob Schiff from TR in *The Selected Letters of Theodore Roosevelt* (2001:448); Annual Message of the President to Congress, *Journal of the Senate*, 68th Congress, 1st session, p.4. The anti-trust laws were indeed bent on a few occasions during the crisis, most notably with the purchase of the Tennessee Coal and Iron Company by Morgan's United States Steel. See Chernow (1990:123-24).

⁴⁰⁰ On August 16, 1907, for instance, TR was writing Taft "you are asking me to abandon the effort to enforce the laws [...] and this because you think harm will come to 'business' if corruption is exposed." *The Papers of William Taft*, "Correspondence with Roosevelt," reel 321.

Between 1929 and 1933, financial crisis spread around the world much more radically than it had between 1907 and 1908. This overlapped with crises of significant proportions in other sectors of the economy, ending a decade of financial boom and prosperity in the United States (Table 3) and an equally long period of financial instability and tentative economic recovery around the world.⁴⁰¹ By April 1933 the international financial system had officially disintegrated and, although widespread banking crises subsided after 1933, prices did not stabilize until 1936 (Eichengreen 1992:4; Friedman and Schwartz 1963:300; Gourevitch 1986:24; Eichengreen 1957:4,48; Eichengreen and Temin 2000:183-207; Clavin and Wessels 2004:765-795). From shortly before the onset of the Wall Street crash of October 1929 until the inauguration of Franklin D. Roosevelt in March 1933, the White House was led by the cosmopolitan administration of Herbert Hoover who clearly committed to international financial cooperation and a conciliatory foreign policy posture. Although the Hoover government continued America post-WWI pledge to fiscal protection of the American shipping industry, and fiscally conservative bilateral trade (Lake 1988:180-182), the administration's affinity with high finance and financial orthodoxy was unquestionably high. Its exposure to high finance after the financial crisis outbreak was also high. Noting

⁴⁰¹ Crisis in the United States took the form of several waves of banking panic, mostly concentrated between 1931 and 1933. The crisis itself was initially given little importance by the Hoover administration and high finance. Financial crises had been a staple abroad throughout the 1920s and international financial cooperation had always triumphed, or so it seemed. National alarm mounted after the spread of the crisis across Europe, the related failure of the Austrian Creditanstalt (May 1931), the closure of a number of German banks, and the freezing of British short-term assets in Germany (July 1931). Things kept worsening. Austria and Germany suspended the convertibility of their currencies (summer of 1931); Great Britain abandoned the gold standard in (September 1931); Japan devalued the yen (December 1931); and France defaulted on its war debt payments (December 1932).

the deterioration of national finances and a low-performing international financial system a year and half after the stock market collapse of October 1929, President Herbert Hoover committed to crisis-resolution efforts which, first and foremost, brought about “a condition of affairs favorable to the beneficial development of private enterprise” internationally as well as domestically.⁴⁰²

The one-year moratorium on international payments (summer 1931); the encouragement of rescue-loans organized by eminent American bankers Jack Morgan and Thomas Lamont to save Austria, Germany, and Great Britain—or better the schilling, the deutschmark and the pound (May-September 1931); resistance to wide-ranging proposals for federal action on behalf of the unemployed (1930-32); and unrelenting commitment to multilateral economic negotiations are just some primary examples of Hoover’s pro-business strategy of financial recovery.⁴⁰³ This strategy failed resoundingly, financial scandals flared, and the Senate Committee on Banking and Currency began a harsh grilling of the American banking community in March 1932.

The failure and increasing domestic resistance to Hoover’s orthodox strategy of crisis response resulted, in 1932, in the overwhelming political victory of Franklin D. Roosevelt (1932), whose government was still cosmopolitan in kind—

⁴⁰² Hoover’s words in Schlesinger (1957:238). See also *The Memoirs of Herbert Hoover: The Cabinet and the Presidency 1920-33*, New York: The Macmillan Company (1952), pp.11,179-180; and Schlesinger (1957:474).

⁴⁰³ Significantly, private debts were not excluded from the moratorium. On Hoover’s response to the crisis, see also Schlesinger (1957:236) and Chernow (1990:319). Challenges to the workings of orthodox crisis measures were concrete, however, as Hoover himself admitted and as some of his policies (like the infamous Smooth Hawley tariff) proved. Letter of President Herbert Hoover to Secretary of State Henry Stimson, April 21, 1931, and letter by Stimson to Hoover, same day, in *The Papers of Henry Stimson*, reel 81, Manuscript Division, Library of Congress; *The Memoirs of Herbert Hoover: The Cabinet and the Presidency 1920-33*, New York: The Macmillan Company (1952), pp.29-31.

an assertive government would have been unelectable—but with low exposure to high finance. Having run on a clearly anti-Wall Street agenda, funded by lawyers rather than bankers, Roosevelt’s crisis-response strategy entailed a retreat from financial internationalism and the “replacement,” as the President put it, of “old fetishes of so-called international bankers” with “efforts to plan national currencies” aimed at “giving those currencies a continuing purchasing power.”⁴⁰⁴ Examples of this new financial stance included the issuing of a national banking holiday (March 1933); the introduction of a Silver Purchase Act (June 1934) and major banking laws that strengthened the financial power of the Treasury versus the Federal Reserve (1933, 1935); the lifting of the gold-dollar par during the London financial conference (July 1933); the Johnson Act, ending any possibility of international debt revision (1934); the Reciprocal Trade Agreements Act (1934); and the Tripartite Monetary Agreement of 1936 (Dallek 1979:35-38,51; Rhodes 2001:98-101; Eichengreen and Uzan 1990; Lake 1988:204-209). For a number of reasons that are well documented in the literature, a full transition to new financial and security principles throughout the crisis did not occur (Schlesinger 1958:18; Dallek 1979:38,93,94).⁴⁰⁵

Notably, since the American government found itself in scenario HA–LE after the start of the crisis, the framework does not allow formulating specific

⁴⁰⁴ Quoted in Freidel 1973:478-89; Dallek 1979:54; Rhodes 2001:101.

⁴⁰⁵ For instance, after rather consensual Hundred Days Congressional political divisions and domestic unrest often paralyzed crisis response. As many within the administration noticed, the spirit of Roosevelt’s New Deal clashed with the democratic tradition of free trade and ingrained domestic abhorrence to public spending. Additionally, the Democratic Party had not been in power since the Presidency of Woodrow Wilson. Even the Democratic majority that overwhelmingly elected F.D.R. in 1932 remained a patchwork of disparate political forces and divergent philosophies thereafter.

expectations on the course of American national security policies in this instance. Following the logic of the framework, however, it can be expected that the low exposure of the American government throughout the crisis should have released existing constraints on the exercise of greater assertiveness in the sphere of national security. The removal of these constraints should have been more evident from 1933 onwards, as a new phase in the process of financial crisis response started under the Roosevelt administration, and less pronounced under the Hoover administration.

SAVING THE GOLD-DOLLAR PAR AND SHELVING EXPANSION:
Explaining American imperial understretch in the 1880s and the 1890s

An examination of whether the local financial crises of 1884 and 1893-96 paved the way for, respectively, LA-HE and HA-HE—both crises steering American security policies towards a major cautionary position—provides an excellent outlet for contributions to two debates in the literature of international relations and international political economy: one concerning the role of the world economic depression in triggering the process of American expansionism, and the other regarding the reasons behind the United States' delayed rise to global influence. The first debate originates from the works of Walter LaFeber and William Williams, who attributed American military awakening to persistent price deflation, low consumption, and overproduction suffered by the United States between 1873 and 1897. The phenomenon, the authors reckoned, stimulated American interest in the acquisition of foreign lands and markets to sell accumulated surplus.⁴⁰⁶ Since their

⁴⁰⁶ LaFeber identifies three macro-periods within the interval 1873-1897 and specifically 1873-78, 1882-85 and 1893-97. He argued that there were moments within these periods

appearance in the 1960s, important limits to these studies have been recognized. David Pletcher, Donald Mitchell, and Walter Herrick observed that while the deflationary periods identified by LaFeber and Williams had a persistent and enduring character, the movement towards a new, expansionist American strategic posture was sluggish.⁴⁰⁷ More pointedly, as Figure 1.1 shows, the process of naval revival stalled exactly during those intervals where, according LaFeber, it should have been most virulent.

The second debate, which emerges from the writings of analysts such as Henry Kissinger and Fareed Zakaria, stems from the very same evidence that LaFeber and Williams overlooked, that is, the lack of translation of American manufacturing power into military expansion until 1898.⁴⁰⁸ Explaining this oddity, a clear challenge to the predictions of classical realism, Zakaria argued that the lack of a strong central government, which could harness the nation's enormous wealth for the purposes of expansion, forced American statesmen to diplomatic and military inactivity. Zakaria observed that presidents and administrations attempted to set the United States on an expansionary path whenever they saw an increase in the nation's relative economic power, yet a weak state and a small central government curbed their plans.⁴⁰⁹

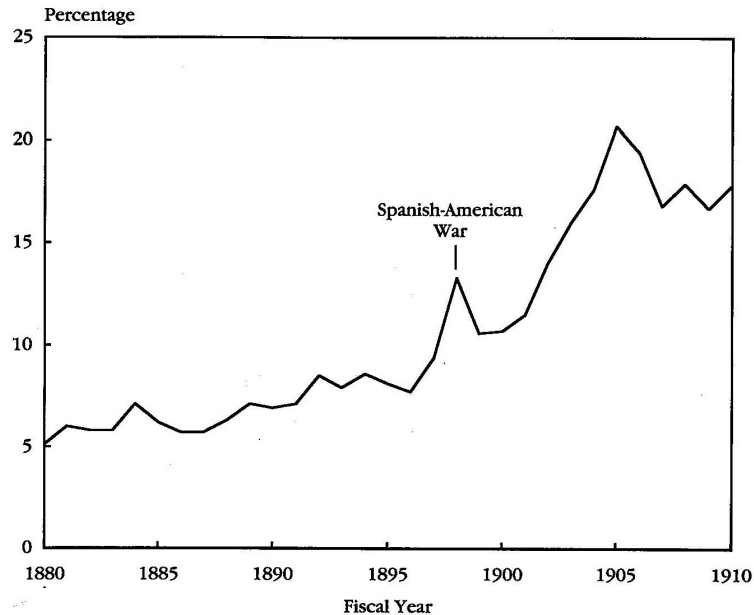
during which the impetus for foreign market search and expansionism peaked due to the worsening depression. See LaFeber, (1963:20,217), and Williams (1969).

⁴⁰⁷ This is not the only problem that has been noted in relation with the glut theory thesis, but it is by far the most relevant for the purposes of this work. See David M. Pletcher (1984:125); Mitchell (1946); and Herrick (1966:3,160,230). Also see William H. Becker (1973:466-481).

⁴⁰⁸ Notice that in the mid-1880s the United States' industrial power had surpassed that of Great Britain's, then considered the world's industrial power, in manufacturing output. See Kissinger (1994:37).

⁴⁰⁹ Zakaria considers this position as consistent with realist theories of international relations. Kissinger offers a different institutionalist explanation for slow American conversion

Figure 4.1. Naval Share of the Federal Budget, 1880-1899, *Historical Statistics of the US, Colonial Times to 1970, 1975, p.1115, Series Y 457-465. Adapted from Trubowitz, Defining the National Interest, p.39.*



While recognizing the value of Zakaria’s emphasis on institutional variables, this section offers an alternative explanation to the delayed or better conflicted and inconstant American embrace of the expansionist path—one grounded in the national security influence of the local financial crises of 1884 and 1893-96. In agreement with the formulated expectations, and contrary to the arguments of LaFeber and Williams, both of these crises overturned American attempts at rearmament and expansion, thus setting the nation on a radically cautious national security path. The withdrawals from expansion occurred, respectively, between 1884 and 1889, and between 1893 and 1898—that is, during, and in the aftermath, of the discussed

to expansion, one that focuses on the role of Congressional pressures. The American Senate, Kissinger argues, remained focused on domestic priorities and thwarted all expansionist projects, keeping the army small (25,000 men) and the navy weak. The explanation, however, is more an allusion than a statement backed by solid empirical evidence.

crises—and they were so radical as to infringe on American national security. The following paragraphs explain these claims.

In the early 1880s, the national security policies of the Arthur administration (1881-1885) rested on four major security objectives, which the nation had pursued since the end of the Civil War and the administration of President Ulysses Grant.⁴¹⁰ In their most toned-down formulation, these objectives consisted in impeding the construction of a foreign-built isthmian canal in Central America; protecting the Caribbean Sea; and defending American influence in Hawaii. This national security trinity demanded, in turn, the construction of a strong American Navy, although debate continued over whether the acquisition of naval bases for the control of the Caribbean and Hawaii was preferable to the establishment of closer commercial relations with those lands.⁴¹¹

In line with these objectives, between 1881 and 1884 the Arthur administration embarked on a plan to modernize the navy and intensify national expansionist efforts. This policy was rooted in the preservation of heterodox financial policies, namely bimetallism and silver coinage. Without the printing—by Treasury Secretary Hugh McCulloch—of 200 million silver dollars to assist in the

⁴¹⁰ See, amongst many, Campbell (1964:50-84); Leopold (1962:3-143); Stevens, (1945:201-202); Grenville and Young, (1966:83); Pletcher (2001); Pratt (1936:257); Trubowitz, Goldman, and Edward Rhodes (1893); Schulzinger (1984:18,19).

⁴¹¹ A strong navy was linked to the acquisition of naval bases as much as to the intensification of commercial relations between the United States and the Caribbean and Pacific islands. See Kissinger (1994:37); Mitchell (1946:11-16); Trubowitz (1998:36-37); Trubowitz et al. (1983:12). Building up a strong navy was a commitment of Democratic and Republican administrations alike. See the electoral campaign platforms between 1869 and 1900 in Porter and Johnson (1961).

national industry, this expansionist ambition would have collapsed.⁴¹² Congressional documents show that, between December 1882 and April 1884, increases in appropriations for the naval service were satisfactorily adopted. In April 1884, before the financial crisis had reached momentum, Secretary of State Frederick Frelinghuysen lauded the bill which approved, for the fiscal year ending June 30, 1885, the build-up of “a new American navy, and, as an installment of that navy, [...] seven additional cruisers.”⁴¹³

The administration’s interest in propping up naval budgets dovetailed with the adoption of a militant security posture in Central and Latin America, a position which brought the United States in sharper conflict with Great Britain. Building on its assertiveness, Frelinghuysen successfully concluded a number of reciprocity treaties, including the Frelinghuysen-Zavala Treaty negotiated in late 1884. By virtue of this Treaty, Nicaragua granted the US permission to construct an interoceanic canal in exchange for a permanent American-Nicaraguan alliance.⁴¹⁴

The project, which violated the requirements of the Anglo-American Clayton-Bulwer Treaty banning the construction of an American canal, was welcomed by President Arthur in December 1884 as an achievement whose “political

⁴¹² “Is This a Mystery?” *The Daily Register*, March 23, 1891.

⁴¹³ *Record of the US House of Representatives*, Committee on Appropriations, Department of the Navy, 47th Congress, Second Session, HR48A-F3.11, Box no.15, NARA; Naval Appropriation Bill, Congressional Record, House, vol.15, part 3, 48th Congress, 1st session, April 14, 1884, pp.2920-2927. In 1883 Congress had also authorized the construction of the country’s first steel warship. On these efforts see also, more broadly, Mitchell (1971:10-16); Narizny (2007:88); Long (1903:chapter 1); Sprout and Sprout (1946:162-64); and LaFeber (1963:104,105).

⁴¹⁴ Treaties were negotiated, for instance, with Mexico, the Dominican Republic, Cuba, Puerto Rico, Hawaii, and Nicaragua.

and commercial advantages could scarcely be overestimated.”⁴¹⁵ By this time the financial crisis had practically reached its conclusion.

These developments seem to refute the expectation that the Arthur administration was in LA–HE, facing strong pressures to endorse cautionary national security policies during the financial crisis (May through November 1884). Indeed, if the financial crisis was having an effect on national security policies, curbing the expansionist plans of the *incumbent* administration was not one of them. This lack of influence on the Arthur administration, however, has a simple explanation that strongly corroborates the framework and the rest of the earlier formulated expectations on the national security influence of the 1884 crisis.

The Arthur administration doubled down on its pre-crisis, assertive security posture because it was convinced that it was operating under LA–LE. This assumption was clearly wrong, although it remains unclear whether President Arthur would have benefited politically from behaving as if he were under LA–HE (as he indeed was). As the New York Stock Exchange collapsed in mid-1884, spreading alarm across the transnational business community and American financial elites, the presidential campaign was about to start.⁴¹⁶ Rather than trying to fix the policies of an incumbent administration, which transnational financial

⁴¹⁵ Message of the President, *Journal of the Senate*, 48th Congress, Second session, December 1, 1884, NARA; “The Nicaragua Treaty,” *New York Times*, December 3, 1884. See also Walton (1953). Concluding a treaty with Nicaragua had been on the agenda since 1876, the year in which the Canal Commission unanimously recommended this route for an interoceanic canal. Frelinghuysen had tried to pressure Great Britain to abrogate the Clayton-Bulwer Treaty and recognize the Monroe Doctrine even in 1882, and then Britain’s refusal did not weaken the administration’s efforts to overrule the treaty with Britain.

⁴¹⁶ “On the Verge of Panic: Wall Street Alarmed by a Succession of Failures,” *New York Times*, May 15, 1884.

markets regarded as tainted by an unorthodox financial record, American financial elites worked towards assuring the election of the presidential candidate who would most successfully signal credibility to financial markets and stopped the gold drain.⁴¹⁷ Despite their growing concerns regarding the “impairment of the national credit,” candidates Chester Arthur and James Blaine, respectively incumbent president and incumbent secretary of state, faced extremely bleak re-election prospects.⁴¹⁸

As financial newspapers of the time indicate, between May 1884 and November 1884, American business magnates Daniel Manning, Samuel Jones Tilden, and Thomas Bayard sided with Grover Cleveland. Cleveland was a more credible opponent of free silver and inflation than Arthur or Blaine could ever be. Cleveland also abhorred imperialism, interventionism, and entangling alliances.⁴¹⁹ As a banker put it, American financial elites were looking for “a business man” who could defend “sound monetary principles” and “the honest, commercial law of the

⁴¹⁷ Arthur’s re-election prospects were already dim before the campaign started. He withdrew due to health reasons.

⁴¹⁸ Neither Arthur nor Blaine could calm the business fears of pursuing a policy at variance with sound monetary principles, even though both had pledged to greater respect of international financial cooperation during the campaign. They kept being associated with inflationary policies and panics. Compared to Cleveland, a member of the Bourbon Democrats, they stood basically no chance of re-election. *Message of the President to Congress*, December 1, 1884, 48th Congress, 2nd session, NARA; “The Reason and Remedy,” *Washington Post*, May 17, 1884; “Mr. Blaine of Panics,” *Washington Post*, June 10, 1884; “Blaine and the Business Men,” *New York Times*, October 13, 1884; “Better Business Prospect,” *Washington Post*, January 2, 1885.

⁴¹⁹ Cleveland had also the advantage of having no connection with the running Republican candidates whose policies had allegedly caused the financial crisis and endangered American commitment to the gold standard. Cleveland’s letter to Senator Morrill, December 8, 1884, in *The Papers of Grover Cleveland, 1859-1908*, Manuscript Division, LOC, DC, Series 2, General Correspondence, 1846-1910, Reel 3; “Rallying to Cleveland: The Great Demonstration of the Business Men,” *New York Times*, October 10, 1884; “The Great Parade Today: The Monster Procession of the Business Men Who Favor Cleveland,” *New York Times*, October 24, 1884; “The Administration Outlook,” *Washington Post*, March 13, 1885. See also Grenville (1966:42-45).

world,” as much as a statesman who was diffident “about making star route contracts.”⁴²⁰ No presidential candidate fit this profile better than Cleveland. In March 1885, during the installment of the new administration, the business community would happily declare that “Mr. Cleveland [would] never place himself at variance with sound monetary principles” and that “the character of his foreign policy” promised to “keep [the US cabinet] religiously aloof from all entangling alliances and fully in line with the characteristic reluctance of American people to meddle with other people’s affairs.”⁴²¹

The expectation that the financial crisis of 1884 created pressures for endorsing more cautious national security policies is therefore verified. The electoral campaign was the terrain upon which these pressures played out, while the victory of Cleveland and his financial and security platform attested to their strength. As expected for a statist-nationalist government meeting financial crisis in LA–HE, the pre-1884 national security agenda was overhauled, and the withdrawal from expansionism involved the broad spectrum of national security policies, namely military spending, threat assessment, and war prospects.⁴²² I will examine them in turn.

The ambitious expansionist agenda of the Arthur administration started to crumble as early as December 1884, when the conclusion of the financial crisis and

⁴²⁰ “Rallying to Cleveland,” *New York Times*, October 10, 1884.

⁴²¹ “The Administration Outlook,” *Washington Post*, March 13, 1885. Notice also that Cleveland had held no federal or military office before becoming president in 1885.

⁴²² A number of scholars have already noted the prudent national security policies endorsed by the Cleveland administration after 1884, although no one has recognized the fundamental role of the financial crisis of 1884 in engineering this foreign policy calmness. Amongst these scholars are, for instance, Narizny (2007:39-92); Campbell (1964); and Trubowitz (1998:37-38).

the presidential campaign left no doubt about the binding commitment of the newly elected administration to defend gold and financial orthodoxy, and, inevitably, the ostracizing of silver production and coinage.⁴²³ A letter sent to the House by the Secretary of the Navy Chandler reveals that by late December 1884, existing bills for appropriating additional cruisers had been dropped in the Senate.⁴²⁴

By January 1885 the House, too, had approved a Navy bill that suspended naval construction for two and half years, in an attempt to impede “money squandering.”⁴²⁵ After its official installment in March 1885, the Cleveland administration pushed forward military retrenchment and rejected pleas for battleships from the navy department in order to place American finances “on a sound and sensible basis.”⁴²⁶ As Table 4 exhibits, between 1883 and 1886, the naval modernization program of the Arthur administration stalled. Military spending decreased 32 percent compared to a GNP decrease of 4 percent, and a decrease in total government spending of “only” 8 percent. In the summer of 1886, *The New York Times* denounced 16-month delays in contract assignments for vessel building, and the laying off of thousands of navy employees for “lack of funds.”⁴²⁷

⁴²³ In 1885, Daniel Manning took possession of the Treasury, replacing “tainted with heterodoxy” Hugh McCulloch.

⁴²⁴ Letter sent by Chandler to Chairman of the Committee of Appropriations of the House Samuel Randall on December 31, 1884 in *Record of the US House of Representatives*, 48th Congress, HR48A-F3.11, Box 14, NARA.

⁴²⁵ Naval Appropriations Bill, Congressional Record, House vol.16, part 3, 48th Congress, 2nd session, February 23, 1885, pp.2041-43; and “Appropriations for the Navy,” *Washington Post*, January 13, 1885; Message of the President of the United States to Congress delivered on December 8, 1885, *Journal of the Senate*, 49th Congress, 1st session, NARA.

⁴²⁶ James D. Richardson, ed., *A Compilation of the Messages and Papers of the Presidents, 1789-1897*, Washington, DC, (1899), vol. VIII, p.302.

⁴²⁷ “The New Navy,” *New York Times*, June 26, 1885; and “The Navy Yard Deserted: Over 1,000 employees laid off because of lack of funds,” *New York Times*, July 2, 1886.

Military retrenchment was accompanied by the endorsement of a more cautious foreign policy stance, and a milder threat assessment. With the exception of the treaty between the United States and Hawaii, which Cleveland firmly defended and renewed in 1886, all reciprocity treaties concluded by the Arthur administration were withdrawn under the premise that the United States, in Cleveland's words, was committed to a policy of "peace, commerce, and honest friendship with all nations, and entangling alliances with none."⁴²⁸

Table 4.4 American real military spending (ME), GNP and government spending (CGE) between 1880 and 1897

Year	Real ME	Real CGE	Real GNP	ME/GNP	ME/CGE
1881	56	261	11483	0.004	0.21
1882	59	258	12343	0.005	0.23
1883	65	270	12590	0.005	0.24
1884	58	250	12348	0.005	0.23
1885	60	265	11656	0.005	0.22
1886	49	249	12113	0.004	0.19
1887	54	266	12162	0.004	0.20
1888	55	268	12420	0.004	0.21
1889	68	308	13315	0.005	0.22
1890	68	324	13524	0.005	0.21
1891	75	366	13742	0.006	0.21
1892	76	345	14081	0.005	0.22
1893	81	387	14390	0.006	0.21
1894	90	386	13937	0.006	0.23
1895	83	363	14330	0.006	0.22
1896	78	352	14044	0.006	0.22
1897	85	369	15065	0.006	0.23
1898	151	443	15869	0.010	0.34

Supporting framework and expectations, Cleveland justified this withdrawal from expansionism and the related promotion of international peace with the necessity of pursuing financial policies that expressed greater commitment to the

⁴²⁸ *Annual Message of the President*, December 8, 1885, Richardson, A Compilation, VIII, pp. 327-28; Cleveland expressed his conviction of the necessity to preserve the American-Hawaiian Treaty in a message to Congress of December 6, 1886; *Journal of the Senate*, 49th Congress, 2nd session. See also Richardson, *A Compilation*, VIII, pp.500-501.

gold standard. “Nothing,” he stated in a speech to Congress in December 1885, was “more important” than the “present condition of [...] currency and coinage.”⁴²⁹

The lack of adequate financial means and the necessity to strengthen national financial credibility was reiterated when the Frelinghuysen-Zavala treaty was scrapped in early 1885, providing for the most remarkable “softening” of American threat assessment compared to the pre-financial crisis period. Previously established plans to construct an American canal were abandoned by the administration and Congress because of their excessive financial cost and the “embarrassing” alliance against Great Britain—the primary defender of the gold standard—that the US-Nicaragua treaty entailed.⁴³⁰

Ultimately, with the withdrawal of the Frelinghuysen-Zavala treaty and the cancellation of the progress made towards the construction of an American canal, the United States moved from its pre-crisis position as Great Britain’s foremost challenger in Central America to Great Britain’s best ally, determined to preserve the Clayton-Bulwer Treaty and subordinate American national security decisions to the British will.⁴³¹ Rearmament and the acquisition of an American canal were

⁴²⁹ Message of the President of the United States to Congress, *Journal of the Senate*, 49th Congress, 1st session, December 8, 1885.

⁴³⁰ *Journal of the Executive Proceedings of the Senate* (Washington 1901), XXIV, 453, pp.456, 481; the treaty failed ratification in February 1885. “The Nicaragua Canal Bad Bargain,” *New York Times*, January 9, 1885; “Cleveland on Expansion: His Views Clearly Defined in Connection with Nicaragua and Hawaii,” *Washington Post*, October 30, 1900; “The President’s Message,” December 9, 1885, *New York Times*.

⁴³¹ The Cleveland administration also withdrew American participation in the international convention concerning the Congo Free State, lest it entangle the US in diplomatic conflicts with England or Europe in Africa. The US had joined the Berlin Conference in November 1884, in view of the trade opportunities offered by the Congo. The American representative in Berlin signed the Berlin Act, but Cleveland declined to submit it to the Senate. His explanation was the same as the one offered for the ditching of the United States-Nicaraguan Treaty. President Cleveland, Message to Congress, *Journal of the Senate*, 49th Congress, 2nd session, December 6, 1886. See also Kasson (1886:119-33).

pushed out of the agenda and there remained for many years. British-American war prospects collapsed as a result. Had the financial crisis of 1884 not occurred, and had American financial elites and the transnational power of financial orthodoxy not been strong, the US Treasury would have not complied to a strict program of adherence to the gold standard; silver coinage would have continued, enlarging the financial capacity of the Treasury; military and expansionist plans would have moved forward; the construction of a Nicaragua canal would have been at the very least initiated; and stronger alliances between the United States and countries in Central America would have been concluded. American national security policies between 1884 and 1887 would have been remarkably different from what we know about them today.⁴³²

The Cleveland administration faced strong pressures to endorse—and eventually did endorse—greater national security restraint even during the financial crisis of 1893-96. More so than between 1884 and 1885, and by HA–HE, diplomatic and military wariness reached alarming heights in the mid-1890s, providing further confirmation of the framework. This time, as emerges from press records and presidential papers, American financial elites had acted preventively before the outbreak of the crisis. When *fears* of a national gold default surfaced between 1891 and 1892, shortly after the global financial crisis of 1890-91, Wall

⁴³² Interestingly, the election of the Harrison administration in 1888—an administration which was visibly in favor of an expansionist foreign policy—occurred in the absence of a financial crisis and when American gold reserves were rising, as Tab.1 shows. Also, by 1888 Cleveland’s incentives for a strict observance of financial orthodoxy had receded as exports kept shrinking and financial conditions failed to match the enormous manufacturing power (Tab.1). Significantly, in 1888 President Cleveland was newly pressing for an international conference on bimetallism. In 1889, before the installment of the Harrison administration, Cleveland had shown an increasingly belligerent attitude by sending American warships to deter Germany from taking control of the Samoan islands. See Hagan (1991:193-227); Herrick (1966:11).

Street bankers took advantage of the electoral campaign of 1892 to support, once again (and once again successfully), Grover Cleveland.⁴³³ As Table 4.1 shows, gold outflows increased between 1891 and 1892, following the global financial crisis of 1890-91. Although the American economy had escaped the crisis, alarm newly spread across American financial circles. As in 1884, pressures on presidential candidates mounted.

In agreement with expectations, between 1893 and early 1895 the course of national security policies gave in to these pressures. In 1892, Cleveland clearly knew how to give business elites a run for their money. His position against the coinage of silver dollars, his anti-imperialist views, and his overall cautious presidential record made him extremely appealing to high finance.

By contrast, as was true for James Blaine in 1884, the financial record of incumbent president and runner-up Benjamin Harrison was tainted. Since Harrison's ambitious national security policies stood little chance of being realized without enlarging the financial capacity of the US Treasury through silver coinage, between 1889 and 1892, the administration had pursued heterodox, silver-friendly policies, as well as expansionist and inflationary military policies (Tab.1 and Tab.5).⁴³⁴ In

⁴³³ Letter of the State Treasurer of Missouri to Cleveland of November 5, 1891 in *The Papers of Grover Cleveland*, 1859-1908, Manuscript Division, LOC, DC, Series 2, General Correspondence, 1846-1910, Reel 69; "Secretary Foster Discusses Relations of Gold and Silver," *Washington Post*, November 11, 1891; "Gold Supply and Bimetallism," and "Finances of the Nation: Annual Report of Treasury and Results of Reciprocity," *Washington Post*, December 7, 1892; "Alarm in Financial Circles," and "Getting All our Gold: Treasury Officials Anxious to Stop the Drain made by Europe," *Washington Post*, December 19, 1892; "American Nation in Jeopardy," and "Nothing But Money: This has been the Absorbing Topic on Wall Street" *Chicago Daily Tribune*, December 19, 1892.

⁴³⁴ Secretary of the Treasury John Foster was wholeheartedly committed to silver coinage and justified it based on the country's remarkable economic growth. "Mr. Foster's views," *New York Times*, June 26, 1891.

particular, the latter set of policies included an offensive naval strategy and the related build-up of a world-class battle fleet; the creation of American commercial empire through sustained trade reciprocity; and a spirited defense of the Monroe Doctrine.⁴³⁵ A foremost pillar of these plans was the furthering of the American hold on Hawaii. Envisioning the forthcoming annexation of the Islands, the Hamilton administration aided in the overthrow of the native monarchy of Queen Liliuokalani in January 1893, hastily negotiating an annexation treaty with the provisional government.⁴³⁶

Cleveland's victory in November 1892 shattered this ambitious national security agenda. Confirming framework and expectations, immediately upon his March 1893 installment—and, just as the financial crisis was starting, Cleveland curbed his predecessor's imperialist policy by withdrawing the Hawaiian annexation treaty from the Senate.⁴³⁷ The administration justified the maneuver with ethical

⁴³⁵ On the expansionist program of the Harrison administration, see "The Grand Possibilities of Secretary Blaine's Reciprocity Policy," *Chicago Daily Tribune*, February 15, 1891; Charles Hedges, *Speeches of Benjamin Harrison: A Complete Collection of His Public Addresses from February 1888, to February 1892*, New York, (1892), pp.287,325,388,409,415,467-68,499-500; Hagan (1991:194-95); Herrick (1966:3); Trubowitz et al.(1983:32); Grenville and Young (1966:93); and Richardson, *A Compilation*, pp.122-123. Under Secretary of the Navy Benjamin Tracy, a series of ambitious naval acts was passed. Over the course of 1890, the Navy's share of the federal budget more than doubled. Between late 1891 and early 1892, the United States had also come very close to a war with Chile. LaFeber (1963:130); Hagan (1991:199).

⁴³⁶ After the Hawaiian revolution of mid-January 1893, which deposed the Queen and established a provisional government, American Hawaiian minister John Stevens urged the administration to annex the islands before Great Britain "plucked the Hawaiian Pear." Stevens to Foster, February 1, 1893, *House Executive Documents*, 53rd Congress, 2nd session, no.48, p.136; the text of Stevens' announcement is in *Congressional Record*, 53rd Congress, 2nd session, p.191.

⁴³⁷ Secretary of State Water Q. Gresham to Blount, March 11, 1893, *House Executive Documents*, 53rd Congress, 2nd session, n.47, p.2. The withdrawal of the Hawaiian annexation treaty in 1893 echoed the withdrawal of the Frelinghuysen-Zavala canal treaty soon after the crisis of 1884. Cleveland accompanied the withdrawal of the Treaty with the setup of a commission to investigate the causes of the revolution and Hawaiian sentiment towards annexation. James Blount was the commissioner appointed by the administration to investigate the Hawaiian revolution.

considerations on the circumstances surrounding the downfall of the Hawaiian government.⁴³⁸

Yet the President's inaugural speech made clear that the withdrawal did not respond *primarily* to considerations of morality, but to the need to abide by the principles of international financial cooperation. In March 1893, Cleveland stated: "*Nothing is more vital to our supremacy as a nation [...] than a sound and stable currency. [...] In dealing with our present embarrassing situation [...] we will be wise if we temper our confidence and faith in our national strength and resources with the frank concession that even these will not permit us to defy with impunity the inexorable laws of finance and trade.*"⁴³⁹ Further tempering confidence in American national strength was the concomitant decision, in March 1893, to scrap warship authorizations for that year. As displayed in Figure 4.2, however, no warship was authorized for two years, indicating that the financial crisis of 1893-96 pushed cautionary national security policies forward and caused what Herrick has defined as a "hiatus" in American naval revolution.⁴⁴⁰

⁴³⁸ The emphasis on moral factors to justify the righteousness of hijacking the annexation treaty emerges from a variety of the administration's declarations with regard to Hawaii in 1893 and 1894. The interference of the Harrison administration in the process leading up to the Hawaiian revolution also made ethical debates rather legitimate. *Foreign Relations of the United States*, 1894, Appendix II, pp.197-205; Committee on Foreign Affairs of the House, *Record of US House of Representatives*, 53Congress, First session, HR 53A-F11.1, box 139, NARA; *Congressional Record*, 53 Congress, 2session, pp.5499-5500; Lorrin A. Thurston, *Memoirs of the Hawaiian Revolution*, Honolulu: Advertiser Publishing Co. (1936), p.302; Blount to Gresham, July 17 and 31, 1893, *House Executive Documents*, 53rd Congress, 2nd session, n.47, pp.144,164. Ethical debates on the issue of Hawaiian annexation occurred frequently in Congress in 1893 and 1894.

⁴³⁹ Grover Cleveland, Inaugural Address, March 4, 1893. "President's Address: Cleveland's Inaugural Speech Smooth and Well," *Chicago Daily Tribune*, March 5, 1893.

⁴⁴⁰ Herrick (1966:153,154).

Archival records confirm that, between 1893 and 1895, the House and the Senate strongly supported Cleveland's policy of economy in the naval appropriations bills so that legislative energies could center, as one senator put it, on the supreme issue of "how to maintain the present standard of gold and not have to adopt monometallism." Congressional pressures for economies in the naval appropriations bill began in early February 1893, before Cleveland entered office, and before the start of the 1893-96 crisis.⁴⁴¹

Figure 4.2. *Warships Authorized 1893-9 (Mitchell, History of the Modern American Navy, p.26)*

TABLE II
WARSHIPS AUTHORIZED, 1890-97

name	class	tonnage	speed knots	main armament
1890				
OREGON	B. S.	10,288	16	four 13", eight 8", four 6"
MASSACHUSETTS	B. S.	10,288	16	four 13", eight 8", four 6"
INDIANA	B. S.	10,288	16	four 13", eight 8", four 6"
COLUMBIA	P. Cr.	7,375	23	one 8", two 6", eight 4"
One torpedo boat				
1891				
MINNEAPOLIS	P. Cr.	7,375	23	one 8", two 6", eight 4"
1892				
IOWA	B. S.	11,340	17	four 12", eight 8", six 4"
BROOKLYN	A. Cr.	9,215	22	eight 8", twelve 5"
1893				
Three gunboats, one submarine.				
1894				
One tug, three torpedo boats.				
1895				
KEARSARGE	B. S.	11,525	16	four 13", four 8", four- teen 5"
KENTUCKY	B. S.	11,525	16	four 13", four 8", four- teen 5"
1896				
ALABAMA	B. S.	11,565	16	four 13", fourteen 6"
ILLINOIS	B. S.	11,565	16	four 13", fourteen 6"
WISCONSIN	B. S.	11,565	16	four 13", fourteen 6"
Ten torpedo boats.				

⁴⁴¹ Committee on Foreign Affairs of the House; Various Sessions; Record of the House, 53rd Congress, 1st session, HR 53A-F11.1, Boxes 100,139, NARA; Committee on Banking and Currency of the House Record of the US House of Representatives 53rd Congress, 1st session, HR 53A-F4.1, Rg 233, Boxes 39,41,44, Statement of Mr. W.T. Grant of Louisville, Kentucky on July 2, 1894 in Committee on Banking and Currency of the House Record of the US House of Representatives, 53rd Congress, 1st session HR 53A-F4.1, Rg 233, Box 41, NARA; "Economy in the Naval Appropriations Bill," *Washington Post*, February 8, 1893.

Yet, the historical record indicates that had the financial crisis not occurred, Cleveland's national security decisions between 1893 and 1895 would have been remarkably different from the ones actually undertaken. To begin with, the President was not a dove. Cleveland was strongly persuaded of the vital importance of Hawaii to American security. From the conclusion of American-Hawaiian Reciprocity Treaty in 1875 until the financial crisis of 1893-96, no Republican or Democratic administration had refused to renew the Treaty or dared to question the strategic significance of Hawaii and American military presence in the Pacific—nor did Cleveland before 1893. Even when retrenchment plans were undertaken during and soon after the crisis of 1884, the Bourbon Democrat had saved and strengthened the American reciprocity treaty with Hawaii, considering it an unyielding bastion of US foreign policy and concluding—in 1886—that the “paramount influence” acquired in Hawaii and “the telegraphic communications between those Islands and the United States” needed to “be maintained.”⁴⁴²

Moreover, despite his distaste for Harrison's imperialism, Cleveland completely understood the necessity of strengthening the American navy for defending the nation's seacoast, confronting the first-class vessels of other powers, and preventing an infringement of the Monroe Doctrine. By endorsing economies in

⁴⁴² Message of Cleveland to Congress, December 6, 1886, *Journal of the Senate*, 49th Congress, 2nd session, NARA. Notice that American fears of British influence in Hawaii had been the most impellent reason behind the conclusion of the treaty in 1875. Article IV of the US treaty with Hawaii expressed its essence. It prohibited Honolulu from granting “any special privilege or rights or use therein to any other power, state or government.” See Kirshner and Abdelal (1999:128).

the naval appropriations bill in early 1893, Cleveland did not intend to scrap American naval rearmament.

In March 1893 he even appointed Hilary A. Herbert, an ex-colonel commonly known for backing expansionist bills, as head of the Department of the Navy. In fact, Herbert was quite successful in mustering support for allocating resources to the navy (slowdown in battleship construction aside), which also explains why military spending did not drop substantially between 1893 and 1895, as Table 4.5 shows.⁴⁴³

Table 4.5. Total Investments of American Bank

Year	Commercial Bank Investments	Year	Commercial Bank Investments
1900	1410	1880	904
1901	1676	1881	985
1902	1821	1882	1055
1903	2016	1883	1028
1904	2226	1884	1041
1905	2523	1885	1042
1906	2563	1886	1051
1907	2744	1887	1011
1908	2912	1888	1131
1909	3153	1889	1129
1910	3156	1890	1173

The President placed no opposition on Herbert's work indicating that, had the financial crisis not occurred, naval spending figures for the years 1893 and 1894 would have been much higher. Further attesting that American national security decisions between 1893 and 1895 would have been markedly different had the financial crisis not occurred and had the administration not felt the utmost need to

⁴⁴³ See sketch of Herbert in DAB, VII, 572-73, in *Philadelphia Evening Telegram*, February 23, 1893; and in *Troy Daily Press*. See also Herrick (1966:154-155).

reassure financial markets of American creditworthiness, President Cleveland did not limit American retreat from expansionism to the withdrawal of the American-Hawaiian annexation treaty. He went further, and then some. As the crisis deepened between July 1893 and January 1895, Cleveland felt an increasing obligation to defend the nation's respect of the inexorable laws of international finance, and plunged into an exceedingly restrained national security path. Between July and August 1895, as the depletion of gold from the vaults of the Treasury continued, Cleveland convened an extra session of Congress to alert the State to the immediate necessity of obtaining the seal of approval of international financial markets. As the President stated, "lack of confidence at home and abroad" over American pro-silver financial policies was "shunning the country out of the nations of the first class."⁴⁴⁴ A few weeks after this statement, the administration instructed the American minister in Honolulu, Albert S. Willis, to tell the deposed Queen that the United States regretted American military presence in Hawaii and supported her reinstatement *provided that she promised to assume the provisional government's debt.*⁴⁴⁵

⁴⁴⁴ Message from President Cleveland, Journal of the Senate, 1st session, 53rd Congress, 1893, August 7, 1893, NARA. Cleveland could not have used stronger words to convey the necessity, at this stage of the crisis, of a stricter adherence to orthodoxy. As he put it, "the present perilous condition is largely the result of a financial policy which the executive branch of the government finds embodied in unwise laws, which must be executed until repealed by Congress." He was referring here to the Sherman Act.

⁴⁴⁵ Albert S. Willis, new US Envoy and Minister Plenipotentiary in Honolulu after the ousting of Stevens carried the message to the dethroned Queen and Hon. S.B. Dole, who was head of the provisional government. Gresham to Willis, October 13, 1893, FRUS 1894, Appendix II, pp.1189-91; Willis to Gresham, January 14,16,19 and February 10, 1893, Committee on Foreign Affairs of the House, Various Sessions, *Record of the US House of Representatives*, 53rd Congress, 1st session, HR 53A-F11.1, Box 100 NARA; Oliver T. Morton to Gresham, November 17, 1893, in *Papers of Walter Quintin Gresham*, vol.41, August 23, 1893 to Jan 9, 1894, Manuscript Division, Library of Congress, Washington, DC. See also Alexander (1896).

Besides further exposing the weakness of American Hawaiian policy, the decision to reinstall the Queen would have been unthinkable for a moralist of the caliber of Grover Cleveland had he not been increasingly entangled in his battle to defend American adherence to the gold par, and therefore unable to take on foreign debts.⁴⁴⁶ Indeed, how could someone concerned with American and international morality reinstall a government that, as the Blount report of July 1893 made clear, was undesired by the Hawaiians to the point that they preferred American annexation to a return of the Queen? The picture of a Democratic president advocating monarchy was already strange enough. Unfortunately, in his assessment of the reasons “shunning the United States out of the nations of the first class,” Cleveland could not have been more mistaken. Taking advantage of American “disinterest” in the Pacific, Great Britain in October 1894 drafted an agreement with Honolulu to lay a submarine cable between the British colonies of Canada and Australasia.⁴⁴⁷ It is impossible to underestimate the significance of this plan for Great Britain: the domain of the British Empire would have been enlarged, while two British colonies would have served as counterweights to America’s rising power. The only condition barring the Hawaiian government from concluding the agreement was its reciprocity treaty with the United States.

⁴⁴⁶ The American Congress took the side of the Hawaiians, agreeing on one basic point (which Cleveland would not have disputed in the absence of a financial crisis): the United States should not attempt to undo the Hawaiian revolution. Cleveland and Gresham accepted the recommendation in the end. The Queen was not reinstated. On the Blount Report, see *Senate Reports*, 53rd Congress, 2nd session, n.227, pp.xxi,xxxiii-iv.

⁴⁴⁷ Memorandum of the Agreement between the Hawaiian government and representatives of Great Britain and the British colonies, Honolulu, October 1894, Committee on Foreign Affairs of the House, Various Subjects; *Record of the US House of Representatives*, 53rd Congress, 1st session, HR 53A-F16.1, Box no.100, NARA.

Providing extra support to the hyperbolic diplomatic and military carefulness foreseen by HA–HE, in January 1895 the administration brought its cautionary foreign policy stance to its most dangerous extreme, practically repudiating the US Reciprocity Treaty with Hawaii and American Hawaiian policy more broadly. While the treaty had been consistently renewed by American administrations from 1875 onwards, Cleveland had fully endorsed and pledged to defend it.⁴⁴⁸ In December 1895, however, engaged in what he later defined as “averting” the “imminent disaster” resulting from the “collapse of the entire system of credit,” Cleveland asked Congress to amend the existing reciprocity treaty with Hawaii so that telegraphic rights could be awarded to Great Britain, and British colonies Canada and Australia, instead of the United States.⁴⁴⁹ Concurrently, American naval forces were withdrawn from Hawaiian waters.⁴⁵⁰ In doing so, Cleveland was letting Great Britain “pluck the Hawaiian pear,” to use an expression that was popular at the time—and not the only pear to pluck, as revealed by British statements and actions towards Nicaragua in May 1895 and towards Venezuela shortly thereafter. Between 1894 and 1895, Great Britain assumed an increasingly interventionist posture in Central America. In May 1895, British marines occupied the

⁴⁴⁸ Message of the President relative to proposed submarine cable in Hawaii, *Congressional Record*, Vol.27, part 1, January 9, 1895, p.768; and Message of Secretary of State Gresham, Committee on Foreign Affairs of the House, Various Subjects; *Record of the US House of Representatives*, 53rd Congress, 1st session, HR 53A-F16.1, Box no.100, NARA; “Hawaiian Cable Looks Certain Now,” *Chicago Tribune*, February 1, 1895; “Cleveland is keeping up a policy of infamy,” *Chicago Daily Tribune*, January 15, 1895; “Hawaiian Cable: The Question Comes Before Both Houses,” *Los Angeles Times*, February 19, 1895; “Will Not Aid the Hawaiian Cable,” *Chicago Daily Tribune*, February 22, 1895.

⁴⁴⁹ Annual Message of the President, December 2, 1895, *Journal of the Senate*, 54th Congress, NARA.

⁴⁵⁰ On the withdrawal of naval forces from Hawaii between late 1894 and January 1895, see Leopold (1945:136).

Nicaraguan port of Corinto for a few days, expelled the British consul there, and demanded an indemnity after the government incorporated the Mosquito islands. The Cleveland administration closed one eye. The United States' prudent threat assessment lured Great Britain, and a couple months later London intensified its demands towards Venezuela over the boundary line of the British Guyana.

The administration's exposure to high finance was making a mockery of the Monroe doctrine and trumping American national security. Things were about to change, however. Pressures for pursuing greater national security caution eased off starting in late February 1895 when, in agreement with framework and expectations, Cleveland's cosmopolitan government found itself in HA–LE. In the following months, a move away from an exceedingly cautionary security stance occurred but, as expected, the American government did not unwaveringly embark on a more assertive national security course, instead showing substantial ambiguity—arguably the same ambiguity that characterized its post-February 1895 financial policies of crisis response. Soon after the failure of the Morgan-Cleveland agreement, Congress voted out the proposed amendment to the American Hawaiian treaty and a bolder program of battleship construction was authorized (Fig. 4.2 and Tab. 4.5).⁴⁵¹ Between spring and summer of 1895, President Cleveland

⁴⁵¹ President Cleveland and Secretary of State Walter Gresham resisted the rising tide of American bellicosity until February 1895. On the rising bellicosity and the resumption of military build-up starting in February 1895 see *Congressional Record*, 53rd Congress, 3rd session, p.3113; Richardson, *Messages and Papers*, pp.540-41; “New Battleships and Torpedo-boats Authorized to be constructed,” *Los Angeles Times*, February 21, 1895; Navy Department, Annual Report, 1894-95. See also Mitchell (1946:22-26); LaFeber (1963:175-8); Herrick (1966:175-85); Grenville and Young (1966:120-123); Leopold (1962:138); and Ferrell (1987:18).

and newly installed Secretary of State Richard Olney adopted a much less dovish foreign policy stance towards Great Britain. In July 1895, Olney notified the British cabinet that its Venezuelan demands infringed upon the Monroe Doctrine, and that the United States would act as a Venezuelan ally if needed.⁴⁵² Strategically and diplomatically, this increase in national security readiness was far from being a secure foray into international assertiveness. The American government was just defending principles of regional security that it had established back in 1823. Moreover, Cleveland waited months before responding to British provocations; he continued to advocate for an international arbitration of the Venezuelan dispute; and had he really wanted to flex American diplomatic and military muscles, he could easily have begun by liberating Cuba from the Spanish oppressor—an action that was explicitly opposed by both Cleveland and Olney even when domestic pressures to intervene mounted throughout 1895.⁴⁵³

However, when the British refused to take Olney's message seriously, Cleveland pledged to "resist by every means in its power" ongoing British efforts to exercise jurisdiction over Venezuelan territory, a promise that the government would not have made in 1893, 1894, or early February 1895.⁴⁵⁴

⁴⁵² In April 1895 British marines landed in Nicaragua for a few days after Nicaragua had expelled the British consul from the Mosquito islands. On the Venezuelan border dispute between Great Britain and the United States, Cleveland's stance, and its resolution, see Campbell (1976:chapter 11).

⁴⁵³ On the Cleveland administration's position versus an American-Spanish conflict, see Grenville and Young (1966:181,182,184); Trask (1981:11-22); Offner (1992:2,25); and Kirshner (2007:32-33). See also "No Action Toward Cuba: The President Will Not Recognize the Insurgents," *New York Times*, June 12, 1896.

⁴⁵⁴ See Cleveland's Presidential Address to the Royal Historical Society in Humphreys (1967), pp.131-164.

In this context of ambiguity regarding threat assessment, war prospects, and, obliquely, military spending too, one thing was clear: Cleveland was no longer linked to or could no longer rely on a pro-finance friendly, pro-British, and anti-Treasury American foreign policy to kick-start national financial and economic recovery. Preserving national honor after a phase of conciliatory diplomacy “gone bad” was surely a reason for this development.⁴⁵⁵ Another reason, which validates HA–LE, was an increased uncertainty in the administration’s crisis response strategy. After February 1895, this strategy no longer required the demands or suggestions of high finance.⁴⁵⁶ Throughout that year, Morgan and his acolytes continued to stand ready to assist the Treasury with individual and collective offers of syndicates and gold deposits to save the nation from bankruptcy but Cleveland and Carlisle regarded a new private loan as “politically inexpedient” and opted for a public loan in January 1896 (Carosso 1987:340-343).⁴⁵⁷ In sum, American financial policies and security policies in 1895, during the second stage of response to the financial crisis of 1893-96 reproduced a political fracture between the Cleveland administration and high finance that helped polarize domestic politics.

⁴⁵⁵ As Cleveland stated in November 1895, “I am nevertheless firm in my conviction that, while it is a grievous thing to contemplate the two great English-speaking peoples of the world as being otherwise than friendly competitors in the onward march of civilization [...], there is no calamity which a great nation can invite which equals [...] the loss of national self-respect and honor”; Cleveland’s words in Whittle (1920:216).

⁴⁵⁶ Many eminent Wall Street firms (including J.P. Morgan) were very close to exhausting their available gold too at this point.

⁴⁵⁷ Facing a much more undecided American government, and convinced that the American public was the culprit for a failed financial recovery, Wall Street titans embarked on a reform movement against Free Silver in the attempt at converting the American public to gold monometallism. On Wall Street’s attempts to convert the masses, see Livingston (1986:88,89).

Under McKinley, the ambiguity in national financial policy increased as the president continued along the path laid by his predecessor by strengthening the taxing and spending powers of the Treasury in reaction to the financial crisis,⁴⁵⁸ and by *reaching an international bimetallic agreement* to preserve American participation in the gold standard (McCulley 1992:54). This investment in the independence of the American Treasury, a strategy that insulated the government politically from the pressures of “gold monometallists” and “silverites,” is a fundamental variable to help explain how an cosmopolitan administration like that of McKinley’s, which in stable financial conditions would have committed to international peace, was slowly dragged into a war that it did not want to fight between 1897 and 1898. The transition to assertiveness would have been much more difficult had the administration not prioritized national legislation favoring a stronger Treasury—a policy heritage of the financial crisis—and had the financial crisis not contributed, as previously illustrated, to alienating Wall Street from the rest of the American public, the administration from Wall Street, and ultimately the administration from financially splintered interests. All of these elements are compatible with the expectation that the American administration after February 1895 found itself in HA–LE—guarded national security policies being gradually abandoned.

Ultimately, the financial crisis of 1893-96 profoundly shaped American threat assessment and war prospects. Without it, American financial elites would not have

⁴⁵⁸ In his acceptance speech to the G.O.P. Notification Committee, McKinley stressed the government’s need of raising sufficient revenues and avoiding paying excessive interest rates to private finance because of the negative financial and economic repercussions of this policy domestically. See the *Cleveland Gazette*, August 8, 1896.

placed such intense pressures on the Cleveland administration as they did during the first stage of the crisis; Cleveland would not have miscalculated the British threat and staged an American military withdrawal from the Pacific or accepted a more timid interpretation of the Monroe Doctrine; heterodox financial policies would not have gained the popular support that they did between 1894 and 1895; polarization in Congress between gold-standard defenders and silverites would not have been as strong; the cosmopolitan government of Cleveland and McKinley would not have leaned towards a more assertive national financial policy and, as a result, a less cautionary national security policy; and a Spanish-American war would have appeared much less inevitable in Washington.

It is difficult to determine which factor mattered most in bringing about the national security shift from greater caution to greater assertiveness after February 1895—Cleveland’s “collusion” with high finance until February 1895 and following populist backlash, or the very timid national security course that Cleveland agreed to pursue and that stunned the president himself in due course. Regardless of the answer, which might entail a combination of the two factors, it is worth noting that neither would have occurred without the financial crisis of 1893-96.⁴⁵⁹

This assessment and the evidence backing it suggests that LaFeber might have overestimated the causal role of heterodox financial policies and underestimated the cautionary influence of the financial crises of 1884 and 1893-96 on American expansionist plans. On the other hand, Zakaria’s explanation does not account for the timing and variation of American retreat from expansionism

⁴⁵⁹ On the relevance of both factors see Humphreys (1967:131-164).

between 1880 and 1900. In addition, the independent variable ‘weak state and a small central government’ does not do a good job of explaining the yo-yo effect of American leaders’ expansionist attempts. Why would state weakness matter more at certain times and less at others? Zakaria does not fully explain this phenomenon, although he argues that jumps forward in relative economic wealth changed American leaders’ attitude towards expansionism.

That said, Zakaria’s explanation is not incompatible with the one proposed here. A weak state and a small central government or, more exactly, a poor Treasury, are here described as epiphenomenal products of the relative power of American financial elites vis-à-vis national authorities and particularly the change in the domestic balance of power following financial-crisis outbreak and its influence on national security policies. Overall, evidence suggests that the financial crises placed significant limitations on the translation of American wealth into power.

SOLVING A SECURITY DILEMMA WITH
INTERNATIONAL FINANCIAL COOPERATION:

How Japanese-American war scares disappeared and dollar diplomacy thrived

At the start of the global financial crisis of 1907-08, international arms races were in full swing, and diplomatic and military tensions had been mounting in some corners of the world, like the Pacific, for quite a while.⁴⁶⁰⁸⁸ Throughout 1907, as the financial crisis spread around the world, escalating military measures by Washington and Tokyo and long-standing diplomatic tension between the United

⁴⁶⁰ The failure of the Hague conventions of 1899 and 1907, respectively, diminished the prospect of an international court for compulsory arbitration and of an international agreement over arms limitations.

States and Japan brought the two countries to the verge of war. Interestingly, between the summer of 1907 and early 1909, war scares subsided. With the possible exception of Schweller (2010:26), who has recently acknowledged that the United States and Japan were facing a security dilemma in 1907 over the defense of the Philippines, international relations literature has shown substantial disinterest in the peaking and subsequent resolution of this diplomatic and military crisis.

Explanations as to how—or why—a worsening of the Japanese-American security dilemma was avoided in 1907 can be derived from structural realism’s balance of power theory as well as from one of its analytical rivals, Schweller’s theory of underbalancing. The former would predict that conflict escalation in the Pacific in 1907 and 1908 was avoided through successful balancing, namely by strengthening military deterrence and establishing new alliances. The latter would emphasize the role of elite consensus, social cohesion, and strong state structures in explaining successful balancing by either side. This section demonstrates that both explanations fail to reveal the evolution of American national security policies in this period and that the global financial crisis of 1907-08, and its resolution according to LA-HE, mattered greatly in the non-escalation of the 1907 Japanese-American security dilemma and war scare. These conclusions are attuned to and shed further light on the observation—advanced by many studies in American foreign policy—that between 1907 and 1909, a paramount departure from Roosevelt’s global strategy of “balanced antagonism” occurred as the White House became more eager

to accept Japanese influence in Manchuria and the Far East and resort to dollar-diplomacy in the conduct of American foreign affairs.⁴⁶¹

Dangers of a Japanese-American war materialized over the issue of Japanese immigration to California. Following the October 1906 decision by the San Francisco Board of Education to exclude Japanese children from regular schools, along with mounting anti-Japanese riots in California and anti-American riots in Japan, the ministry of Prince Kimmachi Saionji raised sharp diplomatic protests in December 1906. A long path of diplomatic negotiations between Tokyo and Washington began while anti-Japanese rioting continued, peaking in the spring, summer and fall of 1907. Between the fall of 1906 and the spring of 1908, *The Washington Post*, *New York Herald*, *Chicago Daily Tribune*, *Los Angeles Times*, and much of the world press predicted a Japanese attack on the Philippines within five years at most.⁴⁶²

⁴⁶¹ American dollar diplomacy was initiated under Roosevelt as the administration decided to supervise the finances of Central and Latin American states to prevent British or German incursions into American waters. Between 1907 and 1909, there was a jump in quality in its exercise. Taft and Knox elevated international business to the position where they, rather than diplomats, represented the best interests of the United States overseas. See, amongst many, Beale (1956:157,326-28;332-334); Esthus (1959:46-51); Esthus (1966: chapters 8 and 11); Griswold (1938:87-132); Neu (1966:433-449); Kennedy (1987:247-248); Schulzinger (1984:39); Leopold (1962:chapter 18 and 19); Becker and Wells, *Economics and World Power*, chapter 4; John P. Campbell, "Taft, Roosevelt, and the Arbitration Treaties of 1911," *Journal of American History* 53:2 (1966), pp.279-298.

⁴⁶² "Note from the Japanese Embassy," October 25, 1906, Record Group 59, *General Records of the Department of State*, 1797/16, NARA; "Japan is warlike" and "Paris Thinks War with United States Inevitable," *Washington Post*, December 1, 1906; "Expect Japan war within five years," *Chicago Daily Tribune*, December 8, 1906; "Must Fight Japan," *New York Herald* December 11, 1906; "Europe expects a war," *Washington Post*, December 16, 1906; "Predicts war with Japan: Eminent Japanese urges his countrymen to prepare," *Los Angeles Times*, December 21, 1906; "Hawaii, the Philippines and American Pacific Commerce all at the Mercy of Japan's Many Effective Warships," *The Washington Post*, January 20, 1907; "Japan has War Plans: Believed destroyers could work havoc with battleships on the Pacific," *The Washington Post*, July 6, 1907; "Japan Must Secure the Philippines Islands: Manila Bay Believed Inevitable Destination of the Mikado's fleet," *Los Angeles Times*, September 8, 1907; "Russians Want Us to War with Japan," *New York Times*, December 1, 1907. See also Roosevelt to Charles Fairbanks, February 21, 1908, Morison (ed.), *Letters of Theodore Roosevelt* VI,

War scares were buttressed by escalating military orders or agendas on both sides of the Pacific, which made an incident possible. For instance, in April 1907 the Imperial Defense Policy approved by the Japanese Emperor gave its navy the freedom to designate the United States as its most likely opponent, authorizing the construction of a modern fleet inclusive of battleships, cruisers, and destroyers (Evans and Peattie 1997:148-151; LaCroix and Wells 1997:1-4; White 1995:217).⁴⁶³ The Japanese government also signed an agreement with France in June 1907, and another with Russia in July 1907. Adding to the existing Anglo-Japanese alliance these understandings formed, potentially, a quadruple front against the United States and Germany (White 1995: 256).⁴⁶⁴

American leadership was not standing militarily idle, either. In October 1906, Roosevelt started to fear “a bitterly humiliating and disastrous [defeat] which would turn not only the Philippines but [also] Hawaii to Japan.”⁴⁶⁵ Almost a year later, the Philippines still remained, in Roosevelt’s view, the United States’ “heel of Achilles,” and “all” that made the American “situation with Japan dangerous.”⁴⁶⁶ The

pp.950-52. On the war scare, see Esthus (1966), chapters 8 and 11; and Bailey (1934:54-55). See also Chessman (1969:106,121-122); Leopold (1964:273-75); Sprout (1946):259-264).

⁴⁶³ The fleet consisted of a squadron of eight battleship and eight cruisers. It was to be supported by second-class armored cruisers and ocean-going destroyers. Japanese rearmament plans were stimulated by American rearmament plans, which, in turn, had originated from the Anglo-German naval race.

⁴⁶⁴ A quadruple alliance in the formal sense did not materialize, but attempts to bring it out in practice were made.

⁴⁶⁵ Roosevelt to Senator Eugene Hale, October 27, 1906; Roosevelt’s letter to Cecil Spring Rice, December 21, 1907, pp.462-64; H.C. Barns, *The Secret Letters of Theodore Roosevelt*, New York: First Copper Square Press (2001), pp. 436-438; Manuscript Division, Library of Congress, Washington, DC.

⁴⁶⁶ Roosevelt to Taft, August 21, 1907, *The Papers of William H. Taft*, reel 321, Correspondence with Roosevelt, Library of Congress, Manuscript Division, DC. Note that the fleet was kept in Atlantic and Caribbean waters to demonstrate American determination to uphold the Monroe Doctrine.

stationing of American ships in the Atlantic, the lack of a Panama Canal ready to use, and the absence of an American logistical base in the Pacific increased Roosevelt's fear that a Japanese attack would find the United States unprepared or helpless. As a result, between December 1906 and March 1908, Roosevelt embarked on three tasks that would keep him occupied until March 1908: "pushing forward" battleship construction, guaranteeing a "formidable defense" of American naval bases in California and the Philippines, and completing canal works in Panama.⁴⁶⁷ Not surprisingly, as displayed in Table 6, between 1907 and 1909 American military budgets reached the American pre World War I record level of 43-45 percent of total government spending, and, as revealed by much of Roosevelt's internal and external correspondence, Japan was the primary target of American rearmament efforts.⁴⁶⁸

Additionally, in early 1907 the American Presidency and the Navy and War departments began to work on contingency war plans in preparation for a possible

⁴⁶⁷ Taft to Roosevelt, March 9; Roosevelt to Taft August 21, 1907; Taft to Roosevelt, August 31; Taft to Roosevelt, January 13, 1908; Roosevelt to Taft, January 15, 17; Roosevelt to Charles W. Fairbanks, February 29, 1908; Roosevelt to Victor Metcalf, March 9, 1908; Roosevelt to Henry Cabot Lodge, April 22, 1908; *The Papers of William H. Taft, Secretary of War*, reel 321, Correspondence with Roosevelt; *Theodore Roosevelt Papers*, series 1, reel 81; series 2, reel 347; Manuscript Division, Library of Congress, DC; *The Letters of Theodore Roosevelt*, John M. Blum, Alfred D. Chandler, Jr., and Sylvia Rice, editors, Harvard University Press, Cambridge Massachusetts, 1952, v. 6; Message of the President of December, 3, 1907; Roosevelt to Harrison G. Otis, a veteran of the Civil War and the Spanish-American war, January 8, 1907 and Roosevelt to Stone, July 26, 1907 in Elting E. Morison, *The Letters of Theodore Roosevelt*, Cambridge: Harvard University Press (1951), vol. V, pp.547, 728;- Roosevelt to Henry Cabot Lodge, April 22, 1908 in selections from *Selection from the correspondence of Theodore Roosevelt and Henry Cabot Lodge 1884-1918*, Vol.II, Charles Scribner's Sons, New York, 1925, Library of Congress, Washington, DC.

⁴⁶⁸ Roosevelt to Secretary of State Elihu Root, July 13, 1907; Roosevelt to British ambassador James Bryce, June 10 1907; *The Secret Letters of Theodore Roosevelt*, pp.452-54; in July 1907, Roosevelt confessed to being "more concerned" over the situation with Japan "than almost any other."

Japanese attack in the Pacific. Before 1906, neither service had seriously considered an invasion of the Philippines, but in January 1907, at the president's suggestion, the American Army and Navy undertook joint studies on the conduct of a possible war with Japan.⁴⁶⁹

Between March and the summer of 1907, Roosevelt's alarm grew and his military orders intensified. In March the War Department was ordered to complete permanent fortifications in the Philippines and in California "as promptly and expeditiously as possible."⁴⁷⁰ In June and July, Roosevelt directed the Navy Department to mount the advanced defense of Subwig Bay, resolving to send the American fleet on a practice voyage around the world as a precautionary war measure.⁴⁷¹ With the American blue-water navy heading to the Japanese coast, the Japanese- American security crisis reached its most intense stage. British Ambassador to the US (and Roosevelt's friend) Cecil Spring Rice expected that a Japanese- American war was about to begin at that point.⁴⁷² Hawaiian governor G.W. Carter claimed that Hawaii would be taken hands- down, while Senator Latimer of South

⁴⁶⁹ Admiral Dewey to Victor H. Metcalf, March 5, 1908, General Board Letterpress V, pp.196-201 in Braisted (1954:37).

⁴⁷⁰ Admiral Dewey to Victor H. Metcalf, March 4, 1907, R.G. 80, File No.11406-159. NARA, DC. See also Morton (1949:95-104) and Braisted (1954:32,33).

⁴⁷¹ The fleet needed to be sent, as Roosevelt put it, to "show that it can be done," and avoid running the risk of "experimenting in a matter of vital importance in time of war." TR to Henry Cabot Lodge, July 10, 1907, and to Elihu Root, July 13, 1907, in Barnes, *Secret Letters*, pp.451-454; On this point, see also Beale (1956:328-29) and Esthus (1966: chapter 11); Roosevelt to Charles

Fairbanks, February 21, 1908; TR to Cortelyou, April 19, 1908 in *The Letters of Theodore Roosevelt*, John Blum et al., p.1013. Fearing not only a war with Japan but a military defeat to Japan, the President even confided to Taft that he would award the Philippines independence rather than seeing United States lose them "under duress." Roosevelt to Taft, August 21, 1907. Morrison (ed.), *Letters of Theodore Roosevelt V*, pp.761-62.

⁴⁷² Taft to Roosevelt, July 26, 1907; Roosevelt to Admiral William Brownson, July 26, 1907; Roosevelt to Taft, August 21, 1907; Roosevelt to Cecil Spring Rice, December 21, 1907. See also Krauss and Nyblade (2004:122-24).

Carolina was ready to give the Philippines to Japan to put an end to the war scare.⁴⁷³

In the spring of 1908, American rearmament stopped and the fleet returned home.

The described American military preparations show that, in 1906 and the first half of 1907—when the global financial crisis had not fully reached the United States—President Roosevelt could behave as if he were in LA–LE, pushing forward its financial and national security agenda. Showing low exposure to the demands of high finance, the President firmly stood his ground vis-à-vis notable financiers, like Andrew Carnegie, who demanded a reduction in national military spending.⁴⁷⁴ Like President Harrison had done during the global financial crisis of 1890-91, Roosevelt’s first response to this crisis was to ignore the demands of high finance and strengthen American defense. By doing so, however, he fueled the war scare and hastened the outbreak of financial crisis in the United States. Indeed, it was not a coincidence that worsening financial conditions in the United States and the Japanese-American war scare peaked exactly in the second half of 1907, as the two events fueled each other. *The Washington Post* made this clear in June 1907, when it reported that London brokers had sold an estimated total of 15,000 shares on the New York Market chiefly owing to the Japanese-American situation (“War Scare in Wall Street: Liquidation starting from London depresses stocks”).⁴⁷⁵ In other words, the war scare was causing losses to Wall Street, and Wall Street, in turn, could find

⁴⁷³ “Hawaii at Japan’s mercy,” the *Washington Post*, June 30, 1907; “Give Philippines to Japan: Senator Latimer suggests that it would settle the war scare,” *New York Times*, July 14, 1907.

⁴⁷⁴ Roosevelt to Andrew Carnegie, March 28, 1906, and August 6, 1906 in Brands, *The Secret Letters*, pp.410-11;423-424.

⁴⁷⁵ Newspapers of the times could not describe this phenomenon any better. See, for instance, “War Scare in Wall Street,” *Washington Post*, June 2, 1907; and “War Scare Affects American Stocks,” *New York Times*, October 6, 1908.

further reason to believe that a war was imminent, fueling further war rumors and further liquidations. As expected, after the spread of the financial crisis in the United States in the second half of 1907, government exposure to high finance was high, and the administration found itself in LA–HE. Assertive military measures could no longer withstand the wrath of high finance as easily as they had previously. In various exchanges with Secretary of War William Taft in the fall of 1907, a frustrated President complained of the “senseless folly” of American “high financiers” who resolutely attacked the administration and “objected” to the American fleet going to the Pacific.⁴⁷⁶

The pressures of high finance on Roosevelt’s policies continued through November 1907 as Wall Street, once again, warned the president not to “demand an increase in the navy” or “alarm” would “spread through the country and through the world” at the worst “juncture.” Andrew Carnegie kept reminding Roosevelt that the United States should have followed the example of Great Britain, which had apparently reduced its shipbuilding program for 1907 and, “in all probability,” would have done the same in 1908.⁴⁷⁷

The president defended American military efforts to balance Japan against the demands of high finance as strongly as he could. He briskly replied to Carnegie that naval rearmament had to be pushed forward and evocatively wrote that he

⁴⁷⁶ Roosevelt to Taft, September 5 and September 19, 1907, *The Papers of William Taft*, reel 495.

⁴⁷⁷ .Andrew Carnegie to Roosevelt, November 18, 1907; *Theodore Roosevelt Papers*, series 1, reel 79; Roosevelt to Mr. Schroers, November 11, 1907; *George Cortelyou Papers*, “General Correspondence, Box 62; Roosevelt letter to Douglas Robinson, *Theodore Roosevelt Papers*, series 2, reel 347; Emlen Roosevelt to Roosevelt, December 23, 1907 and T.E. Watson to Roosevelt, December, 16, 1907 in *Theodore Roosevelt Papers*, series 1, reel 80.

would not “‘surrender’ to the bankers,” or any “‘secret midnight conference’ with any big financier, or anyone else.” In February 1908, the president gave orders to fortify Pearl Harbor and informed congressional authorities of his determination not to let “considerations as to the needs of the economy” offset “the greater need of guaranteeing the preservation of peace, honor and national interests.”⁴⁷⁸ This resolve on the part of Roosevelt signals that the President attempted to behave as if LA–LE could occur, and the administration could overcome the crisis by relying on the national advantages of pursuing greater assertiveness in military spending, threat assessment, and war prospects, *and* having business activities resume as normally as possible. History proved him wrong.

In the end, the administration’s necessity to side with financial elites to solve the crisis, differently from what had occurred after February 1895, counteracted ongoing attempts at balancing Japan.⁴⁷⁹ Roosevelt eventually promised to do “everything in [its] power” to revive financial confidence: this statement, and the policy decisions that accompanied it, dampened war prospects and softened diplomatic and military tensions between Washington and Tokyo.⁴⁸⁰ The propaganda

⁴⁷⁸ Roosevelt to Carnegie, November 19, 1907; Roosevelt to Thomas E. Watson, November 12, 1907, *The Secret Letters*, p. 459. Roosevelt letter to Henry White, November 27, 1907; Roosevelt to Cecil Spring Rice, December 21, 1907; Roosevelt to Thomas E. Watson, December 21, 1907; *The Secret Letters*, pp.461-66; Roosevelt to Charles Bonaparte, January 2, 1908; Roosevelt to Charles Fairbanks, February 21, 1908; Roosevelt to Victor Metcalf, March 9, 1908; and Roosevelt to Cortelyou, April 19, 1908 in *The Letter of Theodore Roosevelt*, Blum et al.; Confidential letter to the Speaker of the House February 29, 1908, *Theodore Roosevelt Papers*, series 2, reel 347.

⁴⁷⁹ As the international gold standard triumphed abroad, and the United States risked being excluded from it, the costs of behaving as between 1895 and 1898 became increasingly clear to the American public and the administration. Further scrutiny into the preferences of the American public and how the influenced the administration might be needed.

⁴⁸⁰ Roosevelt became increasingly concerned about the national financial situation as his reassurance speeches regarding the nation’s sound economic position failed to instill business confidence throughout 1907. In December 1907, the President confessed to being

campaign that the State Department started in late April 1907, just as the financial crisis gained momentum in the United States proves this point. Between April and December 1907, Secretary of State Elihu Root issued statements on the “groundless” nature of the Japanese-American war scare, and on the continuing “friendship,” “absence of friction,” “harmonious path,” “enduring peace,” and “unthinkable war” between Washington and Tokyo. American papers started publishing “calm statements of reason” by the Department of State over the “absurdity” of a Japanese-American conflict in view of the “respect and love” Americans felt for Japanese state officials. This discourse served to reassure financial markets that there was nothing to fear; that international financial cooperation would continue; and that Japan stood in “good faith.” *The Washington Post*, *Wall Street Journal*, and *Chicago Daily Tribune* concluded that financial interdependence between Washington and Tokyo could only draw the two countries together and that “the mere thought of war” would have been, in the words of Japanese vice-finance minister Reiziro Wakatsuki and Japanese ambassador to the US Aoki, “a grave injury to civilization.”⁴⁸¹

Secretary of War Taft, too, committed to publicly downplaying the prospects of a war with Japan to help relieve national financial conditions and respond to Wall Street’s outcry. While visiting Japan in early October 1907, Taft

“under great strain with financial matters” and to “have more difficulty with the currency than anything else.” Roosevelt to Emlen Roosevelt, December 13, 1907; Roosevelt to T.E. Watson, December 16, 1907; *Theodore Roosevelt Papers*, series 1, reel 80; Roosevelt to Cecil Spring Rice and T.E. Watson, December 21, 1907, *The Letters of Theodore Roosevelt*, Blum et al.

⁴⁸¹ “Japanese War Scare Groundless Root Says,” *Chicago Daily Tribune*, April 20, 1907; “Japan’s Future and the United States Along Harmonious Path,” *Wall Street Journal*, June 9, 1907; “Why War is Unlikely: Notwithstanding our Misunderstandings with Japan,” *Washington Post*, June 30, 1907; “US War with Japan? No, Says Envoy Aoki,” *Chicago Daily Tribune*, July 4, 1907; “Why Japan wants no war: Lack of money, if nothing else, would prevent it at this time,” *Washington Post*, August 18, 1907; “War with Japan Out of Question: Tokyo in Good Faith,” *Chicago Daily Tribune*, December 5, 1907.

delivered a sensational speech in which he condemned American jingoes as “infamous” and “criminal.”⁴⁸² It is unlikely that these public declarations would have been made had they not been necessary, and perceived as necessary, in refueling the confidence of American financial interests and increasing the appeal of presidential candidate Taft amongst Wall Street financiers and a large majority of the American public—who, after 1900, had come to depend on the international gold standard as never before.⁴⁸³ As Japanese Minister of Foreign Affairs Count Hayashi noted in December 1907, disavowing assertive national designs created the unfortunate impression that some critical military situation was being covered up. Covering up and making his platform as appealing to Wall Street was exactly what Taft was doing when he delivered his speech in Tokyo. The American fleet had started its journey to reach the Japanese coast. Albeit unsound from a military point of view, Taft’s allusion to war as a criminal act gained points within financial circles, painting him as the “honest” man high finance needed.

By the same token, this propaganda campaign to stir business confidence worked entirely against the rallying of Congressional support around Roosevelt’s military agenda. In March and April 1908, the rearmament plans that the administration had since then successfully advocated were halted in both the House and the Senate. The requested increases in naval appropriations to match “four battleships in the Japanese fleet” that were “superior to any four [American]” were

⁴⁸² Taft’s visit to Japan had been decided by Roosevelt in late September 1907 while Secretary of War Taft was visiting the Philippines to make sure that military plans proceeded expeditiously. The visit had two major goals: calming transnational business and investigating Japan’s military preparedness. Taft to McIntyre and to TR, October 4, 1907; *The Papers of William Taft*, reel 495; “War is a Crime, Taft tells Japs,” *Cable to the Chicago Tribune*, October 1, 1907; “Taft Removes Cloud,” *Washington Post*, October 1, 1907; “Tokyo Cheers Taft’s Message of Peace,” *Los Angeles Times*, October 2, 1907.

⁴⁸³ In the US, a gold standard had been the only legitimate national financial system since 1900.

blocked in Congress due to “harmonious relations between the United States and Japan” and the obstacles that further rearmament attempts would pose to the “gospel of peace throughout Asia.” Strengthening the cause of high finance and paving the way for the triumph of international financial cooperation over a worsening security dilemma, Congress had concluded that there was “nothing to provoke the multiplication of American battleships.”⁴⁸⁴ By late 1907, the President, too, was aware that the realization of his military agenda was being hindered by the political alliance between the administration and high finance established to solve the financial crisis. Early in 1907 he would carelessly voice his concern in Congress about the Japanese threat and the necessity of keeping the navy at the highest point of readiness as he had done in early 1907. By later that year, however, he knew that using Japanese-American tension to influence Congress would have meant trouble: thus, when high financiers objected to the fleet going to the Pacific in October 1907, Roosevelt ordered that all military measures, including those related to the voyage of the fleet, be conducted “as quietly as possible.”⁴⁸⁵ Had preparations not proceeded quietly, domestic outcry would have compounded financial and economic recovery.

⁴⁸⁴ Roosevelt to Metcalf, March 9, 10, 28, 29, 1908, and Roosevelt to Cabot, April 22, 1908, in *The Letters of Theodore Roosevelt*, Blum; Roosevelt to Taft, April 16, 1908 *The Papers of William Taft*, reel 321; “Hale Attacks Taft: Clash Over Army Plan,” *Washington Post*, April 8, 1908; “Two Are Enough,” April 10, 1908, *Chicago Daily Tribune*; “Big Navy Needed, Says Taft,” *Chicago Daily Tribune*, April 11, 1908; “Naval Plan Causes Clash: Congressman Hobson Fears Nation is in Grave Peril,” *Chicago Daily Tribune*, April 12, 1908. The Naval Appropriation Bill originally foresaw the creation of eight battleships to curb Japanese ambition. Only two were approved in 1908.

⁴⁸⁵ Taft to Roosevelt August 31, 1907, *The Papers of William H. Taft*, reel 321; Taft to Roosevelt, October 18, 1907, RG 59:1797/383, NARA. See also Neu, “Roosevelt and the Far East,” p.441.

Table 4.6. American military spending (ME), GNP, and government spending (CGE), 1880–1897 (in million \$)

Year	Real ME	Real CGE	Real GNP	ME/ GNP	ME/ CGE	CGE/ GNP
1900	189	516	18694	0.01	0.37	0.028
1901	204	520	19991	0.01	0.39	0.026
1902	178	480	21180	0.008	0.37	0.022
1903	196	503	22099	0.009	0.39	0.022
1904	266	578	22828	0.012	0.46	0.025
1905	246	573	25043	0.010	0.43	0.023
1906	243	560	27171	0.009	0.43	0.020
1907	237	556	28442	0.008	0.43	0.019
1908	299	671	28765	0.011	0.45	0.024
1909	314	707	31647	0.010	0.44	0.023
1910	272	664	31793	0.008	0.41	0.020
1911	283	691	33712	0.008	0.41	0.021
1912	277	672	35502	0.008	0.41	0.018
1913	288	703	37610	0.008	0.41	0.018

Gradually, and as expected, the administration had to pull back ambitious security policies. As Table 4.6 shows, starting in the spring of 1908, American military spending stopped growing. Similarly to what occurred in Italy after the financial crisis of 1893-94, American military appropriations from 1909 onwards were consistently, or “orthodoxly,” firm at the ceiling of 41 percent of total government spending. This was not coincidental, as evidence shows that American business elites throughout 1907 and 1908 openly supported the adoption of stable military budget “quotas.”⁴⁸⁶ More importantly, in May 1908, military withdrawal from the Pacific began: the war vessels placed in defense of the Philippines and Hawaii—those vessels that were supposed to resist a Japanese

⁴⁸⁶Andrew Carnegie to TR, November 1907; Theodore Roosevelt Papers, series 1, reel 79; “Forced to Secure Peace,” Washington Post, April 16, 1907; “Finance: The Government’s Fiscal Year and the Outlook,” Harper’s Weekly, July 18, 1908 in George Cortelyou Papers, box 19.

attack as the American fleet mobilized—returned home. During the same month the *Indianapolis News*, under “Why Wall Street Switched to Taft,” reported: “Something happened which convinced Wall Street that Taft is the man for it.”⁴⁸⁷ A few months later, the battle-fleet also made its way to American shores, while Roosevelt was called to deny that he had ever contemplated a war against Japan. The portrayal of a relationship of mutual “gratitude” and “friendship” between Washington and Tokyo replaced previous allusions to an impending war. Japan “shuddered” at the idea of war, it was said, and fully committed to deflationary orthodoxy and cuts to the military budget.⁴⁸⁸ By 1909, the United States and Japan were no longer on the brink of war. Diplomatically, and militarily, they were moving away from power balancing.

The shift away from power balancing occurred in three stages. It started with Taft’s visit to Japan and the Asian mainland in late 1907, and the anti-war, pro-business speeches that he delivered throughout the journey.⁴⁸⁹ It then gained momentum throughout 1908, as American financial elites reached the pinnacle of their power vis-à-vis the administration because, as discussed earlier, the administration needed their complicity to quell the financial crisis and restore business confidence. Lastly, the shift became a reality with Taft’s electoral victory

⁴⁸⁷ *Indianapolis News*, May 19, 1908, in *The Papers of William Taft*, reel 321.

⁴⁸⁸ “War scare has Subsided: Secretary Metcalf Says the Navy Beats Diplomacy,” *Los Angeles Times*, May 18, 1908; “Roosevelt Denies Remark Touching War with Japan: Hobson must be misquoted,” *Chicago Daily Tribune*, July 10, 1908. “Japan Shudders At War: Mikado’s Representative Says His Country is Grateful to United States,” *New York Times*, July 11, 1908; “Japan’s Economies Severe: They Involve Heavy Sacrifices in Navy and Army Expenditures,” *New York Times*, September 15, 1908; “Our Fleet in Japan,” *New York Times*, October 20, 1908; “Friendship with Japan,” *Washington Post*, February 4, 1909.

⁴⁸⁹ See in particular “Taft’s Significant Shanghai Speech,” *New York Times*, November 24, 1907; and “Taft Ridicules Japan WarTalk: War Chief Tells Easterners There’s No Possibility of Conflict,” *Washington Post*, February 20, 1907.

in 1908, thereby confirming once again the relevance of this variable for studying the national security influence of financial crises in the American context.⁴⁹⁰ In 1908, Taft was Wall Street's honest man as much as Cleveland had been in 1884 and 1892.⁴⁹¹ As explained in *The Washington Post* of October 18, 1908, one major issue set Taft on a different level from his competitors to the Presidency: his support of a foreign policy of market enlargement and financial penetration on the Asian mainland. As *The Post* wrote, Taft had the advantage of "realizing that the amazing industrial growth of the US" made the creation of new markets abroad "an imperious necessity."⁴⁹²

With the installment of the Taft-Knox administration in 1909, US leadership openly legitimized national security policies that were tailored to the desires and protection of financial elites. American leaders embarked on the very same plan that Roosevelt had consistently opposed during his two terms as president—the overly ambitious agenda of "civilizing" regions of the world through the promotion of international financial competition.

The contrast between this American foreign policy and pre-1907 American national security objectives was explicitly and enthusiastically acknowledged by the new administration.⁴⁹³ A "crusade for peace" only on paper, the new foreign

⁴⁹⁰ Roosevelt had decided not to run for President in 1908, a decision that he later regretted; he supported his Secretary of War, who would have disappointed him later. Roosevelt letter to Kermit Roosevelt, January 27, 1908, *The Secret Letters*, pp.74-5.

⁴⁹¹ "William Taft is Wall Street's man," *Indianapolis News*, May 19, 1908.

⁴⁹² "Taft Foreign Policy: One Important Point in which He and Bryan Differ," *Washington Post*, October 18, 1908; "Talks of Money and Taft," *Los Angeles Times* March 19, 1908. *The Post* also wrote, "Mr. Bryan evidently has no conception of that greater America which Mr. Taft sees so clearly and would work to build up. Mr. Bryan's political outlook does not extend beyond our Atlantic and Pacific seaboards. Mr. Taft's view sweeps over a wider area".

⁴⁹³ Many members of business and/or political figures like William Straight and Francis M. Huntington, who staunchly opposed Roosevelt's pro-Japanese and investment-shy Asian stance,

policy transferred international competition from the military to the economic sphere and made it universal and perpetual—as opposed to localized and intermittent, as it had been in the pre-1907 context and as Roosevelt understood it.⁴⁹⁴ Knox’s 1909 neutralization proposal and, during the same year, the linked establishment of an international investment consortium in China killed the spirit of the Open Door and sowed the seeds of the forthcoming Chinese Revolution of 1911 and 1912. Thus, in creating the conditions for transferring competition from the military sphere to the economic sphere, the financial crisis of 1907-08 still increased the probability of conflict, though the results were not fully visible until a few years after the crisis. Moreover, international financial competition in Manchuria did not improve American relations with Japan or Germany, or among Japan, Russia, and China. Rather, it involved all nations in complex political entanglements that, along with the ambitious goals of the new foreign policy course, pointed towards a far less cautious American foreign policy stance. Notably, unleashing international financial competition in China was an option that the Roosevelt administration had deliberately shunned, as this promised to disregard Japanese and Russian security interests and negatively affect Chinese territorial integrity.

were now promoted to high-ranking positions. William W. Rockhill was removed from the scene and sent from Peking to St. Petersburg in May 1909. Inaugural Address of William H. Taft, March 4, 1909; “Diplomatic Changes: Taft’s Appointments to Foreign Policy Posts Meet With Strong Approval, *Washington Post*, December 22, 1909; “Carnegie Aids Peace Crusade: America’s Aim Stated,” *Chicago Daily Tribune*, May 30, 1909; “President Taft Delighted,” *New York Times*, July 16, 1909; “Germany is Warned of Our New Policy: Chinese Loan First Step,” *New York Times*, July 18, 1909. On Taft and Knox’s “dollar diplomacy,” see Ferrell (1957: chapters 9 and 10); Esthus (1966: chapter 14); Schulzinger (1984:39); Beale (1956:333).

⁴⁹⁴ Archival evidence shows that between Taft’s electoral victory and the installment of the new administration, Roosevelt tried to resist the national security change. In a few letters to future Secretary of State Philander Knox and future President Taft, TR stressed the necessity of maintaining good relations between United States and Japan and preserving the existing spheres of influence in China, as Japan needed to “feel safe” and be prevented from “attacking the United States” down the road. TR to Knox, February 8, 1909; and TR to William H. Taft, March 3, 1909, *The Secret Letters*, pp.510-515.

Thanks to the financial crisis, war scares and mutual suspicions between the American and Japanese leaderships were quelled, and military competition in the Pacific was replaced with financial and economic antagonism. Being in LA–HE caused this redefinition or change of direction of American national security policies. As historians like Howard Beale and Raymond Esthus have observed, in late 1906 and early 1907 the Open Door policy and the strategy of international balancing that underpinned it were more established in Asia than ever before. The policy enjoyed the full backing of prominent Japanese, French, and Russian statesmen as well as a large majority of American diplomats, including Secretary of State Root and the American minister to Peking William Rockhill.⁴⁹⁵ Ito Sajonji, prominent Japanese statesmen like Foreign Minister Tadasu Hayashi, and important Japanese newspapers similarly favored a strict observance of the Open Door.⁴⁹⁶ More remarkably, respect for China's sovereignty, a foundational principle of the Open Door and power balancing, was also very successfully upheld by Roosevelt when he used the threat of force to defend American trading rights against Chinese boycott and staunchly stood against further Japanese incursions into Manchuria in 1905-06.⁴⁹⁷

⁴⁹⁵ Beale (1956:121;333) and Esthus (1966:34).

⁴⁹⁶ The *Nichi Nichi Shimbun*, the paper of Foreign Minister Takaaki Kato, stated that nothing would be more detrimental to Japan than violating the principle of the Open Door. The leading newspaper *Jiji Shimpō* agreed. *Jiji Shimpō*, March 28 and April 25, 1906, and *Nichi Nich Shimbun*, April, 11, 1906, in Beale (1956:121;333) and Esthus (1966:34).

⁴⁹⁷ Roosevelt dispatched battleships to Asia and threatened the Chinese government with military intervention to end the Chinese boycott of American exports (1905-06). Five destroyers were sent to Canto, two cruisers went to Shanghai, a battleship squadron arrived in Hong Kong, and a warship was transferred from Chefang. On this point, see Beale (1956:213) and Riccards (2000:55). The Open Door doctrine or policy, coined by Secretary of State John Hay in 1900, justified and defended Chinese territorial integrity and international spheres of influence in China for trade and commercial purposes. Roosevelt to Cecil Spring Rice, June 13, 1904; Roosevelt to Baron Kentaro Kaneko, May 31, 1905; TR to Elihu Root of July 13, 1907; TR to Cecil Spring Rice, June 16, 1905, in Brands, *The Secret Letters of Theodore Roosevelt*, pp.361-362 and pp. 381-385. Esthus (1959:435-454).

Roosevelt *intended* to keep balancing Japan in 1907 and 1908, but his crisis resolution strategy—that is the strategy that he needed to endorse to solve the crisis—prevented this, forcing him to opt for greater international financial cooperation and greater national security caution. American Asian policy was therefore transformed. In 1907, given the strengthening of relationships among Japan, Russia and France, balancing Japan would have required the United States to form an American-German-Chinese entente. Although this relationship was actively pursued by Germany and China, the United States did not consider it. Instead, in July 1908 Washington signed the Root-Takahira agreement, which reinforced Japan’s position in Eastern Asia by isolating China diplomatically and drawing the United States much further into the treaty network by granting special privileges to foreigners in the Chinese Empire.⁴⁹⁸ Successful balancing would also have required an increase in military build-up between 1907 and 1910, but, as explained earlier, was stopped when the war scare intensified.

Ultimately, the argument that the Japanese–American security crisis was solved through balancing diplomacy—an argument derived from existing IR theory on power balancing—is unconvincing.⁴⁹⁹ In actuality, its resolution lay in the defense of sound financial and trade relations between Washington and Tokyo to relieve the confidence of high finance and escape financial crisis. It also seems likely

⁴⁹⁸ Reid (1935:34); and Bailey (1940:229).

⁴⁹⁹ Roosevelt to Cecil Spring Rice, June 13, 1904; Roosevelt to Baron Kentaro Kaneko, May 31, 1905; TR to Elihu Root of July 13, 1907; TR to Cecil Spring Rice, June 16, 1905, in Brands, *The Secret Letters of Theodore Roosevelt*, pp.361-362 and pp. 381-385. See also Dennett (1924:15-21), and Reid (1940:66-70).

that, in the absence of the financial crisis, American business elites would not have persuaded Roosevelt's administration to backtrack from the assertive foreign policy towards Japan; the Roosevelt administration would not have felt pressured to abandon its military plans in the Pacific to resolve the crisis and restore business confidence; the American rearmament program would have continued; the public defense of an alleged "enduring friendship" between Tokyo and Washington would have been much less necessary; the American Japanese conflict would have escalated much more easily; American– Asian policy would have focused more on the Pacific than on the Asian mainland; and President Taft and his administration would have adopted a less pro-business set of national security policies. US diplomatic and military policies would have manifested significant differences.

MILITARY CAPITULATION VERSUS GREATER NATIONAL
DEFENSE: *Hoover, Roosevelt, and their different approaches to crisis
resolution and American security*

In contrast to the financial crises discussed so far, the national security influence of the financial crisis of 1929-33, more commonly known as the Great Depression, has been long acknowledged. Robert Ferrell concluded as early as 1957 that, "more than any other single factor," the Great Depression "palsied" American statesmen's hands, resulting in a timid diplomatic and military response to the disruption of peace in the Far East and the rise of a threatening new order in Europe.⁵⁰⁰ Since then, works at the intersection of international political economy and security studies (Trubowitz 1998:159,160,163; Narizny 2007:107,146) as well as

⁵⁰⁰ Ferrell (1957:5, 278, and chapter 2).

a number of historical studies (Divine 1961; DeConde 1989; Doenecke and Stoler 2005; Schmitz 2007) have acknowledged that the Depression constrained the American national security agenda, curbing the military budget and reinforcing the isolationist, defensive, and anti-military tendencies in American foreign policy. From this perspective, which the American State Department shares, the collapse in state revenues and the related need to rescue the regions or sectors of the country most affected by the Great Depression created strong incentives within the administration and Congress to economize on armaments, compounding the development of a timid foreign policy and American disinterest in war.⁵⁰¹

This analysis emphasizes a distinct but equally important aspect of the influence of the crisis of 1929-33 on American national security policies. Specifically, the similarly low exposure to high finance but diverse affinity with high finance characterizing the Hoover and Roosevelt administrations channeled American military spending, threat assessment, and war prospects towards extreme prudence if not military surrender under Hoover, and towards new assertive avenues under Roosevelt. In other words, although American national security policies remained much closer to internationalism than assertiveness for most of the decade and throughout both administrations for reasons that have been amply shown in the literature, Roosevelt's diplomatic and military *intentions* were much less timid than commonly recognized by existing accounts on the national security influence of the Great Depression. This lessened timidity was largely due to the inability of high finance to solve the crisis and, relatedly, the strong public

⁵⁰¹ <http://history.state.gov/milestones/1921-1936/GreatDepression>

components at the core of the New Deal and of the second stage of financial crisis response.

Notably, throughout most of the 1930s, as was true throughout most of the 1920s, American national security policies had an inherent, unprecedented bias towards caution or internationalism in security affairs (Trubowitz 1998:96-168; Narizny 2007:147). In 1923, for instance, the share of total government spending going to defense was lowered by 20 percentage points compared to the prewar years, and remained there for several years.⁵⁰² This cautionary bias was primarily a reaction to the Great War, its deleterious military and financial consequences, and the resulting American shift towards isolationism. Second, national security prudence was intrinsic to the post-World War I, Anglo-American architecture of world economic reconstruction—an architecture that depended upon the promotion of international peace and disarmament efforts, was initiated by the Washington Treaty of 1921-22, and was carried forward at the Geneva Disarmament Conference of 1927, the London Naval Conference of 1930, and the Geneva Disarmament Conference of 1932-34.⁵⁰³

Linked to the presence of weighty reasons for pursuing a cautionary set of national security policies, the impact of a number of other variables and related snowballing effects that influenced national security policies in this period

⁵⁰² *Historical Statistics of the United States*, Washington, DC: Bureau of Census, U.S. Department of Commerce (1975), Millennial Edition Online, Cambridge University Press. See also Hoff (1971:48-50); Offner (1975:80); and Eloranta (2003).

⁵⁰³ As Herbert Hoover stated when he was Secretary of Commerce in October 1922, a message earnestly repeated thereafter by President Warren Harding and Calvin Coolidge, “reductions in armaments” were “contributing to the balancing of budgets and the cessation of inflation” and, ultimately, world economic recovery and growth. Hoover’s address at Toledo, Ohio, October 16, 1922 in Records of the House, 67th Congress (1921-23), Committee on Foreign Affairs, Box 392, HR 67A-F17.7, NARA. DC.

complicates an analysis of the national security influence of the financial crisis of 1929-36, and renders problems of multi-causality, multicollinearity, and over-determination particularly daunting to solve. In the 1920s, and even more so in the 1930s, for instance, American national security policies were also affected by the workings of a flawed international financial system; the greater political relevance of previously marginalized domestic groups; and the concomitance of financial crisis with crises in the agricultural, farm, and real estate sectors. Determining the relative weight of these factors versus that of the financial crisis is a complicated enterprise and one into which this work does not venture. Despite these analytical constraints, the following pages suggest that the framework's scenarios, particularly scenarios HA-HE and HA-LE, are as analytically useful to discern the national security influence of this crisis-period as they have been for the examined crisis periods.

Validating the formulated expectations, between 1930 and 1932 the financial crisis led the Hoover administration to escalate its pre-crisis national security caution. To begin, significant reductions in military spending were deemed necessary to solve the crisis and implemented at least twice between 1930 and 1932. As Table 7 displays, American defense spending was on the rise when the stock market crashed in October 1929. The ascent had begun in 1927, after the failure of the international disarmament talks in Geneva and growing fears of arms races (Dewey 1968:536; Carlton 1968:573-598; Offner 1975:78; Rhodes 2001:69).⁵⁰⁴ In an attempt to strengthen American diplomatic leverage and

⁵⁰⁴ At the Geneva Conference of 1927, cooperation failed due to incompatible goals between the Americans and the British over whether large or small cruisers needed to be protected. Fearing British armed merchantmen, the Coolidge administration insisted on the right to build large rather

reignite international cooperation on naval disarmament, the Coolidge administration had amended the cautious set of national security policies pursued since 1923 with a slightly more assertive program of military spending.⁵⁰⁵ President Hoover initially carried forward his predecessor's "tougher"—or, more appropriately, "less dovish"—military stance and passed legislation that increased military spending for four years, from July 1929 to July 1933, just a few months before joining Britain, France, Japan, and Italy in London for the London Naval Conference held January-June 1930.⁵⁰⁶

By late 1931, this greater military vigor had come under criticism and the American cruiser program begun under Coolidge had been abandoned, allowing the US Navy to fall, numerically at least, far behind Great Britain and Japan (Rhodes 2001:79). Archival evidence shows that the administration's efforts to stop the spread of the crisis demanded military retrenchment. As Hoover explained at the opening meeting of the International Chamber of Commerce in May 1931, "arms

than small cruisers and arming any small cruisers with eight-inch guns. The British refused to abandon their naval supremacy in cruisers. France and Italy had declined to attend the conference.⁵⁰⁵ A diluted Naval Construction Act for the buildup of fifteen cruisers was therefore authorized in February 1929 while dialogue with Britain and Japan over the upcoming naval conference in London continued in the spirits of the Kellogg-Briand pact of war renunciation approved by Congress. The Act, which President Calvin Coolidge had strenuously backed in view of the waning bargaining leverage against Britain at disarmament meetings in 1927, was diluted by a clause providing for its suspension if a naval limitation agreement became a reality. On these developments, see Hagan (1991:276-279).

⁵⁰⁶ President Hoover's Press Conference Statement of July 23, 1929 in William S. Myers, *The State Papers and Other Public Writings of Herbert Hoover*, vol.1, New York: Doubleday, Doran and Company (1934), p.76; Message of the President to Congress, December 3, 1929, *Senate Journal*, 71th Congress, 2nd session and special session 1929-1930; *Memoirs of Herbert Hoover: The Cabinet and the Presidency*, 1920-33, New York: MacMillan (1951), p.330; James T. Shotwell, "The Londo Conference: Parity for Defense and the Impossibility of a Purely Mathematical Adjustment," *New York Times*, March 12, 1930; James T. Shotwell, "Navies and Policy: Necessity of Deciding Whether Naval Armaments is to be Determined by the Needs of Defense," *The New York Times*, March 14, 1930; "Outlines Naval Treaty Success," *Wall Street Journal*, May 13, 1930; "Prosperity Glimpsed by Occasionally in 1930," *Los Angeles Times*, December 28, 1930.

cuts” and “world disarmament” were primary factors in “encouraging the revival of world business.” Along similar lines, in the following days and months “sharp economies in national defense budgets” and “particularly the naval budget” were described by the administration as “necessary” for promoting a “vast plan of *capital expenditures*” and promoting the “rehabilitation of the country.”⁵⁰⁷ In the words of Treasury Secretary Odgen Mill, “drastic reductions in arms expenditures across the world and at home” were “essential” for their “profound,” “psychological” promise of stirring business out of the “present lethargy.”⁵⁰⁸

The intensification of Japanese military incursions in the Far East between late 1931 and early 1932 stirred fears in California over United States’ naval weakness, raising voices in Congress to stop ongoing cuts to national armaments.⁵⁰⁹ But the world disarmament conference of 1932 was about to begin in Geneva, and the Hoover administration was committed to going full speed ahead with its disarmament plans. Hoover further solidified America’s extra cautious military stance by offering, during Geneva’s inconclusive disarmament talks, a radical plan

⁵⁰⁷ “Hoover Urges Arms Cut to Revive Trade in Opening World Chamber of Commerce, Special cable to the *New York Times*, May 4, 1931; “Plea for Reduction of Armament as Essential to Peace and Prosperity,” Hoover’s Opening Address at the Opening Meeting at the Sixth General Congress of the International Chamber of Commerce, Washington DC, May 4, 1931; Stimson to Hoover, several messages, May 27, 1931; in *Stimson’s Papers*, reel 81. “Cabinet Inquiry Into the Financial Situation of the Government: Hope for Relief in Expenditures,” July 18, 1931; “Drastic Economies in Public Expenditures are proposed with special reference to Naval Budget,” October 16, 1931; Announcement of Reductions in Departmental Budgets,” Hoover’s Press Statement, November 6, 1931; in Myers, *The State Papers*, vol.1, pp.358, 558, and vol.2, pp.11, 27.

⁵⁰⁸ Mill to Young 12/16/1932; Mill’s preliminary draft Jan. 1932; and “Undermining Confidence,” *New York Herald Tribune*, 10/05/1933, in *The Papers of Odgen Mills*, Box 11, General Correspondence, Manuscript Division, Library of Congress, DC.

⁵⁰⁹ “A Feeble Navy,” *Washington Post*, August 10, 1931; “Uncle Sam’s Navy Weakness: Our Perilous Inferiority at Sea Both to Japan and England,” *Los Angeles Times*, January 17, 1932. *Congressional Record*, 72nd Congress, 1st session, January 2, 1932, pp. 2948-49; “Hoover and Cabinet Act,” *New York Times*, February 1, 1932 “Crisis in East Stirs Congress Activity,” *The New York Times*, February 2, 1932.

for scrapping one-third of all arms. This proposal marked the capitulation of the American Navy. On January 1, 1932, the United States had in commission only 148 fighting vessels of all classes, compared to 187 for Great Britain and 219 for Japan. By December 31, 1932, the American Navy was down to a mere 101 compared to 140 for Great Britain and 184 for Japan.⁵¹⁰ Hoover's maneuver is especially striking if one considers that it was proposed *after* Hugh Gibson, the American delegate to the Geneva disarmament conference, had alerted the State Department that further American initiative on the disarmament front needed to stop, the American fleet being already far below the limits of the London Treaty.⁵¹¹

Table 4.7. American military spending (ME), GNP and government spending (CGE), 1926–1937 (in million \$)

Year	Real ME	Real CGE	Real GNP	ME/ GNP	ME/ CGE	CGE /GNP
1926	583	2916	96736	0.006	0.200	0.030
1927	586	2899	97187	0.006	0.202	0.030
1928	665	3005	99113	0.007	0.221	0.031
1929	696	3127	103900	0.007	0.222	0.030
1930	753	3405	94359	0.008	0.221	0.037
1931	813	3970	85562	0.009	0.205	0.051
1932	795	5274	67011	0.012	0.151	0.089
1933	683	4849	59786	0.011	0.141	0.085
1934	524	6443	64291	0.008	0.081	0.097
1935	694	6342	71945	0.009	0.109	0.0861
1936	903	8321	83000	0.012	0.108	0.099
1937	905	7472	76404	0.010	0.121	0.081

Not surprisingly, national military spending for the year 1932 exhibited a 10 percent decrease compared to its 1931 levels (Table 4.7). Had the financial crisis

⁵¹⁰ See in particular Mitchell (1946:278,292); and Rhodes (2001:69).

⁵¹¹ Hugh Gibson to Stimson, June 4, 1932, *Stimson's Papers*, reel 83; "New Role at Home Seen for Stimson," *New York Times*, May 15, 1932; "Hoover Urges World Cut in Armies, Navies," *Chicago Daily Tribune*, June 23, 1932.

not occurred, there would have been no reason for these cuts to be as swift and radical as they were. The commitment of the Hoover administration to attempt to respond to the financial crisis in central Europe and Britain starting in May 1931 provides exactly that reason.

Although the influence of the financial crisis on American threat assessment and war prospects is possibly less striking than the examined influence of the crisis on military spending, evidence indicates that the crisis tilted the Hoover administration towards a softer assessment of the Japanese threat than would have otherwise occurred. Indeed, the administration's primary commitment to rescue the international gold standard from collapse and win the confidence of high finance impelled the adoption of a strategy of "watchful waiting" towards Japan. The Far Eastern Crisis—the staging of the Mukden incident by Japan's Kwantung Army—started on September 18, 1931, just three days before the collapse of the pound and British abandonment of the gold standard on September 21, 1931. After the failure of international financial cooperation, financial troubles mounted at home, too, with a second wave of banking crises in October 1931. Hoover's absorption in promoting international financial cooperation and buttressing the confidence of high finance internationally and domestically took priority over the Manchurian crisis.

More importantly, investing in national financial credibility and restoring confidence amongst financial elites to save the international gold standard demanded a response to rising military threats with greater military sacrifices and commitment to world disarmament. This is symptomatically illustrated by Stimson's non-recognition doctrine, the toothless American policy articulated in January 1932

after the Japanese occupation of the Chinchow port.⁵¹² As Stimson specified in late February 1932, American authorities refused to accept Japanese territorial changes *based on* American “willingness to surrender its commanding lead in battleship construction” and “leave its positions at Guam and in the Philippines without further fortification.” The administration’s maneuver would appear nonsensical to military strategists, if not to most people who ignored the mental frames sustaining a properly functioning international financial order.⁵¹³ In Japan, where those frames held together a small minority and alienated the masses, Stimson’s doctrine could only appear, as has been acknowledged (Rhodes 2001:83), a “bluff.”⁵¹⁴ To the Hoover administration, however, bluffing meant negating the value of those frames at a time when resolving the global financial crisis made them most necessary. The costs of this strategy became clear a year and half after the October 1929 crash.

In alignment with the expectations and the analytical framework, Roosevelt’s strategy of crisis response replaced *some* of the constraints pushing American national security policies towards caution with incentives to pursue greater assertiveness. Like Hoover’s before him, the Roosevelt’s administration had to coexist with a number of forces within the nation buttressing a foreign policy of

⁵¹² Stimson stated in his non-recognition note that the United States would not recognize any treaty, agreement, or de facto situation that impaired the rights of American citizens or the territorial and administrative integrity of China, or that violated the Kellogg-Briand Pact of war renunciation.

⁵¹³ Stimson to The Secretary of State to the Chairman of the Committee on Foreign Relations (Borah), United States Senate, February 23, 1932 in U.S., Department of State, Publication 1983, *Peace and War: United States Foreign Policy, 1931-1941*: U.S., Government Printing Office, Washington DC (1943:167-173). See also “Secretary Stimson’s Speech at Philadelphia on Hoover’s Foreign Policy,” *New York Times*, October 2, 1932; and Rhodes (2001:84).

⁵¹⁴ The Act authorized the construction of three new battleships armed with 16-inch guns, two additional aircraft carriers, nine new cruisers, 23 new destroyers and nine additional submarines (Rhodes 2001:152).

isolationism and virtual pacifism. Yet, Roosevelt's low exposure to high finance during the second stage of crisis response pushed American military spending, threat assessment, and war prospects away from Hoover's conciliatory stance *even if* passing the various reforms and legislative acts of the New Deal required defending military and diplomatic caution. The result was an ambiguous security posture in which caution and assertiveness coexisted. Policy paralysis was often reached and a cautious approach triumphed in that sense, but elements for the curbing of appealing military spending, threat assessment, and war prospects appeared too.

Evidence shows that, from his first days in office, President Roosevelt backed naval military buildup as a means to create jobs, contribute to national economic recovery, and defend the country against the rising Japanese threat. In June 1933, as part of the National Industrial Recovery Act, Roosevelt allocated \$238 million in public works funds for the modernization of 32 cruisers, destroyers, and submarines—the largest naval building program since 1916. Under the new administration, crisis resolution and naval rearmament were no longer, or not always, at odds. Naval rearmament was pushed further at the beginning of 1934 when Roosevelt gave support to the Vinson-Trammell bill, which provided for the construction and replacement of ships up to the limits allowed by the Washington and London naval treaties of 1922 and 1930 (Borg and Okamoto 1973:207-208; Dallek 1979:75; Rhodes 2001:127,130; Doenecke and Stoler 2005:30). Had the American leadership not desired investment in naval rearmament from 1933 onwards, the capitulation of the American Navy that had begun with Hoover would have gone forward. Notably, despite Roosevelt's determination to keep the Navy on

course, it was only in 1938 that Congress approved a comprehensive rearmament program, the second Vinson Act.⁵¹⁵ One must wonder what would have happened had response to the financial crisis continued along Hoover's lines after 1933.

Because his naval program created accusations of ultra-nationalism and widespread criticism across the country, Roosevelt went to great lengths to persuade critics that the White House stood by further international reductions in armaments—especially naval—and that the newly authorized naval building program would not draw the nation into a crisis with Japan.⁵¹⁶ Pursuing disarmament and military restraint, sanctioning a Far Eastern policy of non-provocation and lecturing the Japanese about the principles of good behavior—a task in which Secretary of State Cordell Hull and Chief of the Far Eastern Division Stanley Hornbeck were particularly invested—became key American foreign policy guidelines for allowing national economic reform and rearmament. Crucially, although both Hoover and Roosevelt were fighting for disarmament and attempting to prevent the collapse of the Treaties, their purposes were different. For Hoover, world disarmament *and* sharp cuts to the American Navy were the means for bringing relief and confidence to high finance and solving the financial crisis at home and abroad. For Roosevelt, the pursuit of world disarmament and respect for the Treaties were necessary means to overcome

⁵¹⁵ The Act authorized the construction of three new battleships armed with 16-inch guns, two additional aircraft carriers, nine new cruisers, 23 new destroyers and nine additional submarines (Rhodes 2001:152).

⁵¹⁶ As a result, the policy towards disarmament and the Far Eastern policy that the Hoover administration had pursued were not abandoned but kept as a bargaining chip for passing economic reforms. The same was true for Hoover's policy of non-intervention in Latin America.

Congressional opposition to arms construction, build up the American Navy to treaty limits, and neutralize hostility to New Deal legislation to solve the financial crisis at home.⁵¹⁷

Roosevelt's strategy for crisis response also conveyed, in agreement with expectations, greater alarm vis-à-vis the Japanese threat, and a greater determination not to respond to war prospects with military unpreparedness. On assuming the powers of the Presidency in March 1933, Roosevelt sent a request for a partial arms embargo to Congress. The target was obviously Japan, with the implicit message that the United States would not refrain from punishing aggressors. The act was blocked in the Senate, but Roosevelt resisted the ensuing Congressional pressures to sign a neutrality law and an impartial arms embargo until late 1935, when the Italo-Ethiopian crisis made the passage of any embargo preferable to no action. It is hard to believe that Hoover would have been willing to present Congress with an impartial arms embargo request or send a similar message. American financial interests, upon which Hoover's national security policies depended after the financial-crisis outbreak, equated "economic sanctions" against Japan with "cowardly war," and the mere thought of conflict escalation between Japan and the United States was regarded as an "absurdity" in view of Japanese-American investment opportunities and Japan's faithful service to its obligations.⁵¹⁸

⁵¹⁷ On the aura of domestic legitimacy that the Treaties carried domestically, see Dallek (1979:31,53; Rhodes 2001:127). In May 1934, Roosevelt moved unsuccessfully to prevent the collapse of the Geneva Conference on Disarmament (1932-34). In 1935-36 the administration participated in the Second London Naval Conference (December 1935-March 1935) to renegotiate the Washington and London Treaties. The Treaties would have expired in 1936.

⁵¹⁸ "Foreign Entanglements," *Washington Post*, February 1, 1932; "Japan's New Policy," *Washington Post*, September 21, 1933; "Is Japan Our Enemy? Expert Brands War Fears as Fantasy," *Washington Post*, August 19, 1934; "Clash of America's Foreign Policy with Japan's

Hoover himself, in August 1932, forced Stimson to redact any allusion to a discriminatory arms embargo from a speech he was about to deliver to the Council on Foreign Relations.⁵¹⁹ Against both the preferences of high finance and Hoover's foreign policy stance, Roosevelt in the summer of 1933 justified naval build-up based on the fact that "the whole scheme of things in Tokyo" did not "make for an assurance of non-aggression in the future" (Dallek 1979:75).⁵²⁰ Although FDR had no intention of risking war in the Far East when he assumed power, his very admission of the possibility of being attacked by Japan in the future imbued his national security policies with a tone of gravity that Hoover could not afford. In the array of national security responses to the financial crisis that Hoover considered, the Kellogg-Briand Pact for the renunciation of war *could not* be questioned. For Roosevelt, however, the Pact itself was a nuisance.

That Roosevelt's strategy of crisis response unleashed a less cautionary threat assessment than was possible under Hoover's strategy of crisis response is also evident from Roosevelt's use of the post-World War I treaty structure. Like

Causes Concern," *Washington Post*, October 28, 1934. The American business community thus expressed itself with regard to the prospect of economic sanctions towards Japan (February 1932): "The suggestion that the United States should set up an economic boycott against Japan is so silly as to be worthy of the theorists who bungle international relations through the League of Nations. An economic boycott is merely cowardly war."

⁵¹⁹ Richard N. Current, *Secretary Stimson: A Study in Statecraft*, New Brunswick (1954), pp.99,100,108. The summer of 1932 witnessed the start of the Chaco War between Bolivia and Paraguay. Hostilities continued between Japan and China.

American pre-1933 policy stance on war prospects seems unlikely.

⁵²⁰ It is true that by then Japan had officially withdrawn from the League of Nations and disclosed its intention to abandon existing naval limitation agreements. Had Hoover been in power rather than Roosevelt at the time, a similar overhaul of American pre-1933 policy stance on war prospects seems unlikely.

Hoover, Roosevelt was committed to playing within this architecture.⁵²¹ Unlike Hoover, however, FDR envisioned a more flexible use of this structure to serve the United States' national defense needs. Following the failure of the Geneva disarmament conference, in 1934, when the arms races in Japan and central Europe were in full swing and the Italo-Ethiopian conflict was brewing, American isolationist pressures had gained momentum, forcing Roosevelt to accept the passing of the Neutrality Act in August 1935.⁵²²

Knowing that the Act would expire in early 1936, and well aware of the strident opposition by domestic pacifists and isolationists to armament expenditures, Roosevelt used the upcoming Naval Conference in December 1935-March 1936 in London to further the rearmament program. There, he insisted on an extremely unappealing cut of 20 percent on overall naval tonnage, which Japan refused and Britain regarded with skepticism. Concurrently, he pressed for the introduction of an escalatory clause permitting the signatories, and, practically, the United States and Britain, to ignore the agreement if Japan refused to go along with it and embark on rearmament—an outcome that was virtually certain (Rhodes 2001:132).⁵²³ Roosevelt's use of the treaties to make Japan appear the aggressor—Japan exited the conference in January 1936—and Great Britain uncooperative—the British stepped up rearmament in February 1936—paved the way for Congressional

⁵²¹ This measure also embargoed munitions and war materials and barred loans to belligerents, but it denied the President any say over when and how these things would be accomplished (Dallek 119). Roosevelt needed the support of isolationist forces in the Senate to pass New Deal reforms at home. In 1935, the New Deal had come under assault from conservative critics.

⁵²² This measure also embargoed munitions and war materials and barred loans to belligerents, but it denied the President any say over when and how these things would be accomplished (Dallek 119). Roosevelt needed the support of isolationist forces in the Senate to pass New Deal reforms at home. In 1935, the New Deal had come under assault from conservative critics.

⁵²³ Japan had denounced the Washington agreements in 1934. See Rhodes (2001:136,137).

approval, in March 1936, of the largest peacetime naval appropriation ever requested by an American president (Pelz 1974:202; Dallek 1979:90).⁵²⁴

This analysis suggests that the financial crisis of 1929-33 steered American national security policies initially towards greater caution, as per HA-HE, and then towards an unspecified security posture with dashes of assertiveness, as per HA-LE. The complexity of the international context in the 1930s—with increased militarism, the advent of revisionist regimes, spiraling arms races, financial crises spreading within nations and across the world, the collapse of international finance and trade, and states' response to these developments over several years—makes it difficult to assess the relative importance of the national security influence of the financial crisis versus that of other variables. To discount the role of financial-crisis, however, seems misguided. Had the financial crisis not occurred, the Hoover administration would have had little reason to opt for military capitulation or to exalt American abidance by the international treaty structure in the hope of eliciting a similar response on the other side. By the same token, the United States' slow path towards military activism and the strengthening of the Navy would have been even slower in the absence of a strategy of financial-crisis response like that of Franklin D. Roosevelt. Ultimately, it is also difficult to believe that the described shifts from the normal course of American national security policies

⁵²⁴ Facing the outcry of pacifist forces, Roosevelt could respond that the appropriations were strictly for defense reasons and that his attempts to rescue the Treaties demonstrated his commitment to peace. The appropriation included funds for only two newbattleships, and most of that money would provide replacements for outmoded destroyers and submarines.

brought about by the financial crisis of 1929-33 had no effect on other states' policies or produced a safer international security environment.⁵²⁵

Financial crises and American national security policies in nuts and bolts

The American case confirms that financial crises changed the direction and character of American national security policies. This occurred when the ruling administration subscribed to an ambitious security agenda (1884; 1907) and when the American government acted as a dove in international affairs (1893-95; 1929-33); when the national contribution to arms races and war prospects was significant (1907) and when it was not (1893; 1929); when government authorities opposed high finance (1884, 1907-08; 1933-36) and when ruling administrations were closely allied with it (1893-94; 1929-32); and when the United States was a financial hegemon (1929) as well as when its membership in the international financial system was controversial at home and abroad (1884-85; 1893-96). In every instance, and at least temporarily, the crisis reshaped the existing balance of power between the American government and financial elites to the advantage of the latter, and this development produced a shift in existing national security policies towards major prudence. Accordingly, the administrations of Chester Arthur and Teddy Roosevelt were reminded that they were not, respectively, in LA–LE but rather in LA–HE, while the administrations of Grover Cleveland and Herbert Hoover, both of them highly exposed to high finance *after* crisis outbreak, were enthused to take conciliatory military spending, threat assessment, and war

⁵²⁵ By “normal” here I mean “financial-crisis free.”

prospects to further extremes in an attempt to solve the financial crisis. Interestingly, as a result of every single financial-crisis episode, the enhancement of the pre-crisis national security agenda by the crisis-stricken government did not outlast the financial crisis—a clear difference with the Japanese case.

Confirming the framework, assertive national security policies were curbed when high finance played a foremost role in the process of financial crisis resolution (1884-85; 1907-08). In these instances crisis-stricken governments reacted by redoubling on, or attempting to redouble on their assertive national security agendas but, in agreement with the framework, they failed in their endeavor. Also in agreement with the framework, after the start of the financial crisis, American crisis-stricken government attempted to redouble on their intended national security agenda even when they were pursuing cautionary national security policies before the outbreak of the financial crisis (1893; 1929). Finally, since scenario HA-LE materialized in two out of the four financial crises that hit the United States in the examined period, the framework is useful for extrapolating expectations on the course of national security policies only half of the time. Still, even with regards to the financial crisis instances falling in the “obscure” scenario HA-LE, the logic of the framework can still be appreciated in terms of decreasing constraints for the exercise of assertiveness after financial crisis outbreak.

As expected, presidential races and congressional majorities stand out as the two main channels through which high finance exerted or failed to exert cautionary pressures in American in national security policies—and the two channels thought which American governments, after financial crisis outbreak,

resisted or conceded to high finance in the formulation of national financial and security policies. The findings of the chapter also show that American governments' incentive, from LA-HE or HA-HE, to embrace greater national security caution in order to solve financial crisis decreased when high finance and international financial cooperation failed to improve national economic conditions and encountered profound domestic and Congressional opposition. The scarce power of high finance to solve the financial crisis became a fact between 1895 and 1896, and 1931 and 1933, setting the stage for a scenario-HA-LE kind of influence of the crisis on national security policies.

The inflation or curbing of pre-crisis national security policies following financial crisis outbreak (or the release of constraints to pursue greater assertiveness) did not always affect the whole spectrum of national security policies to the same extent. In the 1930s, for instance, structural factors other than the financial crisis kept war prospects close to zero. As a result, the influence of the financial crisis of 1929-1936 remained limited to military spending and threat assessment. Similarly, as the Cleveland administration embarked on a more cautionary assessment of the British threat between 1893 and 1895, military spending, for instance, remained shielded from cuts in 1893-95. A "protected" defense spending policy, however, did not cushion the administration's decision to undertake most radical measures of military withdrawal from the Pacific.

More notably, the chapter suggests that pushing cautiousness to new conciliatory extremes (HA-HE) to signal the respect of international financial cooperation, quell business anxieties, and abide by the prescriptions of high finance

in the attempt to resolve the crisis might not be the most “prudent” or farsighted measure. Also, when more cautious national security policies were undertaken, it was difficult to stop them, placing national security policies on an uncomfortable slippery slope. American leaders’ financial-crisis responses that “glorified” national security caution were often overturned because of the repercussions on national interests and national honor. Moreover, financial crisis responses that promoted an overly dovish security stance were often only fictitiously prudent, paving the way for increased international financial competition to the detriment and security of other states. This occurred during the financial crisis of 1893-1895 and Cleveland’s exceedingly cautionary assessment of the British threat in the Caribbean and the Pacific. Hawaii and Venezuela were the victims. It also ensued soon after the financial crisis of 1907-08, and its influence on American Asian policy. This time it was China who suffered the consequences. Finally, it occurred in 1931-32, with the “honest” scarification of American military power to save the power of high finance and the international gold standard. Ambitious national security policies were then domestically intolerable, but Franklin Roosevelt’s heterodox response to the financial crisis and the collapse of the international financial system opened a new chapter for American national security agenda.

CHAPTER V

WHEN SAVING MARKETS BECOMES TOO COSTLY: FINANCIAL CRISIS AND WAR IN THE SUMMER OF 1914

“Preparation for war had reached the breaking point.
It could not go on, and it could not stop.
Peace had become a luxury too expensive to be borne.
Bankruptcy or war was inevitable.”⁵²⁶

The extraordinary financial calamity that spread across the main state capitals in the summer of 1914 has been customarily portrayed as the inevitable outcome, or simply the fear, of the outbreak of a war having unprecedented magnitude (World War I).⁵²⁷ This thesis has some validity. The financial crisis of 1914 blew through the Bourses of central Europe (July 4 –18) *when* political leaders and investors anticipated an Austrian military demonstration against Serbia and, as a consequence, a potential general war (Table 5.1).⁵²⁸ The crisis also reached the London Stock Exchange (July 25), and led to the closure of all Western Stock Exchanges (July 27 – 31), only *after* that the harsh tones of the Austrian note to Serbia had become public (July 23).⁵²⁹

⁵²⁶ W.C. Van Antwerp, Governor of the New York Stock Exchange, in “The War and Wall Street,” Address Delivered in Rochester, NY, November 14, 1914, emphasis mine.

⁵²⁷ On this interpretation see, for instance, Keynes (1914); Noyes (1916), p.24; Horn (2002), p.28; Feldman (1993), p.29; *The Economist*, August 1, 1914; and Seaborne (1986). A number of studies have admittedly looked at the causes and manifestations of the 1914 financial crisis separately from the analysis of the Great War (Keynes), and some economic historians (one above all, De Cecco) have even concluded that the global financial crisis widely predated the outbreak of the war. Yet, any analysis that has looked at these coexisting developments has tended to see the financial crisis as a result of the War.

⁵²⁸ Members of the financial sectors and governments across the continent started to hoard gold for fear or in preparation to military hostilities.

⁵²⁹ On July 27, the Vienna Exchange closed. On July 28, the day of the Austrian war declaration on Serbia, the rush to acquire funds in London intensified, as the discount houses were forced to knock on the doors of the Bank of England. The St. Petersburg Stock Exchange closed on the 29. The Bourses of Berlin and Paris were shuttered on July 30. Those of London and New York closed on the 31. No previous financial crisis had ever required the closure of one single Stock Exchange market. Chaos followed. *The Times*, July 14,18,19,21,22,28; Brown (1988), pp.1-34; Whithers (1916), p.2; De Cecco (1984), pp.141,142; Hawtrey (1938), p.1230; Lloyd George (1935), p.90.

Without denying the validity of this thesis, this chapter shows that the financial crisis of 1914 shaped the national security policies that led to the Great War as much as it resulted from them. More purposefully, the chapter applies the framework introduced in Chapter One and derived from the Japanese, Italian, and American experience discussed in Chapter Two, Three, and Four, to the novel financial crisis settings and national security policies of Austria-Hungary, Germany, and Great Britain in the summer of 1914.⁵³⁰ Since the outbreak of the financial crisis in 1914 antecedes the outbreak of the Great War, this time period offers a reasonable and interesting ground for study. Moreover, the focus of this chapter on the experiences of three countries at roughly the same time-period offers the opportunity—opportunity which was missing in the previous chapters—to examine the “horizontal” or across-the-international-financial-system influence of financial crises, and therefore to observe related changes in national security as much as international security.

Table 5.1. Changes in market prices in the summer of 1914: Three Countries⁵³¹

	June			July								
	27	29	30	4	11	18	22	23	25	27	28	29
Vienna 4% crown rente	81.6	--	81.6	81.4	81.1	80.9	79.8	79.2	79.0	--	--	--
Berlin 3% Ger. loan	76.9	76.8	76.8	76.9	76.3	76.2	75.8	75.5	74.3	73.9	73.7	73.5
London 2% consols	74.8	75	74.8	75.5	75.3	75.8	75.5	75	73.2	72.3	71.8	71.0

⁵³⁰ “National security policies” throughout this work is a family concept comprising the following three variables: military spending, threat assessment and war prospects.

⁵³¹ Data from *The Times* and *The Frankfurter Zeitung* in Brown (1988), p.8.

Like in the previous three chapters, four claims are under analysis in this chapter—the claim that a correspondence exists between the orthodox (or heterodox) financial policies that a government follows and the national security policies that it is willing to pursue (*claim 1*); the claim that financial crises and the process of financial-crisis response cause a significant shift in national security policies (*claim 2*); the claim that the national security policies of a crisis-stricken government having low affinity with high finance are likely to be curbed when exposure to high finance is high, and to be inflated when such exposure is low (*claim 3*); and the claim that the national security policies of a crisis-stricken government having high affinity with high finance are likely to become extra prudent when exposure to high finance is high (*claim 4*).⁵³²

Various reasons justify a primary focus on Austria-Hungary, Germany and Britain. To begin, the financial crisis of 1914 began in the Vienna Stock Exchange, progressed to Berlin, and culminated in London. Analyzing the process of financial crisis response in Vienna, Berlin and London is meaningful exactly because of this time frame. Also, since in Austria-Hungary and Germany the process of financial crisis response in 1914 was closely related to previous financial crisis, a focus on these two states makes for a more comprehensive picture of the national security influence of the 1914 financial crisis.

Second, Austria-Hungary, Germany and Britain have been assigned important responsibilities for the start of the War. For instance, the Dual Monarchy is often

⁵³² Refer to Figure 1.1, which included at the end of the chapter, before the references, for a clarification on the terms “affinity with” and “exposure to” high finance, and a sketch of the argument that is explained in detail in Chapter One.

described as having a firm desire to punish Serbia in 1914. Similarly, Germany is often depicted as the instigator of Vienna's assertive intentions, while Great Britain is described as guilty for its passivity, failing to adequately signal British determination to fight to Germany.⁵³³ Given the interlocking nature of Austro-Hungarian, German and British national security decisions in 1914, it seems especially promising to examine the national security influence of financial crises in this trio rather than another.

Third, Austria-Hungary, Germany, and Britain present three different theaters in which the battle between governments and high finance took place following the outbreak of the global financial crisis of 1914, as well as some of the previous financial crises. The variation between the institutional contexts and the financial and security policies of Austria-Hungary, Germany and Great Britain is desirable for similar reasons to the ones that have informed the selection of Japan, Italy and the United States, namely findings commonalities in financial and diplomatic or military developments across space.

Examining the national security influence of financial crises in the months and years preceding the summer of 1914 makes sense also in view of the documented financial constraints that the Great Powers faced at the time, and the pressures that such constraints were posing on national security decisions. The preservation of national security required successful deterrence, and spending less on defense was an option that no great power could afford. In Great Britain and the major states in

⁵³³ On the intentions and responsibilities of Vienna, Berlin and London see, amongst many, Albertini (1943:II), p.514; Fischer (1969); Van Evera (1984), p.100; and Lebow (1984:152).

Europe, total defense spending of increased by more than 50% between 1908 and 1913. In 1913, the ratio of defense spending to net national product registered the greatest forward leap in Austro-Hungary, Germany and Russia (Table 5.2).⁵³⁴ In central Europe as well as in Britain, the security dilemma had important economic and financial components.⁵³⁵ The international and national financial systems were under evident strain.⁵³⁶ While the wealth and power of high finance continued to increase, the total supply of money—which included the funds devoted to armaments and industrialization—had grown far beyond the gold reserves of Central Banks and governments’ abilities to extract more financial resources from their population.⁵³⁷ These financial constraints placed state authorities in front of a dilemma: steps made to buttress national security through military or economic investment risked to undermine the confidence of high finance in national financial stability, thereby creating the conditions for financial crisis and bankruptcy. This explains why in the critical years between 1911 and 1914, financial crises and military crises were not only frequent (and, luckily, circumscribed), but also tended to overlap.⁵³⁸ Obviously,

⁵³⁴ In turn, investment in deterrence fostered arms races and insecurity. Some members of high finance in continental Europe were aware of this vicious circle and had, at least partially, accepted the principle that international peace required keeping up the great powers’ deterrence potential while also acknowledging that such an effort was economically intolerable in the medium term. See, for instance, Cecil (1967), pp.160,161.

⁵³⁵ In these years, for instance, Germany surpassed Great Britain in manufacturing and Great Britain lost much of its reserves. See De Cecco (1984); Kennedy (1987); Ferguson (1994); Horn (2002).

⁵³⁶ See, for instance, Feldman, p.30, note 11; De Cecco, p.133

⁵³⁷ All great powers faced important constraints on their ability to finance naval and military expansion. Austria-Hungary did more than any other.

⁵³⁸ In September 1911, during the Second Moroccan military crisis, fears of a war between France and Germany had created a panic in the Berlin Bourse. French assets were recalled from Vienna and Budapest too. Similarly, during the First Balkan (1912) and the Second Balkan War, Slav military advances had an adverse influence upon the Bourses of Vienna, Paris, Berlin, and St. Petersburg, as French and British investors pulled funds out from central Europe fearful that war would break out between Russia and Austria, and that Germany would support the latter. See “Crisis in Germany,” *The*

because of the loss of resources, policy independence, and prestige that it entails, national bankruptcy was an extremely undesirable outcome.

By applying the framework to the pre-World War One political contexts in three crucial states, the chapter shows how the outbreak of the crisis and the process of financial crisis response in each state intensified the security dilemma first in Austria-Hungary, then in Germany, and eventually in Great Britain. *One by one*, these three countries provided a different financial-security solution to the battle between government and high finance during the process of financial crisis response. *Altogether*, these solutions were permissive conditions for the Great War. This does not mean that in the absence of the processes of financial crisis response described in the chapter the Great War would not have occurred. In other words, the chapter is not offering an explanation of the origins the Great War. Rather, the argument that the chapter advances is that an application of the framework to the pre-World War One context helps to understand some of the constraints that were pushing states towards militant strategies and away from diplomacy. At the start of the financial crisis, the power of high finance was low in Austria-Hungary, ambiguous in Germany, and high in Great Britain.⁵³⁹ Throughout the financial crisis, Austro-Hungarian, German and British leaderships gradually found the limits of the orthodox medicine and international diplomatic cooperation to solve their financial problems. By the same token, high finance struggled to craft effective crisis response plans and to trust the national and international financial system, implicitly legitimizing heterodox solutions

Washington Post, September 10, 1911; "Russian Financial Crisis: Misery Caused by the War," *The New York Times*, October 23, 1912; Brown (1988), p.2.

⁵³⁹ High finance did not have a home base in Austria-Hungary as it instead did in Great Britain and Germany. See Table 5.2 later in the chapter.

and governments' low exposure to high finance. As cooperation between governments and high finance broke down in a state after the other, the higher the prospect of a general European war became. Finally, an application of the framework to the pre-World War One context offers a way to reconcile explanations that have emphasized the unintentional or inadvertent nature of the war (Levy 1990-91:87; Albertini 1943:252,253; Kissinger 1976:99), and explanations that have, oppositely, underlined leaders' premeditated or conscious effort at waging military hostilities (Fischer 1969; Hamilton and Herwig 2003).⁵⁴⁰

Table 5.2. Real Defense Burden (Defense Expenditure/Net National Product), 1912-13⁵⁴¹

	Britain	France	Russia	Germany	Austria
1912	3.3	4.0	4.5	3.8	2.6
1913	3.4	4.3	5.1	4.9	3.5

Using the format adopted in previous chapters, this chapter opens with three short sections that extrapolate expectations on the national security policies of, respectively, Austria-Hungary, Germany, and Great Britain on the eve of the Great War based on Figure 1.1. The three sections that follow apply the chapter's expectations and describe the influence of the financial crises of 1914 (and the financial crisis of 1911-12) on Austrian, German, and British military spending, threat assessment and war prospects. Particular attention is placed on the British financial-crisis experience given its role in the transformation of hostilities from localized to

⁵⁴⁰ Note that, for Fischer, it was Germany, more than any other state, to resort to premeditation and assertiveness. For Hamilton and Herwig, all great powers consciously undertook steps towards war. The most famous statement on the inadvertent war thesis is possibly that on David Lloyd George, who in a speech of December 23, 1920 claimed "no one at the head of political affairs quite meant war...it was something into which (they) glided or rather staggered and stumbled."

⁵⁴¹ Source: Stevenson (1996), p.7.

general in late July/early August 1914. Ending the chapter are a few observations on the utility and limits of the framework in contexts different from the ones it was derived from.

AUSTRIA-HUNGARY'S FINANCIAL FATALISM

The financial crisis of the summer of 1914 started in the Vienna Bourse. In 1914 Vienna was the “lead market.” From it, investors took their cues, convinced that financial dealers there had greater knowledge and a better grasp of events in southeastern Europe than did markets in Berlin, Paris or London.⁵⁴² Exactly because of its proximity to the Balkans—the core of international investment as well as international political and military tension—Austria-Hungary had been no stranger to financial difficulties in the months and years preceding 1914, so much so that identifying the start of the 1914 financial crisis in the summer of that year might even be problematic.⁵⁴³ *The Times of India* had already painted a protracted, disastrous financial outlook for the Austro-Hungarian Empire in early 1912.⁵⁴⁴ A few months later, Hofrat von Pranger, the secretary general of the Joint State Bank, the Austro-Hungarian Central Bank, had raised a warning about ongoing symptoms of acute financial stringency affecting domestic markets.⁵⁴⁵ After the onset of the first Balkan War (autumn 1912), the outflow of foreign capital assumed such proportions that the Bank had to sell large quantities of gold abroad to uphold the currency and avoid

⁵⁴² For a similar interpretation see Brown (1988), pp. 4-9.

⁵⁴³ The Creditanstalt, one of the largest Austrian banks, noted in a report for year 1912 that a state of constant tightness on the money market and a disproportion between capital formation and public and private capital requirements had begun in 1911. See März (1981), p.28.

⁵⁴⁴ “Finances of Austria,” *The Times of India*, January 20, 1912.

⁵⁴⁵ In “Money Stringency Distresses Austria,” Wireless Telegraph to the *New York Times*, March 18, 1912.

bankruptcy.⁵⁴⁶ By December 1912, von Pranger reported that “big withdrawals from financial institutions had spread like a contagious disease to all parts of the economy,” and that, “for the first time in decades,” a “loss of confidence in the currency” gripped Austrian investors.⁵⁴⁷ Austrian gold coverage had severely shrunk, a large share of French capital had departed, and domestic investors had begun to place their capital overseas.

These financial events did not catch Austro-Hungarian statesmen off-guard. Eminent officials of the Dual Monarchy had known since 1908 that credit could not be used “in the normal way,” and that the Austro-Hungarian Empire Bank would have to be most likely abrogated.⁵⁴⁸ Governor of the Joint Stock Bank Alexander Popovics was a strenuous advocate of the primary interests of the State and the State-Joint Bank liaison over those of financial markets. Similarly, the large majority of the Hapsburg governing authorities including Emperor Franz Joseph, Common minister of foreign affairs Count Berchtold, Austrian Prime Minister Karl Stürgkh, Common Finance Minister Ritten Leon Bilinski, Common War Minister Alexander von Krobatin and General Conrad von Hötzendorf had all come to value financial policies that had a low affinity with high finance. The Austrian financial sector had admittedly attempted to rescue the power of domestic markets, or at least forestall its decline. In this effort, Austrian bankers had achieved only moderate success, aware as they were that a mercantilist involution had started. Like it was true for Italy and Italian statesmen, high finance in Austria and for Austrian statement had foreign, private roots. In the

⁵⁴⁶ See März (1981), p.100; Strachan (2004), p.33.

⁵⁴⁷ Pressburger (1966), p.277. See also Strachan (2004), p.33.

⁵⁴⁸ Popovics (1925), pp.34, 38-48; and Pressburger (1966), p.277.

lead up to the summer of 1914, however, high finance seemed entirely absent from Austria-Hungarian financial and economic policies. In conversations with Emperor Franz Joseph, financier Alexander Spitzmüller emphasized the great political and military advantages of maintaining an internationally recognized central bank.⁵⁴⁹ Along with the governor of the Boden-Creditanstalt, Rudolf Sieghart, Spitzmüller also endeavored to improve the status of Austrian finances, and a number of financial agreements with foreign consortia were successfully concluded.⁵⁵⁰

In a similar fashion, during the financial crisis of 1912, the German financial community offered loans to the Austrian government. And in 1913 and early 1914, English, German, Belgian and Dutch banks under the leadership of the Rothschilds and the Schröders raised new loans for the Monarchy, thereby providing the means to rescue the country from the financial crisis.⁵⁵¹ The Austrian leadership accepted them, but doubted their long-lasting effects or a long lasting ability to raise new loans by German high finance, indicating that government exposure to high finance in this financial crisis period was already transitioning from high to low. The Monarchy probably appreciated the opportunity of earning some liquidity while endeavoring to find adequate heterodox solutions to respond to increasing monetary tightness. As for the possibility that this cooperation might instill new faith in the working of financial

⁵⁴⁹ Spitzmüller, *Und hat auch Ursach*, p.69, in März (1981), pp.99, 106. März argues that the very fact that Spitzmüller stressed the military potential of the Central Bank is “astonishing.” However, the banker’s behavior is not very astonishing in view of the changed security context of the 1900s.

⁵⁵⁰ See, for instance, März (1981), pp.103. A good picture of the increasing gravity of the Austrian financial situation is painted in “Where the Gold Went,” *The Washington Post*, January 3, 1914. A comparison between the holdings of gold of the central banks of the main industrialized nations showed that the Austro-Hungarian Bank’s reserves were, by far, inferior to those of any other central bank, including the Italian and Spanish central banks.

⁵⁵¹ “The Austrian Loan,” *Wall Street Journal*, April 3, 1914; “Austrian Finance,” *The Times of India*, April 9, 1914; Stevenson (1996), p.254.

markets, the appointment of someone like Popovics to the Joint Stock Bank was a strong indication that the Dual Monarchy had no confidence in the benefits of international financial openness. Throughout 1913 and early 1914, the financial situation improved slightly but in the spring of 1913, Popovics was already thinking about undertaking steps to “dismantle the legal structure of the monetary system, [...] fortify national cash balances, and [...] severely prohibit the participation of domestic capital in foreign loan operations”—a heterodox (or mercantilist) stance that no other central bank governor of a key European state entertained with similar commitment.⁵⁵²

Table 5.3. Liabilities on acceptances at the end of the year, 1912-1914⁵⁵³

	Barings	Kleinwort Sons	Schröders	Hambros	N.M. Rothschild	Gibbs	Brandts	Total of “big seven”
	(Home base: Britain)	(Home base: Britain)	(Home base: Germany)	(Home base: Germany)	(Home base: Britain)	(Home base: US)	(Home base: Germany)	
1912	6.58	13.36	11.95	3.45	3.49	1.38	3.19	43.40
1913	6.64	14.21	11.66	4.57	3.19	2.04	3.33	45.64
1914	3.72	8.54	5.82	1.34	1.31	1.17	0.72	22.62

In the spring of 1914, the situation deteriorated again, however, and the withdrawal of foreign assets from Austria-Hungary resumed. Austrian leaders observed financial developments without much surprise, knowing that a response to the increasing monetary tightness needed to be found, that the financial system was unreliable, and that international sources of liquidity could no longer be trusted. In

⁵⁵² Popovics (1925), p.40; März (1981), p.101. In May 1913 the Austrian Empire had also reached its peacetime borrowing capacity. See Stevenson, p.270.

⁵⁵³ Kleinwort Sons and Schröders were the most exposed. Ferguson (1999b), vol.II, p.436.

June and July 1914, Popovics started to hoard cash regardless of the pledge to buy Austro-Hungarian securities that Austrian bankers had negotiated with French authorities.⁵⁵⁴ Both the affinity with and exposure to high finance of Austrian officials were low this time. Table 5.3 captures the shift in the power of high finance between 1913 and 1914, showing a significant decline in returns on private investments.

In July 1914, withdrawals of foreign assets from Vienna accelerated, triggered by runs on banks by Austrian investors. The process first peaked on July 23, and on July 25 the demand for domestic funds and foreign exchange reached gigantic proportions.⁵⁵⁵ The government responded with a mix of heterodox financial expedients: it expanded banknote circulation; raised the discount rate; and demanded short-term loans from consortia of Viennese banks. Senior bank officials were requested to continue their business “as usual” and domestic hoarding of gold and foreign exchange was initially tolerated as a measure to contain the panic.⁵⁵⁶ As the crisis progressed, new heterodox measures were introduced. On July 27, the Vienna Exchange was closed and on July 31 the Austrian government stopped the disbursement of foreign exchange and foreign notes and coins. A moratorium on payments followed.⁵⁵⁷ On August 4, the Bank Act was suspended.

⁵⁵⁴ On the persistently chronic financial status of the Monarchy in early July 1914 see the Serbian Blue Book, exchange between Yovanovitch, Minister at Vienna, to Pashitch, Serbian Prime Minister and Minister for Foreign Affairs, August 3/16, 1914. On the reconciliation between the Monarchy and the French capital see Hamilton and Herwig, p.485; and “Brief Wall Street Gossip,” *The Washington Post*, July 4, 1914. On cash hoarding by Popovics see Strachan (2004), p.35.

⁵⁵⁵ März (1981), pp.129,130.

⁵⁵⁶ Popovics (1925), p.43; Fischer, p.11.

⁵⁵⁷ See Popovics (1925), p.45 and Pressburger (1966), p.282 on these developments.

Table 5.4. Summary of Expectations for the Financial Crisis of 1914

	AUSTRIA-HUNGARY	GERMANY	GREAT BRITAIN
PRE-FINANCIAL CRISIS AFFINITY WITH HIGH FINANCE	LOW	AMBIGUOUS	HIGH
EXPOSURE TO HIGH FINANCE	LOW Early June—	HIGH July 10—29	HIGH July 25/27— 29/30
		LOW July 29—	LOW July 29/30—
EXPECTATIONS: NATIONAL SECURITY POLICIES BEFORE THE OUTBREAK OF THE FINANCIAL CRISIS	ASSERTIVE	AMBIGUOUS: ELEMENTS OF PRUDENCE AND ASSERTIVENESS	CAUTIOUS
EXPECTATIONS: NATIONAL SECURITY POLICIES AFTER THE OUTBREAK OF THE FINANCIAL CRISIS	Early June— MORE ASSERTIVE	July 11—29 MORE CAUTIOUS July 29— INDETERMINATE	July 25/27— 29/30 EXTRA PRUDENT July 29/30— INDETERMINATE

A first set of expectation is thus formulated. The low affinity with high finance of Austrian authorities in the months and years before the financial crisis of 1914 should have resulted in a willingness to pursue assertive national security policies. Austrian officials' high exposure to high finance during the financial crisis of 1911-12 should have acted as a brake on this assertiveness. By contrast, the Austrian leadership's low exposure to high finance during the financial crisis of 1914—

specifically in the months of June, July, and August—should have paved the way for a turn towards more assertive national security policies (Table 5.4).

GERMANY'S FINANCIAL HOPE

Although less dramatically so than its Austro-Hungarian ally, the German financial system was also under strain in the months and years preceding the summer of 1914. Capital outflow had pushed the Reichsbank close to falling below the statutory minimum of its gold backing in late 1911, during the Agadir crisis. Not much differently from their Austro-Hungarian colleagues, German authorities confronted the potential humiliation of being driven off the gold standard much earlier than during the financial crisis of 1914.⁵⁵⁸ In response to this potential threat, the Reichsbank withdrew gold from circulation, and increased its reserve holding from \$200 million (777 million marks) at the time of the Agadir crisis to \$500 million (1.17 billion marks) in 1914.⁵⁵⁹ Concurrently, the Treasury had encouraged non-cash transactions, and the Reichsbank's note issuing, eliminating the 300 million-mark ceiling on the emission of small notes. The Reichsbank's official discount rate was also raised—quite cautiously—from 5 to 6 percent, to attract investments, but banks were warned to build up their gold reserves and curb the amount of money taken on deposit from

⁵⁵⁸ The trigger had been the financial panic resulting from the Agadir crisis. Fearful that war would break out respectively between France and Germany and between Germany, Austria-Hungary and Russia, French and British investors pulled funds out of Germany and Austria-Hungary while German investors sold investments on Wall Street and moved their activities to Russia. On these developments see Brown (1988), pp.2-3 and Ahamed (2009), p.43.

⁵⁵⁹ On these developments see Whale (1930):185-186; Cecil (1967), pp.160,161; Horn (2002), p.7; Feldman (1997), pp.25-35; Ferguson (2002), p.117; and Strachan (2004), pp.28,29; Ahamed (2009), p.43-44. The Reichsbank's gold reserve never reached the size of the Russian or French gold reserves. Yet, gold circulated widely in Germany, overshadowing both paper and silver. See, for instance, De Cecco (1984), p.109. The Bank of England, by comparison, held only the equivalent to 200 million dollar.

foreigners.⁵⁶⁰ Finally, the Treasury revived a plan conceived by Frederick the Great for a war chest of \$75 million in gold and silver.⁵⁶¹

These measures reflected a mixture of financial heterodoxy and financial orthodoxy. The German Treasury's means of increasing note circulation, for instance, was an expression of financial heterodoxy. The Reichstag's respect of low interest rates and the 1/3 gold rule—the requirement that at least one-third of its issued notes were covered by gold or silver or Reich Treasury Office notes—was an expression of financial orthodoxy. Differently from the Austrian case, there was no doubt amongst German statesmen that the extraordinary growth and prosperity of the national economy rested widely on the credit contributions of great universal banks such as the Deutsche Bank, the Disconto-Gesellschaft, and the Dresdener Bank. Differently from their Austro-Hungarian counterparts, German financiers were respectable members of high finance, and the government valued them and, as a result, the international financial system, to a greater extent than did the authorities in Vienna. German leaders had nonetheless begun to take measures to protect national finances.

Because of these undertakings, the German government had an ambiguous affinity with high finance on the eve of the 1914 financial crisis. This is a possibility that is not specified in Figure 1.1, and which is, as already explained in Chapter One, difficult to explain theoretically. Finding this situation empirically, however, suggests that the “only high” or “only low” government affinity with high finance that the framework postulates does not account for the entirety of state relations with high

⁵⁶⁰ Maneuvering the discount rate was common practice and central banks employed a good deal of discretion and varied their gold reserve ratios.

⁵⁶¹ “Plans Great War Funds: German Government Asks Banks to Keep 10 Per Cent of Assets,” Special Cable to the *New York Times*, July 11, 1914.

finance that can occur in stable financial times. On June 18, noting signs of stringency in the domestic market, Reichsbank governor Rudolph Havenstein tried to convince the main German banks to voluntarily increase their reserve ratios up to 10 percent over the course of three years, in collaboration with the Reichsbank. German bankers were uncooperative. Arthur Salomonsohn of the Disconto-Gesellschaft suggested that Havenstein was acting out of “too much pessimism” and that banks could manage the problem on their own. Henry Nathan of the Dresdener Bank proposed that foreign assets be included in the calculation of banks’ liquidity, which would have easily concealed the problem. Other financiers blamed the provincial and savings banks for the liquidity problem and complained that Havenstein was attempting to increase the Bank’s powers while reducing its role as lender of last resort.⁵⁶² The meeting ended with a general promise by the bankers that they would offer counter-proposals in later months.⁵⁶³

Financial crisis hit Germany in 1914 on July 10, and then on July 14, 18, and 21. Heavy selling began in the Berlin Stock Market after the spread of rumors from Vienna and Belgrade on the character of the imminent Austrian note to Serbia.⁵⁶⁴ Up until July 23 that is during a first phase of the financial crisis government exposure to high finance was high. German authorities expected a successful response to the financial crisis by the German banks, and, to this scope, they were ready to resurrect

⁵⁶² On these developments see Feldman (1997), p.31; Zilch (1980), pp.228-56; Habedank (1981), p.22.

⁵⁶³ Gerald Feldman has explained bankers’ reluctance to cooperate with the Reichsbank by pointing at the difficulty of acting as if one were in an emergency after decades of prosperity and economic growth. See Feldman (1997), p.31. I argue that economic prosperity had come with an augmentation of the powers of the financial sector to the point that the latter strongly refused financial compromises with political authorities and judged them incapable of controlling the risk of war. This point is developed later in the chapter. Both Feldman’s explanations and my explanation can be right.

⁵⁶⁴ See Schmitt (1930), pp.376-377; “War Scare in Berlin,” *Wall Street Journal*, July 21, 1914.

Havenstein's prior plan of increasing banks' reserve ratios to 10 percent, as they urged on July 20. A more compelling threat, the possibility of enacting new and heterodox legislative measures, was only vaguely hinted at.⁵⁶⁵ On July 23, the situation deteriorated. The large German banks panicked and refused to give back deposits on demand, and by July 27, small savers and panic-stricken investors had stormed the large banks.⁵⁶⁶ The collapse in prices was described in *The Chicago Daily Tribune* as the most far reaching in Germany since 1870.⁵⁶⁷ More powerful than the Austrian banks, the large German banks intervened by buying the securities they were most interested in, but the maneuver had only a slight effect. The day after (July 28), spearheaded by German shipping magnate Albert Ballin, German banks formed a syndicate to continue their purchasing attempts. The strategy failed.⁵⁶⁸ In the meantime the Reichsbank had lost 163 million marks' worth of its gold and silver reserves, and the government another 32 million in Reich Treasury Office notes. Thousands of people had lined up to exchange their paper money for gold and silver. By July 29, Bourse authorities had to intervene in the interests of security owners and suspend all dealings. Between July 29 and July 31, government exposure to high finance changed from high to low. On July 31, 1914, to prevent further losses, the Reichsbank suspended the gold convertibility of the mark, an action indemnified by

⁵⁶⁵ "Plans Great War Funds: German Government Asks Banks to Keep 10 Per Cent of Assets," Special Cable to the *New York Times*, July 11, 1914.

⁵⁶⁶ "Uploading in Berlin: Banks Buy Securities Dumped by Panic-Stricken Investors," Special Cable to the *New York Times*, 07/27/1914.

⁵⁶⁷ "London Stocks Least Hit: Bear Austro-Serbian Strain Best in Europe," Cable to the *Chicago Daily Tribune*, July 27, 1914.

⁵⁶⁸ The Norddeutsche Handelsbank, one of the largest banks in Hanover had to close its doors. "Berlin very nervous: Big Banks Will Support Stocks, Keeping Gold in Vaults," Special Cable to the *New York Times*, July 29, 1914. On the failure of high finance to resolve the German financial crisis see Mulligan (2010), p.205

the Reichstag and legalized four days later.⁵⁶⁹ Legislation enacted on August 4 transformed the system radically by relieving the Reichsbank and other money-issuing institutions from the obligation of redeeming paper money for gold on demand. Channels for unlimited monetary growth were also created, and the Bundesrat was permitted to decree economic and financial measures without consulting the Reichstag.⁵⁷⁰

Although the framework omits to consider the possibility that government affinity with high finance takes on an ambiguous character (like the affinity with high finance of the German government before the summer of 1914), expectations about the influence of the financial crisis of 1914 on German national security policies can be formulated using the same logic that informs the framework. Given the ambiguous affinity with high finance of the Hollweg government before July 10, 1914 (that is before the start of the financial crisis of 1914 in Germany), German national security policies should show, in this phase, both elements of caution and assertiveness. Between July 10 and July 29, German national security policies should have shifted towards greater caution given the German government's high exposure to high finance during this first phase of financial crisis response. Vice versa, from July 29 onwards German national security policies should have moved towards greater assertiveness given the low government exposure to high finance that ensued from then on.

⁵⁶⁹ On this point see Ferguson (2002), p.117.

⁵⁷⁰ The transition to the new system was easier than in Britain as the Reichsbank had experimented with preparations for the establishment of state loan banks empowered to issue special notes in the event of a short and decisive war as early as 1912.

GREAT BRITAIN'S FINANCIAL DISBELIEF

As much as Vienna was the “lead market,” London was the “lag market” in the summer of 1914. Differently from Austria-Hungary and Germany, Great Britain experienced no financial crisis in the months and years before 1914. During this period, the financial policies of the (liberal) Asquith cabinet expressed high affinity with high finance and full compliance with financial orthodoxy. Despite its awareness that the delicate mechanism of credit was somehow under strain at home, the British cabinet trusted the operation of both the Bank of England and the joint-stock banks. Enmeshing itself in the banks' affairs was unconceivable. By the same token, the likelihood that waves of foreign financial sales and the cut-off of gold remittances could paralyze the London money market (as a result of a European war or its mere anticipation) was widely underestimated.⁵⁷¹

War nerves hit the London markets on July 25, 1914, and a financial crisis developed there between July 25 and 27, as all foreign banks and particularly the Germans ones took a very large amount of money out of the (British) Stock Exchange. Up until July 30, British authorities found themselves highly exposed to high finance. When it came to financial rules and regulations, the Bank of England was much closer to London's foremost bankers than British state authorities. Governor Walter Cunliffe was no Havenstein, let alone Popovics; he defended the independence of the Bank of England as strenuously as he could. Between July 25 and July 30, the Bank advanced 14 million pounds to the discount market and a similar amount to the London

⁵⁷¹ Keynes (1914), pp.460-61,467; Ahamed (2009), pp.23-25.

banks.⁵⁷² On July 28—the day in which the financial crisis escalated in London—Governor Cunliffe reassured British authorities that the Bank of England was in a very strong position. Although it had worked in the past, Cunliffe’s reliance on the private financial market to solve the crisis struggled to take off this time. Rather than providing gold to an endangered Treasury, as had occurred in 1890, or contributing to a pool of reserves with the Bank of London, as had occurred in 1907, now high finance representatives held onto what gold they had, and expected to be supplied with a steady flow of gold reserve that they could impulsively hoard. As Chairman of the Union of London and Smith Banks, Sir Felix Schuster concluded, “the only possible effective remedy [...] is a gold reserve systematically and scientifically collected and distributed among the great banking institutions which collect it.”⁵⁷³

Because of the Bank’s hostility to state financial interference, the British government hesitated to step in: only on August 29—after a black day of runs on banks in the city (the 28th), and several days after the start of the financial crisis in Continental Europe—Lloyd George organized a visit to the Treasury to the Bank of England.⁵⁷⁴ From then on, the government’s exposure to high finance moved from high to low as the cabinet increasingly transferred pieces of authority over financial

⁵⁷² Ferguson (1999, II), p.433, Rot.

⁵⁷³ Both Lloyd George and Keynes judged this behavior of the joint-stock banks as illogical and idiotic. A more Machiavellian interpretation is proposed by De Cecco (1984:132,140), who describes the joint banks as eminently interested, during the crisis of 1914, in stealing lucrative businesses from British authorities and the Bank of England. This debate is only tangential to a discussion, like the present here, which is mostly concerned with determining the *effective* power of high finance versus that of government in the process of financial crisis resolution. *The Times*, July 23, 1914 and De Cecco, p.140, emphasis mine. Already in early 1914 bankers in the Gold Reserve Committee agreed that they were “unable to devise any protective or retaliatory measure” to meet a financial collapse of the City of London in the case of a war involving European powers (Horn 2002:26).

⁵⁷⁴ See De Cecco 1984, pp.142; Keynes (1914); *The Times*, July 28, 29, 1914. Between July 23 and July 30 the Bank of England lost 12 million pounds.

matter away from the private sector to the advantage of the Treasury, while the Bank of England increasingly lost its political independence.⁵⁷⁵ For instance, on July 30, the Treasury severely reprimanded the banks for their “mischievous” and “dangerous” practice of hoarding coin and creating distrust. On July 31, as the banks refused to pay out gold to investors from Berlin and Paris who sought to turn their securities into money at any price, the Stock Exchange closed its doors. Between July 31 and August 6, the British government’s crisis response measures, which reflected a mutable blend of orthodoxy and heterodoxy, were improvised. On August 2, Lloyd George accepted the banks’ proposal of depositing sterling in the Bank of England but declared it as “*una tantum* remedy,” in no way prejudicing future courses of actions.⁵⁷⁶ Soon afterwards, as gold hoarding continued, the government thought of new ways of injecting liquidity into the system. Since the Bank of England was unable to arrange for the expeditious printing of notes, the British Government extended an existing bank holiday (August 2) to buy time before deciding what to do. In the meantime, a thirty-day postponement on payments of bills of exchange (moratorium) was introduced (August 3)—something that the banks regarded as “a threat to their existence.”

Then, on August 6, British authorities suspended the Bank Act, which governed the amount of notes that the Bank of England was legally entitled to issue, and issued special Treasury notes—notes distinct from the usual Bank of England notes—in denominations of one pound and ten schillings (the “Bradburys”). Concurrently, to staunch any flow of gold away from the Bank of England and

⁵⁷⁵ On this point see Horn (2002:34,35).

⁵⁷⁶ De Cecco (1984:146-148); Keynes (1914), p.461.

dissuade borrowers from seeking to remove gold, the Bank rate was manipulated at will, first raised and from 3 to 10 % between July 30 and August 1 (as prewar orthodoxy suggested), then lowered to dissuade borrowers from seeking to remove gold from the Bank of England. Once it became evident that the normal mechanisms of international finance remained frozen, more far-reaching measures to restore confidence and, by then, to run a war economy, were introduced.⁵⁷⁷

Perhaps nothing demonstrates the overturn of political fortunes between government and high finance in the process of financial crisis response better than the battle over the suspension of gold convertibility. During the bank holiday, the bankers insisted on the importance of going off gold for fear of losing their deposits. They also refused to declare themselves ready to satisfy the cash requirements of their clients at the end of the bank holiday, with Lord Rothschild stepping in to alert the Government that it was handicapping the banks and “profiting from the country’s needs.” All attempts were in vain. Lloyd George, under the expert advice of Blackett, Keynes and Cunliffe, argued strongly that abandoning gold convertibility would have negative consequences for “British position and prestige,” and irreparably damage London’s position as the center of world finance. Lord Rothschild shut up and the banks were demanded not to obstruct the revival of the economy.⁵⁷⁸

⁵⁷⁷ On the strongly interventionist character of British rescue efforts see in particular Horn (2002), pp.30,31; Peter2 (1993), p.127.

⁵⁷⁸ On these developments see De Cecco (1984), pp.150-170. See also See Horn (2002), pp.36. De Cecco acutely captured the victory of the British government in this critical crisis days with the following statement (1984:166): “Certainly banks were defeated [...]: they wanted suspension of convertibility and they did not get it; they wanted a favorable interest rate on Treasury notes and they did not get that either. Moreover, they formally agreed with the government to carry on transactions in a climate of normality and to call off the tough squeeze to which they had subjected the economy until then.”

The last set of expectations of the chapter is therefore formulated. Because of the Asquith's government high affinity with high finance, British national security policies should have had a cautionary nature before the start of the financial crisis of 1914. After the start of the financial crisis (July 25-27), and due to the government's high exposure to high finance during a first phase of the crisis (until July 29-30), British national security policies should have moved towards greater caution. During a second phase, that is from July 29-30 onwards, because of the government's low exposure to high finance in the process of financial crisis response, British national security policies faced lesser constraints to stir away from assertiveness, but their change remains indeterminate in view of the framework. Table 4 synthesizes the expectations so far formulated.

FAITH IN HIGH FINANCE IS LOST:

Financial crises, Austria-Hungary, and (limited) war as the only option

Austrian leaders had witnessed the challenges that financial crises posed on national security policies well before 1914. Concurrently, national security policies had been moving towards increasing assertiveness.⁵⁷⁹ As much of the literature has already shown, some of the reasons for this turn towards national security assertiveness are to be found in the internal and external military threats that the Hapsburg Empire faced, positioned next door to the most conflict-ridden region of the world, the Balkans. Yet, important financial reasons explain the Austrian bet on an assertive national security stance. Between 1911 and 1914, Austria-Hungary confronted constant monetary strain just for being geographically close to the theater

⁵⁷⁹ See Stevenson (1996), pp.253. [...]

of military hostilities. Financial crises exacerbated this uncomfortable financial condition to the point of jeopardizing national military readiness and threatening financial bankruptcy. The liquidity crisis that developed in Austria-Hungary in late 1912, after the onset of the first Balkan war, led the two ministers of finance to conclude that, “from the point of view of preparedness for war,” the prevailing situation was “extremely difficult.”

As expected, on that occasion (December 1912), the Austrian high exposure to high finance acted as a restraint on the exercise of assertive national security policies. In late 1912, as markets faced financial crisis in Vienna, Berchtold accepted German loans to Vienna and reassured the Berlin financial community that Austria-Hungary was not seeking mobilization credits (Stevenson, 1996:254). This behavior might seem to contradict my expectation that the Dual Monarchy was set on an assertive foreign policy course. It is more probable, however, that the Berchtold government was just trying to avoid or contain the blow-up of a financial crisis beyond national borders. Indeed, always in late 1912 the chancellor *secretly* approved a medium-term program of military expenditures in light of a “very probably” war with Russia in the forthcoming years.⁵⁸⁰ Somewhat similarly, in the spring of 1913 Austrian authorities only partially mobilized (again), and desisted from their military plans of achieving a *fait accompli* with Serbia due to “fears” that “the money markets would panic.”⁵⁸¹ In other words, financial crisis fears in 1913 produced the same effects than the financial

⁵⁸⁰ See for instance Stevenson (1996:255).

⁵⁸¹ Zaleski to Bilinski, May 4, 1913 in Stevenson (1996), p.270. The prospect of a war between Austria-Hungary and Russia had materialized already in the winter months of 1912 and again in autumn 1913. Tensions arose after Austria-Hungary’s declaration that it would not tolerate Serbia gaining access to the Adriatic. When Serbia occupied Durazzo, the Albanian port on the Adriatic, international tensions reached a point where both Austria and Russia partially mobilized. On this point see Brown (1988:2).

crisis in 1912. The result, in terms of Austrian national security policies, was the adoption by the Monarchy of some sort of “militant diplomacy” characterized by military mobilization and the preservation of neutrality.⁵⁸²

Confronting financial crisis (and financial crisis fears), Austro-Hungarian officials realized that restrained military was convenient, at least for the time being, because in case of a *general* mobilization, the withdrawal of deposits from saving banks and financial institutions would have assumed “catastrophic dimensions,” complicating Austrian politics and foreign policy.⁵⁸³ Nor was it possible to raise a financial loan abroad to finance Austrian mobilization because the latter *per se* would have caused “immediate uneasiness in the Western markets.” This situation explains why, in April 1913, Austro-Hungarian financial authorities decided that “before issuing (full) mobilization orders”—and at the latest “before firing a shot”—steps needed to be undertaken to “dismantle the legal structure of the monetary system.”⁵⁸⁴ Before any other great power did, the Dual Monarchy had concluded that war readiness and the preservation of the gold standard had become incompatible goals. In other words, it was simply very clear in Vienna that the gold standard was no longer delivering its promise, like it had done, for instance, for Great Britain in occasion of the Boer Wars (1899-1902), or for Italy in occasion of the Libyan War (1911-12).⁵⁸⁵ Austrian war readiness, as the experience of the Balkan wars demonstrated,

⁵⁸² See, for instance, Afflerbach and Stevenson, (2007), p. 62.

⁵⁸³ Popovics (1925), pp. 35, 100-11. Austria-Hungary, differently from any other great power decided to mobilize during the Balkan wars.

⁵⁸⁴ Ibidem, p101.

⁵⁸⁵ Wars could be waged under the terms of the gold standard. Under such terms, the warring nation’s adherence to the system would be suspended for the duration of the war while market participants would assume that the duration of the war would have been short and that deflationary policies would have resumed in its aftermath.

undermined national finances and Austrian international financial credibility. By the same token, however, defending Austrian commitment to the gold standard demanded war readiness: in an environment of continuing international military crises and armament races, the preservation of international peace rested on a credible deterrent threat.⁵⁸⁶

*Table 5.5. Defense spending as a percentage of net national product: Austria-Hungary's relative military unpreparedness.*⁵⁸⁷

	Britain	France	Russia	Germany	Austria	Italy
1913	3.2	4.8	5.1	3.9	3.2	5.1

Table 5.6. Defense spending of the great powers in million dollars

	Britain	France	Russia	Germany	Austria	Italy
1913	72.5	72.0	101.7	93.4	25.0	39.6

Hence, it is not surprising that after the start of the Balkan Wars, many in the Austro-Hungarian administration agreed with the assessment by common finance minister of the Empire, Leon Bilinski, that finance had become the servant of war even when peace still prevailed (Strachan 2004:33).⁵⁸⁸ Financial markets in Austria were gripped by war fears, and nothing seemed to calm them. Having ascertained that, between 1912 and 1913 the Austrian leadership spent increasingly more in military appropriations.⁵⁸⁹ By mid-1914, even foreign minister Count Leopold Berchtold, who in 1908 accepted the view that Austro-Hungary was “satiated” and wanted no more Balkan gains, moved closer to more militant solutions.⁵⁹⁰

⁵⁸⁶ See Stevenson (1996), pp.253

⁵⁸⁷ In Hobson (1993), pp.464f.

⁵⁸⁸ Williamson, *Austrian Hungary*, 157,9; März 27-32; 99-100; Popovics 27-29, 39.

⁵⁸⁹ Stevenson (1996), p.253.

⁵⁹⁰ *Ibidem*.

By late spring of 1914, having already taken mobilization measures and confronted the prospect of war several times, Austrian governing authorities were ready to act decisively to protect the Monarchy's great power status.⁵⁹¹ Acting decisively was not intended as staunchly pursuing an expansionist foreign policy. Although avowed "hawks" like Bilinski, War Minister Krobatin, and General Conrad desired it, a preventive war of conquest against Serbia was not in the cards. If nothing else, the levels of Austrian military spending made this plan unfeasible (Table 5.5 and Table 5.6).⁵⁹² Rather, Berchtold and the rest of the cabinet recognized the need for an assertive policy of self-preservation—a policy in which a war with Serbia was a strong possibility (Afflerbach and Stevenson 2007:62,66; Stevenson, 1996:255). Thus, as expected, before the onset of the financial crisis in June of 1914, the low affinity with high finance of the Hapsburg leadership dovetailed with an assertive national security posture.

Also in alignment with expectations, as financial crisis resumed in June and July 1914, the Hapsburg foreign policy moved towards greater assertiveness. The shift occurred in two ways. First, a war with Serbia moved from a strong probability to an absolute certainty. As Emperor Franz Joseph expressed in a letter to the Austrian ambassador to Constantinople, Marquis von Pallavicini, a war was "the only way out of the existing situation."⁵⁹³ The existing situation was one in which national finances kept deteriorating; Austrian international financial credibility was untenable; and

⁵⁹¹ Before 1914 the prospect of an Austrian war against Serbia appeared twice, in December 1912 and October 1913; in the opening months of 1913 Vienna confronted the danger of a war with Russia and in May 1913 the prospect of a war with Montenegro arose. See Afflerbach and Stevenson (2007), p.61.

⁵⁹² On Austrian comparative military unpreparedness see also Hamilton and Herwig (2003), pp.31, 126-27; 234; 237.

⁵⁹³ Albertini (1953, II):129.

repeated mobilizations without the use of force—a common practice during the Balkan Wars—had become a far too costly option.⁵⁹⁴ Fathomable from this perspective are Francis Joseph’s resigned words: “If the Monarchy is *doomed to perish*, let it at least perish decorously.”⁵⁹⁵ Francis Joseph’s desperation is conventionally attributed to the threat that Serbia’s increasing restlessness or nationalistic forces posed to the *Empire* (see for instance, Albertini, 1956, II:129). But the wording of the Emperor’s cry suggests that the origins of the concern were located inside rather than outside the *Monarchy*.

A second way in which the Austrian shift towards greater assertiveness occurred in July 1914 is that Austrian leaders took actual steps for waging a war against Serbia. The Austrian alliance apparatus was strengthened. Vienna was now committed to learning if Rumania were part of the Triple Alliance and, failing that, aimed to enlist Bulgaria (Afflerbach and Stevenson 2007:62). A number of other policy choices confirmed a more militant commitment, from the celebrated mission in Berlin of Austro-Hungarian hawk, Count Alexander Hoyos, to Berchtold’s desire for an immediate action against Serbia at the Ministerial Council of July 7, and, most evidently, to the character of the Austrian ultimatum to Serbia.⁵⁹⁶ By mid-July, even Hungarian foreign minister Baron Tisza, who had strenuously resisted a militant line, had concluded that military confrontation against Serbia had become a necessity.⁵⁹⁷

⁵⁹⁴ Soundhaus (2000), p.141; Williamson (1991), pp.198-99.

⁵⁹⁵ Albertini (1953, II):129.

⁵⁹⁶ On the assertive character of the Hapsburg foreign policy agenda on the eve of WWI see Williamson (1991:190-212) and (2007:61-74); Schmitt (1930), pp.342.

⁵⁹⁷ On Tisza’s conversion see, for instance, Zeman (1971), p.81; Brown (1988), p.6.

The interpretation that an initial shift in Austrian national security policies towards greater assertiveness occurred before June 28, and that successive shifts towards greater assertiveness took place as the financial crisis continued through July 1914 challenges the hypothesis, advanced elsewhere (Lebow 2007; Afflerbach and Stevenson 2007:66-78), that the assassination was a catalytic event responsible for the Austrian departure from a foreign policy of peace and restraint. It is hard to believe that such an extreme take on existing threats to the Monarchy's prestige and the country's national security matured as a result of the assassination of the Archduke Franz Ferdinand, as Austria-Hungary had endured greater national security challenges during the Balkan Wars years. The argument here is that the Austro-Hungarian belief in such policy disappeared much earlier, although the departure was gradual because of the Austrian elites' high exposure to high finance during financial crisis year 1912 and in 1913.

When the financial crisis resumed in June and July 1914, the low exposure to high finance left the administration's assertiveness unchecked, thus killing the path of restrained militancy adopted in 1912 and 1913. The Serbian minister in Vienna, Sir M. Yovanovitch wrote on July 1, 1914 that a general financial and economic crisis prevailed in Austria-Hungary, and that a "settlement with Serbia" was declared to be the only way out.⁵⁹⁸ He added that Austrian financial circles had been informed.

Although Austrian financial interests were informed, high finance became aware of the new security risks very gradually. The resurgence of the financial crisis in Austria-Hungary made little news after the chain of financial crises experienced by the

⁵⁹⁸ Yovanovitch to Pashitch, July 1 and August 3, 1914. Serbian Blue Book.

country since 1908. Moreover, the kind of “settlement with Serbia” that Austrian leaders were seeking was still very generally formulated and, to the extent that it promised to curb Slavic terrorism—a goal that European capitals all but supported—the settlement could only please high finance.⁵⁹⁹ Finally, high finance (as shown earlier in the chapter) was excluded from the process of financial crisis resolution. Thus, only on July 6, Nathan Rothschild started to wonder: “Will the Austrian monarchy and people remain quiet? Or might a war be precipitated?”⁶⁰⁰ The type of question asked was clear indication that the financial magnate was powerless, at this stage, in the context of Austro-Hungarian security decision-making, which is in agreement with the conclusion reached by existing literature on the origins of World War I in Austria-Hungary. As Michel found, and the recent works reaffirmed, it was the Austria of the diplomats and the generals, not the Austria of bankers, who, at the end of July 1914, pulled Europe into war.⁶⁰¹ What the literature has failed to note, however, is that the absence of high finance in the decision-making process that plunged Austria into a war is in itself a noteworthy development to be explained—development that hinged on the inability of high finance to solve the financial crises of 1914 compared to previous financial crises, and that was ultimately paramount in making the difference between peace and war. Youssef Cassis’ thesis (1994:308-309) that high finance did *not* matter in the process leading to the outbreak of war seems unsustainable from this perspective.

⁵⁹⁹ On the general consensus amongst European leaders that some measures against Serbia needed to be taken see Hamilton and Herwig (2003), p.134.

⁶⁰⁰ Ferguson (1999, Rot, vol.2), p.431.

⁶⁰¹ Michel, p.366; Hamilton and Herwig (2003), pp.481-503. More generally, on the peaceful motives of ahead of the war outbreak see Michel, p.364; Marz (1932), p.168.

That the financial crisis of 1914 and the lack of a solution exerted a role in increasing the assertiveness of Austrian authorities and driving the Monarchy into war is illustrated by the fact that the Berthold cabinet *agonized* over the ability of Austro-Hungarian finances to sustain a war against a fighting Serbian army and another likely war against Russia, and yet it felt it had no other choice than to make a military move against Belgrade.⁶⁰² This agony hinged on a security dilemma which, as Berchtold defined during the Council of Ministers of July 7, was destined to become “more precarious as time [went] on,” having the Monarchy already “lost [...] opportunities.”⁶⁰³ The too-costly-to-sustain binomial financial crises and military-mobilization- short-of-a-*fait-accompli* was surely computed in the Austrian leadership’s perception of precariousness and loss. What was not computed (or better, what was underestimated) was that the news of a forthcoming Austrian war against Serbia would have terrified financial markets, spreading the financial crisis across and beyond Europe, paralyzing any rescue effort by high finance, and removing some critical elements that would inhibit a general war and a general financial crisis. In underestimating this risk, Vienna was not alone. State authorities in Berlin repeated the same mistake. More significantly, underestimating this risk was a rational course of action. Localized financial crises and contained international military crises had been so frequent that the probability of an *overblown* manifestation of either event seemed very low.

An interesting question is why it took so long for Austrian leaders to make a *démarche* in Belgrade given the heterodox nature of their response to the financial

⁶⁰² On this point see, in particular Stevenson (2007), p.397.

⁶⁰³ Quoted in Geiss (1967), pp.81,84.

crisis, and, relatedly, the assertive character of their national security policy were unequivocal already in June. As the literature has observed, however, a number of considerations unrelated to the financial crisis prompted Austrian-Hungarian state authorities to delay the immediate display of their intentions. Among these considerations figure the necessity to secure German military assistance (which was done on July 5); the precautionary decision to wait (until July 23) for the return to France of French President Rarymond Poincaré and his Prime Minister René Viviani from their visit to St. Petersburg; and the desire to act shrewdly to place the world before a *fait accompli*.⁶⁰⁴ The delay had the perverse effect of *momentarily* reassuring high finance and Austrian financial circles that the Monarchy's intentions were not belligerent. Although some members of high finance like Nathan Rothschild were uncertain about Austrian national security policies, the absence of Hapsburg military measures reinforced the belief that international peace could be maintained.

By the same token, the increasing realization that an Austrian military move was unavoidable from July 11 onwards—the date of the famous “no going back” declaration by Emperor Franz Joseph—sent bourses across Europe into a frenzy. Austrian political elites consistently refused to abandon the invasion of Serbia, no matter the Russian threats, British mediation efforts, and German vacillations.⁶⁰⁵ The

⁶⁰⁴ The visit in St. Petersburg by Poincaré and Viviani took place July 20-23. To reduce the risk of wider repercussions, Austrian leaders took the decision of sending the ultimatum to Serbia exactly on July 23. See Goch, (1938, II) pp.436-37; Hamilton and Herwig (2003), pp.138; Lauren et al. (2007), p.229; and Geiss (1967), pp.200-201.

⁶⁰⁵ From July 27 onwards German Chancellor Bethmann Hollweg tried to hold Austria back by intercession of the German ambassador in Vienna. It was suggested that Austria made a fuller explanation to St. Petersburg that the occupation of portions of Serbian territory would be purely temporary. Germany was desperately attempting to avoid a European war by then. Similarly, the British ambassador met with Berchtold to suggest him that Serbia's reply should be a basis for negotiation.

disproportionate (compared to any previous experience) blowout of the financial crisis at the end of July surprised even the Monarchy's highest authorities. As later paragraphs will show, the spread of the crisis to Berlin and London critically contributed to transforming the war from "localized" to "general," with repercussions on the national security policies of the great powers and, obviously, on the crafting of the Hapsburg military strategy. Vienna (and Berlin) had to shift from what was earlier thought as a war against Serbia *only* to a continental war, and possibly a war including Great Britain. When Berchtold on July 30 hinted at the potential problems that Austrian plans to wage a *limited* war were encountering, it was too late to stop them.⁶⁰⁶

GERMANY'S OTHER TWO-FRONT WAR:
Rescuing the nation's financial status through military gambling

Literature has long recognized that preventive war played a critical role in pushing the German Reich over the brink of war in 1914.⁶⁰⁷ Feeling that a window of opportunity was fading, and that chances to preserve Germany's hegemony on the Continent were "slipping away," German civilian and military leaders resolved that they could not win the arms race against their continental neighbors and chose war to forestall their decline. Historians like Paul Kenney (1987), V.R. Berghahn (1973), and Niall Ferguson (1994) have shown the economic and financial dimensions of this

See, for instance, Gooch (1938, II), p. 278, and Brown (1988), pp.23.24; Geiss (1967), pp.276, 301-302; 318-19 (protocol 11203).

⁶⁰⁶ See, for instance, Stevenson (1996), p.397.

⁶⁰⁷ See, amongst many, Kaiser (1983), Van Evera (1984), Ferguson (1994), Copeland (2000), and McDonald (2011).

process.⁶⁰⁸ This section buttresses the conclusions of these studies but draws attention to the role of financial events and processes that have remained unaccounted. Specifically, the financial crisis of 1911-12 and its resolution and, to a greater extent, the financial crisis of 1914 and its resolution were fundamental components of the German plunge into war.

Like Austria-Hungary, Germany faced an intense financial-security dilemma on the eve of World War I. The Schlieffen Plan itself—the risky military strategy designed to overcome Germany’s chronic problem of a two-front war—had a well prepared financial counterpart. More meaningfully, the Second Moroccan crisis or Agadir crisis (1911-1912) had encouraged new insights about the relationship between German finances and German national security policies. Agadir had shown that financial crises could have tremendous consequences on national security. In July 1911, German statesmen had responded to the French military invasion of Morocco by sending the German gunboat *Panther* to the port of Agadir. As a Franco-German military crisis developed throughout the following months, a severe capital outflow pushed the Reichsbank to the verge of defaulting on its gold obligations.⁶⁰⁹ To avoid this outcome, the Kaiser had backed down but the French had ended up taking over most of Morocco. The lesson was clear: financial crises and financial-crisis responses

⁶⁰⁸ Ferguson has arguably provided the most “financial” explanation of German participation in World War One. He finds that the fiscal structure of the German Reich—particularly its federalist and democratic underpinnings of this structure—prevented a greater investment on national defense and exacerbate the security dilemma at the heart of the German war effort (Ferguson 1994).

⁶⁰⁹ The trigger had been the financial panic resulting from the Agadir crisis. Fearful that war would break out respectively between France and Germany and between Germany, Austria-Hungary and Russia, French and British investors pulled funds out of Germany and Austria-Hungary while German investors anxiously pulled in credits to Russia and sold investments on Wall Street. On these developments see Brown (1988), pp.2-3 and Ahamed (2009), p.43.

influenced the crafting of national security policies and set the stage for momentous political and military decisions.

The earlier described heterodox financial measures that the Hollweg government introduced in its otherwise orthodox financial agenda in the months and years following the 1911-12 financial crisis were exactly an attempt to increase the compatibility of Germany's status within the international financial system with the country's position as a major military power able to provide for its own national security.⁶¹⁰ In this vein, a few months after the Agadir crisis, Kaiser William summoned Governor Havenstein and the main representatives of the large German banks and demanded to know whether the latter were capable of financing a European war. At their hesitation, he allegedly told them, "The next time I ask that question I expect a different answer from you gentlemen."⁶¹¹ Havenstein, too, was concerned that German banks were undermining Germany's ability to harness sufficient financial resources to provide for national security. Not for nothing, in June 1914, he had attempted to convince the banks to increase their reserve rations. As it had emerged at the end of May of 1914, the Deutsche Bank was on the verge of a collapse, which threatened incalculable consequences for the German position in the East (Berghahn 1973:164,165; Feldman 1997:31).⁶¹² The prospect of having to save national banks *at the same time that* the German government asked for reserves to supply to its defense needs was both very likely and terrifying. To make it likely were the military crises and wars that spread through the Continent in 1911, 1912, and 1913. Making it

⁶¹⁰ On this point see in particular Feldman (1993), pp.28-29; and Ferguson (1994).

⁶¹¹ Ahamed (2009), p.43.

⁶¹² The Deutsche Bank floated the loans for the construction of the Baghdad Railway, the primary vehicle of German influence in the East.

terrifying was the fear of another financial crisis like that of 1911-12. German national security and the German ability to preserve international peace through financial strength would have been endangered, and, in such a circumstance, the Kaiser could have not repeated Germany's 1911 bow to French imperialism without damaging the national honor and the preservation of international peace through credible (financial and military) deterrence. Significantly, Havenstein's drive to increase the liquidity of the banks was not the expression of as conservative a credit policy as the one implemented by Austrian finance minister Bilinski. On the contrary, as Feldman noted (1997:31-32), "It was precisely the liberality of the Reichsbank's intentions in the event of a war" that drove Germany "in the direction of trying to control the banking system [a little more]," while easing the Reich's mobilization for the preservation of international peace.

As expected, and in agreement with these considerations, before the outbreak of the financial crisis of 1914, this "ortho-heterodox" financial Weltanschauung dovetailed with a matching blend of cautious as well as assertive national security policies. On the one hand, Germany's remarkable economic growth and stunning industrialization rate, which a strong domestic financial sector eminently contributed to, fueled cautiousness and a commitment to international cooperation and peace.⁶¹³ Thus, after the Second Moroccan crisis, German political elites stepped away from the naval race, distressed by the toll on German-British relations that a policy of greater assertiveness in the Mediterranean had provoked.⁶¹⁴ In doing so, German decision-

⁶¹³ On the mesmerizing growth rate of the German GNP see Mitchell (1985); and Bairoch (1976), pp.281;303.

⁶¹⁴ On the German naval détente see Lynn Jones (1986); Herwig (1987), pp.91,78.

makers were very much in synchrony with the preferences of high finance. Albert Ballin's belief that German naval rearmament needed to be slowed down because Germany "could not afford a race in dreadnoughts against Britain," amply resonated with the decision, by Bethmann-Hollweg and Kurt Riezler, to prioritize cooperation with Great Britain because English naval superiority was undeniable.⁶¹⁵ A German-British understanding was further consolidated during and after the Balkan Wars, under the initiative of high finance representatives like Ballin, Paul von Schwabach, Alfred de Rothschild, Max Waburg and Ernest Cassel.⁶¹⁶

On the other hand, the fear of losing the arms race due to inability to harness the necessary financial resources to maintain it fueled financial heterodoxy and assertiveness in the crafting of military spending and foreign policy.⁶¹⁷ After the financial scare of 1911-12, German leaders operated in the constant awareness of a liquidity problem that had the potential to derail national rearmament and the provision of national defense.⁶¹⁸ The threat of being financially unable to provide for the country's defense was significant even without the outbreak of another financial crisis.⁶¹⁹ Accordingly, in December 1912, soon after the Agadir's military-crisis cum financial crisis experience, Chief of the German General Staff, Helmuth von Moltke,

⁶¹⁵ *Ibidem*, p.134. See also Cecil (1967), p.161.

⁶¹⁶ Anglo-German cooperation in the form of the London conference of 1912-13 allegedly ended the Balkan crisis. On this point see, for example, Cashman (2007), p.71; Cecil (1967), p.199.

⁶¹⁷ In terms of defense spending as a percentage of GNP Germany consistently lagged behind the allocations of France and Russia. See Ferguson (1994), pp.149, 154; and (1999a), p.136.

⁶¹⁸ Refer to Going (1996), p.519 and German financial statistics by Holfrerich (1986:52,53) for an illustration of the liquidity problem—mostly due to the spontaneous hoarding of coins by investors, accrued by ongoing European military tension.

⁶¹⁹ Exacerbating this fear that was Russian seemingly indomitable financial capacity that granted Moscow a lingering lead in the continental balance of power. Russia enjoyed privileged access to French capital and a prominent ability to extract financial resources from the Russian public. By 1913 Germany, Great Britain and France all acknowledged Russian dramatic financial powers and military potential. See in particular McDonald (2011), pp.1105.

commented: “Our enemies are arming more vigorously than us, because we are strapped for cash.”⁶²⁰ In 1913 he restated that Germany was losing the armament race because German “money” was “so tight.”⁶²¹ Similarly, Havenstein noted that the power of international financial markets had “reduced the Reichsbank’s ability to cope with a military emergency” and “undermined” Germany’s ability to “extend the nation’s economic and political influence, and maintain peace through financial strength.”⁶²² The cabinet’s struggle to find money to preserve German military power and honorable international peace helps to explain the Cabinet’s acceptance of heterodox measures like the June 1913 extraordinary tax, the Wehrbeitrag. This tax accompanied two Army bills that increased the German defense budget, closing—temporarily—the gap in defense spending as percentage of GNP between the central empires and the triple entente.⁶²³ The less-costly Army came to be seen as a better instrument for arresting the erosion of Germany’s international position.

Before the outbreak of the financial crisis in Berlin, Germany took the military gamble (July 5) of extending to Austria-Hungary the famous “blank check.” The check fully reflected this German amalgam of cautious and assertive policies and intentions. It is true that by endorsing Vienna’s boldest potential move, that is a war against Serbia, Chancellor Theodore von Bethmann Hollweg knowingly pursued a foreign policy that carried the risk of a general European war.⁶²⁴ But a number of

⁶²⁰ Moltke’s words as quoted in Ferguson (1999a), p.137.

⁶²¹ Moltke’s words as quoted in Ferguson (1999a), p.136.

⁶²² Feldman (1993), p.30. On German leaders’ concerns over the country’s financial capacity see Ferguson (1994) and (1999a), pp.136-140, and Coetzee (1990), pp.35-41.

⁶²³ On the army tax see Bendix (1915), p.727 and Going (1916), p.525. On the increase in the German defense budget compared to the defense budgets of the Triple Entente see Fergusson (1994), pp.154-66; Berghahn (1973), p.126-29; Kennedy (1987), p.212.

⁶²⁴ For an overview of this argument see Hamilton and Herwig (2003), pp.150-187.

considerations made this risk, which had existed at least since 1911 (and possibly 1908), much lower than the benefits of safeguarding the financial and military position of the central empires—and with them international peace—that the full support of Germany’s most necessary military ally promised. In this sense, Germany’s foreign policy before the spread of the financial crisis of 1914 in Berlin was significantly pro-finance. Specifically, taking action in support of the Dual Monarchy after the assassination of Franz Ferdinand, thereby endorsing a “final and fundamental” reckoning between Austria-Hungary and Serbia, sent a clear message in favor of the preservation of stability in Europe—the same stability that financial markets necessitated.⁶²⁵

Moreover, given Austria-Hungary’s financial and military weakness, which economic and military statistics confirmed, a German endorsement of Austrian military determination against Serbia had to be bold to be credible enough to serve as a deterrent force. Members of high finance such as Karl Helfferich and Max Waburg concurred that international peace was maintained through deterrence, and the latter required well-thought-out financial *preparations* for war.⁶²⁶ Finally, diplomatic correspondence reveals that, while Vienna never thought of anything beyond a military “reckoning” *limited* to Serbia in early July 1914, Berlin similarly expected a *localized, fait accompli* by the Monarchy against Serbia on the style of the French

⁶²⁵ By early 1914, high finance, for instance German financiers Karl Helfferich and Max Waburg, subscribed to effective financial and military deterrence for the preservation of peace (Mulligan 2010:205).

⁶²⁶ On this point see Mulligan (2010), p.205. Note that although it endorsed deterrence, high finance abhorred arms races. This obviously is different from saying that, through its activities, high finance was indirectly (and inevitably) encouraging deterrence.

intervention in Morocco (1911-12) or the Italian-Turkish War (1911-12).⁶²⁷ The conviction that France and Russia were not ready to fight, and that Great Britain, whose involvement in a continental war was extremely unlikely, would have very likely acted to impede an involvement of Paris or Moscow in the conflict further strengthened the German desire and belief that the dispute would have remained localized.⁶²⁸ The start of the financial crisis in Berlin from July 10 onwards exacerbated the existing security dilemma. Once again, national elites' fears of being driven to bankruptcy while attempting to provide for their security, the security of Austria-Hungary, and the relief of panicked investors at home heightened.⁶²⁹ Like the financial crisis of 1911-12, the financial crisis of 1914 critically jeopardized Germany's ability to sustain rearmament and mobilization, thereby annihilating Germany's ability to preserve the existing status quo and international peace. As expected, the government's high exposure to high finance during the first phase of response to the financial crisis (July 10 to July 29) resulted in a shift towards greater caution. In their daily diplomatic correspondences of July 16, 18, 21, 25 and 27, Chancellor Bethmann Hollweg, Foreign Secretary Gottlieb von Jagow and Ambassador to London Karl Max von Lichnowsky unfailingly stressed that "the situation was not free from dangers," and that it was of the "utmost importance" to

⁶²⁷ This desire for localization explains the emphasis by Hollweg and the German foreign office on the need for speed as delay threatened to bring about premature intervention of other powers (Berghahn 196). On German's understanding of the blank check as a *localized* expedient to preserve the existing European balance of forces *amongst the great powers* see Trachtenberg (1991), Jaraush (1969:55), and Albertini (1943), pp. 252-53.

⁶²⁸ On French and Russian unpreparedness see, for instance, Geiss July 1914, pp.65-8, Ferguson (1994), p.145, and Berghahn, p.203.

⁶²⁹ See, for instance, Ferguson (1999a), p.136. International peace did not coincide with the absence of war (localized political crises and wars had happened on a regular basis between 1907 and 1914 and in Europe), but rather with the absence of war amongst the great powers, achieved through effective deterrence, and the horror that the prospect of a general war amongst them conveyed.

“localize the [Austro-Serbian] difference,” curb “[Austrian] enthusiasm,” “keep France quiet,” “having St. Petersburg admonished to keep the peace,” and “mediate between Austria and Russia.”⁶³⁰

On July 19, the semi-official *Norddeutsche Allgemeine Zeitung* even published a plea personally drafted by Jagow that appealed to the “European solidarity” and to the “united interests of Europe” to preserve, “as on previous occasions,” the peace in the Balkans.⁶³¹ In a confidential telegram to Grey dated July 22, 1914, the German leadership was described as “very anxious to keep Austria in check,” and convinced that “there [was] no real danger of war.”⁶³² Also, on July 24, Jagow ordered the German ambassador to London, Sir Edward Goschen, to call attention to the “enormous financial burden” borne by Austria-Hungary in the previous months and years, while Kaiser William expressed the intention to “not join Austrian efforts against Serbia unless Austria expressly [asked]—an event which was deemed to be “not likely.” Finally, between July 25 and July 27, the German cabinet reportedly “endeavored” to “preserve the peace of Europe” through mediation efforts in London, Vienna and St. Petersburg *at the same time* that Ballin was having conversations with Churchill to limit the Austro-Serbia conflict.⁶³³ On July 27 the German chancellor sent a telegram to Vienna stressing the necessity of “urgently and impressively” exercising restraint

⁶³⁰ See, amongst many, Hollweg to Secretary of State for Alsace-Lorraine Roedern, July 16, 1914 in Geiss (1967), p.118; Jagow to Lichnowsky, July 18, 1914, *ibidem*, pp.122-124; Hollweg to Ambassadors at St. Petersburg, Paris and London, July 21, *ibidem*, pp.149-150; Lichnowsky to Jagow, July 25, 1914, *ibidem*, pp.205-206; Lichnowsky to Jagow, July 27, 1914, *ibidem*, pp.238.

⁶³¹ On the note in the paper see Berghahn (1973), p.200.

⁶³² Rumbold to Grey, telegram 88, July 22, 1914, in Geiss (1976), pp.158-159.

⁶³³ Montgelas et al. (1924), pp.173,74,183-84; Churchill, *World Crisis*, Vol.I, p.207; Cecil (1967), pp.208-210.

and accepting mediation in the conflict with Serbia.⁶³⁴ On July 28, after the Austrian declaration of war with Serbia and the news of partial mobilization, Hollweg allowed, in a conversation with war minister Eric von Falkheneim, that the Chancellor no longer wanted war. Along with Moltke's endorsement, Hollweg refused to mobilize, and on July 29 the Kaiser wrote to the Tzar that a "direct understanding" between Moscow and Vienna was "possible and desirable" and that the German government was continuing its efforts to promote it.⁶³⁵

More to the point, sometime between July 26 and July 28, Bethmann Hollweg proposed to Grey through Goshen the exact arrangement that Ballin had proposed to Churchill on July 25.⁶³⁶ On July 25, during a dinner meeting with Churchill, Ballin proposed: "Suppose we had to go to war with Russia and France, and suppose we defeated France and yet took nothing from her in Europe, not an inch of her territory, only some colonies to indemnify us. Would that make a difference to England's attitude? Suppose we gave a guarantee beforehand." After Ballin's return to Berlin, Hollweg officially telegraphed to the British government such an arrangement: "The Imperial government was ready to give every assurance to the British government that, provided Great Britain remained neutral, Germany aimed at no territorial acquisitions at the expenses of France."⁶³⁷ Ballin's assessment of Britain's intentions fostered the Chancellor's calculation that he could still contain the financial and political crisis.⁶³⁸

As much as the cabinet was trusting high finance to resolve the financial crisis, so it

⁶³⁴ Hamilton and Herwig (2003), p.32.

⁶³⁵ Trachtenberg (1991), p.84; Snyder, pp.76-77.

⁶³⁶ See Churchill (1930:I), pp.195-96; 207; and Cecil (1967), pp.208-210.

⁶³⁷ Churchill (1930:I), p.196.

⁶³⁸ On Hollweg's beliefs that he could still limit the crisis on July 27 see Hamilton and Herwig (2003), p.179.

was relying on the diplomatic power of market forces to promote the resolution of the international political crisis abroad. The liaison between international markets and the German government had tremendous repercussions in international politics. On July 28, despite the Austrian declaration of war, the Kaiser continued to reach an Austro-Russian diplomatic settlement. He even agreed with Grey on the Stop-in-Belgrade proposal, which offered a solution like the one that had ended the Franco-Prussian war in 1871.⁶³⁹

Oblivious to the financial threat that the Empire faced, however, the large German banks offered no cooperation. As late as July 28, German bankers continued to insist with the government that it was not justifiable to speak of a “financial crisis” in Germany.⁶⁴⁰ Concurrently, and as previously described, they continued to shun any cooperation with Havenstein. The Reichsbank’s losses spiked. With Austria-Hungary ready to attack Serbia, Russian mobilization well underway, and the German Central Bank risking financial bankruptcy, German authorities now looked at the behavior of German bankers as “criminal” and “abusive.”⁶⁴¹ The turn to financial heterodoxy was amplified and from July 29 onwards, the chancellor welcomed the assertive foreign policy that military plans promised. Between July 29 and July 31, telegrams sent from Berlin to London and to Moscow in the interests of peace left the place to the belief that German participation in the war was inevitable.⁶⁴² Moltke justified war as a “deliverance from the great armaments (and) from the financial burdens” they

⁶³⁹ Austria-Hungary refused the proposal. See, for instance, Meyer (2006), p.53; Bethmann Hollweg to Wilhelm II, July 28, 1914, in Geiss (1967), pp.28.

⁶⁴⁰ “Berlin Very Nervous: Big Banks Will Support Stocks—Keeping Gold in Vaults,” Special Cable to the New York Times, July 29, 1914.

⁶⁴¹ See, for instance, Going (1916), p.518.

⁶⁴² Albertini (1942-43:II), pp.522-25; Meyer (2006), p.69-71; Montgelas et al (1924), p.;352-55; Snyder, Official documents, pp.80-81.

entailed. His Schlieffen plan, whose details had long been decided upon, promised to rescue Germany's potential military inferiority as much as it tried to save Germany's national credit and finances by employing instruments which had proven so potent in Germany's rise to economic power.⁶⁴³

More specifically, the Schlieffen Plan hinged on a credit system of such elasticity that it could quiet the panic and cope with a suddenly increased call for credit that would mark the beginning of a war. War, thus, for Germany, was a means for rescuing national financial pride. All options to achieve that goal except the military one were being closed. Havenstein's words pronounced about two months after the beginning of military hostilities substantiate these statements further. As the governor declared:

*The enemy, especially the English expected Germany to collapse economically and it was thus essential that Germany falsify such expectations by showing that the sources of her peacetime success would be even more serviceable in war. He further added: In no nation in the world is credit so well-developed as in Germany; in no land is the progress of economic life so dependent upon credit and its maintenance as is ours [...]. All our preparations for the financial mobilization were based upon this, and they have proven themselves superbly, and we can be truly proud that we, as the most productive of all lands on earth, lone among all the combatants, have come through without a moratorium.*⁶⁴⁴

On July 29 the turn away from cautiousness seemed to point more towards confusion than assertiveness. "Germany does not want to bring about this frightful war," Moltke stated in a letter to Hollweg," but *if* the collision between Austria and

⁶⁴³ On this point see Going (1916).

⁶⁴⁴ Speech, probably to the Reichsbank Curatorium, September 25, 1914, BAP, NL Havenstein, Nr.2 Bl.62, in Feldman (1997), p.32.

Russia becomes inevitable, he continued, Germany will also have to mobilize.⁶⁴⁵ In the meantime, however, state authorities had to intervene at the Berlin Bourse to save security holders and national finances. German bankers continued to exert pressure on the British press and Parliament—they would have continued till July 30—but their efforts no longer found a counterpart in Berlin. By July 30, the cabinet had shifted more clearly towards an assertive foreign policy. The Kaiser issued a status of impending war and ordered mobilization (July 30, 31).⁶⁴⁶ These decisions were taken exactly when the government, at the height of a domestic financial crisis and under the threat of bankruptcy, dismissed the behavior of German banks and trusted the nation's financial and military resilience. High finance was left playing the peace game on its own. On August 1, Nathaniel Rothschild made a personal appeal for peace to the Kaiser. Communications were interrupted before a reply could be sent.⁶⁴⁷ Two days later Germany declared war on France.

DELAYING FIRM MILITARY DECISIONS TO PREVENT FINANCIAL COLLAPSE:
Financial crisis and political checkmate in Great Britain

The cautious foreign policy of the liberal government of Herbert Henry Asquith between 1911 and 1914 can hardly be questioned. Shocked by the war prospects that the Agadir crisis had raised, the British cabinet steadfastly acted as a broker to improve Anglo-German relationships. During the Balkan wars, foreign

⁶⁴⁵ Moltke to Bethmann Hollweg, July 29, 1914, in Geiss (1967), pp.282-84. Lichnowsky echoed Moltke's observations in a letter to Jagow delivered on the same day. In Geiss (1967), pp.285-86.

⁶⁴⁶ Exchange between Cambon and Viviani, July 30, 1914 in Smith, p.287.

⁶⁴⁷ Lord Rotschild wrote to the Emperor "Sire, I am fully aware that your Majesty is straining every nerve in favor of peace [...]. Will your Majesty send me a proposal, which I could at once lay before my friends, and which would be of such a nature as would find favor both at S. Petersburg and Vienna?" In Montgelas et al. (1924), p.452.

secretary Sir Edward Grey worked closely with high finance and the German cabinet to prevent a clash between Austria-Hungary and Russia that risked spiraling into a European war.⁶⁴⁸ Undoubtedly concerned about this prospect, in the months and years before the summer of 1914 British state authorities were very keen on adopting a prudent, “businesslike,” and “City-minded” approach to resolving international political differences.⁶⁴⁹

As a result of this attitude, the Anglo-German naval race had practically disappeared by 1914, and, in June of the same year, Britain had even arrived at a fairly wide-ranging agreement with Germany concerning British interests in Mesopotamia.⁶⁵⁰ In the crafting of each achievement, the Asquith cabinet and high-finance representatives like Ernest Cassel had operated in symbiosis, so much so that the latter felt at ease in promising to his German colleagues that “Great Britain was prepared to go ‘very far’ by way of ‘compromise’ or neutrality.”⁶⁵¹ Chancellor of Exchequer Lloyd George had reinforced this stance in 1911-12, when, during the Agadir crisis, he had stated that he “would make great sacrifices to preserve peace,” because “nothing would justify a disturbance of international good will except questions of the greatest national moment.” Considering that British collaborative financial and security policies applied not only to Anglo-German relations but also to Anglo-French and Anglo-Russian affairs, one can safely conclude that there was no great power more cautionary than Britain on the eve of the Great War.

⁶⁴⁸ Hamilton and Herwig (2003), p.273-78; Lynn Jones (1986); Grey (1925:I), pp.249-77; and Robbins (1971), pp.244-54.

⁶⁴⁹ On this approach see Lynn Jones (1986), p.133; Cassis (1985), p.229; and Peters (1993).

⁶⁵⁰ Anglo-German cooperation in Mesopotamia was consolidated through the construction of the Baghdad Railway.

⁶⁵¹ Cecil (1967), p.184.

On a more practical level, during the first six months of 1914, the Bank of England—differently from the Austrian Central Bank and the German Central Bank—undertook no financial preparation for facing a potential war exactly because of the risk of a financial crisis that such measures would have engineered. As concluded in the spring of 1914 by the Desart Committee—the commission appointed by the Treasury with the task of deciding whether the gold that the banks had piled up should be deposited in the Bank of England—no protective or retaliatory measures in preparation of a war effort could be devised in Great Britain because they would have resulted in “the ruin of most people engaged in business,” that is, a major financial crisis (Horn 2002:26). Although the report of Committee was only a memorandum, it made the British Treasury aware that fears of a financial and military crisis were powerful and diffused, and that British military deterrence and war readiness necessitated either the lessening of those fears or domestic financial reform.

As expected, before the financial crisis had reached a peak in Europe and began to upset London (respectively in July 23 and July 25-27, 1914), the British government trusted it could reduce war- and financial-crisis fears through the preservation of a prudent foreign policy (and orthodox financial policies). Throughout most of July 1914, the cabinet considered the Austrian government’s response to the assassination “neither alarmist nor extreme.” In the weeks preceding the issuing of the Austrian ultimatum, the British Foreign Office saw no “complication” or “threat to general peace” deriving from the “Serbian imbroglio” and trusted that the Austrian

demands would be “kept within reasonable limits.”⁶⁵² Close to July 23, the apprehension of the British cabinet grew but did so more slowly than the Foreign Office’s feeling or hope that the crisis would be contained.⁶⁵³

The news on July 23 that Vienna had delivered a message to Belgrade, and the reaction of continental markets to the missive produced intense alarm in London. Grey started to consider the potential “awful consequences of the situation.” Crucially, the apprehension of the British government did not regard *solely* the prospect of a European war but the related collapse of the international system of credit, too. Judging from Grey’s words to the British legations in Central Europe soon after the delivery of the ultimatum, this potential financial downfall had *primary* importance. As Grey told the Austrian ambassador in London, Count Mensdorff, and his German equivalent, Count Lichnowsky, on July 23:

*If as many as four Great Powers of Europe—let us say, Austria, France, Russia, and Germany—were engaged in a war, it seemed to me that it must involve the expenditure of so vast a sum of money, and such an interference with trade that a war would be accompanied or followed by a complete collapse of European credit and industry. In these days, in great industrial States, this would mean a state of things worse than that of 1848, and, irrespective of who were the victors in the war, many things might be completely swept away.*⁶⁵⁴

Hence, British state authorities feared the occurrence of a massive financial crisis even before July 25, the date at which the financial crisis started to *visibly* upset markets in London, and even before the content of the Vienna ultimatum was known

⁶⁵² Quotes from Nicolson to Bunsen, 6 and 20 July 1914 and from Grey to British Ambassador in St. Petersburg Buchanan, July, 20, 1914, in Höbelt and Otte (2010), p.155. See also Geiss (1967), p.54;

⁶⁵³ Headlam-Morley, *British Documents on the Origins of the War*, Vol. XI, pp.63,64.

⁶⁵⁴ Hamilton and Herwig (2003), p.279; Grey to de Bunsen, July 23,1914 in Headlam-Morley, *British Documents on the Origins of the War*, Vol. XI, pp.70,71; Harrison and Sons, *Collected Diplomatic Documents*, pp.2,3.

in London.⁶⁵⁵ Not only did British state authorities start to fear a financial crisis by July 23, but they also took steps to prevent it, which obviously meant taking active steps to preserve international peace, too, by adopting an extra-cautious national security stance. For instance, on July 23 the British delegation in Vienna was instructed to cooperate with the Russian, French, and German ambassadors in “giv[ing] friendly counsels of moderation” to the Austrian authorities.⁶⁵⁶ Since Germany had a pivotal role in this task, later that day Grey and Lord Morley had dinner with Ballin and other notable German bankers to cautiously reassure them and the German government on the absence of an Anglo-Russian naval convention (Cecil 1967:207). Throughout the day after (July 24), the British foreign office endeavored to convince the Austrians to soften the ultimatum by introducing a longer time limit. Simultaneously, Foreign Secretary Grey exerted pressure on the Serbians to “give a favorable reply to as many points [of the ultimatum] as possible within the limit of time.”⁶⁵⁷

The finding that the British shift towards greater prudence occurred starting on July 23 rather than, as expected, on July 25 is not entirely surprising. Although the financial crisis *physically* reached markets in London only on the 25th, the crisis peaked on continental markets exactly on July 23, partly as a consequence of the delivery of the Austrian note. Given the stakes of the British government in the preservation of the existing international financial system; the connection between the

⁶⁵⁵ Grey had a copy of the text of the ultimatum only on July 24. See Hamilton and Herwig (2003), p.279.

⁶⁵⁶ English ambassador to Vienna Buchanan to Grey, July 23, 1914, in Headlam-Morley, *British Documents on the Origins of the War*, Vol. XI, pp.69.

⁶⁵⁷ *Ibidem*, pp.73-75; 82.

British and European financial systems (Keynes 1914); and the government's high affinity with high finance, it is not astonishing that British authorities had already changed their national security policies in response to the start of the financial crisis in Europe. The financial crisis of 1890 exerted a similar effect on the national security policies of the American government.

In partial amendment to the earlier formulated expectations, then, one could argue that between July 23 and July 29-30, which is during the phase of orthodox response to the financial crisis, the British foreign policy shifted towards extra prudence. After July 24,⁶⁵⁸ this shift was especially clear by British efforts to promote mediation and compromise amongst France, Russia, Germany and Austria-Hungary.⁶⁵⁹ Once the disclosure of the Austrian ultimatum had unveiled that Vienna was seeking some form of humiliation for Serbia (July 24), Grey tried to rein in foreign assertiveness by warning the German ambassador that Russia would stand by Serbia, while concurrently avoiding giving Russia and France any reassurance of British support in case the conflict escalated. In the words of the Foreign Secretary and the British Monarch, King George V, Britain "wished to prevent any question that arose from throwing the groups into opposition," since "it had "no quarrel with anyone" and hoped to "remain neutral."⁶⁶⁰ Even after hearing that Austria-Hungary had declared war on Serbia, and that Russia was planning a partial mobilization, the

⁶⁵⁸ On the shift towards extra-prudence that took place before July 24 refer to previous paragraphs.

⁶⁵⁹ As the Times of July 27 reported, Britain was exerting a moderating influence on Russia and pressing Germany to exert moderation on Vienna. The Times, July 27 in Brown, (1988), pp.19,20.

⁶⁶⁰ Albertini (1942-43:II), pp.203-208; Geiss (1967), documents 68, 73, 81, 82, 83, 85, 94, 97, 98, 99; Ferguson (1999a), pp.156-157; Steed (1924), p.4.

As it has already been pointed out in much of the literature, the risk of the British strategy was that it might be considered, as indeed it was eventually, diplomatic rebuff. The cautionary nature of this strategy can hardly be disputed however.

British cabinet hastened to push forwards new mediation efforts among the German, French, Italian and British governments with the object of inducing Austria-Hungary and Russia to suspend military operations (July 28).⁶⁶¹

More pointedly, the financial crisis loomed large in this shift towards extra prudent national security policies. In alignment with what expected, between July 25 and July 28—during the first phase of response to the financial crisis—the Cabinet converged around the “orthodox” crisis response desired by the Bank of England and Governor Cunliffe, who falsely declared that the Bank and the joint-stock banks had the situation in hand and that the situation did not justify any emergency action.⁶⁶² This was not what Edward Grey and Asquith desired, and even less what Winston Churchill wished.⁶⁶³ But the less cautionary decision to “initiate the precautionary stage in the preparations for war,” which part of the Cabinet desired and proposed, was overruled as a result of a “great debate” at the Privy Council—debate that placed the orthodox cause and new international mediation efforts at the forefront.⁶⁶⁴

As expected, on July 29 and 30, when the exposure to high finance of British officials started to transition from high to low, British foreign policy lost features of extra cautiousness and acquired ambiguous traits. On July 29, Grey told the German ambassador in London, Lichnowsky, who demanded a British declaration of

⁶⁶¹ *The Times*, July 28, 1914; Steed (1924), p.4; Morgan (1952), p.11. The mediation proposal was announced in Parliament in the morning of July 29.

⁶⁶² De Cecco (1984), p.143; Steed (1924), p.4.

⁶⁶³ Fitzroy (1925, II), p.558; Morley (1928), p.4; Schmitt (1930, II), p.286; Beaverbrook (1928,I), pp.22-30.

⁶⁶⁴ It was a “great debate” standing to the descriptions offered by prominent contemporaries such as Lord John Viscount Morley and Sir Three quarters of the cabinet rallied around the Bank of England and international mediation efforts. Fitzroy (1925, II), p.557; Morley (1928), p.4-7. Whether the financial crisis escalated on July 28 in Great Britain exactly due to the Cabinet’s decision to initiate preparations for war is a very interesting question, a question however that seems very difficult to answer since the two events occurred practically simultaneously.

neutrality, that, “If war became general, [...] the issue might be so great that it would involve all European interests” and it would “not be practicable for England to stand aside.”⁶⁶⁵ The admission that London would have intervened in a possible general war suggested a step away from the highly cautious approach of the preceding days. Yet, the weak wording of Grey’s message to Lichnowsky revealed the absence of firm assertive intentions. The same was also revealed by Grey’s shocking disclosure, on the same day (July 29), to French ambassador M. Cambon, that Britain still “had not decided what to do in a contingency [like that of a European war],” which Britain authorities still hoped “might not arise.”⁶⁶⁶

Evidence confirms that the convoluted and ambiguous nature of the British national security stance depended widely on the ongoing financial crisis, and Britain’s ongoing attempts to stop it. As Grey explained to Cambon on July 30:

*We [have] come to the conclusion, in the Cabinet today, that we [can] not give any pledge at the present time. The commercial and financial situation [is] exceedingly serious; there [is] the danger of a complete collapse that would involve us and everyone else in ruin....It [is] possible that our standing aside might be the only means of preventing a complete collapse of European credit, in which we should be involved. This might be a paramount consideration in deciding our attitude.*⁶⁶⁷

Grey further declared:

Though we [shall] have to put our policy before Parliament, we [can] not pledge Parliament in advance. Up to the present moment, we [do]

⁶⁶⁵ Grey to Lichnowsky, July 29, 1914, in Geiss (1967), document 130; Grey to British Ambassador in Paris Bertie and Grey to British Ambassador in Berlin, Goshen, July 29, in Stationery Off., *Collected Diplomatic Documents relating to the Outbreak of the European War*, Harrison and Sons, 1915, pp.65-67.

⁶⁶⁶ *Collected Diplomatic Documents*, pp.65-66.

⁶⁶⁷ In Grey to British Ambassador to France, Sir Francis Bertie, July 31, 1914. See Gooch and Temperly, *British documents on the origins of the war*, vol. 11, p.367; Snyder, *Historic Documents*, pp.77-79; French (1982), p.91.

not feel, and public opinion [does] not feel, that any treaties or obligations of this country were involved. Further developments might alter this situation and cause the Government and Parliament to take the view that intervention [is] justified. The preservation of the neutrality of Belgium might be, I would not say a decisive, but an important factor, in determining our attitude.

Several considerations can be made. The first and most obvious is that the financial crisis and the prospect of a collapse of the international financial system were a foremost concern for British authorities and, as a consequence, the crafting of British national security policies in the last days of July 1914. Since offering a firm promise of military support to the French, and more generally a promise of military intervention, might have hastened financial collapse, such a promise could not be made, and indeed was not made in these critical days. The British Cabinet knew that although high finance was not capable of active initiatives to solve the financial crisis, joint-stock banks were clearly very capable of bringing the international and national system to complete financial breakdown. This lingering ability affected the policies undertaken not only *in response to* the financial crisis but also (and simply) *during* the financial crisis. By midnight of July 30, for instance, Grey was aware that the hopes of preserving peace had almost vanished, and yet in the House of Commons he continued to state that “Britain was still working for the one great object of preserving European peace.”⁶⁶⁸

If anything could help the faith of international financial operators at a time in which different expedients were tried to stop the crisis and restore confidence, surely that something was the prospect of successful mediation, not the prospect of British

⁶⁶⁸ Steed (1925), p.5.

intervention in an allegedly forthcoming war.⁶⁶⁹ Significantly, evidence shows that Grey's statements to French ambassador Cambon and the House reflected the desires of financial magnate Nathan Rothschild, other exponents of high finance, and Chancellor of Exchequer Lloyd George. Between July 29 and August 1, Nathan Rothschild attempted to silence the *Times* for its leading articles that, he reasoned, were "hounding the country into war," and were doing so right when maintaining neutrality was "the only way" to avert "a [financial] catastrophe such as the world had never seen."⁶⁷⁰ The resemblance of these words with Grey's message to Cambon is undeniable. Similarly, George had consulted with other financiers in the City, the Governor and the Deputy Governor of the Bank of England, and had arrived at the conclusion that financial interests were "aghast at the idea of [Britain] plunging into the European conflict"; how it would "break down the whole system of credit with London at its center"; how it "would cut up commerce and manufacture"; how it "would hit labour and wages and prices, and [...] inevitably produce violence and tumult."⁶⁷¹

An additional and related consideration to draw is that Grey's words to Cambon of July 30 neatly captured the relation between the financial crisis and British national security stance. Grey's admission that Great Britain was determined to pursue the "only means" in the security realm that could "prevent a financial collapse," indicates that the financial crisis and the process of response influenced British

⁶⁶⁹ An interesting hypothesis for another research project is that this perception might have also informed/fueled the mis(perception) that the war would have been short.

⁶⁷⁰ During these days, the *Times* published editorials on the British "elementary duty of self-preservation" and the government's responsibility to "back [its] friends." On Rothschild's considerations see Steed (1925), pp.8,9, and Ferguson (1999b, II), p.432.

⁶⁷¹ Lloyd George's words in Schmitt (1930) pp.281,287; Tuchman (1962), p.113.

national security policies independently of other factors—for instance, the Austrian declaration of war on Serbia (July 28) and the related likelihood of a European war.⁶⁷² As for the nature of this influence, Grey’s uncertainty with regards to which means would prevent financial collapse—uncertainty which is understandable in view of the orthodox and heterodox financial measures that were tried at the time and that have been previously described—seems to indicate, in line with what has been already found, ambiguity. Ambiguity fostered delay or postponement of crucial military decisions. As late as August 1, *The Economist*—the foremost British financial magazine even at the time—claimed “every British interest points to the maintenance of strict neutrality.”⁶⁷³

A final consideration is that the preservation of Belgian neutrality was a “further development” (in determining the British military stance), which the “exceedingly serious financial situation” still made vague and undefined. In other words, the weight of Belgian neutrality in British war and peace calculations were destined to remain unknown until the risk of a complete financial collapse had been avoided. This was arguably the reason why Grey labeled the preservation of Belgian neutrality an “important” but “not [...] decisive” factor deciding British participation or exclusion from a potential conflict involving Germany and France. By contrast, preventing a collapse of credit was “paramount.”

As British officials gradually appreciated the national security dangers of a now certain European war, assertiveness became an increasingly more evident

⁶⁷² The role of systemic military pressures has been already shown extensively by existing literature. See, for instance,

⁶⁷³ *The Economist*, August 1, 1914, p.219.

ingredient. On July 31, as they resorted to orthodox and heterodox financial measures, cabinet ministers were still very alarmed at the chaos in the City. Grey was still grappling with the consequences of his statements to the Germans and the French, and whether British “uncertainty” was an “encouraging element in Berlin.”⁶⁷⁴ By August 1, as Germany declared war upon Russia, it was clear even in London that saving the interests of high finance jeopardized the government’s responsibility for safeguarding the public good and national security. Cooperating with high finance had become too costly: deciding to remain neutral because of fears of the economy—which was essentially what high finance desired and asked the British government—was tantamount to admitting that Britain could no longer afford to be a great power. It was also equal to saying that the business of high finance had undisputed importance even when it no longer safeguarded the public good.⁶⁷⁵ As the government veered towards heterodoxy to save the economy from ruin, it also moved closer to more interventionist approaches to the protection of British national security. By August 3, the day when the Germans issued their ultimatum to Belgium, the cabinet’s decision to intervene was much less difficult to make than it would have been three or four days earlier.⁶⁷⁶

Interestingly, by having an influence on British national security policies, the financial crisis also had an influence on the national security policies of the main great powers and, ultimately, the Great War. Available evidence indicates that British ambiguous national security policies and ambiguous economic strategy of financial

⁶⁷⁴ Grey to Bertie, July 31, 1914, *British Documents on the Origins of War* (1926), xi, no.367.

⁶⁷⁵ On this point, see in particular French (1981), p.94.

⁶⁷⁶ Sir Edward Grey’s Speech before the House of Commons, Great Britain, Parliamentary Debates, Commons, Fifth Series, Vol. LVC, 1914, pp.1821 ff.; Snyder, pp.95-98.

crisis response did, in turn, influence the national security policies of France, Russia, and Germany. The fatidic days of British military indecisiveness (July 29-August 1) were the most critical days in which the destinies of Europe and great power politics were decided. The French government on July 30 was desperately seeking a strong commitment from the British government to avoid the military mobilization that the Russian government was demanding from Paris.⁶⁷⁷ Although it had called individual reservists and summoned reserve officers to duty, on July 30 France had not yet mobilized. Russia had only *partially* mobilized, and the Tzar was in constant communication with the German Kaiser.⁶⁷⁸ And on July 30, the German Kaiser Wilhelm and Chancellor Bethmann Hollweg were still keeping the mediation door open.⁶⁷⁹ What they needed was a sharp warning word at Paris and St. Petersburg, which, at the time, because of the danger of financial collapse, Great Britain could not give.

Therefore, on August 1, French authorities concluded that the British government was “not favorable to a landing of British troops on the Continent,” and Germany declared war on Russia.⁶⁸⁰ Had Great Britain given Cambon the pledge that France, as Grey later recalled, “had pressed [for] more and more urgently” on the 30th,

⁶⁷⁷ Viviani to the French Ambassadors at St. Petersburg and London, telegrams 453, 373, 374, confidential in Geiss (1967), pp.312-3.

⁶⁷⁸ Russia had partially mobilized on July 29. The Nicky-Willy telegrams began to go wrong exactly on July 30 as the Tzar told the Germans that they had started to mobilize five days earlier for defensive purposes.

⁶⁷⁹ Hollweg stated: “My hope that mediation may still be possible on the basis of Grey’s proposal is most seriously imperiled by the Russian mobilization against Austria. Hollweg to Lichnowsky, telegram 191, July 30 in in Montgelas (1924), pp.352,355. To that communication Kaiser Wilhelm II wrote marginal annotations of the kind: “the only possible way to ensure or enforce peace is that England must tell Paris and Petersburg, its Allies, to remain quiet. Then Germany can remain quiet too.” Ibidem.

⁶⁸⁰ P. Cambon to Viviani, telegram, August 1, Poincaré, IV, p.487.

French mobilization might have been, at the very least, postponed; Russian mobilization might have been halted; and Germany might have not mobilized at all.⁶⁸¹ No one could trust the British lukewarm assurances of neutrality, and—at the same time—it was hard to know how to interpret them as they only created the suspicion that London was bluffing. As the Kaiser wrote on July 29, “[Grey knows that] if he were to say one single, serious, sharp and warning word at Paris and Petersburg [...] both would become quiet at once. But he takes care not to speak the word and threatens us instead! England alone bears the responsibility for peace and war, not we any longer. That must also be made clear to the world.”⁶⁸²

Finally, the presented evidence enriches existing explanations of British (ambiguous) foreign policy on the eve of the war. The literature has emphasized the role of Cabinet partisanship and particularly the division between the supporters of unconditional neutrality, the advocates of simple neutrality, those who were for peace but would open the door to intervention, and those who stood solidly for intervention.⁶⁸³ Grey himself admitted that offering a British military pledge to France would have resulted in the “resignation of one group or the other” and the “consequent break-up of the Cabinet altogether.”⁶⁸⁴ Further paralyzing the cabinet, as shown in this last section of the chapter, was the fact that the financial crisis filtered through intra-cabinet divisions but no group political seemed to have a convincing strategy of financial crisis response.

⁶⁸¹ France and Russia also urged Britain—with “undeniable force” according to Grey—that if Britain could not promise anything to Paris and Moscow, it should at least not give Germany the impression that London would certainly stand aside. See Grey (1925, I), p.340, American Edition p.330.

⁶⁸² Wilhelm’s notes on July 29, in Montgelas et al (1924), pp.321-33.

⁶⁸³ On these divisions see Beaverbrook (1928), pp.22-30; Schmitt (1930), pp.282.

⁶⁸⁴ Grey (1925, I), pp.334-5.

CONCLUSIONS

The financial, diplomatic and military experience of Austria-Hungary, Germany, and Great Britain during the financial crisis of 1914 and in the months and years preceding it supports the logic of the framework. Specifically, Austrian, German and British policymaking in the economic and security realms shows that there is correspondence between the orthodox (and heterodox) financial policies that a government follows and the national security policies that it is willing to pursue (*claim 1*); and that financial crises and the process of financial-crisis response cause a significant shift in national security policies (*claim 2*). Moreover, the Austrian experience validates *claim 3*: the nationalist government of Theobald von Bethmann Hollweg curbed its assertiveness after the start of the financial crisis of 1911-12, when government exposure to high finance was high, and inflated its threat assessment after the start of the financial crisis of 1914, when government exposure to high finance was low. The British experience instead sheds more light on the changes in national security policies occurring in the scenario that the framework cannot pin down (HA-LE). After the start of the financial crisis of 1914, the government of Herbert Henry Asquith pursued first an ultra cautionary foreign policy and then gradually stepped away from it, although the disillusionment with the workings of international diplomacy in Great Britain never reached the radical character that it did in Japan or Italy.

The evidence presented in the chapter also highlights some of the limits of the framework. First, the German experience indicates that a government can have an ambiguous affinity with high finance, and, relatedly, pursue a set of ambiguous

national security policies, with elements of cautiousness and assertiveness. The framework drawn in Chapter One omits to consider this possibility. Ultimately, however, since it is government exposure to high finance that decides whether a shift towards assertiveness or cautiousness will prevail, finding that a government can have ambiguous affinity with high finance does not undermine the framework. Second, and in agreement with findings in previous chapters, evidence collected in this chapter suggests that the influence of a financial crisis on the national security policies of the crisis-stricken states might inspire changes in the national security policies of other states, too.⁶⁸⁵ More theoretical and empirical work on the subject would be an interesting research avenue to pursue. Third, and related to the former finding, national leadership seem to respond to financial crises and adjust their national security policies accordingly even if the crisis has not yet hit their states but is affecting other states. Once again, it is inopportune to make any inference without conducting further research into the subject matter.

It is also imperative to note one last time that, because of its focus on the national security influence of financial crises, this chapter has missed to treat many underlying and proximate causes of the war in depth.⁶⁸⁶ I defend this decision by noting that the objective of the chapter was not to provide an alternative explanation on the causes of World War One, but only to demonstrate the general soundness of the framework, and the utility of examining variation in states' military and diplomatic strategies based on their responses to financial crises. In the process of trying to

⁶⁸⁵ One can imagine adding more branches at the end of the analytical tree of this work. See Chapter 1, Figure 1.1.

⁶⁸⁶ A fairly recent and comprehensive account is the one provided by Hamilton and Herwig (2003).

account for the multifaceted pressures and incentives that, combined, produced a catastrophe that we are still endeavoring to explain, observing the interdependence between financial and military pressures that financial crises and a prevailing status of financial fear helped to propel across and beyond Europe between 1911 and 1914 has the benefit of enlightening variables and phenomena that have remained unjustly overlooked.

In this respect, the findings of the chapter offer a way to conciliate those explanations of World War I that emphasize the inadvertent or unintentional nature of the war (and the array of miscalculations and misperceptions that caused it), and those explanations that have stressed premeditation and deliberately assertive national security policies.⁶⁸⁷ The political necessity of easing financial fears and solving financial crises—not only the global financial crisis of 1914 but also the European financial crisis of 1911-1912, and the inability of high finance to provide an effective response to financial crises and financial fears, gradually moved state actors towards taking greater charge of economic matters, and, as a result, security matters. The financial crisis of 1912 prompted the Austrian decision that the moment to settle accounts with Serbia had arrived, and the German decision to preserve international peace (and act as a brake on Austrian assertiveness). When the financial of 1914 hit, both Austrian and German leaders knew that the preservation of peace required a *fait accompli* between Vienna and Belgrade, as the risks of being driven to bankruptcy during the next military crisis while suffering national security losses now appeared as likely as forbidding. Austrian-Hungarian and German authorities took that decision,

⁶⁸⁷ Refer to the introduction of this chapter for literary references.

assuming that the financial crisis would have remained localized—as much as the Austro-Serbian dispute.

As the Austro-Serbian settlement was delayed, and the financial crisis spread across the continent, the risk of a European war increased. During a first phase of response to the financial crisis, German statesmen relied on Anglo-British cooperation to contain the theater of military hostilities. As the financial crisis reached London, British authorities faced pressure to postpone and hide their escape from neutrality to save the credit system, and later impede a financial collapse. This ambiguity let Russian and French statesmen believe that they were on their own, which exacerbated their security dilemma and hastened mobilization on their part. The same ambiguity led Germany to trust that military hostilities would have very likely been contained since Great Britain would have very likely maintained its neutrality, and, possibly, exerted pressure on France and Russia. In the end, British authorities, too, (like Austrian and German authorities) arrived at the conclusion that only a strong state-led response to the crisis would have impeded financial collapse and preserved Great Britain's national security and great power status. Now awkwardly privileged, Great Britain had the last word on which was the most suitable financial response to embrace and the kind of war to be waged. This unforgettable decision did not sanction the abdication of political authorities to the military or the “cult of the offensive.”⁶⁸⁸ It gave the blessing to a fundamental revivification of great-power strength.

⁶⁸⁸ On the “cult of the offensive” see Snyder (1984) and Van Evera (1984). On the limits of the “cult of the offensive” thesis see Trachtenberg (1991) and Kier (1999).

CHAPTER VI:

FINAL REFLECTIONS

This work originated from the simple intuition that financial crises yield changes in national security policies by triggering collapses in the objective and inter-subjective resources around which governments and government leaders build their power. Because of these collapses, fixing national financial and economic problems and policies becomes paramount for governments and government leaders after the outbreak of financial crises. National security policies are adjusted to meet these new, impellent needs.

Based on this intuition the manuscript has offered a framework on the national security influence of financial crisis that evidence across governments, states and financial crisis periods has largely confirmed. The chapters of this dissertation have shown that crisis-stricken governments change their states' military spending, threat assessment and war prospects because they endorse a positive or a negative set of economic policies of financial crisis response which dominant financial ideas and the power or weakness of domestic financial actors legitimate. Ultimately, when a crisis-stricken government embarks on positive economic policies of crisis resolution, the national security policies of the same government are liable to either shift towards greater assertiveness or encounter lesser constraints to shift towards greater assertiveness. Vice versa, when a government follows negative economic policies and international financial cooperation in its crisis response strategy, the national security policies of the crisis-stricken state are prone to shift towards greater caution.

Whether the shift towards greater assertiveness (or greater caution) results in the intensification or the overhaul of pre-crisis national security policies tends to depend on the correspondence or lack of correspondence between the affinity with high finance and the exposure to high finance of the crisis-hit government. As a general rule of thumb, when there is correspondence, that is when the economic policies that the crisis-stricken government wants to implement solve the financial crisis, pre-crisis conciliatory or assertive national security policies are strengthened or exaggerate. When there is no correspondence, instead, pre-crisis conciliatory or assertive national security policies are either overhauled or more likely to be overhauled than before the crisis.

Fourteen instances: Encouraging Outcomes and Exceptions

The empirical chapters composing this dissertation have each been thought of and drafted as one component of a heterogeneous mix of case studies leading to similar conclusions on the national security influence of financial crises. In this respect, Japan, Italy and the United States between 1880 and 1940, and Great Britain, Austria-Hungary and Germany in the summer of 1914 have shown both remarkable similarities in their post-financial-crisis security policies and remarkable differences in the channels of influence filtering the relation between financial crises and national security policies. Each state has offered a distinct empirical version of the relationship between government authorities and high finance specified in Chapter I, and a distinct example of the relevance of domestic drivers, international drivers, and domestic and

international drivers in the translation of the influence of financial crises on national security policies.

Altogether, the examined case studies provide a comparative analysis of shifts in national security policies across a total of fourteen instances of financial crises in the temporal interval between 1880 and 1940. The striking consistencies across these instances are illustrated in Table 6.1. During the financial crisis that began in Italy in 1889, the one that began in the United States in 1907-09, and the ones that rocked Japan in 1907-09 and in 1920-22, crisis-stricken governments exhibited analogous affinity with high finance (low) and analogous exposure to high finance (high), and they analogously curbed pre-crisis assertive national security policies. In each instance, the shift towards greater military caution (scenario *LA-HE*) also occurred for practically the same reason, namely the materialization of a domestic political context hostile to tolerating private financial and economic losses and a novel understanding by government authorities of the need of endorsing greater international financial cooperation and limiting military ambitions (Table 6.1).

Similarly, the Japanese government and the Austrian government both exhibited low affinity with high finance and low exposure to high finance, and both inflated their pre-crisis assertive military spending, threat assessment and war prospects during, respectively, the financial crises of 1889-90 and 1896-1901 and the financial crisis of 1914 (Table 6.1). Finally, after the outbreak of the financial crises of 1893-94 and 1893-96 both the Italian government and the American government registered high affinity with high finance and high exposure to high finance and, in both cases, national security policies shifted towards extra caution.

Similarities exist even across those financial crisis instances that fall in scenario HA–LE and therefore those post-financial crisis national security policies that the framework cannot figure out, like for example the course of the Japanese, Italian and American national security policies after the outbreak of the Great Depression, and the course of the British and the German national security policies after the outbreak of the financial crisis of 1914. In these five instances, indicated in white in Table 6.1, different governments similarly stricken by financial crisis and similarly pursuing cautionary national security policies before the start of the crisis, all faced lesser constraints to the exercise of assertiveness and all hesitated to embrace greater assertiveness, although notable differences remains with regards to the character of their full slide away from cautiousness. For instance, in the early to mid-1930s, following the outbreak of financial crisis in Japan, the military spending, threat assessment and war prospects of the Japanese leaderships exuded greater assertiveness than the national security agenda of the Italian government, let alone that of the American government. Despite the Italian-Ethiopian war, Italian military spending kept decreasing in absolute value throughout most of the 1930s while American military forces were not engaged in battle until 1941. On the whole, much more than in the other three scenarios leading, respectively, to inflated, curbed or extra-prudent national security policies, in scenario HA–LE the influence of financial crises on national security policies seems especially subject to variables like regime type, personality type, and military tradition and culture. Yes, as the third sections of Chapters Two, Three and Four, and most of Chapter Four have demonstrated, the

influence of financial crises on national security policies can be appreciated even in this scenario.

Across all fourteen financial crisis episodes, the most memorable changes in national security policies have occurred in the presence of a mismatch or disparity between government affinity with high finance and government exposure to high finance. The mismatch took place under either scenario LA–HE or scenario HA–LE, and, for the reasons described above, overhauls in national security policies were constant under scenario LA–HE, less so under scenario HA–LE. Although the framework does not say anything about the specific magnitude of the shifts, the magnitude of the complete overturn of, say, American or Japanese national security policies between 1907-09 or Italian national security policies between 1889 and 1891, both of them under scenario LA–HE, is hard to question. The changes in national security policies that have occurred under scenario LA–LE and scenario HA–HE have been less striking, and one could argue that the magnitude of these shifts, particularly the ones under scenario LA–LE, was inferior to the shifts which took place under the other two scenarios. Significantly, however, in many financial crisis instances, leading government officials did not grasp immediately which scenario they were in or accepted its workings thereby behaving as if they were in scenario LA–LE or HA–HE until the real scenarios LA–HE or HA–LE kicked in. This was true, for instance, with regards to the financial crisis of 1907-09 in the United States and Japan, the financial crisis of 1914 in Great Britain, and the financial crisis of late 1920s and early 1930s in Japan, Italy and the United States.

Table 6.1. Summary of Expectations and Outcomes

JAPAN	1. 1889-90 (local then global)	2. 1896-1901 (local then global)	3 & 4. 1907-09 & 1920-22 (global)	5. 1927-31 (local then global)
AFFINITY WITH HIGH FINANCE	LOW	LOW	LOW	HIGH
EXPOSURE TO HIGH FINANCE	LOW	LOW	HIGH	LOW
EXPECTATIONS: NSP BEFORE FINANCIAL CRISIS OUTBREAK	ASSERTIVE	ASSERTIVE	ASSERTIVE	CAUTIOUS
EXPECTATIONS: NSP AFTER FINANCIAL CRISIS OUTBREAK	INFLATED	INFLATED	CURBED	—
VERIFIED?	YES	YES	YES	—
ITALY	6. 1889-91 (loc then gl)	7. 1893-94 (local)	8. 1907-1908 (global)	9. 1931-33 (global)
AFFINITY WITH HIGH FINANCE	LOW	HIGH	HIGH	HIGH
EXPOSURE TO HIGH FINANCE	HIGH	HIGH	HIGH	LOW
EXPECTATIONS: NSP BEFORE FINANCIAL CRISIS OUTBREAK	ASSERTIVE	CAUTIOUS	CAUTIOUS	CAUTIOUS
EXPECTATIONS: NSP AFTER FINANCIAL CRISIS OUTBREAK	CURBED	EXTRA PRUDENT	EXTRAPRUDENT	—
VERIFIED?	YES	YES	NO	—

UNITED STATES	10. 1884 (local)	11. 1893-96 (local)	12. 1907-1908 (global)	13. 1929-33 (global)
AFFINITY WITH HIGH FINANCE	LOW	HIGH	LOW	HIGH
EXPOSURE TO HIGH FINANCE	HIGH	HIGH	HIGH	LOW
EXPECTATIONS: NSP <u>BEFORE</u> FINANCIAL CRISIS OUTBREAK	ASSERTIVE	CAUTIOUS	ASSERTIVE	CAUTIOUS
EXPECTATIONS: NSP <u>AFTER</u> FINANCIAL CRISIS OUTBREAK	CURBED	EXTRA PRUDENT	CURBED	—
VERIFIED?	NO	YES	YES	—

14. FINANCIAL CRISIS OF 1914	AUSTRIA-HUNGARY	GERMANY	GREAT BRITAIN
AFFINITY WITH HIGH FINANCE	LOW	AMBIGUOUS/CAN'T CODE	HIGH
EXPOSURE TO HIGH FINANCE	LOW	LOW	LOW
EXPECTATIONS: NSP <u>BEFORE</u> FINANCIAL CRISIS OUTBREAK	ASSERTIVE	AMBIGUOUS/CAN'T CODE	CAUTIOUS
EXPECTATIONS: NSP <u>AFTER</u> FINANCIAL CRISIS OUTBREAK	INFLATED	CAN'T APPLY THE FRAMEWORK	—
VERIFIED?	YES	CAN'T APPLY THE FRAMEWORK	—

This equals to observing that, in many of the observed financial crisis instances—namely the ones characterized by scenario LA–HE or HA–LE, the shift in national security policies took a while to mature as leaders of crisis-stricken governments strenuously attempted to push forward their desired crisis response strategy, and crisis-stricken governments, as a result, experienced more than one stage of crisis response. In these instances, shifts in national security policies also took a while to mature.

In one of the fourteen, examined financial crisis experiences, namely the German response to the financial crisis of 1914—Table 6.1, green boxes—applying the framework as presented in Figure 1.1 has not been possible due to the difficulty of coding the German government’s pre-crisis financial, economic and security policies as expression of high or low government affinity with high finance. Since the exposure to high finance of the same government was low, however, expectations on the (more assertive) character of the national security shift (or the lesser constraints for exercise of assertiveness) could still be formulated, like it was formulated with regards to the British government in the same time period. The collected evidence confirmed them. The German national security policies ushered in by the first stage of the financial crisis of 1914 were neither curbed, nor inflated, nor did they become extra-prudent. Yet, they were “rationalized,” as the cautious elements composing them were strengthened and the assertive ones disappeared.

Much more glaring are two instances—Table 6.1, orange boxes—which disconfirm the expectations of the shift in national security policies formulated on the basis of the framework. Specifically, the framework is at a loss in explaining Italian

national security policies, and the behavior of the Italian governing authorities and that of high finance after the start of the financial crisis 1907-09 in Italy. It also cannot make sense of the behavior of the Arthur administration and of American national security policies after start of the financial crisis of 1884. As the following paragraphs clarify, however, more than invalidating the framework both instances suggest new avenues for further research.

Two Exceptions and Their Meaning

A few years after the start of the financial crisis of 1907-1909 in Italy, the cosmopolitan government of Giovanni Giolitti, who responded to the financial crisis by entrusting financial markets with the process of crisis recovery (high government exposure to high finance), waged a long, politically undesirable war against Turkey shortly after the end of the crisis. For the war efforts, Italian authorities even sought and obtained the endorsement of financial circles in London, and, throughout the war and in its aftermath, foreign high finance had only words of praise for the excellent status of Italian finances throughout and after the conflict.

Similarly, after the outbreak of the financial crisis of 1884, and from a position of high exposure to high finance, the American administration of Chester Arthur doubled-down on its pre-crisis assertiveness and Arthur's objective of securing an American expansionist agenda. High finance had no words of praise for the administration this time. Since these instances of unexpected government behavior during financial crisis are only two out of a larger number it seems opportune to speak of outliers but a question remains: what should we make of them?

The Italian experience suggests that, in some circumstances, one of the cardinal assumptions of the framework, that is the predilection of high finance for international diplomatic and military appeasement after the start of a financial crisis (and, relatedly, the effort by high finance to bring appeasing international diplomatic and military policies about after the start of a financial crisis) is no longer true. This might occur for a series of reasons, which the Italian financial, diplomatic and military experience between 1907 and 1911 helps elucidating. A first reason is that, after 1907, the trust of domestic financial actors in the workings of international financial cooperation and high finance broke down. Fearing widespread economic losses and the foreign encroachment of their business in Northern Africa, eminent Italian bankers pressured the Italian government to intervene militarily in defense of their interests. As a result, foreign high finance lost an important ally to exert a restraining effect on the national security policies of the Italian government.

More tellingly, the tense social and economic situation, which many of the outlying territories of the Ottoman Empire, like Libya, were confronting, did arguably create challenges for high finance too as the orthodox medicine did not seem to work there. In turn, high finance might have welcomed the Italian resort to less compromising means to impede an escalation of the crisis and, concurrently, defend the success of the orthodox medicine and the security conditionality accompanying it at the center of the international financial system.⁶⁸⁹ Before settling on a conclusion of

⁶⁸⁹ The financial crisis of 1907-09 was resolved at the center of the international financial system thanks to European governments' cooperation with high finance. The orthodox medicine, however, was unable to solve the financial crisis at the fringes of the international financial system like, for instance, Northern Africa.

this kind, however, more research into the favoring of an Italian-Turkish war by the major German and British financial houses is warranted.

The increasing conversion to assertiveness by the Arthur administration during the financial crisis of 1884 paints a somewhat less concerning outlier. True, the administration ignored the orthodox medicine and continued to prop up American military investment and military presence in Central and Latin American throughout financial crisis year 1884 while relying on the help of high finance to bring the crisis to an end. But high finance suffered a relatively minor political defeat, as it quickly endeavored to assure the election of dovish presidential candidate Grover Cleveland later on that year. Although the argument here advanced would benefit from further research into the relation between Arthur and high finance throughout the first half of the 1880s, President Arthur and his acolytes were arguably aware in 1884 that their national security strategy was alienating the sympathies of the wealthiest Americans. They also knew that they could not compete with Cleveland for re-election. On the one hand, facing very forthcoming elections and dim reelection prospects, the Arthur Presidency could stretch his national security plans forward relatively undisturbed by high finance, albeit for a limited time. On the other hand, the local character of the financial crisis, and the still marginal role of the United States within the international (financial) system at this time did not create the same pressures to stop the Presidency that high finance felt, for instance, during the financial crisis of 1907-09. In this respect, Theodore Roosevelt was not as “lucky” as Arthur.

Interesting and Unexpected Findings

A prominent finding of this work is that the turn towards greater diplomatic and military caution that occurs under scenarios LA–HE and HA–HE is not necessarily peace inducing or a most prudent policy decision to adopt. In financial crisis years 1908 and 1909, the Roosevelt and Taft administrations moved away from the militancy that had characterized American foreign policy in previous years, but reorienting that policy towards international economic competition did not diffuse peace across the world. International financial agreements accelerated the Chinese civil war and fuelled resentment and misunderstandings amongst the great powers, Japan included. Similarly, the withdrawal from assertiveness and the pursuit of a super restrained foreign policy that Japanese cabinets attempted between 1929 and 1931 increased the chances of a Sino-Japanese war by encouraging the nationalist forces of Chinese warlord Chang Kai-shek and creating a profound fracture between the Japanese cabinet and the Japanese Army.

Next to yielding this undesired outcome, national leaderships did not always get their scenario(s) correctly or adequately assessed the domestic political consequences of the strategy of financial crisis response they are keen on implementing. During some financial crises, the power of state leaderships was so superior to that of high finance that the crisis response strategy desired and selected by such leadership worked. In those instances, pre-crisis national security policies could continue uninterrupted. This was true for the Japanese leadership during the financial crises of 1889-90 and 1896-1901. However, during other financial crises—the majority of the ones here examined—crisis-stricken governments either missed to

recognize that domestic financial actors and dominant financial ideas favored the triumph of the orthodox medicine or failed to realize that the latter would not have solved the existing crisis. Responsible for the first mistake were the Crispi government after the start of the financial crisis in 1889, and the Saionji and Roosevelt governments after the start of the financial crisis of 1907-09. In all these instances, heterodox financial policies and ambitious national security policies were replaced, during the financial crisis, with a newly discovered faith in the virtues of private market forces and international diplomacy. The Japanese, Italian and Japanese leaderships between 1929 and 1931 made the second mistake—wrongly trusting high finance and the orthodox medicine, and strengthening the security conditionality attached to them. Nowhere was the failure to notice or surrender to the growing leverage of heterodox crisis response policies and the lessening power of high finance more costly than in Japan. Members of the Hamaguchi government paid for the mistake with their life, and a pre-crisis agenda of diplomatic and military caution was butchered with particular violence.

Other findings stand out. One of them is that whatever strategy of financial crisis response crisis-stricken governments commit to—regardless of whether it works or not to solve the crisis—governments have a tendency to over apply their medicine of financial crisis response, and in doing so they create increasingly polarized domestic settings, vigorous opposition, and significant policy backlashes. In 1895, so strenuously did the Crispi government continue a post-crisis strategy of withdrawal from colonial adventurism (to signal the authenticity of Italy's conversion to the orthodox medicine), that Italian diplomatic and military advantages in Northern

African quickly dissipated, producing outrage amongst pro-military supporters and the armed forces, and ultimately contributing to one of the most inexplicable and regrettable episodes of military capitulation in history, when a small national military contingent was practically sent to die on battlefield. Analogously, in the early 1930s Wakatsuki, Inoue and Shidehara continued to slash Japanese military spending and trust the orthodox medicine until the unpopularity of this agenda thwarted any understanding between Japanese civilian authorities and the Kwantung Army.

This evidence illustrates not only the serious policy blunders of national leaders during financial crises, but also these leaders' lack of foresight and inattention to the larger policy context or medium-medium term implications of their actions. Interestingly, when the crisis-stricken government responds to financial crisis by prioritizing international financial cooperation, it is the larger national security context to the forgotten. Differently, when the crisis-stricken government responds to financial crisis by prioritizing national security needs, it is national financial and economic stability and growth that are set aside.

A second interesting finding is that there does not seem to be any substantial difference between global and local (or local turned global) financial crises in terms of the influence that they produce on the security policies of the stricken governments. Independently of whether financial crises are global or local, governments seem to respond to financial crises only *after* that the latter have started within domestic borders.⁶⁹⁰ Having said that, global financial crises are possibly different from local financial crises in that they influence the national security policies of a higher number

⁶⁹⁰ Note that when financial crises are global, high finance generally starts to respond to them much earlier than governments do

of states or across the globe, and therefore tend to have a greater impact on *international* security than local financial crises are likely to have. Although the objective of this work has been to examine variation in *national* security policies after financial-crisis outbreak and not variation in *international* security after financial crisis outbreak, the implications of the former on the latter during global financial crises have often been striking. Notable in this respect were the American response to the global financial crisis of 1907, the Japanese response to the global financial crisis of 1927-33, and the Austro-Hungarian, German, and British response to the global financial crisis of 1914.

A third interesting finding—and a finding that shows that local financial crises can contribute to international security even if perhaps more modestly than global financial crises—is that states that are not stricken by financial crisis face strong incentives to change their security policies because *other* states confront local financial crisis. Between the mid-1880s and mid-1890s, for instance, Great Britain capitalized on the absence of a strong American defense policy, which local financial crises, as shown in Chapter Four, contributed to bring about. Likewise, following the start of the local financial crisis of 1893-94 in Italy, Ethiopian Negus Menelik exploited Italian military withdrawal from Northeastern Africa to regain the lost ground and prepare to launch, a few months later, the deadliest Ethiopian attack against Italian troops. Since both the British and Ethiopian retaliations against took place during local financial crises, the relevance of the latter on international security or at least the military and diplomatic interaction between two states cannot be ignored.

Theoretical Contributions

Chapter Three, Chapter Four, and parts of Chapter Five have illustrated the limits that explanations of national security policies in the financial crisis years that I examine encounter when the national security influence of financial crises is excluded from consideration. In illustrating these limits, this work has not attempted to deny or downplay the importance that non-financial variables located at various levels of analysis have in contributing to shifts in national security policies, as well as to the decision-making process, perceptions, and capabilities informing those policies. Equally, this work has not attempted to dismiss the relevance of realist, neorealist or structural pressures; of domestic and international institutions and social processes; and of individual leadership and charisma during financial crises. It would be difficult to deny the importance of these independent variables given the constant resort to them, in each chapter, to reconstruct the national economic and security policies of crisis-stricken states *before* the start of financial crises. It would also be foolish to deny the importance of these traditional variables in view of the gathered economic, diplomatic and military evidence *after* the start of the examined financial crises. For instance, it would be foolish to argue that systemic military and economic pressures and socially constructed concerns about international status and rank played a minor role in contributing to the positivist economic and national security agenda that Japanese leaderships were prone to resort to during financial crises. By the same token, it would be difficult to deny that the temperament of Theodore Roosevelt or Francesco Crispi shaped American and Italian decision-making in the security sphere throughout the financial crises that hit the United States and Italy in, respectively, the

late 19th century and the mid-to-late 1900s. And it would be difficult to deny that the particular configuration of Italian politics and the triumph of transformism prevented any radical change in Italian foreign policy during financial crisis years 1907 and 1908.

Rather than assessing the relative power of financial crises versus that of other variables in informing changes in military spending, threat assessment, and war prospects after financial-crisis outbreak, this work has drawn attention to whether the changes in national security policies which occurred in the financial-crisis instances here examined would have also occurred in the absence of the examined financial crises. In synthesis, the crucial question that has informed the treatment of the fourteen instances of financial-crisis response analyzed in the dissertation, while pitching the explanation offered by the framework against alternative explanations based on, say, neorealist pressures or domestic institutional variables *only*, has been the following: “Was the financial crisis, other things being equal, a necessary condition for the greater caution (or assertiveness) in military spending, threat assessment, and war that followed the crisis outbreak?”⁶⁹¹ When the answer was “yes,” I concluded that the financial crisis at hand exerted an overlooked influence on national security policies, stirring them towards greater aggressiveness or greater caution and determining the character of the realized national security outcome.⁶⁹² This counterfactual approach helped me limit as much as possible endogeneity problems deriving from the simultaneity and interdependence of national economic

⁶⁹¹ On the relationship between necessary conditions and counterfactual analysis see Goertz and Levy (2007:9–45).

⁶⁹² On necessary causes see, for instance, Mahoney et al (2009:218).

and security decisions, and shed light on the inappropriateness of allowing national and international security considerations trump the relevance of financial crises when evidence suggests differently.⁶⁹³ Like military-security crises, two of the main variables of this work, government affinity with high finance and government exposure to high finance, shape national security decision-making of crisis-stricken governments in their own right. The argument here is *not* that the influence of these variables is weaker or inexistent without financial crises, but rather that financial crises transform these factors and their interplay, and, as a result, they transform national security policies too. These long ignored transformations exemplify the influence or independent causality of financial crises on national and international security. Accordingly, this work confutes two null or alternative hypotheses. The first is that no change in national security policies occurs after a financial crisis outbreak. The second is that, after a financial crisis outbreak, changes in military spending, threat assessment, and war prospects are impelled by developments that have little to do with the financial crisis.

Both hypotheses are implicit in neorealist theories of world politics, and their understanding of “state capability” as the ensemble of population, industrial and military power, raw material endowment and little else.⁶⁹⁴ Collectively, these theories postulate that the causes of alliances, foreign policy, and war prospects—or, more broadly, states’ answers to the security dilemma—are to be identified in states’

⁶⁹³ On the utility of counterfactuals to solve endogeneity problems, see King, Keohane and Verba (1994:21).

⁶⁹⁴ See in particular Jervis (1978); Waltz (1979); Walt (1987); Van Evera (1999); Mearsheimer (2001). Neorealist theories such as the balance of power theory, offense-defense theory, balance-of-threat theory, and “window theory” all assume a more limited understanding of state capability or “capacity” than the one that this work accepts.

responses to shifts in the distribution of state capabilities; shifts in the offensive power of state capabilities; shifts in perceptions regarding state capabilities; and threats based on each of the aforementioned shifts. By omitting financial stability from their understanding of state capabilities, these theories implicitly negate that financial crises exert an independent causal influence on national security policies.⁶⁹⁵ This work denies the validity of this assumption. By posing a threat to important national security values; by unveiling an uncertain financial and economic future that necessitates an effective crisis-response; and by affecting government exposure to the pressures of high finance, financial crises produce shifts in perceptions regarding state capabilities, shifts in threat assessment, and ultimately shifts in national security in the same way as with military-security crises.

In contributing to some of the existing literature, particularly the existing scholarship on financial crises, existing theories on the political economy of national security and existing literature on the causes of war and foreign policy, the framework is indebted to three scholarly traditions or literatures more than any other. A first tradition is concerned with the role of financial ideas in the processes of power redistribution that characterize domestic, international, and transnational policymaking (Gabel 1996; Haggard and Maxfield 1996; Kirshner 2003). A second tradition deals with the change in domestic and international politics, ideas, and policies that financial or economic shocks create (Katzenstein 1978; Gourevitch 1986; Seabrooke 2006; Pepinsky 2009). A third tradition revolves around the assumption that security dilemmas and real or perceived shifts in relative gains (or losses) inevitably

⁶⁹⁵ State capabilities are commonly understood as referring to a state's total population, industrial and military resources, and endowment of raw material.

characterize interstate relationships (Jervis 1978; Schweller 2007; Cesa 2011). While indebted to these traditions, I have not been impartial in using some of their analyses and findings. For instance, Peter Gourevitch (1986:19-22) explains how, in times of economic crises, new coalitions emerge and new policy packages are formed, as politics, the system of relationships, and policy become more fluid. Trusting this finding but having a primary interest in whether specific coalitions and specific packages win or lose, in this work I have stressed the importance, after the outbreak of financial crisis, of power shifts benefiting or harming high finance and the orthodox medicine. The formation of a coalition is in the picture but it's whether it has an orthodox character or not that matters the most.

Similarly, the framework recalls the argument by Leonard Seabrooke (2006) that state leaders can broaden or narrow their financial power by intervening for or against the interest of private economic elites. Specifically, in Seabrooke's view, state leaders will increase their state's international influence by allying against the interests of private economic elites, and decrease their state's international influence by allying with the interests of private economic elites (and against the interests of low-income groups). If one understood "increasing a state's international influence" in the same terms of "increasing a state's assertiveness," and private economic elites as high finance, then my argument and Seabrooke's would not be very different. However, there are some substantial differences, the first being that Seabrooke's (2006:11) argument is meant to apply to times of financial and economic stability (or to "everyday economic struggles" as he calls them). Other points of distinction are, as already hinted, that Seabrooke is not concerned with national security policies, and

that the complete conflict of interests between low-income groups and private economic elites that he envisions is not a good representation of the relationship between high finance and public forces that appears in this work.

The reasons that link this work to arguments advanced by Gourevitch and Seabrooke also explain why, although this work borrows from structural realism the principle that security dilemmas and real or perceived shifts in relative gains (or losses) are foundational to interstate relations, I understand state capabilities in broader terms than structural realism would. Financial power and financial relations, let alone financial crises would not figure in any faithful neorealist account. In this respect, this study is theoretically close to scholars like Snyder (1991), Solingen (1998), Trubowitz (1998), Lobell (2003), and Narizny (2007), who have recognized the advantages of a broader understanding of state capabilities in the explanation of national security policies and changes in national security policies.⁶⁹⁶ In these works, however, financial stability and financial crisis have remained very marginal variables. Also, the most distinctive aspect of financial crises, specifically the threat/opportunity that they pose to national and international financial systems, and, as a result, to national financial-security agendas and perceptions of the security dilemma, is entirely overlooked. By contrast, as hinted in Chapter One, the few, recent scholarly works on the geopolitical implications of the AFC and the GFM (Dibb, Hale and Prince 1998:5; Devlen 2008; Friedberg 2010:32,35) have recognized that financial crises can trigger changes in international security and balance-of-power, but their focus has remained

⁶⁹⁶ These works have acknowledged the weight of domestic variables such as coalition, partisan conflict, state structures and institutions as well as international and transnational factors like economic liberalization or international commercial orientation in the crafting of national security policies. Some of these variables figure prominently also in this work.

on the changes that are potential and that derive from relative gains and losses amongst states, not within states or governments.

Finally, the project also makes a theoretical contribution to the existing debate on scapegoat-war or diversionary-war theories (Levy 1993). These theories assume that, during economic instability, the domestic elite will display a more assertive foreign policy stance, choosing war to divert attention from domestic troubles and shore up their political position. The analytical framework here advanced offers a more nuanced explanation of escalating war prospects in times of economic turbulence. To begin, it suggests that during a financial crisis, a special form of economic instability, war prospects increase when a government's affinity with high finance is low and remains low throughout the process of crisis response. Secondly, it indicates that war prospects increase not as an attempt to divert attention from pressing economic challenges but, to the contrary, in an effort to solve them via increased military spending and linked magnification of existing threats. Diverting attention from the crisis—or obscuring its presence—might be part of the strategy of crisis response, but the diversion will mostly be targeted to foreign governments rather than domestic constituencies, and to high finance above other interest groups. Thirdly, the dynamic analytical framework offered here addresses fundamental questions of causality linking financial crises to shifts in national security policies, which diversionary theory leaves unanswered.⁶⁹⁷

⁶⁹⁷ On this point, see Stoessinger (1982).

The Framework in Contemporary World Politics

Next to its theoretical contributions, explaining the contemporary variation in national economic and security policies around the world in response to the greatest market failure since the Great Depression is possibly what the framework is most useful for. Shifts towards or away from greater diplomatic and military caution resulting from high government exposure to high finance have affected states across different regions of the world. United States, Japan, and Italy are, once again, good examples. Since the start of the global financial meltdown in late 2007, American national security policies have been profoundly transformed. The military ambitions and grand geopolitical visions of the Bush administration have been lowered sharply. American wars in Iraq and Afghanistan have been wound down to the point where even the appetite for keeping a significant military presence in loco has waned.⁶⁹⁸ Between 2009 and 2010 the Obama administration undertook concrete steps to promote national and international reductions to costly nuclear arsenals. It ratified a new strategic arms reductions treaty with Russia (“New START”) and passed a “Nuclear Posture Review” that narrowed the declared role of nuclear weapons in American strategy. In the Middle East the United States has exhibited a noteworthy reluctance to engage. When it has engaged (Libya), it has done so by participating to multilateral, limited interventions for the preservation of peace, not very differently (so far, at least) from the international intervention against the Boxers in 1900-1901. Moreover, the Pacific pivot strategy launched in early 1912 and now described as the “Pacific Dream” of creating a “stable security environment rooted in economic

⁶⁹⁸ The ‘zero option’ is already a reality with regards to Iraq—thanks to some help from the Iraqi government too. See, for instance, “So long, buddy,” *The Economist*, January 12, 2013.

openness” recalls the American pivot to continental Asia realized during the global financial crisis of 1907-09 and discussed in Chapter Four. Although American marines have been relocated to northern Australia and Singapore, the primary economic and diplomatic rationale of the pivot is promoting international financial and economic cooperation as evident from major American initiatives like the Transpacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP).⁶⁹⁹

At the core of these developments have been acute budgetary pressures and a crisis response strategy heralding the high exposure to high finance of the Bush and Obama administrations. After the start of the financial crisis, no change in the international security was initially contemplated. The Bush administration resorted to quantitative easing and to the TARP (Troubled Asset Relief Program), to award money, credit and the ultimate task of solving the financial crisis to the rocks of the international financial system, Wall Street’s behemots like Bear Stearns, AIG, and Citigroup.⁷⁰⁰ When the deficit hit a peacetime record of 10.1% of GNP in 2009, the necessity of drastic cuts to the American defense budget and a transformation of the national security agenda emerged clearly as policy priorities if the United States wanted to remain competitive and preserve its leadership within the international

⁶⁹⁹ The TPP is an ambitious free-trade agreement that groups members of the North-Atlantic Free-Trade Area with Asian communities including Japan. On American Pacific policy see, for instance, “Pivot or Rebalancing,” in *The Economist*, May 11, 2013; Trefor Moss, “America’s Pivot to Asia: A Report Card,” *The Diplomat*, May 5, 2013. Initially understood by China and possibly a few members of the American National Security Team as a strategy for containing China, American National Security Advisor Tom Donilon has stated and restated that the US government aims at forging a “productive and constructive relations with China.”

⁷⁰⁰ As previous Treasury Secretary Henry Paulson put it, letting these banks fails would have meant allowing the “vaporization of the international financial system.” Paulson’s words in *The Economist*, May 11, 2013, p.11.

financial system.⁷⁰¹ Former Director of American National Intelligence Dennis Blair called the financial crisis the “single greatest threat to American strategic interests” already in 2008. In 2010 Mike Mullen, then the Chairman of the Joint Chiefs of Staff anticipated “belt-tightening” measures in the military, and Hillary Clinton talked endlessly about “smart power,” or power that does not come from the barrel of a gun. The American government’s surrender to the orthodox medicine was also clear, in 2010, with the passage of the Dodd-Frank financial reform laws, which enshrined the principle that leading banks are “too big to fail.” The same principles were restated through the “sequester,” the series of across-the-board federal spending cuts (including cuts in defense) that took effect in March 2013.⁷⁰²

Japan has remained unscathed by the global financial meltdown only at a surface level. Although no serious bank run or bank failure has occurred (so far at least), the Japanese leading political class has lived the past ten to fifteen years under the constant concern of an impending financial crisis giving the final blow to an especially sluggish national economy. The privatization policies and dovish foreign policy pursued by the cabinet of Koizumi Junichiro for most of the 2000s were still a response to the decade-long period of banking crises that gripped the country in the 1990s. The numerous cabinets that led Japan through the meltdown (2007-2012) continued to push forward Koizumi template, and promoted low inflation, exchange rate stabilization, war on terrorism, the phasing out of nuclear energy, and diplomatic

⁷⁰¹ See “The budget. Something for everyone,” in *The Economist*, April 13, 2013, p.32.

⁷⁰² It is worth noting that Obama did not have the intention to newly rank debt reduction as the top priority of the American government during its first year of his second term. His inauguration speech made this clear. Pressures for deficit and debt reduction were too high however: by the time of the State of the Union Address (February 2013), the administration had newly placed control over American finances at the top of the agenda.

cooperation with China and North Korea. Even Aso Taro, the most hawkish prime minister amongst the prime ministers at the head of Japan between 2007 and 2012, fostered the Koizumi agenda, recognizing that the national economy was the “greatest concern.” As he stated in late 2008, “America is facing a financial crisis. We must not allow that to bring us down as well.”⁷⁰³

After years of failed orthodox attempts to pull Japan out of its slump and resist a financial crisis, Japanese agenda has changed in January 2013. The newly elected government of Abe Shinzo welcomed a heterodox strategy (known as “Abenomics”) that prioritizes a ¥10.3 trillion stimulus package, reflation (or so-called “new dimensions in monetary easing”), exchange rate depreciation, and extensive supply-side reforms.⁷⁰⁴ In agreement with the essential logic of the framework, Abenomics is as much a financial and economic strategy of financial crisis response as it is a military and diplomatic one. Nationalists that desire a geopolitical and constitutional rebranding of Japan and reject Japan’s “apology diplomacy” for its wartime misdeed compose the entire cabinet.⁷⁰⁵ On taking office, Abe delighted them by promising to “turn Japanese foreign and security policy around,” and since then Japan has adopted a tougher stance with China by strengthening Japanese-American ties and threatening and planning new military actions to safeguard Japanese maritime interests around the

⁷⁰³ On the more conservative character of Aso’s policy preferences see his 2006 speech “Arc of Freedom and Prosperity: Japan’s Expanding Diplomatic Horizons,” in Calder and Fukuyama (2008), pp.179–180.

⁷⁰⁴ The “new dimensions in monetary easing” that the new Central Bank governor Haruhiko Kuroda has promised are not the common quantitative easing recipe that the United States, Great Britain and many states in central Europe have resorted to throughout the financial crisis. It is not without reason that Abe has gushed about an ongoing “regime change” in Japanese economic policy. On this revolution see “Win Some, Lose Some,” *The Economist*, January 26, 2013, p.64.

⁷⁰⁵ On this point see, for instance, “Back to the Future,” *The Economist*, January 5, 2013; “Japan’s Master Plan” in *The Economist*, May 18, 2013, p.13.

disputed Senkakus/Diaoyus islands.⁷⁰⁶ In another significant departure from the pre-crisis policy of Noda Yushiko government of bringing the state out of nuclear energy by 2040, the Abe government announced that it would restart nuclear reactors after the passing of new safety tests.⁷⁰⁷

Interestingly, in September 1931 the Kwantung Army of the Japanese Empire organized the incident that marked the first step of the Japanese invasion of Manchuria, widely in reaction to the official orthodox medicine of financial crisis response. A new cabinet and heterodox economic and security policies were implemented. In a similar way, in December 2012 the Japanese Self-Defense Force (JSDF) sent eight fighter jets to intercept a Chinese surveillance aeroplane that flew over the Senkakus, the first Chinese incursion in to Japanese-controlled airspace since the 1950s.⁷⁰⁸ A month later, a new cabinet with a positive economic and security agenda was in power. The very different security contexts in East Asia today compared to the 1930s makes a swift escalation of military incidents much harder than it used to be. The higher international financial success of the orthodox medicine this time (so far), compared to the early 1930s, might also put some brakes on Japan's new positive agenda. Yet, the transition to greater assertiveness (and low exposure to high finance) is very evident both then and now, and the changed strategy of financial crisis response is at the heart of this transition.

⁷⁰⁶ In April 2013, Premier Abe warned that Japan would “expel by force” any Chinese attempt to land on the disputed islands. See “Japan vows to use force if China lands on the disputed islands,” *Agence France-Presse*, April 23, 2013.

⁷⁰⁷ On this change in nuclear policy see “Japan to Phase Out Nuclear Power,” *Financial Times*, September 14, 2012; “Japan’s nuclear future: Don’t Look Now,” *The Economist*, April 20, 2013.

⁷⁰⁸ These days the Japan’s Ministry of Defense is also keen on creating a special assault team fully equipped to fortify remote islands and recapture them should an invasion occur.

Due to their membership in the European Monetary Union, Italian authorities have had much less room for maneuver than Japanese authorities in responding to the eruption of the financial crisis within Italian borders. Orthodox fiscal discipline is the glue that hangs EMU members together, Italy, included, and the sacrifices made and costs paid (albeit perhaps not in full) to join the EMU fifteen years ago, and the benefits collected from it up until the start of the financial crisis give the orthodox medicine an advantage. This explains why, after the outbreak of the financial crisis, the Italian cabinet in power at the time found itself in scenario LA–HE—not much differently from the Crispi government in late 1880s or early 1890s—and, between 2009 and 2012, Italian national security policies shifted towards greater caution. Before the outbreak of the financial crisis, the cabinet of Silvio Berlusconi followed an extravagant and controversial fiscal policy and energy policy in total disinterest of Maastricht’s (orthodox) financial standards.⁷⁰⁹ Complementing this fiscal stance was a bombastic foreign policy that included close diplomatic relations with Muammar al-Gaddafi’s Libya (and opposition to the NATO anti-Qaddafi coalition in early 2011), close diplomatic partnership with Russia, and continued support to Italian troops in Afghanistan.⁷¹⁰

As Italian borrowing costs soared, and after the beginning of a southern-European-style sovereign debt crisis (2009), the Berlusconi government came under increasing foreign financial pressure, like it occurred in the late 1880s and the early

⁷⁰⁹ Wide-spread tax cuts were levied, as promised during the election campaign, and copious amount of money were spent on the extension of oil and gas contracts and the development of new oil and gas fields (in Libya) by the ENI (Ente Nazionale Idrocarburi, that is National Institute for Hydrocarbons).

⁷¹⁰ As the financial situation deteriorated throughout the spring of 2011 and as international pressures from NATO and the United Nations intensified, Berlusconi backtracked from his ideal foreign policy plans and joined the international military intervention front.

1890s. Foreign high finance and EU leaders demanded firm plans of debt reduction and a solid crisis response strategy. Like Crispi, Berlusconi continued to promote his economic and security agenda while denying or trying to assuage financial crisis fears. In late 2011, the Italian parliament forced him to resign and approved harsh austerity measures to restore Italian economic competitiveness.⁷¹¹ Committed to regain the lost national financial discipline, the non-party government of Mario Monti (2011-2012) ordered drastic cuts to armed forces personnel, and took a major step towards long-term procurement planning by publishing a three-year, itemized defense budget (2013-2015) to which the newly elected government of Enrico Letta is currently abiding.⁷¹²

A published, multi-year defense budget is a clear attempt at improving the transparency and financial credibility of the Italian government, and avoiding a repetition of the debt crisis.⁷¹³ The pre-crisis, ambitious threat assessment and war prospects have similarly shifted towards caution. Part of this shift has been the result of the influence of the global financial crisis on the national security policies of other states. For instance, the American planned withdrawal from Afghanistan have changed many of the conditions that sustained Berlusconi's diplomatic and military agenda. More importantly, since 2012 the Defense Ministry has stressed the Italian government's pledge to strengthen Italian relations with Arab countries in the

⁷¹¹ On these developments, see, for instance, William L. Watts and Myra P. Seafong, "Rising Italy bond yields pressure European leaders," *The Wall Street Journal*, July 11, 2011; and Uri Friedman, "Mario Monti assumes power in Italy," *Foreign Policy*, November 14, 2011.

⁷¹² Both Monti and Letta are members of the Trilateral Commission (the powerful financial lobby founded by David Rockefeller in 1973), and have strong ties to the international financial circles.

⁷¹³ The defense budget dropped to 13.6 billion euro in 2012 thanks to austerity cuts. The overall defense spending for 2013 is decreed to be 14.41 billion Euro. In 2014, this amount should decrease to 14.1 billion Euro in 2014. See 1.1, Italy's Defense Expenditure as a percentage of GDP in Gary Schmitt, "Italian Hard Power: Ambitions and Fiscal Realities," American Enterprise Institute, November 1, 2012.

economic field, and has promoted armament cooperation deals with Germany to save costs—measures that realign Italian national security interests and foreign policy decisions closer to Brussels’ financial and economic agenda. The evidence presented in this work on the behavior of Italian governments across several financial crisis episodes offers a helpful historical perspective against which evaluating these developments.

As for the national economic and security decisions that government officials *should* take after the outbreak of financial crisis, the advice of maintaining a flexible approach to revising pre-crisis financial-security agendas and never pushing policy revisions too far is seemingly the wisest. Crisis-stricken government should stir towards positive financial-crisis economics and assertive national security policies, or towards negative financial-crisis economics and cautious national security policies depending on the nature of their pre-crisis financial-security agenda. Changing policy direction, welcoming compromising solutions, and avoiding fixations with one crisis medicine or another will help mitigate political opposition and skewed distributions of the costs of the crisis on society. This strategy is also likely to impede radical and abrupt changes in national and international security executed under the influence of orthodox or heterodox medicines. Literature in international political economy has already suggested that responding to financial crises based on this influence is as much captivating as mistaken. More should be done to disclose how and why economic policies and security policies are both part of this mistake.

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THE INFLUENCE OF FINANCIAL CRISES ON NATIONAL SECURITY POLICIES

A Dissertation

Presented to the Faculty of the Graduate School

of Cornell University

In Partial Fulfillment of the Requirements for the Degree of

Doctor of Philosophy

by

Maria Sperandei

August 2013

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THE INFLUENCE OF FINANCIAL CRISES ON NATIONAL SECURITY POLICIES

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Cornell University 2013

ABSTRACT

What influence do financial crises exert on states' security policies, specifically crisis-stricken states' military spending, threat assessment, and war prospects? This dissertation finds that, after the start of financial crises, the national security policies of crisis-stricken governments shift towards greater assertiveness or greater caution. Whether greater assertiveness or towards greater caution is realized depends on government exposure to high finance, that is the extent to which crisis-stricken governments rely on the largest transnational financial and business interests to solve the financial crisis. Specifically, the national security policies of a crisis-stricken government will move towards greater assertiveness if the government's exposure to high finance is low, and towards greater caution if the government's exposure to high finance is high. As a result, the national security policies of a crisis-stricken government having low affinity with high finance, namely a low predisposition to include the financial and economic preferences of high finance in its policy agenda, will be *inflated* when the government has a low exposure to high finance and *curbed* when the same government has a high exposure to high finance. Differently, the national security policies of a crisis-stricken government having high affinity with high finance, namely a high predisposition to include the preferences of high finance in its policy agenda, will become *extra cautious* when the government has a high exposure to high finance. The theoretical foundations underlying the argument of this dissertation do not allow determining the character of the national security policies of a crisis-stricken government having a high affinity with high finance and a low exposure to high finance. Relying on archival research, process tracing, text analysis, numerical data analysis and counterfactual analysis, I demonstrate these relationships over a total of 14 instances of financial crises affecting the security policies of a total of six states—Japan, Italy, the United States, Austria-Hungary, Germany and Great Britain—in the period between 1880 and 1940.

BIOGRAPHICAL SKETCH

Maria Sperandei was born and raised in a provincial town in Central Italy (Umbria). Having developed an interest in the mechanics of interstate relations, she completed a B.A. in International and Diplomatic Science at the University of Bologna (Italy). She then moved to Wales (United Kingdom) to earn a Master degree in Strategic Studies at the University of Aberystwyth. In 2005 she came to the United States under a Fulbright to study international political economy at the University of Denver, Colorado. In 2006 she enrolled in the Doctoral program at Cornell University that she will complete by August 2013. At Cornell, Maria cultivated an interest in research at the intersection of political economy and international security, and particularly the process through which perceptions, ideas and emotions about core financial and military values are revised during crises, with profound consequences for states' domestic and foreign behavior. Along these lines, her dissertation investigates the puzzle of why governments that are stricken by financial crisis refuel their assertive or prudent national security policies at times but retreat from them at other times. Maria's previous work on coercive diplomacy and the linkage between alliances and war has appeared in the *International Studies Review* and *Quaderni di Scienza Politica*. In September 2013 she will be a postdoctoral fellow at the Dickey Center for International Understanding at Dartmouth University.

A Diana, Luciano e Laura,

ACKNOWLEDGEMENTS

Ithaca, July 29, 2013

Research for this manuscript originated from a mix of perplexity and fascination with unsubstantiated claims that became popular in late 2007 and early 2008. These claims held that, due to the outbreak of the global financial crisis, sweeping changes in the national security policies of crisis-stricken states were imminent and warranted. The fact that resourceful state authorities and distinguished policy experts endorsed these claims in the absence of systematic theoretical and empirical research on the subject both raised some red flags and made this alleged connection between financial crises and national security policies all the more intriguing. The dust has not settled yet, as similar claims continue to appear—if anything, they have become more numerous. In the meantime, my research journey has left me less perplexed as to how, when, and why national security policies take one sweeping turn or another after the start of financial crisis. By contrast, my fascination with the general absence of a common language to talk about these developments, and with the possible policy benefits and dangers of providing one, has grown. My hopes are that this manuscript can raise awareness on the significance of having this discussion. Despite its risks, not having this conversation will just perpetuate ignorance and misunderstanding.

In the process of attaining less perplexity and more fascination, I have contracted numerous intellectual and personal debts. Starting with the weightiest, I could not have written this manuscript without the groundbreaking work, wise guidance, and firm encouragement of Professor Jonathan Kirshner. Throughout the years, I have marveled at and learnt from the lucidity of his feedback, and his relentless push for improvement and simplicity. Through careful mentoring and precise reading suggestions, Professor Kirshner has helped me avert hazardous blunders, and stop unhelpful theoretical tinkering. At a broader level, I am particularly grateful to him for leading by example, and constantly reminding me of the value of striving for intellectual honesty and meaningful scholarly challenges.

I own earnest thankfulness to Professor Peter J. Katzenstein, whose presence, foresightedness, and generosity have constantly left me speechless. His scholarly and human talents are branches of a tree that stretch towards multiple directions, shatter barriers, and simultaneously reinforce each other's growth. Every academic or life advice that I have received from him has 'stretched,' 'shattered,' and 'reinforced' like one of those branches.

I am also very much obliged to Professor Thomas B. Pepinsky, for the down-to-earthiness, promptness, and intelligence of his reactions, and for having adeptly balanced words of encouragement with the sensible recommendation of handling paramount methodological matters at the best of my ability.

For being a breathtaking source of inspiration as a scholar, mentor, and friend, I am profoundly grateful to Professor Ilene Grabel. She has made a huge difference in my life and continues to do so. I hope she can find traces of her teaching and wisdom in this manuscript.

I have to express a very special thanks to Professor Richard F. Bense, who not only supplied me with a tremendously comprehensive and most ingenious review of this manuscript before my defense, but also shared fresh and exciting ideas at several stages of the process, with exceptional involvement and style.

I own similar thanks to Professor Marco Cesa, for his mentorship, and always finding the time to talk to me since 2001. Without his work, generosity and trust I would not be here now.

Professor George Boyer, Professor Sarah Kreps, Professor Elizabeth Sanders, and Professor Alexander Kuo have either heard a talk on this project or read material related to it.

My conversations and correspondence with them have been precious. I thank them for their time. On a more practical level, most heartfelt thanks go to Tina Slater, Judy Virgilio, and Laurie Coon, for graciously helping me navigate the official procedures, offering grant application assistance, and patiently understanding any unplanned administrative misstep on my part.

For their memorable contributions to my academic and personal growth—contributions that predated the start of this manuscript but widely informed its spirit—I thank Professor Rachel Epstein, Professor Enrico Fabrizi, Professor George De Martino, Professor Martin Alexander, and Professor Riccardo Rovelli.

A big thanks to Deondra Rose, Noelle Brigden, Gaurav Kampani, Jennifer Erickson, Audrey Comstock, and Danielle Cohen, for their candid friendship. I miss some of you already and will miss the rest of you dearly. Call me.

For their insightful feedback on previous drafts of this work, and their great company throughout the years, I must thank Pinar Kemerli, Simon Gilhooley, Don Leonard, Jennifer Hadden, Alison McQueen, Lucia Seybert, Jenny Stepp, Kristin McKie, Simon Cotton, Desmond Jagmohan, Phil Ayoub, Diego Fossati, Michelle Greco, Sinja Graf, Onur Ince, Andrew Yeo, Jason Oaks, Katrina Browne, and Danielle Thompsen.

For their expert assistance with archival documents, data analysis, and editing, whether from Ithaca (NY), Rome (Italy) or Washington (DC), I am especially indebted to Lynn Thitchener, Daniel McKee, Linda McLean, Sarah Tarrow, Annarita Rigano, Stefania Ruggeri, Mariapina Di Simone, the staff of the Banca di Roma, the Staff at the Archivio del Ministero degli Affari Esteri, the staff of the Archivio Centrale dello Stato, and the staff of the Manuscript Division of the Library of Congress.

For having funded this project, having provided forums and debates I highly benefited from, and their gracious help and company, I am much indebted to the Mario Einaudi Center for International Studies, and the Smith-Richardson Foundation, especially Allan Song, Scott Boston, Sydney Van Morgan, Ike Michelsen, Mark Wilson, Walt Baschnagel, Elizabeth Edmonson, and Elaine Scott.

For solidifying my interest and thrill in this research endeavor, many thanks to the 2009 Institute on Qualitative and Multi-Method Research at the Maxwell School of Syracuse University, and to the participants to the 2009 Summer Workshop on the Analysis of Military Operations and Strategy, particularly Professor Colin Elman, Professor Richard Betts, Professor Steven Biddle, Professor Barry Posen, Professor Cindy Williams, Josh Shiffrin, Richard Maas, Diane Pfundstein, and Amr Jossel.

For the bond I have shared with them throughout the years, and for reminding me who I am, and where I am going, I am especially obliged to Christina Bristow, Sian Owen, Gafar Zaaloff, Carlotta Fioramonti, Sadia Tasleem, Sara Sighinolfi, Elisabetta Petrini, Gladys Evangelista, Jody Tong, Joanne Baum, Lia Zaaloff, Andy Mcpherson, Baran Han, Josephine Martell, Marion Luger, Carol Bristow, Michael Marozzo, Anna Goehner, Danielle Corciullo, Bill Kennedy, Claudia Volpe, Gemma Collantes-Celador, Andrew Lui, and Hung-Jen Wang.

Since this project began with a scary medical ride, continued through a few others, and wrapped up with a commitment to prevent more, I must thank Doctor Mark D. Adelson, the staff of St. Josephs Imaging Associates, the medical team of the Fifth Floor of the Crouse Hospital in Syracuse, Doctor Sharon Ziegler at Cayuga Family Medicine, and Doctor Wai Wong at Gannett. I would not be alive without the professionalism and attentive care.

Most importantly, I am thankful to Diana, Luciano e Laura, for showing me every single day what love and happiness are and where to find them.

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