

PRINCETON STUDIES IN INTERNATIONAL FINANCE

No. 61, July 1988

American "Reparations" to Germany,
1919-33:
Implications for the Third-World Debt Crisis

Stephen A. Schuker

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
PRINCETON, NEW JERSEY

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IN INTERNATIONAL FINANCE

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Library of Congress Cataloging-in-Publication Data

Schuker, Stephen A., 1939-
American "reparations" to Germany, 1919-33.

(Princeton studies in international finance, ISSN 0081-8070 ; no. 61, July 1988)
Bibliography: p.

1. Debts, External—Germany—History—20th century. 2. Investments,
American—Germany—History—20th century. 3. World War, 1914-1918—Rep-
arations. 4. Germany—History—1918-1933. 5. Debts, External—Develop-
ing countries. I. Title. II. Series: Princeton studies in international fi-
nance ; no. 61.

HJ8654.S28 1988 336.3'4'0973 88-12747
ISBN 0-88165-233-4

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Printed in the United States of America by Princeton University Press at Princeton,
New Jersey.

International Standard Serial Number: 0081-8070
International Standard Book Number: 0-88165-233-4
Library of Congress Catalog Card Number: 88-12747

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ACKNOWLEDGMENTS

I wish, first of all, to express my gratitude to Gerald D. Feldman, Carl-L. Holtfrerich, Peter-Christian Witt, and their colleagues in the project on Inflation and Reconstruction in Germany and Europe after World War I for encouraging my research in the field. Feldman kindly arranged for me to present an early version of this work at a conference on *Die Nachwirkungen der Inflation auf die deutsche Geschichte, 1924-1933*, held in 1983 under the auspices of the Historisches Kolleg in Munich. Holtfrerich offered helpful substantive comments on the penultimate draft, as did David Calleo, Robert Dahlberg, Charles Kindleberger, Proctor Reid, and Clemens Wurm. Maria Tatar provided searching stylistic criticism of the final manuscript and accepted my resistance with her usual good humor. Bernard Wasserstein made insightful suggestions regarding the last chapter. Paul Salstrom assisted with bibliographical chores.

Among the archivists and librarians who facilitated my work, I particularly want to thank Renate Köhne-Lindenlaub at Krupp, Horst Wessel at Mannesmann, Lothar Schoen at Siemens, Hermann Weiss at the Institut für Zeitgeschichte, Alice Guillemain at the French Ministère des Finances et de l'Economie, Henry Gillett at the Bank of England, Carl Backlund at the Federal Reserve Bank of New York, Ronald Swerczek at the National Archives, and F. Nathaniel Bunker and Carolyn Fawcett at the Harvard College Library. Support to finance the research came in part from the American Council of Learned Societies, the American Philosophical Society, the Deutscher Akademischer Austauschdienst, a Fulbright-Hayes Western European Area Fellowship, and the Mazer Fund at Brandeis University.

“And now ladies and gentlemen, you will see that I’m really going to tell you a fairy tale. Do you know what Papa said? Papa said: ‘A deal is a deal, and whatever you promise, you have got to fulfill.’”

—Walter Hasenclever, *Der Froschkönig*

“Small debts are like small shot; they are rattling on every side, and can scarcely be escaped without a wound: great debts are like cannon; of loud noise, but little danger.”

—Samuel Johnson

I INTRODUCTION

The Current Debt Problem and the Weimar Precedent

The losses on private investment during the Great Depression of the 1930s had a chilling effect on the world economy. The experience proved so devastating for those who had risked their money abroad that it discouraged lending outside official channels, except among closely allied industrial countries, for a generation and more. Only in the early 1970s did international lending on a massive scale resume. Then, scarcely more than a decade later, a new debt crisis erupted. All but a few of the principal borrowing nations experienced liquidity problems of one sort or another in the early 1980s. Some, despite efforts at adjustment extending over several years, still have not put behind themselves the threat of ultimate insolvency. Yet bankers, and even certain economic analysts, maintain that an examination of traditional debt ratios failed to provide clear warning of the new impending difficulty before 1980. Prudent men could not have foreseen the looming danger to global financial stability, Díaz Alejandro (1984, pp. 342-345) typically contends, except through the application of "nonquantitative, metaphysical insights."

This study deals with one important aspect of the international debt crisis preceding the current one—the cycle of German borrowing and default during the Weimar Republic, 1919 to 1933. It does not aspire to the insights of metaphysics; it relies instead on the humbler tools of historical investigation. All the same, an examination of capital flows and their political context during the Weimar era may offer a useful perspective to the student of contemporary political economy.

Long-term lending took place at that time primarily through the bond market rather than under the aegis of commercial banks. In other respects, however, the parallels are suggestive. Germany rated as the largest single debtor of the 1920s, at first on official account, later on private account as well. The sovereign debt stemming from Germany's reparations obligations, if it were to be paid, would have necessitated an adjustment in the balance of payments analogous to that required of oil-importing nations after the successive energy price increases of the 1970s. Half a century ago, as today, recycling loans that demanded no sacrifice on current account represented the easy way out. Germany was obviously not a developing country. It figured as Europe's locomotive economy and as a pillar of the world monetary system. But that endows the case with potentially greater heuristic value. The Weimar Republic could not hope to act as a free rider in international economic affairs. What it

did about reparations and debt mattered to the world. This study examines the considerations that led Germany to borrow in the United States and elsewhere. It explores the political constraints that inhibited the use of the capital inflow to generate export-led growth. It enlarges on the peculiarly nationalistic response in the Reich to the exogenous shocks that jolted the world economy in 1931. Finally, it traces the country's subsequent descent from moratorium to willful default.

Debt generates controversy. The volume of German foreign borrowing, the deployment of the proceeds, and the domestic policies that made repayment seem infeasible reflected an intensely political process. The shifting configuration of the international economy naturally structured the opportunities open to Berlin policymakers in dealing with their external accounts. At home, the business cycle conditioned the incentives to labor and capital, given the accessibility of foreign resources, to behave as they did in their distributional struggle. Yet if economic forces supplied the motive for borrowing, politics at every point controlled the steering mechanism that led in the 1930s to the breakdown in international payments.

This is not to say that the documentary evidence points to a neat distinction between economic constraints and political choices in Weimar Germany. In almost all disturbances of external indebtedness, policymakers find economics and politics inextricably linked. The latter is superimposed upon the former. The records reflect the confusion or conflation of the two. The borrowing nation necessarily undertakes obligations without knowing what the future holds. But it does know one thing. A market economy must be to some degree unstable; instability is what provides scope for dynamism. The chief political issue may thus be framed: how will the borrower respond when, inevitably, economic circumstances change?

The Cyclical Phenomenon of Debt Delinquency

The pattern of periodic "manias" followed by crashes has proven to be a durable feature of modern capitalism. At least twenty-nine major episodes of varying severity have taken place since the eighteenth century. For almost that length of time, economists have labored mightily to understand the cycle and to explore methods of limiting its excesses (Minsky, Vol. 3, 1972, pp. 95-136; Kindleberger, 1978, pp. 14-24, 253-259). Some "displacement," or change in perceived opportunity, sets off a boom. An expansion of credit and investment at first stimulates a genuine increase in income. Prices and interest rates rise. Then euphoria develops. Speculators no longer evaluate rationally the prospective return relative to risk. They engage in "overtrading." At length, another incident makes clear that the boom has gone too far. A "reversal" takes place against commodities and securities. Banks cease to lend,

and everyone strives at once to increase liquidity. Unless a lender of last resort emerges, a panic may ensue leading to ruinous liquidation.

The pattern, as Kindleberger (1981) demonstrates, applies to international lending as well as to the domestic business cycle. Indeed, because of the inevitable lag in response to events taking place in faraway countries, developments at the financial center tend to produce magnified effects on the flows of money and goods at the economic periphery. External debtors may encounter particular difficulties if real interest rates increase (as a consequence of deflation or disinflation), if additional credit dries up unexpectedly, if commodity prices fluctuate unfavorably, or if export opportunities dwindle following an economic downturn in major markets.

The problem became acute and systemic for the first time in the mid-nineteenth century, as the volume of transnational borrowing rose exponentially relative to loan recipients' income and immediate export capacity. Between 1864 and 1914, foreign investment by the main creditor nations expanded by a factor of 11 (Aldcroft, 1977, p. 239). Kindleberger calls attention to a repetitive cycle of the period: euphoric overlending from Europe overseas, then exogenous shocks leading to suspension of debt service, and eventually re-funding of the defaulted obligations at a discount, coupled frequently with new lending. Present-day economists, noting the ample risk premiums often built into Victorian-era foreign loans, can wax philosophical about the process. Sachs (1982, p. 221) goes so far as to characterize sovereign default before World War I as a "normal and accepted part of the financial system" that "typically did little to interfere with the flow of capital to other LDCs." But few nineteenth-century bondholders' committees, after wearisome negotiations, sometimes stretching over decades, with inefficient, corrupt, and recalcitrant overseas governments, would have affected comparable equanimity.

The dynamics of the lending cycle offer a congenial field for economic inquiry. They afford scope for a fruitful emphasis on practical and quantifiable problems. No wonder economists are frequently drawn to approach the multifaceted issues involved in international debt from the technical side and to treat the political and cultural conflicts that emerge during payments crises as epiphenomena. Given the fluctuations in costs and prices over every business cycle, both creditors and debtors are bound to make miscalculations. One can profitably investigate how to manage the difficulties of an individual debtor so as to minimize systemic risk. One can demonstrate mathematically that, in all but extreme cases, it will pay lender and borrower to adopt a cooperative rather than an adversarial attitude to delinquency. The judgment holds even if it requires the involuntary advance of new funds by the creditor and compensating stabilization adjustments by the debtor in order to keep capital markets open (Sachs, 1982, pp. 211-219; Cline, 1984, pp. 71-93). One can

develop strategies to promote such cooperation. It becomes easier to attain that end when negotiators on both sides recognize the convergent interests of the lender and the solvent borrower. Those convergent interests may even include some latitude for effective creditor retaliation if all else fails, since elimination of that possibility would reduce the debt ceiling for future borrowing and impede the free movement of capital to where returns are highest (Eaton and Gersovitz, 1981).

Analysis along these lines leads naturally to a focus on the role of the lender of last resort. The lender of last resort cannot do much about "overtrading"; if it emerges prematurely with its safety net deployed, it indeed runs the risk of encouraging speculation. But it can help to prevent the temporary illiquidity of a solvent and well-intentioned borrower from leading to bankruptcy during the "revulsion" and "discredit" phases of the cycle. It can thus plausibly hope to shorten economic crises and depressions (Kindleberger, 1978, pp. 161-226).

The argument has embedded itself deeply in contemporary thinking. Received opinion now considers countercyclical lending during economic downturns to be a public good (Sachs, 1984b). No study of international debt can aspire to completeness without a disquisition on the position of the lender of last resort and the techniques it should employ; some analysts so far assume the familiarity of the concept that they refer in acronymic fashion to "LLR responsibility" (Cline, 1984, pp. 119-121; also Wallich, 1982; Guttentag and Herring, 1983; Makin, 1984, pp. 189-192, 227-242). Since its creation at the end of World War II and especially since 1974, the International Monetary Fund, acting both in its own right and as coordinator of other lenders of last resort, has enjoyed considerable success in that role. Adapting the old precept of Walter Bagehot to modern times, it has discounted somewhat less than freely but at considerably less than a penalty rate. Equally important, it has elaborated an institutional framework and fostered a public environment that encourages lenders and borrowers to work together when rescheduling proves unavoidable. All of this marks a sharp departure from pre-World War II experience (Killick, 1982 and 1984; Williamson, 1983).

The Volitional Component in Debt Delinquency

The diminished incidence of open confrontation in rescheduling negotiations since 1945 may account for the lessened interest of economists in the volitional component of debt delinquency. Yet even in the unstable lending environment of the last fifteen years, country-specific risks (including the political and social considerations that affect export and import trends, money-supply growth, and the level of hard-currency reserves) appear to loom substantially larger in most cases than nondiversifiable risks (for example, the changing price of imported oil) (Goodman, 1982). Specialists on the debt

problems of the 1980s tend nevertheless to assume that payments disturbances result primarily from unforeseen economic adversity. Sachs (1982, p. 235) characteristically attributes most reschedulings to a "combination of 'bad luck.'" Lever and Huhne (1986, p. 14) ascribe problems of the debtors both in the 1930s and today to the fact that they are "relatively poor countries, in the grip of economic forces outside their control." Díaz Alejandro (1984, pp. 335-337) concedes the "incompetence and torpor" of policymakers in six key Latin American nations during the early 1980s, but on balance considers them victims of an abrupt change in the "conditions and rules for international lending."

The convention of examining payments disturbances with the politics left out offers one potential advantage. If the parties to a rescheduling negotiate in an atmosphere of ostensible econometric dispassion, they may well find it easier to bridge underlying political differences without dwelling on them. The historical analyst of debt delinquency, however, labors under no compunction to observe similar restraint. He may, without ignoring economic limitations, credibly focus more attention on the element of political volition. The willingness to honor financial commitments in the face of inconvenience or adversity is not a normative value spanning all cultures and historical eras. The record points the other way. A legal framework assuring the security of private property and guaranteeing the sanctity of contract evolved in Western nations only over several centuries as concomitants to the rise of a liberal economic order. During the nineteenth century, the major industrial countries sought to impose on the wider world the legal precept that property could not be seized without fair compensation. But in the best of times international law remains a fragile construct, honored more by lip service than observance. In the twentieth century, the rise of nationalism among borrowing countries has led to an alteration in the perceived balance of legitimacy and to greater world acceptance of "sovereign rights" at the expense of "property rights" (Lipson, 1985, pp. 8-139).

Moreover, law reflects, albeit with a lag, the cruder equation of power. A hegemonic political regime, where the direct or indirect extension of military and commercial dominion accompanies capital flows, encourages borrower compliance with obligations. The relative success of the international system created by Great Britain during the nineteenth century or that orchestrated by the United States more briefly after World War II depended on such linkages. In contrast, a multipolar system, where a defaulting debtor need not anticipate armed retaliation or even the elimination of technology transfer, trade accommodation, or access to alternative capital markets, allows greater maneuvering room for sovereign rights (Gilpin, 1981).

In short, even under favorable circumstances, foreign investment (except among kindred countries with similar values and legal systems) has usually

involved a political hazard on top of normal business risk. When bank economists argued—as astonishingly many did in the heady atmosphere of the early 1980s (see, for example, Porzecanski, 1982, p. 270)—that international lending involves “much less risk” than domestic lending and that Western European economies register higher loan losses than do less developed countries, they were obviously restricting their vision to short-term charge-off data. They could not have taken much account of longer-term evidence. Herbert Feis, whom we shall encounter later in this narrative as the U.S. State Department economic adviser fated to deal with the Weimar default, drew the opposite conclusion from his classic study, still pertinent today, of Europe’s experience as the world’s banker prior to 1914 (1930, pp. 102-103). “A loan to a foreign government is an act of faith,” Feis observed pessimistically. “The financing of an enterprise in a foreign land is hardly less so.” The foreign government might refuse to meet its obligations owing to misfortune, miscalculation, or simple bad intention. In most cases, the investor would find no authority willing or able to pass judgment on the rights of the parties in the face of a “borrowing world inclined to take its debts lightly.”

Who, after all, is to distinguish between circumstances in which it is really impossible for a borrower to meet its international obligations and those in which it merely becomes inconvenient or politically embarrassing for it to do so? The distinction, which Lipson (1985, pp. 48-49) describes as “the crux of laissez-faire economic diplomacy,” has always proven elusive to draw in practice. The willingness to accept sacrifices is not easily quantifiable. It depends on attitudes that cannot readily be externally imposed. J. P. Morgan, in his old-fashioned way, alluded to this very problem when he gave an unexpected lesson on banking principles to the 1913 Pujo Committee investigating the so-called money trust. “Is not commercial credit based primarily upon money or property?” asked the committee counsel. “No, sir,” replied Morgan, “the first thing is character” (Allen, 1935, p. 184; Carosso, 1987, p. 633). That is what the international departments of commercial banks, in their models of country risk, refer to in the argot of the computer age as the “judgmental political indicator” (Heller, 1982, p. 266).

Of course, one must guard against deceptive simplicity. Neither direct nor portfolio investment across frontiers occurs in a vacuum. Investment forms one strand in a more complex pattern of diplomatic relationships. Powerful countries formulate the rules. Weaker countries must conform to them. No wonder the latter often find suspect such rhetoric as “the willingness to accept sacrifices.” On the other hand, world financial institutions have generally evolved—at least since market economies replaced mercantilist ones—to reflect a degree of consensus among participants in the system. That is why prevailing arrangements have frequently broken down when conditions deteriorated to the point where a rough consensus ceased to obtain. In principle, at

least, the international monetary system facilitates trade and exchange across national boundaries for the common good. Its legitimacy and effectiveness rest on the conviction among trading partners that the system offers an equitable basis for international transactions and promotes the fair exchange of resources.

Within this framework, sovereign powers inevitably face diverse temptations to take advantage of the system. Failure to preserve the security of foreign investment by no means exhausts the possibilities. A country can maintain an exchange rate that benefits its exports and employment level at the expense of those abroad. It can impose nontariff barriers of varying subtlety to keep out competitive foreign goods and promote import substitution. In these and analogous cases, the dividing line between aggressive but permissible defense of the national interest and actions that sabotage the larger system often seems exceedingly fine. Unfairness, in other words, is relative. Moreover, accepted standards of international comity shift over time. No nation adhered throughout the Great Depression to gold-exchange-standard rules that precluded the effective management of domestic demand. Significantly, the sort of exchange-rate manipulations that routinely characterized the 1930s (Nurkse, 1944; Howson, 1980) came to appear dangerously destabilizing to the treasury officials who conceived the cooperative monetary regime of the postwar period. Then, by the late 1970s, academics, and ultimately policymakers, began to see new virtues in "managed floating." The norms for regulating direct investment have also undergone a sea change in the last two generations. The difference between ordinary commercial regulation and the expropriation of foreign assets once seemed self-evident. But recently international opinion, or at least the sort of opinion represented by the United Nations, has shown a willingness to tolerate many forms of host-country interference with the operations of foreign firms (including contract renegotiation under duress and limitations on profit repatriation) that have eroded traditional distinctions (Lipson, 1985, pp. 24-27, 85-98).

Still, relativism can stretch just so far. The concept of equity in international transactions may be elusive. Yet, however imprecisely defined, it contributes to the broad sense of trust without which world capital markets cannot function efficiently. Default on international indebtedness frequently involves situations where the case for equity proves reasonably determinable. At times, debt delinquency stems from genuine economic distress. But it also has historically constituted the most serviceable weapon of the weak. It is a method that less powerful sovereign actors in the world economy have often employed successfully to abuse the rules of the game. In effect, those who manage to write down or write off their international debts achieve a cost-free transfer of claims on real resources from those who have produced them to themselves. In the nineteenth and early twentieth centuries, individual

bondholders divided their losses with other borrowers to whom they charged higher risk premiums. In the current environment, commercial bank stockholders seem likely to share their losses with the taxpayers of creditor countries, who, acting through supranational financial intermediaries, add their own advances to those proffered earlier by the banks. Generally, creditors tend to acquiesce in a measure of readjustment because they believe that they stand to gain more from the continued stability of the system than they will lose as a result of a particular failure to repay.

Even before World War I, when creditor nations enjoyed clear political predominance, those detailed to cope with debt delinquency labored in an atmosphere of exasperation and frustration. The British Foreign Office exhibited consistent reluctance to police private loan transactions. Except in cases of outright fraud or when borrowers denied British investors equal treatment, Whitehall preferred to avoid the expenses attendant on intervention in backward countries and to leave sanctions to the market. As Viscount Palmerston put it in 1848, Her Majesty's Government held that "the losses of imprudent men who have placed mistaken confidence in the good faith of foreign Governments would prove a salutary warning to others" and serve to restrict further lending to those "of known good faith and of ascertained solvency" (Platt, 1968, pp. 398-399).

That strategy, however, proved only partially effective. The Corporation of Foreign Bondholders institutionalized delinquency negotiations and obtained some results by barring the obligations of flagrant defaulters from the stock exchange. Yet, in practice, defaulted bonds passed from weak to strong hands; the buyers settled for a fraction of face value; and, in good times, investors in new issues displayed little solidarity with losers on the old. Borrowers succeeded with monotonous regularity in evading repayment; European countries like Portugal and Greece proved scarcely more scrupulous than Guatemala or Peru. Nor did the British government, despite its circumspection, manage always to hold itself aloof. Problems attributable to recalcitrant borrowers obliged it to take over Egypt, to join in extraterritorial administration of the Ottoman debt, and to land forces in Latin America no less than forty times. Other creditors did worse. The French and German governments employed military muscle with less hesitation in local controversies, in part because their investors served more directly as the foot soldiers of imperial advance. Paradoxically, the fortunes of war overwhelmed their defensive maneuvers with catastrophic consequences for their respective national loan portfolios (Platt, 1968, pp. 34-53, 330; Feis, 1930, pp. 102-117, 146-186, 331-341; Rippey, 1959; Sosa-Rodriguez, 1963).

If the period before 1914 witnessed ubiquitous chicanery, no one openly challenged the legitimacy of international property rules. Only certain North American states got away with unvarnished repudiation. After World War I,

in contrast, revolutionary regimes regularly declined to recognize financial obligations incurred by predecessors, even though they hastened to lay claim to the infrastructure built with the proceeds of those obligations. The Bolshevik government in Russia, after some obfuscation concerning alleged counterclaims, repudiated the loans incurred by the Czar.¹ The Turkish regime of Kemal Atatürk hoisted the nationalist banner at Lausanne in 1923 and denounced the capitulations that had protected foreign holders of the Ottoman debt; from its new position of strength it offered only token compensation. The Mexican revolutionary government asserted ownership in its constitution of all subsoil mineral rights, and, after two decades of mounting ill humor, expropriated American oil-company holdings. The People's Republic of China offered no greater accommodation to foreign investors when it overthrew the Kuomintang in 1949 (Lipson, 1985, pp. 66-84; White, 1985; Smith, 1972; Silva Herzog, 1964). Whatever the rhetorical gloss placed on their actions, each of these regimes proceeded on the principle that the assets seized held greater value than continued access to capital markets and foreign technology, at least for the proximate future. Almost always, that calculation proved correct. The cruder forms of military or economic retaliation had now become politically inadmissible. However great the immediate outrage of bondholders or direct investors, defaulting debtor governments invariably regain access to capital markets within a generation, and frequently very much sooner. Bondholders write off their losses. Emotion fades. New exporters emerge within creditor countries eager to promote loans in order to sell their goods.

The rapidity with which adjustment characteristically proceeds following defaults of modest proportions speaks for itself. Individual investors may suffer devastating reverses. Others take their places. Hence countries at the periphery of the world economy can abuse the prevailing rules of credit and exchange without destroying the larger sense of trust that undergirds the monetary system. But what happens if a leading industrial nation disputes the fairness of the reigning political order? What if, in an era of perceived scarcity, a crucial participant in world monetary arrangements seeks to resolve a conflict over distribution of domestic resources through policies that displace the bulk of the sacrifices outward? When a pillar of the system declines to support an equitable burden, the edifice itself cannot stand for long without fundamental redesign. That is what happened in the 1920s as a result of German strategy respecting reparations and external debt.

¹ In 1986, Great Britain resigned itself to the Russian confiscation and accepted derisory compensation. "These bonds are still worth far more on your living room wall or at Sotheby's or Christie's than you would get trying to cash them in," commented one investment banker. The United States subsequently began discussing a mutual waiver of claims on similar terms with the Soviet Union (*New York Times*, July 16, 1986).

Capital Flows under Weimar and Systemic Equilibrium

Scholars have focused considerable attention on the unwillingness of American policymakers to assume a broad mantle of responsibility under the gold-exchange standard of the post-World War I decade. The United States stands indicted for not maintaining a market for distress goods, for not offering countercyclical loans, and for failing to provide adequate discount facilities to countries facing payments difficulties (Kindleberger, 1973). According to the orthodox interpretation, Great Britain could no longer afford to undertake such responsibilities in light of its extended imperial commitments and its mistaken decision to return to a prewar exchange parity that its declining economy could not sustain (Moggridge, 1972). A leadership vacuum supposedly resulted. Whatever the validity of this interpretive structure, it remains incomplete without comparable emphasis on the destabilizing consequences of German foreign economic policy from the 1918 Armistice to the bottom of the Great Depression.

The political and monetary authorities in Berlin could not fully control the three successive stages of violent inflation, relative stabilization, and accelerating deflation that marked the Weimar economy. But insofar as they could make conscious choices, they moved aggressively to draw what benefits they could from prevailing international economic arrangements during all three periods. Regarding themselves as disadvantaged, these policymakers gave relatively little thought to systemic stability. In the short run, they proved remarkably successful in turning their putative weakness to profitable account.

Conventional historiography has focused on the reparations burden imposed on Germany as the result of its World War I defeat and the reputedly harsh financial stipulations of the Versailles treaty. In fact, as this study will demonstrate, the net capital flow ran toward Germany during both the inflation and stabilization phases of the Weimar Republic. Not only did the Reich entirely avoid paying net reparations to its wartime opponents; it actually extracted the equivalent of reparations from the Allied powers, and principally from the United States. Its methods of obtaining that income stream varied from 1919 to 1933. The resources reached Germany through speculation on the mark in the first phase and through a long- and short-term capital inflow (comprising a mix of bond finance, interbank lending, and direct investment) in the second stage. Then, a Standstill agreement that accorded preference to "essential" imports, and ultimately a default on long-term bond debt, sheltered the country from a deleterious reverse flow during the final years of the Republic and the subsequent era of Nazi rule. The gross capital inflow amounted to an astounding 5.3 percent of German national income during the entire period from 1919 to 1931. The net capital inflow, after subtracting

all reparations transferred and making generous allowance for the disguised return of German funds, still came to a minimum of 2.1 percent of national income over the same thirteen years.

This result can be calculated easily enough from balance-of-payments statistics and other familiar data. Yet the existing literature devotes almost no attention to the political implications of the flow of funds in both directions. The most perspicacious German economic historians of the present generation have renounced the phantasmagoric propaganda so often heard in the interwar years and soberly warned against exaggerating the impact on the Weimar economy of reparations actually transferred (Fischer, 1974, pp. 46-47). All the same, the debate continues to turn very largely on the outward flow alone. In a characteristic summation of current scholarly thinking, Krüger (1981, pp. 21-47) contends that even payments of modest magnitude had greater depressing effects on the German economy of the 1920s than would a similar percentage transfer on the rich industrial countries of the present era. After emphasizing the destabilizing effects on Weimar politics of the reparations controversy (quite apart from the figures), Krüger goes on to fault Allied leaders for embracing a zero-sum view of war-cost apportionment rather than the enlightened precept that international cooperation could promote recovery and growth for all. Other observers, like Keese (1967, pp. 66-67), adopt a more extreme position. Given Allied policies, they intimate, the German economy might have performed better if the Reichsbank had kept the discount rate lower in order to promote domestic investment and high employment, and if the country had bypassed American loans and risked an early "transfer crisis" under the Dawes Plan. Analysis along these lines, however, typically does not take full account of the magnitude of the capital inflow and of the role that this stream of payments played in the country's credit base.

The "reparations" to Germany allowed the maintenance of living standards in the Weimar Republic at a level appreciably higher than domestic productivity would have justified. Savings and investment remained notably low compared with either the prewar pattern or the long-term trend. The inflow of funds accommodated increased wages and salaries, even in sectors with lagging productivity gains, and despite the more precipitous decline in the length of the work week in Germany than elsewhere. These funds found reflection also in mounting government welfare expenditures before as well as after the onset of the Depression, in an uneconomic shift to white-collar employment in labor-force composition, and (although precise figures remain a matter for conjecture) in the accretion of German assets abroad that would later help finance Nazi rearmament. In Weimar's middle period, many bond issues were of course initially targeted at productive business investment. But liquid bank credit is fungible, so that given accommodative government policies all lending tends to become, as in this case, general lending. The re-

sult was the opposite of what the architects of the Versailles treaty had hoped to achieve.

How much of what happened stemmed from intentional policy? Did German bankers and statesmen consciously strive to manipulate the international system? Readers must make up their own minds after reviewing the record. From the beginning, virtually all Germans wished to remove the millstone of reparations from their necks. As a popular Berlin cabaret lyric of the early 1920s had it, the Versailles treaty was "only paper." The majority of Germans hoped that, once they had rid themselves of reparations by whatever means, they could go on to eliminate other features of what they viewed as an oppressive and unfair peace. Yet the most Machiavellian of Reichsbank officials would have denied any prior intention to attract private loans and then repudiate them. As Bismarck had put it many years earlier when asked whether he had conceived the strategy of German unification in advance: "It would be a misinterpretation of the spirit of politics to believe that a statesman can formulate a comprehensive plan and determine ahead of time what he is going to do one, two, or three years hence. . . . The statesman is like a man wandering in a forest who knows his general direction, but not the exact point at which he will emerge from the wood" (Friedjung, 1905, Vol. 2, p. 565).

For the most part, Weimar politicians retained a defensive cast of mind. They saw themselves as victims, struggling against long odds for a measure of relief from economically unreasonable foreign claims. In reality, nonetheless, German fiscal and monetary policies played a decisive role in promoting the capital inflow throughout the 1920s. The same apparent contradiction between psychology and policy manifested itself in the crisis of 1931. In that crisis, the Brüning cabinet and the Reichsbank cast about in seeming despair for a lender of last resort. But, by scheming to secure a customs union with Austria and then insisting—against the advice of Finance Ministry professionals—on a premature reparations revision, the government in Berlin had brought the crisis on itself. It thereby helped set in motion the second downward spiral in the Depression that contributed to the breakdown of the gold-exchange standard. The deepening downturn after 1931 further constricted the options open to German policymakers. All the same, this study suggests, the default that took place by stages between 1931 and 1934 occurred for political rather than for strictly financial reasons.

To what extent did the United States, by its own policies, help make that default inevitable? The evidence to be presented here indicates that American tariff legislation, at least during the period when the loans were initially made, did not substantially impede the servicing of German debit balances. Nor did Washington's insistence that the Allies fund their war debts play the deleterious role sometimes attributed to that demand. The magnitude of actual payments remained small, so that the circular flow of funds often held to

characterize the international economy of the 1920s turns out to have been exaggerated. But weak American policy did make it easier for Germany to default. The United States, as the main creditor power, failed to defend its citizens' equity vigorously after 1933 because it favored exporter over bondholder interests. For a variety of reasons Great Britain, the other major world creditor, did not suffer anywhere near the default rate that afflicted American-issued securities during the Depression.

2 HOW GERMANY BECAME INDEBTED TO AMERICA

The Reparations Burden

“Practical men who believe themselves to be quite exempt from any intellectual influences,” John Maynard Keynes once shrewdly remarked (1936, p. 383), “are usually the slaves of some defunct economist.” The observation surely applies to the issue of German reparations after World War I, and the defunct economist in question is none other than Keynes himself. University students of the present day still frequently obtain their initiation into the mysteries of reparations by reading Keynes’s famous polemic against the Treaty of Versailles, *The Economic Consequences of the Peace* (1919). Lekachman (1971, pp. xxii-xxxiv), in what now serves as the standard exegesis introducing that work, castigates the treaty as “vindictive and unworkable” and denounces the “general insanity of the whole reparations system.” Germany was “broke,” he insists; with the best will in the world it could not have paid. Lekachman deems it possible, even plausible, that if the wartime victors had instead framed a generous settlement, canceled reparations and inter-Allied debts, promoted free trade and international cooperation, and spared Weimar the humiliating admission of war guilt, German democracy might have flourished. The hyperinflation that destroyed the mark and the middle classes in 1923 and then the severe Depression of 1929 might never have taken place. Hitler might not have risen to power. World War II might not have occurred. The Nazi death camps might never have existed.

While these propositions continue to form part of the internationalist catechism and thus to command substantial assent among the wider educated public, specialized historians no longer view them as credible.¹ In particular, those scholars who had an opportunity to examine the archives that became available for the first time in the 1970s found little to confirm the simple older view that the Versailles treaty had saddled Germany with an impossible reparations bill (Marks, 1969 and 1978; Maier, 1975; Schuker, 1976; Bariéty, 1977; McDougall, 1978; Trachtenberg, 1980; Silverman, 1982). The conclusions of American experts on the period converge sufficiently so that it has

¹ Note, as an example of the common public view, George Kennan’s formulation in commemoration of a recent Armistice Day: “The vindictive madness of the British and French peace terms; . . . the economic miseries of the postwar years; the foolish attempts to draw the blood of reparations and war debts from the veins of the exhausted peoples of the Continent—all these phenomena . . . assured that only twenty years later Europe would stand confronted with the nightmare of Adolf Hitler and a second vast military conflagration (*New York Times*, Nov. 11, 1984).

become fashionable in professional circles to speak of a "new international history of the 1920s" (Jacobson, 1983, pp. 617-645).

The emerging consensus now holds that the statesmen who assembled at the Paris Peace Conference of 1919 faced a task replete with contradiction. Before the war, Germany had possessed the fastest-growing and most advanced industrial economy in Europe. If the Weimar Republic were unduly hampered in employing its skilled population and material resources productively, the Continent as a whole would not easily recover its prosperity. Stagnant economies might well fall prey to Bolshevism. The European negotiators who pressed for high reparations figures understood this perfectly. On the other hand, they also knew that the expenditures for which they sought recompense had already been incurred. Someone would have to pay for rebuilding the devastated provinces of France and Belgium, for the British ships at the bottom of the sea, and for the widows' and orphans' pensions that would burden state treasuries for the indefinite future.

Clever young men at the British Treasury, as well as the less percipient French finance minister, initially hoped to inveigle the United States into paying for everything through a gigantic recycling loan. But their American counterparts made clear at once that this did not constitute practical politics. In the two years since American belligerency began, the United States had spent or lent the equivalent of 25 percent of its gross national product annually for war purposes. Congress showed no disposition to authorize further appropriations; nor, given the insular nature of the American economy and the small importance of European trade in national accounts, could the administration have made a convincing case for more taxpayer sacrifices, even if it had wanted to do so. American financiers who explored the possibility of private loans on a business basis found the British unwilling to contemplate sharing their South American banking monopoly and the French similarly adamant about keeping restrictionist barriers against U.S. manufactured goods. No basis for a deal emerged. Inevitably, the reparations settlement would have to reflect some reasonable apportionment of reconstruction costs among German taxpayers, investors, and consumers and those of other European countries.

Considerations of military security resulted in an additional economic constraint. The Allies had won a narrow and precarious victory as a consequence of American intervention alone. But the United States lacked a tradition of participation in European affairs. It had no intention of maintaining an expensive standing army capable of renewed deployment on the Continent. Realists did not attach much importance to the prospect of collective security through the fledgling League of Nations. They saw no demonstrable evidence as yet that the emerging Weimar elites would renounce the territorial aspirations of their predecessors. The powers of the Western Entente could not

therefore expect to preserve the balance of power without imposing some limitations on Germany's ability to translate its potential industrial preeminence into political and military hegemony. In short, those entrusted with hammering out the financial and economic terms of peace could hope at best to frame a series of ambiguous compromises that would imperfectly reconcile the exigencies of security and prosperity. The political parameters within which Europeans would have to work out the specific terms of recovery and stabilization appeared narrow from the start.

Keynes (1919, p. 225) would trumpet his indignation against a policy of "reducing Germany to servitude for a generation, of degrading the lives of millions of human beings, and of depriving a whole nation of happiness." The concrete financial stipulations of the treaty, however, did not confirm that prospect. Some French and British financial experts at the Paris Peace Conference had contemplated stratospheric indemnity figures. But in the end caution had prevailed. The negotiators simply provided for interim payments and set up a Reparation Commission that would survey the destruction and report by May 1921 what Germany owed. That procedure set the stage in the meantime for much acrimonious diplomacy. It also militated against private lending or investment while Germany faced an indeterminate liability. Yet it bought precious time for passions to cool.

The 1921 London Schedule of Payments, which set forth Germany's formal obligations for the first time, demanded less than met the eye. The Supreme Allied Council resolved the differences between the unrealistic expectations of the taxpaying public in Allied countries and the actual capacity of Germany to pay through artful obfuscation. The Reparation Commission had not found it possible (in part because of British foot dragging) to collect the statistical information that would allow a scientific determination of Berlin's treaty liability.² Its finding that Germany owed 132 milliard gold marks (in round numbers, \$33 billion) therefore reflected a measure of rough political justice.³ Still, the figure was not an unreasonable first approximation of damages. Moreover, the Supreme Allied Council agreed to divide the nominal total into segments. Germany would have to pay interest and amortization on two bond series totaling only 50 milliard gold marks. That represented the essential burden implied by the London Schedule. Significantly, the sum exceeded by just one-quarter what Keynes (1919, p. 261) had described as a feasible maximum.

In theory, the Reich remained legally responsible for an additional 82

² A. Bemelmans note, Jan. 22, 1921, Folder 204B, Papiers Henri Jaspar, Archives Générales du Royaume, Brussels (hereafter cited as AGR).

³ This study reserves the familiar term *billion* (a thousand millions) for American numeration only. It employs the equivalent *milliard* when referring to European currencies. In the German and British systems of numeration, *billion* means a million millions. To prevent ambiguity, that use is avoided here.

milliards of "C-bonds." In practice, however, the Reparation Commission would issue parts of this latter series only should it become manifest that Germany had grown sufficiently prosperous to service them in addition to its senior obligations. Belgian Premier Georges Theunis joked pointedly that when the commission printed up debentures beginning to bear interest at some indeterminate date in the distant future, it could "stick them in a drawer without bothering to lock up, for no thief would be tempted to steal them."⁴ The C-bonds retained a certain political importance, but mainly as a stratagem to effect a potential redistribution of revenues among the Allies. Louis Loucheur, the brains behind the French cabinet of 1921, suggested hopefully that these pieces of paper could be passed around in ostensible settlement of inter-Allied debt. Britain and the United States, as the end recipients, could then "throw them into the fire when and how [they] pleased."⁵

As a practical matter, the London Schedule committed Germany to pay initially a fixed reparations annuity of 2 milliard gold marks plus a variable addition equivalent to 26 percent of exports. The diplomatic documents contain hints, furthermore, that the Allied negotiators by no means considered that formula sacrosanct. These statesmen might eventually have come down to a flat 3 milliards (the sum necessary to service the two primary series of bonds), although the political process through which they would seek to reconcile their respective constituencies to the reduction remained obscure.⁶ No straightforward way exists to determine the precise weight of the resulting burden on Germany. With prices on a roller coaster since the Armistice, the Reich Statistical Office had nevertheless failed to generate inflation-adjusted figures for national accounts; instead, the government continued to register all transactions according to the illogical legal principle that one paper mark equaled another. The official export figures also understated the true export volume, although no one knew by how much. If, however, one averages the two best retrospective scholarly estimates of national income and accepts the Reparation Commission export figures, it appears that under the London Schedule Germany would have had to pay reparations amounting to 5.37 percent of 1921 national income at factor cost. Upkeep of the occupation armies would have required a budgetary outlay equal to 0.43 percent of national income, but no additional transfer across the exchanges. A similar projection for the postinflationary years, for which the official statistical services generated somewhat better data, indicates that in 1925-29 the London

⁴ "A propos de l'article de M. Tardieu," memorandum of Aug. 30, 1923, in Série Politique, Nr. 10.074, Ministère des Affaires Etrangères et du Commerce Extérieur, Brussels (hereafter cited as BMAE).

⁵ Léon Delacroix note, "Communication de M. Loucheur," Dec. 7, 1921, Classement B, Nr. 366/V, BMAE; also Henri Jaspar note, "Conversation avec Loucheur et Avenol," Feb. 25, 1921, Folder 205, Papiers Jaspar, AGR.

⁶ Theunis to Delacroix, June 2, 1922, Classement B, Nr. 366/VII, BMAE.

Schedule would have imposed a burden of 7.21 percent of national income at factor cost, or 6.63 percent of national income on expenditure account. Occupation armies would have added a levy not exceeding 0.35 percent of national income. If the Allies had at length reduced the annuity to the indicated 3 milliard gold marks, the primary charge would have come down to 4.33 percent of national income at factor cost in 1925-29.⁷

These figures appear relatively high compared with historical examples of actual unilateral transfers. Hitler, of course, offered brutal proof during World War II that it is feasible through direct exploitation to expropriate a quarter to a half of a conquered population's income over a short period; Stalin repeated the demonstration in East Germany after 1945. But extreme cases like those did not involve payments across the exchanges of truly independent nations. Transfers among sovereign states linked in a capitalist trading order have never approached such magnitudes. British external remittances in the wars against Napoleon, for example, amounted to a mere 2.7 percent of national income; American foreign payments in the post-World War II era averaged 3.0 percent and did not exceed 3.5 percent even in the Marshall Plan years. Finally, French reparations to Germany in 1872-75 averaged only 5.6 percent of national income, after briefly peaking at 11.2 percent immediately following the Franco-Prussian War (Machlup, 1964, pp. 374-395).

On the other hand, had the German government summoned the political

⁷ Henning's (1974, pp. 42-63) estimates of national income during the inflation years derive from comparisons with 1913 equivalents of disaggregated production volumes in industry and agriculture, as well as employment in service sectors, as do his supplementary calculations as reported by Holtfrerich (1980, pp. 221-224). Witt (1974, pp. 401, 424-425) generates his figures from tax assessments, using production statistics as a control. The two series diverge for the war years, but they run close together thereafter. The resulting mean must be corrected for the change in gold prices subsequent to the outbreak of the war. That is necessary because Germany, in effect, had to pay the reparations levy in dollars—the only gold currency remaining and the true international standard of value after the end of hostilities. American wholesale prices rose 39.8 percent from 1914 to 1921. These calculations point to a German national income of 55.532 milliard "current gold marks" in 1921.

In 1922, the Allies agreed to cap occupation expenses at 240 million gold marks; army cost figures here reflect that understanding. Acknowledged German exports, according to Reparation Commission figures, totaled 3.777 milliard gold marks in 1921 and averaged 11.520 milliards in 1925-29 (Weill-Raynal, 1947, Vol. 1, p. 655).

German national income from 1925 to 1929 averaged 69.291 milliards at factor cost and 75.369 milliards at market prices (Hoffmann, 1965, pp. 508-509, 826). Theoretically, indirect taxes less subsidies should account for the difference. Actually, the discrepancies between the two calculations—as much as 14.4 percent in 1925-26 and 35.6 percent in 1932—bulk too large for that and remain imperfectly explained. Apparently, employers underreported wages to save on social security charges; in addition, production-side calculations did not fully capture income from secondary occupations during economic downturns. For an introduction to the controversies surrounding these figures, see Hoffmann (1965, pp. 165-170); Holtfrerich (1980, pp. 220-224); and H. A. Winkler (1985, p. 57n).

resolve to reduce domestic living standards enough to generate the appropriate budgetary resources, conditions in the early 1920s offered a propitious setting for effecting the transfer. The Continental recipients of reparations needed to expand economically in order to rebuild their devastated areas. The elasticity of foreign demand for German coal, coke, potash, chemicals, and building materials was accordingly high. And the potential for reducing German luxury imports by plugging the so-called hole in the West remained substantial. Under these circumstances, neither a large secondary compression of German incomes nor a substantial deterioration in the country's terms of trade appeared necessary to carry out the transfer. With good will on both sides, some combination of deliveries in kind, additional general exports, and Allied reinvestment of reparations proceeds in German equities would probably have sufficed to facilitate payment on London Schedule terms, even without the American loans that most Europeans continued to regard as a panacea for their problems. But the requisite good will did not exist. To examine the demand elasticity for German exports more closely has no greater practical relevance than to calculate the number of angels fitted for the head of a pin. The German government accepted the London Schedule with much lamentation and gnashing of teeth, and with a single-minded determination to prove fulfillment impossible. Berlin made only one full quarterly payment—by the transparent expedient of printing paper marks and selling them for hard currency—and thereafter maneuvered from one partial moratorium to another until it declined to provide any further remittances at the end of 1922 (Schuker, 1976, pp. 14-25; Trachtenberg, 1980, pp. 214-289). The grounds for the chaos in German public finance after World War I must be sought elsewhere than in the burden of reparations.

Inflation

War often acts as a spur to economic growth (Milward, 1977, pp. 1-17). But World War I proved so destructive that it diminished the net resources of the principal European belligerents. Paradoxically, that war also increased expectations among the working classes that had fought in the trenches and suffered domestic privation. Each combatant nation underwent an inflation during the war and in the immediate postwar period. Inflation constituted the easiest means by which governments everywhere could meet their own expanded fiscal requirements and at the same time reconcile the conflicting claims of opposed social groups. Suspension of the gold standard and then adoption of a floating-exchange-rate regime after the Armistice removed the previous international constraints on inflation (Nurkse, 1944). The lost war and the ambiguous outcome of the 1918 revolution fostered a situation in which Germany encountered even sharper distributional conflicts than did other industrial countries.

The early years of the Weimar Republic provide a paradigm for Olson's

(1982) dictum that, in a society where well-organized distributional coalitions contend over a national income that is growing too slowly to requite all desires, inflation emerges as the likely result. The day-to-day course of the German inflation depended on subtle interconnections between monetary phenomena and their political setting; for significant periods, depreciation of the paper mark reflected future expectations and therefore ran ahead of money-supply expansion (Webb, 1984). Over the long haul, however, a budget deficit that could not be financed except through the issue of floating debt discounted by the Reichsbank represented the real engine of inflation. The decision to perpetuate that budget deficit turned primarily on politics.

The Weimar coalition (comprising the Socialist, Democratic, and Center parties) sought to promote social stability after the war through a calculated redistribution of income and wealth. Transfer payments reached some 50 percent of the budget in 1919-23. The government extended largesse to veterans, widows, and orphans; to the unemployed, the old, and the disabled; to consumers generally through subsidized food; and to its own lower-level employees through disproportionate salary adjustments. It concomitantly kept the social peace by showering lavish compensation on firms that had lost assets in postwar territorial changes, by awarding lucrative public-works contracts, and by holding raw-material prices and freight rates below market costs. These multiple subventions, open and disguised, dwarfed the charges stemming from the peace treaty. Who would pay the piper? Matthias Erzberger crafted his financial reforms in 1919-20 on the principle that "a good finance minister is the best minister of socialization" (Witt, 1974, p. 414). But Erzberger's attempt to shift from indirect to direct taxation proved technically inept and undercut tax collection altogether. The deficit consequently mounted to almost two-thirds of the budget in fiscal 1921 and reached more than 99 percent of all expenditure in 1923 (Henning, 1974, p. 61; Holtfrerich, 1980, p. 67). In the face of this disaster, each pressure group clung to its political and ideological agenda. The industrial "peak organizations" did not wish to undergo the rigors of a stabilization crisis until they could end the state regimentation of the economy imposed during the war and roll back the gains achieved by labor in 1918-19. Socialist and union forces meanwhile insisted on preserving those gains, as well as the intricate web of government subsidies that complemented and perpetuated them.

Hardly any government officials or business leaders anticipated hyperinflation in 1919. Few originally conceived of currency depreciation as an expedient to produce a sustained current-account deficit and thereby to evade the reparations bill. The tenor of discussion in the Reichsverband der deutschen Industrie (RDI) and in other business forums during the years 1919-20 indicates that most of those who guided the economic destinies of the Reich at that juncture both hoped and believed that the mark would eventually stabi-

lize.⁸ The artful Walther Rathenau, head of the giant electrotechnical trust AEG, frankly warned his American competitors in mid-1920 that he intended to take advantage of the mark's depreciation and the resulting low labor costs in dollar terms in order to reconquer export markets; a few months later, he insisted to a government committee that the currency presses should, if necessary, turn even faster to keep unemployment under control.⁹ Yet for every Rathenau, who early understood the logic of the inflationary process and positioned his firm to profit from it, there was at least one traditional businessman like Gustav Krupp von Bohlen und Halbach who neither grasped nor approved what was happening.¹⁰ The prevailing climate of opinion changed radically, however, after the imposition of the London Schedule of Payments in May 1921.

Government officials ritually proclaimed that so long as the trade balance remained passive—with a seemingly insurmountable deficit on merchandise account—there was nothing they could do about the external depreciation of the mark. Yet the economic sophistication displayed in ministerial discussions improved so markedly after the inflation ended that it passes credence to believe that policymakers were as confused about cause and effect as they frequently professed to be.¹¹ In fact, both the Reparation Commission and the financial experts whom the Berlin authorities consulted independently repeatedly advised that the central problem lay in the budget deficit. A considerable body of evidence suggests that, from the adoption of the London Schedule through the final collapse of the mark in the summer of 1923, the Wirth and Cuno cabinets more or less deliberately postponed balancing the budget and stabilizing the currency for foreign-policy reasons. They hoped that seeming monetary chaos would bring a reduction or an end to Allied reparations claims. The Reichsbank, as well as certain key opinion makers from industry and the private banks, supported this ordering of priorities (Schu-

⁸ See, for example, Vorstandssitzungen des Reichsverbandes der deutschen Industrie, Nov. 21, 1919 and June 9, 1920, respectively in P 8 25 27.3 and P 8 25 27, Historisches Archiv, Mannesmann-Aktiengesellschaft, Düsseldorf; also Handelskammer Nürnberg to Staatsministerium für Handel, Industrie und Gewerbe, Jan. 29, 1920, MA 103850, Bayerisches Hauptstaatsarchiv, Munich (hereafter cited as BHStA).

⁹ Report of Anson W. Burchard to C. A. Coffin et al. on meeting with Rathenau in Basel, Aug. 28, 1920, Box 6-16, Owen D. Young Papers, Van Hornesville, N. Y.; "Vermerk über eine Besprechung im Auswärtigen Amt am 24. Januar 1921 über die Frage des sogenannten Indexschemas," R2/3216 (Reichsfinanzministerium), Bundesarchiv, Koblenz (hereafter cited as BA).

¹⁰ On the failure of the Krupp firm to position itself for inflation, see files WA VIII 1081 (Finanzgebarung) and FAH IVE 10 (Wilhelm Berdrow, "Die Firma Krupp im Weltkrieg und in der Nachkriegszeit"), Historisches Archiv, Fried. Krupp GmbH, Essen.

¹¹ See, for example, Finance Minister Rudolf Hilferding's testimony to the Reichsrat and the ensuing discussion, in Ministerialrat Seyboth (Staatliche Bayerische Wirtschaftsstelle) Nr. 3323 to Staatsministerium des Äußern, Oct. 3, 1923, MA 103854, BHStA.

ker, 1978; Specht, 1982). The argument has not proven universally persuasive (Holtfrerich, 1980, pp. 135-154; Kindleberger, 1984, pp. 10-33; Webb, 1985). Economists tend to express skepticism when faced with assertions that governments adopt self-defeating policies on nationalistic grounds. Moreover, some problems with the interpretation remain unresolved. The inclination to calculated lethargy did not apparently percolate far down the bureaucracy; at least one middle-level Economics Ministry bureaucrat of proven veracity subsequently denied having heard of an explicit decision along these lines.¹² All the same, it is reasonable to assume that politicians, however devious on the hustings, usually mean what they say in secret planning meetings. One must therefore attribute significance to Chancellor Wirth's declaration in January 1922 that capital taxation would be a mistake because it would "render the [London] Ultimatum about 80 percent bearable." One ought similarly to take at face value Chancellor Cuno's private confession in July 1923 that "naturally the wish had been to deal with reparations first and clean up the tax problem afterward."¹³

Up to the summer of 1922, Berlin's inflation policies resulted in an enormous and virtually cost-free net capital inflow deriving from the depreciation of foreign-held mark bank balances, paper currency, and mark-denominated securities. This phenomenon attracted wide attention in the financial press of the period, although it did not temper the rhetoric emanating from German government offices about the magnitude of the reparations load.¹⁴ Even if contemporaries differed about the size of the inflow, it demonstrably bulked large enough to cover all reparations paid in cash and kind, a substantial and continuing import surplus, and the export of some German capital to safe havens abroad. Precise figures will be reserved for later discussion. No outcome, however, could present more of a paradox. Since the war's termination, a procession of official and private emissaries from the Reich had cooled their heels disconsolately in the antechambers of Wall Street. The New York investment bankers had repeated as if by rote that they could lend no money until the mark was stabilized. Yet in the last analysis, through the back door, Germany obtained far more in real resources than it could ever have aspired to secure through bond flotations.

¹² See Hans Schäffer's unpublished review of Leopold Schwarzschild's *World in Trance* (1942), Sept. 20-21, 1943, in ED 93, Bd. 48, *Tagebuchaufzeichnungen und andere Papiere Staatssekretärs Dr. Hans Schäffer*, Institut für Zeitgeschichte, Munich (hereafter cited as NL Schäffer, IFZ).

¹³ Wirth comment in "Besprechung mit Parteiführern vom 9. Januar 1922," in BA, Alte Reichskanzlei, R431/2393, also in ARK Wirth (1973, Vol. 1, pp. 507-509); Cuno remarks to his banking advisers in Notiz Warburg, Aug. 1, 1923, in *Nachlaß Max Warburg*, Bd. 157a, Brinckmann Wirtz & Co., Hamburg.

¹⁴ On the mechanism behind the capital inflow, see Holtfrerich (1977b); for contemporary press discussion, note J. M. Keynes, "Speculation in the Mark and Germany's Balances Abroad," *Manchester Guardian Commercial*, Sept. 28, 1922, in Johnson (1978, pp. 47-55).

Surprisingly, the exchange-rate profits from inflation seem to have figured more as a by-product than as a prime motive for Berlin's policy choices. Neither Wirth nor Cuno proved amenable to stopping the inflation even after foreigners ceased to believe that the mark would recover its value and when, as a result, the capital inflow sputtered to an end. Instead, German leaders hazarded the final collapse of the currency by breaking with the tactic of fulfillment and risking a Ruhr occupation as part of a general revolt against the Versailles treaty. German strategy during the Ruhr crisis of 1923 reflected the tradition, dating back to Bismarck, of the *Primat der Außenpolitik*. It emphasized foreign-policy objectives over prudential considerations of public finance.

Stabilization and Social Conflict

Stabilization after hyperinflation is characteristically fraught with peril. The end of the German inflation in November 1923 led to an acute capital shortage. During the final stages of the old currency's collapse, neither businesses nor households retained appreciable cash balances. Afterward, working capital became difficult to obtain. The Reichsbank had to maintain a tight hold on credit for fear of reigniting inflation, and the traumatized domestic banks charged a substantial risk premium for such funds as they could make available. Capital markets remained subject to prolonged maladjustment (Diehl, 1932). Under the circumstances, numerous politicians, particularly on the right of the political spectrum, fell back on familiar habits and continued to attribute the country's economic difficulties at least partly to Allied rapacity. They found a receptive audience, not only in the dispossessed *rentier* class, which received meager compensation in the token revaluation of old debts, but among all the diverse groups (for example, upper-level civil servants, skilled craft workers, landlords, and small businessmen) whose social fortunes had deteriorated as a consequence of the decade-long inflation and the precipitate stabilization. The millions who felt that the political process and the workings of modern industrial society had failed them were tempted to project their diffuse resentment on the foreigner (Childers, 1983, pp. 50-118; L. E. Jones, 1985; Hughes, 1981).

Actually, however, the Dawes Plan, which came into operation in September 1924, shielded the German economy from large reparations demands during the projected recovery period. The plan emanated from an inter-Allied committee of experts charged with adjusting the reparations annuity to German capacity to pay. As modified at the political level, it bore witness to the weakened position of France—the most obdurate as well the largest reparations creditor—after the Franco-Belgian occupation of the Ruhr failed of its purpose. Even more significant, its terms reflected the disinclination of international bankers to lend the money to initiate the scheme unless Germany obtained relief from that deleterious combination of financial uncertainty and

military menace that had earlier helped destabilize the country's external accounts (Schuker, 1976, pp. 171-382; Bariéty, 1977, pp. 292-747).

The Dawes Plan sheltered the Reich government from an immediate budgetary drain. During the first two years, modest payments would come exclusively from interest on railroad and industrial bonds and from a small transport tax. After that, the direct claim on government coffers would phase in slowly. In the event, as a result of a complex accounting agreement that stretched out later remittances, Berlin provided an initial budgetary contribution of 300 million Reichsmarks (RM) as early as October 1926 (4.2 RM, the new currency, equaled \$1). But the budgetary burden did not rise to 1 milliard RM before calendar 1929. Furthermore, the lion's share of all payments, totaling no more than 3.13 milliard RM through August 1927, went for occupation armies and deliveries in kind. Cash transfers made by the Agent General for Reparation Payments amounted to a bare 330 million RM up to that date (Reparation Commission, 1927; Agent General, 1925-27). Reparations, therefore, could scarcely account in a significant way for the recurring problems of German public finance after stabilization, nor for the resumption of import surpluses on a large scale. (The merchandise deficit, attributable more to a rush of imports than to faltering export performance, reached 2.4 milliard RM in the first Dawes year alone.) Tables 1 and 2 indicate the true magnitude of the budgetary drain and of reparations outpayments compared with other government commitments.

The complex difficulties of the German economy in the postinflationary years—fitful and unstable growth, persistently high unemployment, and malfunctioning capital and labor markets in addition to the chronic inability of public authorities at all levels to find revenue to match their ambitions—did not stem from the external burden. Instead, these difficulties derived from the familiar distributive conflicts that had troubled the social polity since the war. The dispute over the origin of Weimar's economic problems commands more than narrow scholarly interest in the contemporary Federal Republic. As the *Wirtschaftswunder* yielded to economic stagnation in the late 1970s, business and union circles, and even the popular press, turned to earlier precedents and began to lavish attention on matters that habitually remain within the province of the specialist.¹⁵ Borchardt (1982, pp. 165-224) and Balderston (1982), among others, have examined many of the fundamental economic issues of the later 1920s with such authority that it is feasible to treat the subject in relatively brief compass here.

In real terms, German national income did not surpass the 1913 level until 1927 (see Table 3). But expectations grew much faster. Even if no reparations transfer had taken place, the nation's productive capacity would not have suf-

¹⁵ See, for example, the frequent references to the question in the *Frankfurter Allgemeine Zeitung* (e.g., Borchardt, 1983; Holtfrerich, 1986).

TABLE 1
 GERMAN NATIONAL INCOME, ITS INTERNAL DISTRIBUTION, U.S. LENDING TO EUROPE, AND REPARATIONS OUTPAYMENTS, 1925-30
 (in milliards of gold marks/Reichsmarks, 4.2 RM = \$1)

| Year | German National Income ^a | Government Revenues (All Levels) | Reparations Outpayments ^b | U.S. Lending ^c to Germany/ to Europe | Pretax Income-Distribution Shares ^d | | | NNP Deflator ^h |
|------|-------------------------------------|----------------------------------|--------------------------------------|---|--|-------------------------------------|-------------------------------|---------------------------|
| | | | | | Agricultural Enterprises ^e | Industrial Enterprises ^f | Wages / Salaries ^g | |
| 1913 | 48.8/52.4 | 7.0 | — | | 6.5 | 11.2 | 23.3 | 100 |
| 1925 | 58.6/67.3 | 12.9 | 0.884 | 1.294/5.603 | 5.7 | 11.8 | 35.0 | 143.6 |
| 1926 | 57.6/65.5 | 14.7 | 1.108 | 1.739/3.066 | 5.8 | 12.8 | 36.1 | 140.5 |
| 1927 | 72.0/80.5 | 17.1 | 1.379 | 1.315/3.520 | 5.9 | 13.8 | 41.7 | 151.5 |
| 1928 | 78.2/84.0 | 18.7 | 1.815 | 1.772/4.318 | 5.8 | 13.9 | 44.6 | 155.6 |
| 1929 | 80.1/79.5 | 18.9 | 2.149 | 0.124/0.596 | 5.5 | 13.5 | 45.8 | 153.8 |
| 1930 | 72.9/71.9 | 18.8 | 0.861 | 0.701/0.978 | 5.0 | 10.3 | 41.2 | 145.8 |

SOURCES: Hoffmann (1965); Jostock (1955); Brown (1940); Agent General (1930); League of Nations (1931); League of Nations (1932).

^a Net social product (national income) at factor cost in current prices/national income at market prices. Figures as cited by Hoffmann (1965, pp. 508-509, 826); alternative series for German national income show some small variations.

^b German figures (slightly different from those of the Agent General). Includes reparations in kind, but excludes amounts spent in Germany for occupation armies and commissions, as well as the sum raised abroad in 1930 through the Young loan for reparations account.

^c U.S. capital issues for, and foreign investments in, Europe, not counting trade, short-term loans, or currency transactions. 1924-28 figures, from Brown (1940, Vol. I, p. 586), include refunding. 1929-30 figures, from League of Nations (1931, pp. 320-331), do not include refunding.

^d Major shares only.

^e Income of agricultural enterprises.

^f Income of industrial enterprises.

^g Income from wages and salaries.

^h 1913 = 100.

TABLE 2

GERMAN PUBLIC FINANCE, 1924-30: CONSOLIDATED BUDGET STATEMENTS OF THE REICH
(in millions of Reichsmarks)

| | 1924-25 | 1925-26 | 1926-27 | 1927-28 | 1928-29 | 1929-30 ^a |
|--|------------------|--------------|--------------|--------------|--------------------|----------------------|
| Current revenues: | | | | | | |
| Tax revenues | 7,322 | 6,856 | 7,175 | 8,490 | 9,025 | 9,096 |
| Administrative revenues | 435 | 478 | 515 | 471 | 626 | 815 |
| Industrial charge | — | — | — | — | — | 150 |
| Total revenues | <u>7,757</u> | <u>7,334</u> | <u>7,690</u> | <u>8,961</u> | <u>9,651</u> | <u>10,061</u> |
| Current expenditures: | | | | | | |
| Tax transfers to states and communes | 2,270 | 2,596 | 2,626 | 3,016 | 3,413 | 3,299 |
| General administration | 1,521 | 1,884 | 2,156 | 2,296 | 2,401 | 2,399 |
| Public-debt service | 450 | 262 | 421 | 512 | 502 | 673 |
| Charges arising out of the war: | | | | | | |
| Execution of Dawes Plan | — | 291 | 550 | 899 | 1,220 | 665 |
| Execution of Young Plan | — | — | — | — | — | 410 |
| Internal charges ^b | 2,108 | 1,513 | 1,496 | 1,560 | 1,915 | 1,752 |
| Social expenditure | 259 | 507 | 811 | 766 | 1,101 | 1,345 |
| Investments, loans, etc. | <u>112</u> | <u>391</u> | <u>483</u> | <u>267</u> | <u>334</u> | <u>305</u> |
| Total expenditure ^c | <u>7,220</u> | <u>7,444</u> | <u>8,543</u> | <u>9,316</u> | <u>10,888</u> | <u>10,846</u> |
| Current surplus/(deficit) | 537 | (110) | (853) | (355) | (1,237) | (785) |
| Transfers from previous years: | | | | | | |
| Surplus/(deficit) brought forward from previous years ^c | — | 672 | 782 | 259 | 217 | (704) |
| Transfers from special working fund | — | — | — | 190 | 62 | — |
| Surplus/(deficit) after fore- going transfers ^c | 537 | 562 | (71) | 94 | (959) | (1,489) |
| Proceeds of loans issued or authorized | 355 | — | 329 | 123 | 101 | 1,192 |
| Cumulative surplus/(deficit) indicated in the accounts ^c | 892 ^d | 562 | 258 | 217 | (859) ^e | 298 ^f |

SOURCES: Agent General (1930); Harris (1935, p. 99). For additional detail on the carry-forward of surpluses, deficits, and loan authorizations, see the former publication.

^a Estimates.

^b Includes war pensions and other outlays that shade into social expenditure.

^c Differences result from rounding off.

^d Of this surplus, 672 million was transferred to 1925-26 and 220 million to 1926-27.

^e Of this deficit, 704 million was transferred to 1929-30 and 154 million was rolled forward to 1930-31.

^f This does not include the 154 million rolled forward to 1930-31, nor the cumulative "extraordinary budget" deficit of 1,192 million, which was covered only by a loan authoriz-

ficed to satisfy all domestic claimants on existing resources. The precarious political balance made it difficult to impose discipline on special interests. And while the Dawes Plan offered a breathing space for reparations transfers, it tied Germany into the international economy immediately. The plan's banking stipulations required the Reichsbank to maintain adequate reserves to preserve the currency's exchange value under a fixed-rate system. The gold-exchange standard in effect precluded resort to devaluation as a method for lowering real wages and other costs to a competitive level. Nor could Berlin force the pace of economic activity through monetary expansion beyond a certain point without incurring the Agent General's displeasure.

Hardach (1976) contends that these international commitments led the Reichsbank to follow an unduly restrictive discount policy and hence exerted an inexpedient deflationary pressure on the economy. Yet it is hard to see how Reichsbank President Hjalmar Schacht could have followed any other course. In light of the experience of hyperinflation, both domestic and foreign holders of liquid assets remained skittish. They stood prepared to export short-term funds at the first signs of relaxation. As Hardach concedes, when Schacht experimented with a lower discount rate in early 1927 and again in 1929, the reserve ratio fell alarmingly. Moreover, while Schacht frequently mounted the verbal barricades against inflation, he did not keep as tight a rein on money creation as often supposed. The broad money supply grew at an annual rate of 16.2 per cent from 1924 to 1930, and even high-powered money increased by 9.2 per cent annually until the end of 1927, though it backed and filled thereafter. In 1927-28, officials on the Agent General's staff became preoccupied by what they considered excessive credit growth; Shepard Morgan, the third in command, commented acidulously that, in the absence of bank reserve requirements, the rate of monetary expansion was limited only by "the consciences of bankers, which are elastic" (James, 1985, pp. 43-44, 54-55, 364-368).

This complaint cannot be dismissed as a mere indicator of fusty conservatism at the Luisenstraße. In part because of monetary policy, which accommodated growing deficits in both federal and local government budgets, German prices increasingly diverged from international trends as the decade progressed. Between 1925 and 1929, consumer prices rose by 8.5 percent in Germany, while they fell by 2.3 percent in the United States. Owing to a remarkable spurt of rationalization, wholesale prices fell everywhere during that period, but only 3.2 percent in Germany, compared with 8.0 percent in America. At the same time, German export prices declined only 1.7 percent, compared with 12.8 percent in the United States and 10.7 percent in industrial Europe as a whole (Bureau of the Census, 1960, pp. 117, 125; Bry, 1960, pp. 406-410; Lipsey, 1963, pp. 143, 418; Hoffmann, 1965, p. 606). If anything, the loss of German competitiveness loomed larger than those figures imply. A fall in German agricultural prices masked a sizable increase in labor-

TABLE 3
DISTRIBUTION OF GERMAN NATIONAL INCOME AT MARKET PRICES, 1899-1959
(in millions of marks in constant 1913 prices)

| Year | Private Consumption ^a (1) | Net Invest- ment (2) | Public Expendi- ture (3) | Capital- Account Balance ^b (4) | National Income at Market Prices (1-4) (5) | Current- Account Balance ^c (6) | National Income at Market Prices (1-3 + 6) ^d (7) |
|------|--|-------------------------------|-----------------------------------|--|---|--|--|
| | | | | | | | |
| 1899 | 28,837 | 6,010 | 2,723 | 400 | 37,970 | - 710 | 36,860 |
| 1900 | 28,825 | 5,330 | 2,941 | 426 | 37,522 | - 630 | 36,466 |
| 1901 | 29,168 | 4,470 | 3,026 | 448 | 37,112 | - 467 | 36,197 |
| 1902 | 29,841 | 4,060 | 3,055 | 580 | 37,536 | - 88 | 36,918 |
| 1903 | 31,029 | 5,890 | 3,138 | 482 | 40,539 | 75 | 40,132 |
| 1904 | 31,857 | 6,630 | 3,298 | 677 | 42,462 | 478 | 42,263 |
| 1905 | 32,434 | 6,710 | 3,580 | 1,457 | 44,181 | 622 | 43,346 |
| 1906 | 32,641 | 7,040 | 3,883 | 527 | 44,091 | 735 | 44,299 |
| 1907 | 34,208 | 7,740 | 4,019 | 153 | 46,120 | 214 | 46,181 |
| 1908 | 35,566 | 6,020 | 4,025 | 579 | 46,190 | 799 | 46,410 |
| 1909 | 35,901 | 6,700 | 4,281 | 439 | 47,321 | 630 | 47,512 |
| 1910 | 35,400 | 6,610 | 4,258 | 796 | 47,064 | 1,189 | 47,457 |
| 1911 | 36,699 | 7,830 | 4,301 | 683 | 49,513 | 818 | 49,648 |
| 1912 | 38,254 | 8,590 | 4,577 | 453 | 51,874 | 493 | 51,914 |
| 1913 | 38,202 | 8,170 | 5,129 | 939 | 52,440 | 939 | 52,440 |
| 1925 | 37,471 | 5,380 | 5,804 | - 1,229 | 47,426 | - 1,758 | 46,897 |
| 1926 | 36,917 | 3,300 | 6,132 | 1,142 | 47,491 | 238 | 46,587 |
| 1927 | 41,919 | 8,070 | 6,381 | - 1,700 | 54,670 | - 3,262 | 53,108 |
| 1928 | 42,527 | 6,880 | 6,686 | - 157 | 55,936 | - 2,143 | 53,950 |
| 1929 | 42,154 | 3,550 | 6,565 | 294 | 52,563 | - 575 | 51,694 |
| 1930 | 40,400 | 2,790 | 6,496 | 1,022 | 50,708 | - 397 | 49,289 |
| 1931 | 39,030 | - 1,360 | 6,321 | 1,241 | 45,232 | - 78 | 43,913 |
| 1932 | 38,160 | - 680 | 6,277 | 325 | 44,082 | - 1,997 | 41,760 |
| 1933 | 39,600 | 2,310 | 7,720 | 199 | 49,829 | - 2,255 | 47,375 |
| 1934 | 42,072 | 3,250 | 9,774 | - 515 | 54,581 | - 2,994 | 52,102 |
| 1935 | 42,289 | 5,790 | 12,367 | - 94 | 60,352 | - 1,788 | 58,658 |
| 1936 | 42,895 | 7,260 | 15,691 | 380 | 66,226 | | |
| 1937 | 45,434 | 11,200 | 16,253 | 280 | 73,167 | | |
| 1938 | 47,244 | 11,950 | 22,461 | - 320 | 81,335 | | |
| 1950 | 30,779 | 6,970 | 7,811 | - 543 | 45,017 | - 656 | 44,904 |
| 1951 | 31,915 | 7,290 | 8,277 | 2,343 | 49,825 | 830 | 48,312 |
| 1952 | 34,541 | 7,580 | 9,074 | 2,144 | 53,339 | 465 | 51,660 |
| 1953 | 37,673 | 7,380 | 9,071 | 3,055 | 57,179 | 607 | 54,731 |
| 1954 | 40,419 | 9,900 | 9,579 | 2,810 | 62,708 | - 164 | 59,734 |

Continued on next page

Table 3—Continued

| Year | Private Consumption ^a (1) | Net Investment (2) | Public Expenditure (3) | Capital- Account Balance ^b (4) | National Income at Market Prices (1-4) (5) | Current- Account Balance ^c (6) | National Income at Market Prices (1-3 + 6) ^d (7) |
|------|--|--------------------------|------------------------------|--|---|--|--|
| 1955 | 43,676 | 12,620 | 9,769 | 2,104 | 68,169 | -1,309 | 64,756 |
| 1956 | 47,538 | 12,240 | 9,890 | 3,664 | 73,332 | -457 | 69,211 |
| 1957 | 50,274 | 11,920 | 10,313 | 4,422 | 76,929 | -716 | 71,791 |
| 1958 | 52,693 | 11,290 | 11,362 | 4,020 | 79,365 | -2,262 | 73,083 |
| 1959 | 56,240 | 13,420 | 12,558 | 2,465 | 84,683 | -3,692 | 78,526 |

SOURCE: Hoffmann (1965, Table 249).

^a Excluding government-purchased services.

^b Including gold and foreign-currency balance + balance of unilateral transfers (including reparations).

^c Excluding reparations.

^d National-income figures in column 5 differ from those in column 7 except for the base year 1913. When items in the balance of payments are disaggregated and then deflated individually, the current-account balance (the net of goods and services + factor income from abroad) no longer is the reciprocal of the capital-account balance (capital movements + net gold and foreign exchange + unilateral transfers), which it is by definition when calculated in current prices. The column 5 figure, but not the column 7 figure, includes as part of national income the value of reparations transferred.

intensive finished-goods prices included in the wholesale index. Germany's ability to sell manufactured products abroad at a gain diminished accordingly. Notwithstanding severe profit compression, German finished-goods export prices rose 1 percent in 1925-29, while the export prices of U.S. manufactures fell 11.5 percent over the same period (Balderston, 1982, pp. 499-500; Lipsey, 1963, p. 143; Hoffmann, 1965, p. 606). Under these circumstances, the path of least resistance was for Germany to finance its seemingly intractable current-account deficit by drawing in resources from the rest of the world through loans.

The perception that Germany was living beyond its means in the later 1920s does not, however, rest on consideration of the current account alone. A number of concordant measures indicate that social changes under the Weimar Republic had a deleterious effect on economic activity. The individual statistical series for the period reveal minor inconsistencies that make them hard to reconcile precisely with each other, but the general magnitudes they suggest point only one way.

At the postwar recovery high in 1928, real national income at market prices reached a mere 102.9 percent of the 1913 level (see Table 3). What perpetuated this stagnation in an era of general (if unequally distributed) world pros-

TABLE 4
DISTRIBUTION OF GERMAN NATIONAL INCOME SHARES, 1913, 1925-31 ^a
(in percent)

| Sources of Private Income | 1913 ^b | 1925 | 1926 | 1927 | 1928 | 1929 | 1930 | 1931 |
|--|-------------------|-------|-------|-------|-------|-------|--------|--------|
| Wages and salaries | 45.3 | 56.3 | 55.5 | 54.9 | 56.5 | 56.6 | 56.4 | 57.9 |
| Business and commerce | 20.1 | 18.2 | 17.3 | 17.0 | 16.2 | 15.5 | 14.2 | 13.2 |
| Agriculture and forestry | 12.5 | 9.5 | 9.3 | 8.4 | 7.7 | 7.6 | 7.4 | 8.2 |
| Invested capital | 12.5 | 2.0 | 2.5 | 3.0 | 3.7 | 4.2 | 4.6 | 5.3 |
| Rents and leases | 2.0 | 0.9 | 1.0 | 1.1 | 1.1 | 1.1 | 1.3 | 1.6 |
| Pension and government transfers | 3.0 | 9.2 | 11.4 | 10.5 | 11.2 | 12.0 | 14.3 | 17.6 |
| Adjustments: | | | | | | | | |
| Employer social security contributions | 1.1 | 2.1 | 2.6 | 2.7 | 3.0 | 3.2 | 3.4 | 3.9 |
| Other adjustments ^c | 5.2 | 8.2 | 8.9 | 10.2 | 9.0 | 9.1 | 9.6 | 6.5 |
| Double counting owing to transfer payments | (1.7) | (6.4) | (8.5) | (7.8) | (8.4) | (9.3) | (11.2) | (14.2) |

SOURCE: Statistisches Reichsamt (1932a, p. 84).

^a Figures before direct taxes. Depreciation rules changed from the prewar to postwar period, slightly affecting national-income shares.

^b Adjusted to reflect postwar territorial changes.

^c Undistributed profits, income of public enterprises, and taxes not included in private income.

perity? Part of the explanation must lie in the fall of savings and investment. Between 1899-1913 and 1925-29, Germany's *ex post* private-sector savings ratio declined from 15.5 percent to 8.6 percent, and its net investment rate dropped from 14.8 to 10.5 percent (Balderston, 1982, p. 490; Hoffmann, 1965, p. 828; also Table 3). These developments in turn reflected a striking alteration in the distribution of income away from those who had done most of the saving and investing before the war. Table 4 bears eloquent witness to the destruction of the *rentier* class during the inflation and to the painfully slow reaccumulation of investment capital thereafter. It demonstrates also that the relative position of business and agriculture continued to deteriorate steadily after the return to currency stability. And it shows that wage and salary earners managed to hold all their inflation-era gains, while recipients of government support payments radically increased their share of the pie. Table 5 examines the same phenomenon from the point of view of the individual wage earner or pensioner. It makes clear that, until 1931, most of those in both categories made steady real advances despite the vicissitudes of the economy. Finally, the comparison in Table 1 above of reparations outpayments with the absolute size of some major income shares reinforces the conclusion that the indemnity did not exacerbate the country's capital shortage as much as did domestic income redistribution.

Holtfrerich (1984, pp. 121-141), among others, disputes the simple view that wage gains disproportionate to productivity, secured by the application of Socialist and union muscle, supplies the key to Germany's faltering economic performance. But the most sophisticated business strategists at the time acknowledged that the growth in the ratio of white-collar personnel to production-line operatives, mandatory social-welfare contributions, and

TABLE 5
RELATIVE CHANGES IN GERMAN PRICES, WAGES, SALARIES, AND PENSIONS, 1925-31
(percentage change from previous year)

| | 1925 | 1926 | 1927 | 1928 | 1929 | 1930 | 1931 |
|---|------|-------|------|------|-------|-------|--------|
| NNP deflator | — | (2.2) | 7.8 | 2.7 | (1.2) | (5.2) | (8.8) |
| Wholesale prices | 3.3 | (5.2) | 2.3 | 1.9 | (2.0) | (9.2) | (11.0) |
| Cost of living | 8.5 | 0.2 | 4.0 | 2.6 | 1.5 | (3.8) | (8.2) |
| Gross employee compensation | 19.8 | 11.8 | 6.1 | 13.8 | 6.4 | (1.7) | (7.2) |
| Hourly wages in manufacturing | — | 6.6 | 9.7 | 11.1 | 5.9 | (2.8) | (7.6) |
| Public-sector salaries | — | 1.5 | 9.8 | 10.3 | 0.7 | 0.7 | (11.6) |
| White-collar employees' private-sector salaries | — | 8.5 | 4.6 | 7.5 | 3.3 | 0.4 | (3.2) |
| Disability pensions | 55.0 | 22.7 | 8.9 | 11.4 | 11.0 | 3.8 | 0.5 |
| Widows' pensions | 36.5 | 18.6 | 18.0 | 21.8 | 5.3 | 7.4 | (6.7) |

SOURCES: Bry (1960, pp. 406-416); Hoffmann (1965, pp. 487, 601, 825-828); Skiba (1974, p. 194); Witt (1985, p. 85).

management's inability to motivate mass-production workers to labor with the intensity of their American counterparts hurt profit margins quite as much as did soaring contract wage rates.¹⁶ The current academic controversy on this subject turns partly on definitions (Borchardt, 1982, pp. 165-182; H. A. Winkler, 1985, pp. 46-75; Balderston, 1985, pp. 168-176; James, 1986, pp. 190-245). From an international point of view, it is of secondary importance whether employees received their enlarged share of national income directly in their pay packets, or rather in fringe benefits, shorter work weeks, higher salary classifications, and more persons employed per family. The impact on the country's international competitiveness remained much the same.

Taxation and government welfare outlays magnified the effects of the shift in pretax income distribution. By 1928, government revenue had already risen to 172 percent of the prewar figure in real terms (see Table 1 above). Direct and indirect taxes jumped from 8.1 percent of national income in 1913 to 24.0 percent in 1932 (Andic and Veverka, 1964). Taxation even at the latter level appears moderate compared with the levies imposed by European welfare states after World War II. But the judgments of businesses and households whether to invest, save, or spend under these conditions depended on their own frame of reference and not on the contemporary one. Business in particular perceived taxation as intolerably heavy. In fact, the burden ran some 15 percent higher than it did in Britain and France during 1925-29, a figure all the more remarkable because, thanks to the Versailles treaty, Germany had neither an overseas empire to police nor an extensive standing army to maintain (James, 1986, p. 132). The disparity grew larger when the Depression struck because the Reich government, having reached the limits of its borrowing capacity, found itself with no practical option but to appropriate for its own use an increasing share of declining incomes.¹⁷

A look at the expenditure side of the equation explains why the need for additional revenue—through taxation and borrowing in equal measure—became so urgent. Table 6 calls attention to the upward trend in government outlays at all levels, both absolutely and as a share of national income. And it further underscores the growing significance of transfers (particularly unemployment and social-insurance payments) as a component of public spending; such transfers reached 13.2 percent of national income by 1932. A more detailed breakdown reveals that the combined allocation per inhabitant for the armed forces, police, education, debt service, and promotion of business remained virtually stationary in real terms from 1913 to 1932, while the per cap-

¹⁶ Carl F. von Siemens to Chancellor Brüning, July 31, 1930, in SAA 4/Lh 301, Siemens-Archiv-Akten, Munich (hereafter cited as SAA); Carl Köttgen to Felix Linke, May 21, 1924, SAA 11/Lf 488; Köttgen to Fritz Jastrow, Aug. 8, 1924, SAA 11/Lf 431.

¹⁷ On the political controversy surrounding financial issues at the end of the 1920s, see Timm (1952); Maurer (1973); Weisbrod (1978); and Dahlberg (1983).

TABLE 6
 CONSOLIDATED CURRENT-EXPENDITURE ACCOUNTS FOR ALL LEVELS
 OF GOVERNMENT IN GERMANY, 1925-32
 (in *milliards of Reichsmarks*)

| | 1925 | 1926 | 1927 | 1928 | 1929 | 1930 | 1931 | 1932 |
|---|------------|------------|------------|------------|------------|------------|------------|------------|
| Purchases of goods and services | 7.9 | 8.3 | 8.7 | 9.6 | 10.0 | 8.7 | 7.8 | 6.9 |
| Defense expenditures ^a | 0.6 | 0.7 | 0.8 | 0.8 | 0.7 | 0.7 | 0.6 | 0.6 |
| Interest on public debts | 0.2 | 0.6 | 0.7 | 0.8 | 1.0 | 1.2 | 1.3 | 1.2 |
| Transfers to households | 3.2 | 4.6 | 4.7 | 5.5 | 6.2 | 7.0 | 7.2 | 6.7 |
| Reparations ^b | 1.1 | 1.2 | 1.6 | 2.0 | 2.3 | 1.7 | 1.0 | 0.2 |
| Public investment and reconciliation with capital account | <u>2.0</u> | <u>2.3</u> | <u>4.0</u> | <u>3.5</u> | <u>2.7</u> | <u>3.1</u> | <u>1.4</u> | <u>0.7</u> |
| Total | 15.0 | 17.7 | 20.5 | 22.2 | 22.9 | 22.4 | 19.3 | 16.3 |
| Percent of national income at market prices | 22.3 | 27.0 | 25.5 | 26.4 | 28.8 | 31.2 | 33.0 | 32.1 |

SOURCES: Keese (1967, p. 47); Hoffmann (1965, p. 826).

^a On-budget outlays, not including secret rearmament.

^b German government accounting.

ita sum devoted to public-sector salaries rose 65 percent and the amount spent on social services quintupled (Andic and Veverka, 1964). Agent General S. Parker Gilbert never tired of generating similar comparisons in his annual surveys of the federal budget. During his six years as reparations overseer, he found that transfers from the Reich to the states and municipalities went up 19.1 percent, administrative costs of government rose 57.7 percent, and social expenditures ballooned by 419.3 percent (see Table 2 above).¹⁸

Social revolutions have economic benefits as well as costs. In other circumstances, a flattened distribution of income and wealth and a more densely woven net of welfare supports might have boosted aggregate demand and diminished the class antagonisms that retarded productivity in the workplace. These apparently constituted two important elements in the complex formula that restored European prosperity after World War II (Maier et al., 1981). If political enmities under Weimar had run less deep, perhaps these factors might have helped offset income displacements that discouraged saving and a tax structure that offered fewer incentives to capital formation than businessmen used to easier conditions before 1914 thought reasonable. But the search for a "warranted growth" path encountered other, complementary obstacles in the 1920s. The fear that inflation might recur, or that unpredictable shifts in relative prices might take place, continued to keep real interest rates

¹⁸ Gilbert did not adjust his figures for inflation. But since prices stood only 1.5 percent higher at the end of the period than at the beginning, the differences are minimal.

abnormally high by historical standards, and that in turn generated pressures leading to the politicization of credit allocation.

The German investing public exhibited a persistent disinclination to hold long-term debt even when such obligations contained seemingly airtight "gold" clauses. The risk premium demanded by the market did not decline much further after 1925. Hence ten-year domestic paper of the highest quality produced an average expected yield of 8.24 percent in 1925-29 (Balderston, 1982, pp. 506-514, and 1985, pp. 160-164). At the same time, profits in the corporate sector remained discouragingly low. In 1926-29, the years of greatest prosperity, German corporations attained an average pretax profit ratio (income to book value) of only 5.67 percent. A mere four of the twenty-six standard industrial classifications produced profits equal to those available without entrepreneurial effort on high-grade bonds. And none of the four—clothing, musical instruments, mortgage banks, and insurance companies—stood in the ranks of the unionized heavy industries (Sweezy, 1940). No one knew these statistics in advance. In retrospect, however, it becomes manifest that in relatively few cases did the net return on capital investment exceed the domestic borrowing rate.

Foreigners, who bore fewer scars from the inflation experience, subscribed to a third of the stock of new German bonds between 1925 and 1929. But large corporations and public authorities alone had access to foreign capital. Irresistible political pressures therefore grew for state assistance to provide below-market credit for agriculture, construction, and small business. Yet the various schemes for public intermediation often worsened matters, among other things by centralizing credit allocation in Berlin and retarding the revival of private mortgage banks. For example, a government-sponsored agricultural credit institute, originally set up with a view to attracting long-term funds from America and lending at retail to farmers, fell under farm-bloc domination. It ended by borrowing at home, crowding out more promising credit seekers, and distributing the proceeds indiscriminately on a three-to-five-year basis to hopelessly inefficient East Elbian grain producers. Barring a miraculous recovery of world commodity prices, this policy set the stage for a catastrophic agricultural credit crisis in 1929-31. Similarly, municipalities exercised their power to borrow abroad to build subsidized workers' housing, while the private housing industry, squeezed between the upper and nether millstones of insufficient long-term mortgage money and drastic rent taxes and controls, languished.¹⁹ Each sector of the economy registered its own lugubrious story.

In short, evidence drawn from a variety of approaches supports Borchardt's

¹⁹ See the files, "Rentenbank-Kreditanstalt," 1924-32, and "Geld- und Zinswesen," 1924-27, respectively in MA 103863-865 and MA 103857, BHStA; on housing, see also Welter (1931, pp. 163-169) and Hartmann (1932).

contention (1982, pp. 179, 282) that Weimar developed a "sick economy." An examination of longitudinal income and productivity series over the course of a century confirms that in the later 1920s the elevated real-wage position, depressed returns to capital, stagnating national income, and relatively slow growth in productivity diverged from long-term trends. Given the low profitability of German industry, it seems likely that, even if an international crisis had not erupted, the country would have found it impossible to finance its current-account deficit through capital imports forever. Nor could a Reich government that had failed to redeem fully its reputation for creditworthiness expect to cover its own deficits indefinitely through internal borrowing—at least not without reawakening anxiety about inflation. Reparations added but marginally to those fundamental difficulties; indeed, the modest reparations in kind that Germany delivered through private channels undoubtedly served to mitigate the severity of the 1925-26 recession. Nonetheless, in the long run, reparations added a crucial dimension to political instability. The Dawes Plan had reduced the annuity but not the theoretical sum due under the London Schedule of Payments. For makers of foreign economic policy in Berlin, ending reparations always remained the ultimate goal, and one worth considerable sacrifice (Link, 1970; Krohn, 1974; McNeil, 1981). While the denizens of the Wilhelmstraße spoke in the accents of economic rationality when it suited their purposes, many in government and industry stood prepared to run substantial financial risks in order to rid the country of a hated symbol of powerlessness and humiliation.

American Lending Begins

One must not read history backward. Could a political risk analyst in the autumn of 1924—even one preternaturally armed with today's skills of the trade—have accurately predicted how Weimar capital and labor markets were likely to malfunction in the ensuing years? Very likely not. In the quarter century before 1914, the German economy had operated as a mighty engine of growth. The skills of the population remained intact. New technologies, methods of scientific management, and more sophisticated forms of business organization stood ready for application (Brady, 1933; Maier, 1970). It was a calculated businessman's wager that if the Dawes Plan paved the way to political appeasement in Europe, a stabilized Reich might climb the path to prosperity and gradually achieve the capacity to pay reasonable reparations and to service an appreciable magnitude of private loans as well. That, at least, was the outlook of Wall Street optimists.

The Dawes Plan opened foreign capital markets to Germany for the first time since the war. The major corporations that had joined—and indeed led—the "flight to real values" during the inflation now desperately required working capital. Such loans would enhance industrial productivity. Foreign lenders deemed them "productive." Even carefully targeted flotations for

states and cities, if employed to modernize the energy and transportation infrastructure on which industry depended, might spur productivity.

Prospective German borrowers recognized at once that they could secure the volume of funds they needed only from the United States. The raw data indicate that America and Britain together provided roughly two-thirds of long-term foreign investment in the interwar era (Lewis, 1945, pp. 48-50). But closer examination reveals that the other ranking lenders—France, the Netherlands, Belgium, and Switzerland—either concentrated their energies on overseas empires and political clients or were engaged in recycling other peoples' money. Great Britain, obliged to husband resources for its planned return to gold, placed an embargo on most foreign loans for a crucial year starting in the fall of 1924. And when the formal prohibition finally ended, the Colonial Stock Act and other trust legislation continued to ensure preference for borrowers within the Empire and to promote a shift in British long-term asset distribution away from foreign countries generally.²⁰

The authorities in Berlin knew that they had no choice, but they did not welcome exclusive dependence on the good graces of New York. The Reich Economics Ministry urged the credit-hungry not to snap at every offer and sought to dissuade the private sector from paying more than the interest rate that the government had itself undertaken to pay on the Dawes loan. Fearing that American investment houses might use credit analysis as a cover for trade espionage, the ministry applied moral suasion on borrowers to work through German banks instead. It cautioned against convertible bonds that might allow Yankee sharpers to gain an equity toehold in sensitive industries, and it maneuvered anxiously (if unnecessarily) to preempt any attempt by the Agent General to guarantee commercial-loan repayment in dollars.²¹ But official Berlin made little headway promoting the hard line. The credit committee of the Reichsverband der deutschen Industrie (RDI) believed that even credit-worthy German corporations would encounter quite enough trouble pleasing American lenders given differences in accounting standards and the Teutonic practice of keeping hidden reserves out of the balance sheet. In late 1924, furthermore, German banks were still charging 20 percent and more to smaller

²⁰ Moggridge, 1971; 1972, pp. 199-219; RIIA, 1937, pp. 97-98, 133-135. In 1910-13, foreigners had obtained 75.6 percent of overseas new issues; in 1925-29, the figure shrank to 34.8 percent. While the Empire accounted for only 47.3 percent of British overseas portfolio investment in 1913, its share rose to 58.7 percent by 1930. The trend accelerated in the 1930s (RIIA, 1937, pp. 121, 134, 142).

²¹ See in particular memoranda by Dr. Singer of the RDI, "Sicherstellung ausländischer Kredite," Dec. 12, 1924, and "Aufnahme privater Auslandskredite," Feb. 4, 1925, in SAA 11/Lb 323; for the extensive debate among government departments on the matter, consult also BA, R2/2000-2001. Germans complained that, because of the way the Dawes loan was structured, the true debt-service burden came to 9.5 percent even though the nominal yield to maturity was only 8.7 percent; see calculations in Kuczynski (1929, pp. 241-242).

borrowers, while the Dutch doled out short-term accommodation at nothing less than monopoly rates. Corporate lenders could scarcely contain their worry lest the fickle Americans close their purses while the bureaucrats at home spun out their red tape.²² Then, within a few months, the pursuer became the pursued. America is a country of fads and enthusiasms. Suddenly, on Wall Street and in financial centers across the land, everyone wanted a piece of the action in German bonds. Once-skeptical investment bankers soon found themselves combing the four corners of the Reich, seeking to ferret out business.

The Americans who knew Germany best did not share the general fervor. Agent General Gilbert, after getting the lay of the land, confided to associates that he thought Reichsbank President Schacht needed "lots of watching."²³ Owen D. Young of General Electric, the principal architect of the Dawes Plan, hedged his bets about the safety of German loans. In early 1925, Young entreated German industrialists to stop grousing about reparations and to "get to work with full confidence" using the funds now flowing their way. Yet he added with unaccustomed vehemence that bankers who provided state and municipal flotations for schools and roads should be "hung." Consumption loans contributed nothing to an export surplus—they merely "prevented the recovery of Germany from proceeding from within."²⁴ To an Iowa minister who solicited investment advice, Young replied frankly that, while a rich man might take a flyer on German obligations in order to "make his capital do a service for world restoration and the security of all capital," such bonds remained subject to "the political risks of Europe"; the minister would do well to place the bulk of his money in "good safe American securities paying smaller interest rates."²⁵ But sober counsel of this character stood at a discount. By the fall of 1925, the responsible officials in Washington came to feel that both the volume of lending and the uses to which the funds were put had gotten out of hand. Herbert Hoover's Commerce Department had long favored imposing strict government supervision over foreign lending. After wrestling with the problem, however, State and Treasury Department ex-

²² Minutes of the RDI Ausschluß für Bank- und Kreditfragen, Sept. 4 and Oct. 24, 1924, and Singer memorandum, "Bedingungen der Banken," Nov. 4, 1924, in SAA 11/Lb 305; Oskar Sempell (Dortmunder Union) to Max Haller (Siemens), Apr. 27, 1924, on Dutch profiteering, and Haller to Sempell, Nov. 17, 1925, on Price Waterhouse frustrations with German accounting, SAA 11/Lb 110. On business resistance to government interference with loan terms, see Springer to Dr. Guggenheimer, Jan. 27, 1925, SAA 11/Lb 323. For Dillon, Read & Co.'s insistence that Americans preferred equity to debt investments, see K. G. Frank to Haller, Mar. 20, 1925, SAA 11/Lb 359.

²³ T. N. Perkins to Owen D. Young, Nov. 25, 1924, Box R-3, Young Papers.

²⁴ K. G. Frank, "Memorandum einer Besprechung mit Mr. Owen D. Young," Feb. 18, 1925, SAA 11/Lb 359.

²⁵ Young to Rev. B. H. Morse, Dec. 8, 1924, Box R-17, Young Papers.

perts reluctantly concluded that the United States government dared not interfere.²⁶

Historians have frequently reproached American officials of the 1920s for not exerting more leadership to stabilize the international monetary order. Often key personnel at the three main executive departments in Washington and at the Federal Reserve Bank in New York exhibited a keen grasp of the issues. But prevailing convictions about the proper purview of government limited what they could do. The decade of the twenties witnessed a profound transformation in American securities markets. The long-established, predominantly conservative underwriting houses found themselves on the defensive. More flamboyant firms, especially the well-capitalized security affiliates of commercial banks and investment trusts that catered to a vastly expanded retail business, gained market share at their expense (Carosso, 1970, pp. 240-299). The mass of novice investors included many who evinced willingness to speculate unreflectively in foreign bonds. The interest-rate differential on foreign securities did not always compensate for the political uncertainties involved.²⁷ Yet while old-style bankers had felt some responsibility to guide the market, their more aggressive challengers were prepared to satisfy demand without finely calibrating risk against return. One of the latter later told a Congressional committee: "The banker is like the grocer. He supplies what the customer wants."²⁸

²⁶ For details on the interagency debate, see Box 85 (German Foreign Loans, Jan. 1925–Apr. 1926), Record Group 39 (Treasury, Bureau of Accounts), U.S. National Archives; also Benjamin Strong–S. Parker Gilbert correspondence for 1925 in file 1012.1 (1-2), Benjamin Strong Papers, Federal Reserve Bank of New York (hereafter cited as FRBNY).

²⁷ The expected yield to maturity on a weighted portfolio comprising all new foreign bonds issued in America from 1921 to 1929 averaged 6.47 percent, compared with a mean yield of 4.84 percent on a domestic portfolio including one-fourth each industrial, railroad, utility, and municipal obligations. The foreign premium was thus 163 basis points. In Britain, by contrast, the yield to maturity at issue price for non-Empire borrowing averaged 7.28 percent from 1921 to 1929, compared with a Consol rate of 4.54 percent. In that case, the foreign premium amounted to 274 basis points (RIIA, 1937, pp. 135, 170). The disparity, admittedly, was not as great as it looks; when Canadian bonds are eliminated from the American sample, the current rate of return on all foreign bonds (not a strictly comparable figure) rises to 7.28 percent for the period 1921-29 (Madden et al., 1937, p. 154). The significant fact is that all foreign risk premiums had plummeted over the previous half-century owing to the closer integration of capital markets. From 1870 to 1880, for example, when Consols averaged 3.84 percent, British investors could obtain an effective yield of 7.5 percent on American public obligations, 9:3 percent on U.S. rails, and a nominal return of 12 to 15 percent on really hazardous fixed-income obligations overseas. And, as late as 1900-04, yields to British investors on foreign bonds averaged twice the Consol rate (5.39 vs. 2.70 percent) (RIIA, 1937, pp. 117-119).

²⁸ Quoted in Garrett (1932, p. 13). In the 1930s, progressives directed much criticism at "bankers' profits" from foreign loans. Underwriting fees on German flotations averaged 4.83 percent of gross issue price from 1924 to 1930. Generally, however, those fees reflected the unavoidable costs of retail syndication (Kucyzinski, 1932, pp. 83-84, 158-167). The fundamental question remains whether the business should have been done at all. Mintz (1951) discerns a deterioration in the "quality" of foreign bonds issued as the decade of the 1920s wore on. But

Officials in Washington, who had initially looked with favor on the beneficent recycling of American surpluses to capital-short countries overseas, understood the perils inherent in the evolution of domestic securities markets. What's more, they did not fail to perceive the political implications of improvident borrowing, particularly by German public authorities. If a crisis came, they realized, Germany might well claim that repayment of commercial debts ought to rank ahead of reparations (contrary to the stipulations of the Versailles treaty). That would exacerbate the latent conflict of interest between Allied reparations creditors and American private lenders, and the upshot might be to give the Allies an excuse to renege on their war-debt agreements. Still, a more immediate danger loomed. If the Treasury once began evaluating the business risk involved in German loans, it would open itself to litigation on the charge of having implicitly endorsed loans that it did not forbid. The Treasury could not take that chance.

The American government consequently sought to induce Germany to supervise the quality and volume of borrowing directly. No other procedure could have worked, even had the U.S. Treasury laid its legal scruples aside. An attempt to ration individual loans according to purpose from the lending side is bound to meet with frustration. A lending institution can do no more than ensure that a flotation appear productive and that the prospective obligor presently rank as solvent and well-intentioned. As American issue houses would discover, they could not prevent public borrowers from later adopting policies that compromised the safety of debentures that had originally seemed sound.²⁹ Moreover, the most responsible borrowers, public or private, could not hope to insulate their own credit positions from the political currents that manifested themselves in the financial and tax policies of the

Eichengreen and Portes (1986, pp. 628-629), who have followed the performance history of a representative sample of such bonds to maturity, do not discover significant differences in realized rates of return over the life of the bonds marketed in successive years, except for 1927 issues. The two findings appear to be compatible only if the defaults that reduced the realized rates of return to maturity stemmed more from political considerations than from the commercial characteristics of the obligations concerned. Fisher's (1959) study of the bond market also turns up no statistically significant evidence that investors became less risk-averse in the late 1920s. On the contrary, investors' preferences seem not to have changed substantially over the entire period from 1927 to 1953. Fisher attributes the declining risk premium on foreign bonds relative to domestic flotations in the late 1920s to investors' perceptions (however erroneous) that foreign countries' income and export earnings had become more stable as postwar reconstruction progressed and, above all, to the enhanced liquidity of foreign issues resulting from overall growth in the market's size.

²⁹ Note, as a representative example, the difficulties encountered by the Equitable Trust Co. and Harris, Forbes & Co. respecting their Bavarian loans, documented in MA 101096 ("Bayrische Anleihen, 1919-32"), BHStA. After locking in the foreign money, the hard-pressed Bavarian state issued a domestic flotation in lots as small as 100 RM, in effect creating a constituency of voter-investors who would demand servicing priority whatever the fine print of prospectuses might state to the contrary.

Reich. Foreseeing these problems, Agent General Gilbert, acting as Washington's proxy, engaged in a protracted struggle to oblige German authorities to impose restraint on their own. Over a three-year period he won a few skirmishes, but lost the war. The *Beratungsstelle für Auslandskredite* (Foreign Loans Advisory Council)—which passed on state and municipal issues—had the power to exempt foreign bonds from the flat 10 percent income tax and the 2 percent securities turnover tax. A Finance Ministry committee could grant similar tax-free status to industrial loans not traded on the Berlin Bourse. Without tax exemption, neither type of loan would appeal to the American market, and on that issue the battle was joined. Reichsbank President Schacht, occasionally seconded by Peter Reinhold during his tenure as finance minister, vetoed some of the more flagrant municipal loan proposals. Yet generally the economics minister and the *Länder* representatives on the Advisory Council outvoted them when state loans came up for review.³⁰

Schacht's closest associates could not always fathom his intentions. His fellow prisoners in the dock at Nuremberg would later say: "The only thing clean about Schacht is his white collar" (Gilbert, 1947, p. 316). But insofar as so egocentric an individual can be said to have followed a consistent policy, he appears to have opposed municipal loans for two complementary reasons. An immoderate capital inflow might lead to an inflationary expansion of the money supply. Even more significant, the dollars pouring in made it inconveniently obvious that Germany could meet the Dawes Plan requirements. Nothing could lead to more embarrassment for Schacht and his confreres at the Finance Ministry, who had eagerly anticipated transfer difficulties that might "prove" the country's inability to pay and set the stage for further reparations revision.

The economics of transfer remained imperfectly understood at this time. Yet not all the key players in governing circles felt equal optimism that a calculated display of poverty would bring about the desired international consequences. Under the professional tutelage of Hans Schäffer and Wilhelm Lautenbach, Economics Minister Julius Curtius groped toward the realization that a cutoff of borrowing by so capital-short a country as his own might produce a recession, reduce internal demand, and paradoxically demonstrate that the Reich could generate an export surplus after all.³¹ The cyclical down-

³⁰ See the records of the *Beratungsstelle* in BA, R2/2000-4, 2126-30, 4057-58, 4065-69; also the exceptionally frank record compiled by the Bavarian representative in MA 103859-62, BHStA. Foreign loans began to dry up when the Reich experimented with suspension of the tax exemption for such issues between December 1926 and June 1927 (McNeil, 1986, pp. 140-150).

³¹ Link (1970, pp. 382-437, esp. p. 433); McNeil (1981, pp. 174-177); Schacht and Köhler statements at *Beratungsstelle* meetings of Jan. 18 and Oct. 19, 1927, in Dr. von Wolf to Staatsministerium der Finanzen, Jan. 19 and Oct. 21, 1927, in MA 103860; also analysis by State Secretary David Fischer in the committee to work out loan guidelines, Nov. 11, 1924, MA 103859, both in BHStA; Aufzeichnung Schäffer, "Mit Ritscher und Heinze bei Schacht," Sept. 20, 1928, ED 93/28, NL Schäffer, IfZ. For further evidence on Schacht's views, or at least what he wished

turn of early 1926, furthermore, lent credence to Curtius's views. That contraction also focused bureaucratic attention on the weaknesses of German capital markets and the misallocation of investment in plant and equipment that persisted as a legacy of the inflation. The supposedly conservative Luther cabinet responded in some panic to the upsurge in unemployment by starting a make-work program and channeling funds into state-run enterprises. It financed those initiatives by liquidating the small surplus accumulated over the previous two years and by creating an "extraordinary" budget (Blaich, 1977; Hertz-Eichenrode, 1982). Deficit spending, once begun, invariably conjures up political constituencies that press for its continuance. The clamor soon became irresistible.

In 1927, Germany enjoyed an economic boom. Conditions seemed propitious—as Agent General Gilbert urgently observed—for a countercyclical policy and for generation of the export surplus necessary to make the Dawes Plan work smoothly.³² Instead, the Reich widened its budget deficit, increased its subsidies to the states, and temporized ineffectually in face of an avalanche of borrowing that in effect financed imports for consumption. At meetings of the *Beratungsstelle*, spokesmen for local government offered a succession of ingenious arguments against curbing foreign loans. Currency considerations, they contended, had to be balanced against social needs. The states and cities had postponed capital improvements during the war and now inevitably had to catch up. Municipal amenities were really "productive" if viewed in the proper perspective. Moreover, control of external flotations would prove futile because the Reichsbank couldn't prevent foreigners from purchasing domestic issues; alternatively, public authorities would crowd out indigenous private borrowers if deprived of access to funds abroad and thus force a rationing of home-market credit. Last but not least, the endeavor by bureaucrats in far-off Berlin to infringe on the prerogatives of regional entities would upset the constitutional balance in the Reich. The defenses put forward for individual flotations often had the ring of plausibility. But no one could, or would, set priorities. In October 1927, representatives of the states and cities managed to weaken proposed new loan guidelines to the point of meaninglessness.³³

In fairness, one must concede that the popular strivings for a better life did

foreign bankers to think he believed, see his letters to Bank of England Governor Montagu Norman, esp. Dec. 31, 1926, May 21 and Aug. 19, 1927, and Dec. 15, 1928, in G1/414, Bank of England (hereafter cited as B/E); also Schacht interview with Ernest Rowe-Dutton, June 19, 1928, and his remarks to the General Council of the Reichsbank, Apr. 30–May 1 and Nov. 30–Dec. 2, 1929, respectively in OV34/111, G1/414, and OV34/89, B/E.

³² See Gilbert's public report of Dec. 10, 1927 (in *Agent General, 1927*); also his further explanations to officers of the FRBNY in Binder 1, George L. Harrison Papers, Columbia University Library.

³³ Accounts of *Beratungsstelle* meetings, Jan. 18–Nov. 12, 1927; also Reichsminister der Finanzen to *Regierungen der Länder*, Oct. 2, and Reichsbank circular, Oct. 29, 1927, in

not lend themselves to easy containment through a Finance Ministry or Reichsbank ukase. The later 1920s witnessed the flowering of a new urban sensibility. The visionary mayors of the age—Adenauer of Cologne, Böß of Berlin, and Landmann of Frankfurt, to name just three—self-consciously aimed to fashion a revived civic culture as a fundament for social stability. Aesthetically designed public buildings and green spaces, sleek subways and soaring bridges, tasteful flats and swimming pools for the masses, opera houses and concert halls for the classes would combine to form a harmonious environment appropriate to modern industrialism (Stehkämper, 1976; Re-bentisch, 1975; Engeli, 1971; James, 1986, pp. 85-109). The cities had lost their tax autonomy in the financial reforms of 1919, but they retained their traditions of municipal independence and considerable spending and borrowing authority. To finance their ambitions, they tapped every till—at home, abroad, even in publicly owned savings banks whose liquidity they undermined—operating seemingly on the principle attributed to the bank robber Willy Sutton, who plied his trade where he did because that's "where the money was."³⁴

With general elections approaching, the federal government also succumbed to political temptation in mid-1927. In July, the Reichstag passed a drastically underfunded unemployment insurance scheme that represented a virtual blank check on government coffers; within four years, the deficit in this one account would claim 14 percent of combined Reich and *Länder* tax revenue (Preller, 1949, p. 520; Witt, 1985, p. 88). In October, the legislators followed with a Civil Service Compensation Act that raised government salaries across the board by 20 percent. Public-sector compensation had earlier lagged, but this measure constituted a crude remedy that produced immediate ripple effects on white-collar pay throughout the private economy.³⁵ Many conservatives privately deplored Finance Minister Heinrich Köhler's

MA 103860, BHStA. The Reich Finance Ministry records in BA, R2/2002 and 2128, are significantly less complete.

³⁴ Hansmeyer, 1973; Reulecke, 1985, pp. 100-116; Sutton, 1976, pp. 119-120. Local governments varied widely in the proportion of debt that they contracted abroad between 1924 and 1930. While Hamburg did 73.4 percent of its borrowing outside Germany and the figures for Krefeld, Munich, Nuremberg, Bremen, Stuttgart, and Hannover ran between 30 and 40 percent, the average for all cities with a population over 200,000 amounted to only 14.1 percent. Municipal overborrowing had equally devastating consequences for domestic credit institutions (quantitative data in Eicher, 1932, pp. 654-659).

³⁵ According to later analysis by Finance Ministry officials, the act erred by failing to tackle inefficiencies in the system. It perpetuated a bureaucracy swollen with redundant tenured employees (*Beamten*) and too many levels of administration, and it foisted additional costs on local government and the Reichsbahn. At the same time, it rigidified relative salary distortions prevailing since the inflation, leaving senior civil servants below prewar levels in real terms and ever more embittered. See Hans Schäffer to Max Warburg, Sept. 17, 1930, ED 93/29, NL Schäffer, IFZ; for the deleterious impact on freight rates, note Reichsbahn Chairman C. F. von Siemens to Chancellor Marx, Nov. 10, 1927, accusing the finance minister of prevarication, SAA 4/Lh 300.

financial recklessness and political pusillanimity. (The joke circulated in banking circles that it might be a good thing for Germany if Gilbert served as finance minister and Köhler as Agent General.)³⁶ Nevertheless, a sound-money coalition remained a political impossibility so long as Germany benefited from transfer protection.

By early 1928, even such internationally minded Americans as Governor Benjamin Strong of the New York "Fed" had become skeptical about the advisability of further capital issues for Europe.³⁷ Fearing to kill the fatted calf, the Reich government made some belated gestures to slow down municipal borrowing. But soon thereafter the German states rushed into the breach by taking out umbrella loans that they then distributed to smaller borrowers. Moreover, cities that found themselves crowded out increasingly had recourse to the short-term money market to meet long-term needs. A two-step increase in the discount rate in 1927, aimed at dampening stock-market speculation, had the perverse effect of setting off a hot-money inflow that lay beyond easy control. The balance-of-payments figures for 1928-30 demonstrate clearly how short-term capital movements and the quest for rapid securities profits came to dominate international transactions in those years (see Table 7). The Reichsbank, however, evinced a curious indifference to the mounting short-term liabilities of the private banks. Schacht began to collect statistics on the question in late 1927. Yet when the head of the Deutsche Girozentrale asked him whether he worried that political developments might cause foreigners suddenly to withdraw these funds, he replied that "this didn't concern him as Reichsbank president: the private economy had to take care of itself."³⁸

Schacht watchers puzzled in vain over the central banker's deeper motives in 1928-29. Believing that the Dawes loan set an effective interest-rate floor, industry spokesmen warned against trying to spur the economy with easy money. Germany didn't have the luxury of passing up soundly based foreign loans just because they facilitated the reparations transfer, leaders of the RDI insisted; a long-term inflow remained the basis for prosperity until changes in tax and economic policy enhanced capital formation at home.³⁹ Reichsbank

³⁶ Pierre Jay to Benjamin Strong, Nov. 13, 1927, Strong Papers 1012.3 (2), FRBNY. Businessmen mustered less humor about these matters once the Depression hit. RDI notable Clemens Lammers then typically tagged Köhler as "one of those run-of-the-mill politicians who can't see beyond the empty babble of the day" (Lammers to C. F. von Siemens, Mar. 12, 1930, SAA 4/Lf 647).

³⁷ Strong to Jay, Mar. 26, 1928, Strong Papers 1012.3 (1), FRBNY.

³⁸ "Niederschrift des Herrn Stadtrats Jursch über eine Besprechung mit Dr. Schacht am 26. September 1927," (Oct. 13, 1927), NL Hans Luther, Nr. 337, BA. By that point, according to Schacht's educated guess, private-bank foreign liabilities alone had reached 3.7 milliard RM, 62.7 percent of the July 1931 figure.

³⁹ Memoranda by Ludwig Kastl of the RDI, "Unterlagen für die Besprechung mit Reichsbankpräsident Schacht," July 25 and 26, 1928, SAA 11/Lb 344.

TABLE 7
THE GERMAN BALANCE OF PAYMENTS, 1924-33
(in millions of Reichsmarks)

| A. 1924-28 | | | | | | | | | | | | | | | |
|---------------------------------------|--------|-------|---------|--------|--------|---------|--------|-------|---------|--------|--------|---------|--------|--------|---------|
| | 1924 | | | 1925 | | | 1926 | | | 1927 | | | 1928 | | |
| | Credit | Debit | Balance | Credit | Debit | Balance | Credit | Debit | Balance | Credit | Debit | Balance | Credit | Debit | Balance |
| Merchandise | 7,810 | 9,626 | - 1,816 | 9,546 | 11,990 | - 2,444 | 10,677 | 9,884 | + 793 | 11,118 | 14,078 | - 2,960 | 12,627 | 13,938 | - 1,311 |
| Shipping and other services | — | — | + 191 | — | — | + 289 | — | — | + 449 | 1,337 | 897 | + 440 | 1,460 | 963 | + 497 |
| Armies of occupation, etc. | 83 | — | + 83 | 173 | — | + 173 | 93 | 10 | + 83 | 205 | — | + 205 | 175 | — | + 175 |
| Interest payments | 325 | 166 | + 159 | 320 | 326 | - 6 | 340 | 513 | - 173 | 335 | 680 | - 345 | 382 | 945 | - 563 |
| Reparations payments | — | 281 | - 281 | — | 1,057 | - 1,057 | — | 1,191 | - 1,191 | — | 1,584 | - 1,584 | — | 1,990 | - 1,990 |
| Balance on current account | — | — | - 1,664 | — | — | - 3,045 | — | — | - 39 | — | — | - 4,244 | — | — | - 3,192 |
| Gold and foreign exchange | — | 1,255 | - 1,255 | 476 | 566 | - 90 | 56 | 624 | - 568 | 574 | 122 | + 452 | — | 931 | - 931 |
| Long-term loans and bonds repurchased | 1,000 | — | + 1,000 | 1,136 | 12 | + 1,124 | 1,463 | 87 | + 1,376 | 1,345 | 135 | + 1,210 | 1,368 | 100 | + 1,268 |
| Movements of securities | — | — | — | — | — | — | — | — | — | 575 | 20 | + 555 | 2,276 | 1,846 | + 430 |
| Other foreign investments in Germany | — | — | — | — | — | — | — | — | — | 15 | 72 | - 57 | 14 | 57 | - 43 |
| Other German investments abroad | 1,000 | — | + 1,000 | 200 | — | + 200 | — | — | — | — | 5 | - 5 | 147 | 14 | + 133 |
| Short-term capital movements | 1,256 | 750 | + 506 | 182 | 75 | + 107 | 178 | 31 | + 147 | 2,401 | 622 | + 1,779 | 2,170 | 835 | + 1,335 |
| Indefinable capital movements | 413 | — | + 413 | 1,704 | — | + 1,704 | — | 916 | - 916 | 310 | — | + 310 | 1,000 | — | + 1,000 |
| Balance of capital movements | — | — | + 2,919 | — | — | + 3,135 | — | — | + 607 | — | — | + 3,792 | — | — | + 4,123 |

B. 1929-33

| | 1929 | | | 1930 | | | 1931 | | | 1932 | | | 1933 | | |
|---------------------------------------|--------|--------|---------|--------|--------|---------|--------|-------|---------|--------|-------|---------|--------|-------|---------|
| | Credit | Debit | Balance | Credit | Debit | Balance | Credit | Debit | Balance | Credit | Debit | Balance | Credit | Debit | Balance |
| Merchandise | 13,632 | 13,676 | - 44 | 12,175 | 10,617 | + 1,558 | 9,733 | 6,955 | + 2,778 | 5,834 | 4,782 | + 1,052 | 4,957 | 4,288 | + 669 |
| Shipping and other services | 2,069 | 1,545 | + 524 | 1,841 | 1,303 | + 538 | 1,516 | 1,066 | + 450 | 1,163 | 898 | + 265 | — | — | + 232 |
| Armies of occupation, etc. | 188 | — | + 188 | — | — | — | — | — | — | — | — | — | — | — | — |
| Interest payments | 400 | 1,200 | - 800 | 400 | 1,400 | - 1,000 | 300 | 1,500 | - 1,200 | 200 | 1,100 | - 900 | 150 | 850 | - 700 |
| Reparations payments | — | 2,337 | - 2,337 | — | 1,706 | - 1,706 | — | 988 | - 988 | — | 160 | - 160 | — | 149 | - 149 |
| Balance on current account | — | — | - 2,469 | — | — | - 610 | — | — | + 1,040 | — | — | + 257 | — | — | - 52 |
| Gold and foreign exchange | 510 | 345 | + 165 | 192 | 72 | + 120 | 1,653 | — | + 1,653 | 256 | — | + 256 | 524 | — | + 524 |
| Long-term loans and bonds repurchased | 340 | 111 | + 229 | 1,097 | 130 | + 967 | 358 | 232 | + 126 | 100 | 136 | - 36 | — | 250 | - 250 |
| Movements of securities | 1,546 | 1,361 | + 185 | 1,013 | 1,175 | - 162 | 512 | 723 | - 211 | 200 | 150 | + 50 | 200 | — | + 200 |
| Other foreign investments in Germany | 7 | 17 | - 10 | — | — | — | 185 | — | + 185 | — | — | — | — | — | — |
| Other German investments abroad | 275 | 19 | + 256 | 377 | 63 | + 314 | 80 | — | + 80 | — | — | — | 100 | — | + 100 |
| Short-term capital movements | 1,376 | 611 | + 765 | 1,191 | 1,074 | + 117 | 2,682 | 2,205 | + 477 | 250 | 1,013 | - 763 | 703 | 1,250 | - 547 |
| Indefinable capital movements | 879 | — | + 879 | — | 746 | - 746 | — | 3,350 | - 3,350 | 236 | — | + 236 | — | 79 | - 79 |
| Balance of capital movements | — | — | + 2,304 | — | — | + 490 | — | — | - 2,693 | — | — | - 513 | — | — | - 576 |

SOURCES: Statistisches Reichsamt (1934b, pp. 10-11); Harris (1935, pp. 113-114).

policies, on the contrary, seemed to encourage short over long flows and thereby to undermine stability. The charitable interpretation holds that Schacht was maneuvering to accumulate foreign exchange so that he could enter the forthcoming reparations negotiations with the Reichsbank sheltered from unpleasant surprises. It gradually dawned on close observers like State Secretary Hans Schäffer, however, that the central-bank chief was actually steering a more devious course. Schacht appeared to be letting German banks run up short-term liabilities to correspondent institutions in Britain and America so that the latter, fearing for their own liquidity, would entreat their governments to go easy in the next reparations round. Schacht implicitly confirmed these suspicions by occasionally hinting to visitors that he hoped for reparations "chaos."⁴⁰

Whatever the truth of the matter, it is clear that the fabled cessation of American lending in early 1929, which economists have frequently attributed to the New York stock-market boom (Lary, 1943, pp. 91-92, 99-100), occurred—insofar as Germany was concerned—only in attenuated form. Interest rates rose in Germany as elsewhere (James, 1985, p. 350). But neither long- nor short-term borrowers experienced overwhelming difficulty in obtaining money. The net capital-inflow figures, which analysts usually cite, show a decline in 1929 because the onset of the Depression in Germany reduced the demand for funds at the same moment that the securities upsurge on Wall Street enticed speculative German capital to the United States. But the American investment-banking community exhibited no little ingenuity in designing issues with an equity "hook" for those German firms that still cared to borrow.⁴¹ The breakdown of the flow both ways that is detailed in Table 7 suggests that the gross inflow of short-term funds wound down only after the real onset of the American Depression in May 1930 and the startling Nazi gains in the Reichstag elections held in September of that year. As the Depression deepened, Germany possessed a rationalized industrial plant, a social-welfare system unrivaled anywhere except Great Britain, and a conglomeration of municipal amenities that commanded the wonder of the world. The foreigners who had financed much of it held paper claims—just as they had in 1919-23.

⁴⁰ Schäffer to Karl Blessing, Dec. 3, 1953, and Schacht to Blessing, Nov. 13, 1953, ED 93/43; also Schäffer to Wolfgang Helbich, Dec. 4, 1959, and Helbich to Schäffer (reporting Hans Luther's views), Dec. 14, 1959, ED 93/46, NL Schäffer, IFZ. For Schacht's talk of chaos, see Somary (1955, p. 212), cited also by Schäffer in his letter to Helbich.

⁴¹ For evidence on the rivalry among Kuhn, Loeb & Co., Dillon, Read & Co., and other firms over devising products with equity components tailored to evolving market interest, see the file "Anleihe 1930," in SAA 4/Lp 157; also Otto Kahn's explanations to the head of the Bavarian state bank, "Vormerkung" Dr. von Wolf, May 15, 1929, MA 101096, BHStA; and banker Jakob Goldschmidt's explanation of the possibilities to the Krupp board in Arthur Klotzbach's "Niederschrift über die Besprechung auf der Gußstahlfabrik," June 22, 1929, WA IV 2887, Krupp-Archiv.

3 THE PROCESS OF DEFAULT

First Steps

An upsurge in nationalist sentiment worsened the climate for foreign investment in the Reich before the Depression struck with full force. In 1929, the dark cloud appeared no bigger than a man's hand—not large enough, in any event, to produce radically higher interest rates or substantially shorter maturities. German public bodies appeared as eager as ever to fund their deficits by bank borrowing or fixed-income flotations abroad. Still, German businessmen of sober repute began to complain of *Überfremdung*—the unwelcome purchase, particularly by Americans, of equity shares in German corporations. And the reparations negotiations of 1929, which the Berlin government had embarked upon with advance knowledge of the probable terms, did not result in the “final liquidation of the war” that moderates on all sides had anticipated. Instead, bitterness intensified. The right-wing agitation against “enslavement” under the Young Plan that subsequently emerged as a central feature of German politics could not help but spill over into popular resentment of private creditors as well.

By the time the Young Committee met, the reparations controversy no longer turned on German capacity to pay. The key issues had become unambiguously political. The Young Committee members and staff followed in advance drafts the debate about the transfer problem that raged in the pages of the *Economic Journal* during 1929. Most realized that Bertil Ohlin and Jacques Rueff had the better of their argument with John Maynard Keynes. Not only could taxation generate the surplus necessary to pay reparations, but changes in disposable income in paying and receiving countries, magnified through the effects of the multiplier, would facilitate the actual transfer in goods and services. The real dispute concerned who would bear the burden of adjustment (Metzler, 1942; Machlup, 1964, pp. 425-446). But how, as a practical matter, could one expect Germany to accept during an era of hard times the fiscal discipline that it had steadfastly evaded during the halcyon years?

The more sophisticated professionals in the German bureaucracy understood the mechanism of the transfer in a distinctly modern way. Some politicians in Berlin expressed initial reluctance to give up the transfer protection enjoyed under the Dawes Plan in return for a marked-down annuity. Steel executive Albert Vögler, a member of the Young Committee, argued for this faction that the Reich should let the negotiations for revision fail. A transfer

crisis would result. As Vögler saw it, the nontransferred reparations piling up in the Reichsbank would bring about lower interest rates and spark an economic upturn. When the accumulated funds reached the statutory limit, the German government would win a reprieve from further contributions, and that would alleviate the budget deficit as well. But Hans Schäffer of the Economics Ministry made short work of these illusions. He patiently explained to the politicians that a transfer crisis would initially lead to higher discount rates and credit restrictions. Those conditions in turn would force inventory reductions and securities sales. The Reparations Agent had the power to constrict German purchasing power by making capital dearer and thereby to ensure the transfer's success. In fact, Schäffer warned, if the economic downturn persisted at home while foreign countries continued prosperous, Germany would eventually achieve an unaccustomed trade surplus and inconveniently prove the point. As if that weren't bad enough, the psychological disruption accompanying any crisis would provoke a panicky withdrawal of foreign funds and increase domestic unemployment. Given the radicalization of the working class, higher joblessness no longer put downward pressure on wages. Instead, it augmented demands for more extensive welfare supports, and that merely compounded the budgetary problem. In this situation, prudence dictated accepting whatever relief Germany could wring out of the Young Committee. Above all, the country required turnaround time to make structural reforms. It needed to impose sensible limits on unemployment insurance, to alter a tax system that impeded capital formation, and to staunch a multiplicity of budgetary drains.¹

The Socialist members of the Müller cabinet found the last part of the analysis politically unpalatable, but the immediate policy recommendation commended itself to all.² The Young Plan reduced the initial annuity to 1.64 milliard RM excluding service on the Dawes loan, in other words 2.05 percent of current national income at factor cost. The average annuity over a generation would amount to just over 2 milliard RM, a reduction of one-fifth compared with the Dawes Plan figures (Weill-Raynal, 1947, Vol. 3, pp. 447-448). Few insiders, however, expected the Young Plan to last. Even the British expert, Sir Josiah Stamp, who had elaborated many of the technical details embodied in the plan, hoped merely for "as good an approach shot as possible, so that the next effort may hole out."³

¹ Hans Schäffer to Ministerialrat Bruno Claussen, May 1, 1929, ED 93/35, NL Schäffer, IfZ, Schacht and Vögler discussions with the cabinet on Apr. 21, 1929, in ARK Müller (1970, Vol. 1, pp. 569-575); see also the Reich Finance Ministry "Heizstoff" file of correspondence with the German delegation to the Paris meetings, BA, R2/3194, as well as the supplementary records in R2/2923-25.

² For reflections of key ministers on the final result, June 14, 1929, see ARK Müller (1970, Vol. 1, pp. 737-741).

³ Stamp to J. M. Keynes, n.d. (early March 1929), in Johnson (1978, pp. 306-307).

In the short run, both Reich and local government officials counted on the Young Plan to bring a fresh rush of foreign loans flowing their way.⁴ By late 1929, the Finance Ministry's desperate need for cash overwhelmed all other considerations. As tax revenue fell off owing to the Depression, the treasury encountered increasing difficulty in financing its week-to-week expenditures except through a series of precarious expedients. State and local authorities also found themselves embarrassingly short of funds (Timm, 1952; Maurer, 1973). The idea that foreigners should spring to the rescue of the public sector did not of course represent a novelty. Governmental bodies accounted for a startling 70.6 percent of German loans syndicated in the United States between 1924 and 1930. And, looking at matters the other way round, 26.9 percent of all German public debt at the end of 1930 was held abroad (Kuczynski, 1932, p. 5; Eicher, 1932, p. 654). But it did not bode well for the security of those funds that, at the same time, a fierce resistance developed in the business community against direct or equity portfolio investment by foreigners in German industry.

Events came to a head in the fall of 1929, when a cash-flow squeeze obliged the badly managed electrotechnical giant AEG to spin off its telephone manufacturing holdings to the American-based ITT Corporation and to sell a one-quarter share in the parent company to General Electric. Carl F. von Siemens, chairman of the principal rival firm, complained that "the foreign pilot, even if he only stands as an adviser to the German helmsman, neither can nor will offer his advice with an intimate feeling of a common destiny linking captain and crew—all the more so if he also runs his own ships under his country's flag in competition with German labor." And the Siemens finance chief minuted bitterly that Owen Young of GE seemed to have proclaimed "a sort of expanded Monroe doctrine: 'the whole world belongs to the Americans.'" The business press took up the cry, and denunciations of Yankee penetration of Continental production continued to echo down to the end of 1930.⁵

American multinationals did pose a serious challenge to European entrepreneurs across the world during the 1920s. American firms could muster incomparably greater financial resources, and they jumped to a solid technological lead in a variety of key industries entering the growth phase of their product cycles. Earlier, however, France—where the actual American business presence remained minimal—had assumed pride of place in rehearsing the perils emanating from the transatlantic colossus and in propagandizing,

⁴ Hans Schäffer, "Vermerk für den Minister," Feb. 4, 1930, ED 93/29, NL Schäffer, IFZ.

⁵ Siemens speech of Oct. 12, 1929, in SAA 4/Lf 873; finance chief Max Haller's comments in memorandum of Nov. 11, 1929, SAA 4/Lt 398; similar views expressed by the head of the Siemens export department in "Besprechung der Lage in Spanien," Nov. 26, 1930, also in 4/Lt 398; press discussion in *Der deutsche Volkswirt*, esp. Oct. 21, 1929. Note Director Goldshtaub's extreme presentation of the position, "Notiz über die Polemik zwischen Siemens und A. E. G.," Oct. 28, 1929; also C. F. von Siemens-Hermann Bücher correspondence, in SAA 4/Lf 592.

somewhat imprecisely, for a countervailing United States of Europe (Keeton, 1985; Pegg, 1983, pp. 40-156). The emergence of similar sentiment in the capital-starved Weimar Republic underscored a dramatic shift in the public mood. Although individual firms like ITT operated ruthlessly at times, the gross figures offer little confirmation for the fear that aggressive Americans aspired to buy Germany out. While U.S. business employed innovative marketing techniques to broadly diversify overseas sales during the postwar decade, its worldwide direct investment constituted no greater a percentage of gross national product than it had in 1914. Expansion abroad merely kept pace with the flowering of enterprise at home. Moreover, American firms concentrated two-thirds of their direct investment in the Western hemisphere, particularly on mining, raw materials, and other supply functions. Germany accounted for just 2.87 percent of U.S. direct foreign investment in 1929. Canada took eight times, Cuba four times, and distant Chile nearly twice as much (Wilkins, 1974, pp. vi-ix, 49-163; figures on pp. 55-59, 163). The popularity in the Reich of the position that Americans should fund the country's public deficits but keep their hands off its productive enterprises therefore bore witness to the deep contradictions troubling Weimar's polity and economy.

The Young loan of June 1930, syndicated with much fanfare on nine exchanges, produced a last \$300 million to be shared between the Reich and the reparations creditors. Two public-works flotations followed on Wall Street within the next month. Aside from a couple of private placements, that signaled the end of U.S. capital issues for Germany. The outpouring of fury within the Reich that attended ratification of the Young Plan and the unseemly squabbles among the Allies over division of the spoils dashed any hopes that had lingered since the 1926 Thoiry meetings for "commercializing" reparations.

It is evident that the abrupt termination of other lending to Germany primarily reflected Wall Street's anxiety about political developments there. The bond market declined as the American economy contracted in the second half of 1930, yet Canadian issues still sold well. Indeed, the total amount of foreign bonds purchased by Americans bulked 35 percent larger in 1930 than in 1929 (RIIA, 1937, p. 171). And as late as January 1931, Dillon, Read & Co. informed its European clients that a "large purchasing power" still existed for bonds of the "highest and most conservative security."⁶ The sequence of these developments holds no little political significance. It suggests that the cutoff of American foreign lending followed rather than led events. It lends

⁶ Westmore Willcox, Jr. (Dillon, Read) to C. F. von Siemens, Jan. 26, 1931, SAA 4/Lp 157; similar sentiment expressed by B. A. Tompkins of the Bankers Trust Co. to his Berlin representative, Eric Archdeacon, July 10, 1931, BA, R111/23, Bankers Trust Co., Vertretung in Berlin.

some plausibility to President Hoover's oft-derided contention that the second, more devastating wave of the Depression grew out of the 1931 European financial crises, and that it hit America from abroad (Davis, 1975, pp. 225-276). German public authorities, at any rate, should have realized in the early spring of 1930 that the party—for them—was over. In fact, state and municipal borrowers proved remarkably slow to catch on. When they did, they did not miss a beat. They immediately began to demand that the Reich "step into the breach" to help convert their domestic obligations and to guarantee or assume their foreign debts. Ironically, those regional governments that earlier had shown the greatest improvidence in borrowing—among them Saxony, Thuringia, Hamburg, and Bremen, which all had sizable working-class constituencies and concomitant social problems—now clamored most insistently for Berlin to bail them out.⁷

During the easy years, the flow of funds to Germany had provided apparent benefits all around. Discount rates for the period 1924-30 (a rough proxy for capital costs) averaged 333 basis points lower in New York and 273 basis points lower in London than in Frankfurt. If one believed that these differences reflected market inefficiencies and that nations do not go bankrupt, a seemingly golden opportunity beckoned. Lenders could earn a substantial premium over fixed-income yields on offer elsewhere; bankers could generously cover their intermediation costs; yet a sufficient margin remained so that borrowers could save as well. In 1924-30, the German states and cities obtained funds on average 75 basis points more cheaply abroad than they did at home.⁸ Even that figure tells a mere fraction of the story, for if foreign money had been absent, domestic rates would have skyrocketed. The difficulty was that by 1930 Germany's transfer liability for interest on private debts had reached 1.4 milliard RM—not far short of the Young annuity (see Table 7).

The foreign lenders thus found themselves increasingly held hostage to German fiscal policy. It now became a matter of moment that the powers had

⁷ BA, R2 /4057, 4066, 4069; BHStA, MA 103861-862. On regional authorities' illusions concerning prospects for more American money, see esp. "Bespprechung der Staatsbanken in den Räumen der Thüringischen Staatsbank," Mar. 13, 1930, also Staatsrat Schmelzle to Staatsministerium des Äußern, München, June 15, 1930 (MA 103861). For the culmination of the campaign to have the Reich assume responsibility for local foreign debts, see Hamburg Mayor Carl Petersen's plea in minutes of a meeting at the Reichsbank, Oct. 29, 1931 (MA 103862); compare, however, Büttner's mitigating account (1982) of Hamburg's predicament, which stresses "human needs."

⁸ Figures calculated from Eicher (1932, pp. 670, 674). The unadjusted data give the impression that the federal government paid slightly more for foreign than for domestic money, but the rates in that instance are not comparable. The Reich could not have borrowed at home when it negotiated abroad for currency and reparations purposes. What's more, domestic flotations carried tax advantages.

never reached an understanding whether reparations creditors or private creditors should have priority when the Young Plan broke down. The Agent General had steadfastly declined to rule on the matter. The Young Plan, which divided the annuity into "conditional" and "unconditional" parts, could be read to imply that private transfers would enjoy priority over conditional reparations, which not coincidentally equaled the precise amount that the European Allies owed America on war-debt account. But when Germany mounted its final challenge to reparations, it might not do so by invoking the moratorium procedures specified in the Young Plan. The Allies had indeed outsmarted themselves. They had afforded the Reich an opportunity to pay most of the unconditional reparations in kind; hence, as everyone knew, a moratorium following the internationally sanctioned method offered no prospect of appreciable cash relief.⁹ A significant risk existed that Berlin would demand a wider examination of its balance of payments. Under these circumstances, prudent private investors had a strong inducement to withdraw their funds at the first sign of trouble.

The long-heralded crisis came in the spring of 1931 for reasons of foreign policy rather than economic necessity. The Müller cabinet had accepted the Young Plan principally to achieve evacuation of the Rhineland five years early. Those ministers who dismissed the vestigial occupation of the Rhine as a wasting asset for France had rallied to the decision in order to obtain an immediate one-third reduction in the reparations bill. But with those advantages secured, discussion in Berlin turned at once to the practical questions of when and how to demand modification of the settlement. In the spring of 1931, Finance Ministry professionals—resourcefully led by State Secretary Hans Schäffer, then at the zenith of his influence—maintained that the proper time had still not arrived to expect a sympathetic hearing. Admittedly, the accelerating deflation increased the real weight of the debt just when falling revenues had devastated the tax base. Yet the Allies could easily show, Schäffer warned, that "Germany's economic and financial difficulties derive not at all or at least less from reparations obligations than they do from [domestic] financial and economic policy since stabilization."¹⁰ Reichsbank President Hans Luther, who had succeeded Schacht after the latter's ill-tempered resignation, also advised that the country should concentrate on putting its

⁹ In 1930-31, Germany was scheduled to pay 612 million RM unconditionally and 740 million RM in nonpostponable deliveries in kind, leaving a maximum of 289 million RM that could be postponed under a Young Plan moratorium. See Erwin Respondek memorandum for the Reichstag Foreign Affairs Committee, Oct. 31, 1930, copy in SAA 4/Lf 647.

¹⁰ "Denkschrift Schäffers über die Reparationsfrage," Apr. 9, 1931, and concurring memoranda by his staff, in BA, NL Hermann Dietrich, Nr. 214, fol. 5-251; some reproduced in Maurer and Wengst (1980, Vol. 1, pp. 583-610). The analysis here draws also on Brüning (1970); Bennett (1962); Helbich (1962); Born (1967); and Dahlberg (1983).

own house in order and on trying to preserve the short-term lenders' confidence. Center-party stalwart Heinrich Brüning, who meanwhile had stepped into Müller's shoes as chancellor, nevertheless held that the mood of the German people would brook no delay. Brüning had stigmatized the Young Plan as a tragic error from the beginning.¹¹ Now he insisted that the plan had to end forthwith.

The Brüning Program and the Crash of 1931

Brüning attempted in 1930-31 to create a broad-based national conservative coalition. Drawing on the idea of a cooperative national community foreshadowed in the Essen program a decade earlier, he sought to forge an alliance of the old middle classes that had opposed the great inflation, the East Elbian Junkers and other members of the prewar elite, the non-Marxist workers in the free trade unions, and the export-oriented modern growth industries. With the backing of these centrist groups, he hoped to break with the system of cartel prices, administered wages, welfare subsidies, and civil service monopolies that had benefited special interests at the expense of the consumer and taxpayer for most of Weimar's history. Nothing diverged further from Brüning's purposes than to serve as a stalking horse for heavy industry. Not only did he have to take account of the anticapitalist sentiment that had struck root even in the bourgeois voting public, but he largely shared the popular prejudice against the great *Konzerne*. Outside the chemical sector, he would later maintain, small and medium-sized entrepreneurs alone had held the loyalty of their workmen and demonstrated sufficient versatility to compete effectively abroad. A good part of big business, he believed, had juggled the high wage bill since 1927 only through bank borrowing and now stood "practically bankrupt."¹²

Brüning did not intend to default on the commercial foreign debt. Rather, he aimed to improve Germany's export performance by subjecting prices and wages to the discipline of the market. By balancing the budget, he hoped to restore the country's credit and then to reschedule short-term obligations, both foreign and domestic, at a reduced interest rate. It soon became clear, however, that neither a Reichstag majority nor significant support in the Reichsrat existed for the measures of mutual sacrifice that such a program presupposed. In the September 1930 Reichstag elections, the Nazis and Communists, profiting from an influx of young voters, captured one-third of the seats. The fragmentation of the dozen parties in between did not allow for

¹¹ See Brüning's proud acknowledgment of his 1929 advice to Schacht and Müller at the post-war denazification trials: Dr. H. Brüning, "Eidesstaatliche Erklärung," Aug. 24, 1948, Spruchkammerverfahren gegen Dr. Fritz Thyssen, MC2 /H6, IfZ.

¹² Brüning to Wilhelm Sollmann, Feb. 1, 1945, F206 (Brüning-Sollmann Correspondence), IfZ.

any working majority. Brüning had no choice thereafter but to rule by emergency decree. Still, as the chancellor and Finance Minister Dietrich saw it, the economic outlook by itself afforded no grounds for despair. The trade balance had held up remarkably well in the Depression (for confirmation, see Table 7). The key problem remained psychological. The country suffered from a "deficit in entrepreneurial spirit" as well as a lack of capital. Yet if all those who had shuttled their assets to the Netherlands and Switzerland repatriated them, the credit shortage would disappear. "In the structure of the German economy lies no grounds for a collapse," Dietrich declared in mid-October, "everything depends upon the bargaining process."¹³

A fierce nationalist by instinct, Brüning shortly came to believe that he would have to offer tangible foreign-policy successes in order to secure public backing for his program of equitable deflation. Brüning spoke English so well and displayed such an impressive grasp of economics and statecraft that his Anglo-American negotiating partners considered him a singularly agreeable interlocutor. They did not generally realize that, behind his donnish manner, the chancellor hid a less accommodating side. Brüning nourished many dark suspicions, for example that the French were using reparations money secretly to finance the Nazis.¹⁴ And he despised the "pack of Levitical naysayers" [eine Rotte Korah] in the bureaucracy—so partial, he felt, to the foreign point of view—as much as did the hard right.¹⁵ Brüning hoped to bring about abolition of the Polish Corridor, some sort of union with Austria, and extension of German influence in the Danube basin generally. But he set his sights first on torpedoing the Young Plan in such a way that the short-term lenders would not take fright and that the Bank for International Settlements (BIS) would find no handle to impose a financial quid pro quo.¹⁶

In 1931, the German government played a dangerous game. It undertook to destroy reparations once and for all. It scarcely expected to set in motion a process that would bring down the fragile international monetary system that had taken shape since the war. That happened as a byproduct of its political maneuvering. There is no space here to rehearse the dizzying rush of events that filled the spring and summer of 1931—the failure of the Austrian Kreditanstalt, the delay in implementing the Hoover moratorium on intergovern-

¹³ Brüning and Dietrich comments in "Niederschrift über die Besprechung der Reichsregierung mit den Vertretern der vier süddeutschen Länder im Staatsministerium in Stuttgart," Oct. 21, 1930, MA 104218, BHStA; see also the elaboration of similar ideas in the government's numerous meetings with interest groups during late 1930, in ARK Brüning (1982, Vol. 1).

¹⁴ Hermann Lutz to Institut für Zeitgeschichte, Aug. 9, 1952 (quoting Brüning letter of ca. Aug. 6), ZS 2319 (James Warburg), IfZ.

¹⁵ Brüning to Frau Dr. Theo Kordt, Aug. 6, 1947, NL Theo and Erich Kordt, ED 157/1, IfZ.

¹⁶ Brüning explanation to South German minister-presidents, Oct. 21, 1930, MA 104218, BHStA.

mental debts, the problems of the Darmstädter- und Nationalbank, and ultimately the collapse of the pound sterling. Suffice it to say that, the common wisdom notwithstanding, the U.S. government could not have saved the situation had it intervened more forcefully as a lender of last resort.

The difficulties were everywhere fundamental and political; no injection of liquidity could have reversed the downward spiral. For example, the Kreditanstalt had suffered losses six times greater than those publicly announced and, owing to the parlous condition of Central European agriculture, had teetered secretly on the brink of insolvency for years. The Reichsbank knew ahead of time that the Danatbank faced trouble, but it hushed up the matter instead of organizing a backup consortium for fear of compromising the government's adventurous foreign policy. The Bank of England too could probably have obtained additional support for the pound in Paris, if not in New York, had it cared to push the matter. Whitehall threw in the towel because it became evident that public attitudes had changed: the fierce opposition of Labour politicians to budgetary reform, coupled with the Invergordon naval mutiny, signaled the mounting determination of the working class to tolerate no further sacrifices for the sake of sterling's world role.¹⁷ The New York bankers charged with protecting private creditor interests watched the chain

¹⁷ For the delay in foreign discovery of the Kreditanstalt's true situation, compare Bank of France governor Clément Moret's note of May 12, 1931, reporting opinion at the BIS, with Charles Rist's subsequent "Note sur la réorganisation de la Crédit-Anstalt," Dec. 2, 1931, F³⁰/628, Ministère des Finances et de l'Economie, Paris. For Jakob Goldschmidt's futile efforts to warn the Reichsbank about the Danatbank's position, see Hans Luther diary, June 15, 1931, BA, NL Luther, Nr. 365; also Paul Silverberg to Gustav Stolper, July 19, 1931, copy in ED 93/44, NL Schäffer, IfZ. For an illuminating contemporary analysis of the underlying reasons for the fall of sterling, see Financial Attaché Jacques Rueff's "Note sur les causes et les enseignements de la crise financière anglaise," Sept. 30, 1931, Carton 52, Pierre-Etienne Flandin Papers, Bibliothèque Nationale, Paris; watered-down version in Rueff (1977, pp. 299-320). In contrast to the prevailing Depression-era mythology, new evidence suggests that the British government faced a virtual "workers' ramp" in the summer of 1931. Trades Union Congress leaders turned a deaf ear when apprised of the danger to the currency. They were "not convinced that the situation was quite so desperate as alleged," the TUC general secretary coolly observed at a meeting with cabinet members in late August; "there were enormous resources in the country." When, shortly afterward, Edward Peacock of the Bank of England revealed to seven top unionists the precise figures showing how close the nation stood to the abyss, Ernest Bevin finally conceded, "I think you have made your case. But," he added with a wink, "don't expect me to say so in public." Sir Horace Wilson of the cabinet secretariat correctly maintained in retrospect: "All talk of credits to bridge a period while the house was set in order was eye-wash because the house-keepers could never agree to the end of time that any action was necessary" (see Meeting of a General Council Subcommittee and the Cabinet Subcommittee, Aug. 20, 1931, Ernest Bevin Papers II /7/ 8, Churchill College Archives, Cambridge; L. P. Thompson-McCausland note of a conversation with Sir Edward Peacock, Apr. 21, 1943, and H. C. B. Mynors memorandum of a conversation with Sir Horace Wilson, Sept. 22, 1943, both in G15/29, B/E). Kunz (1987) now provides the best full study of Britain's departure from gold.

of catastrophes lengthen in Europe without finding a suitable way to exert a steadying influence. The account here will focus on the consequences of what happened in 1931 for their clients—the investors who had hopefully committed their funds to the German economy. No crisis illustrates better the precept that in international finance the lender easily becomes the prisoner of the borrower, particularly the borrower in bad faith.

In the early months of 1931, New York banking leaders repeatedly warned Berlin that to refuse further reparations transfers would affect German credit adversely. As a last resort the Reich might apply to the BIS for an advance, as the Young Plan had prescribed. The most sensible course, however, was to hang on until the U.S. bond market revived sufficiently to make long-term borrowing feasible again. Ambassador Sackett seconded that judgment. Germans who had sent their money abroad after the strong Nazi showing in the 1930 elections showed signs of willingness to repatriate it in order to earn the higher return available at home. The Reichsbank should therefore bide its time. The proper fiscal policy would raise government credit and allow conversion of short debt to longer maturities. But these counsels of patience fell on unreceptive ears. As Berlin saw it, Americans who preached the old-time religion did not understand the political costs of fiscal sobriety. The German government could not afford to examine the question from a purely financial point of view.¹⁸

Opinions differed about Reichsbank President Luther's technical skills. After Luther had moved on to the Nazi embassy in Washington, Hjalmar Schacht joked maliciously that his erstwhile rival had "perhaps become a diplomat; a banker he had never been."¹⁹ Yet those who had worked most closely with Luther described him as "decent, intelligent, and an absolute straight shooter," frequently wanting in political intuition, but well deserving the reputation for integrity that he had gained as finance minister and chancellor during the 1920s.²⁰ The critics, in any case, concentrated their fire on Luther's dramatic lowering of the discount rate as a method to fight the Depression. That policy had led to an outflow of hot money and thereby weakened the banking structure, while predictably failing to produce any appreciable downward movement in the long-term rates crucial for investment.²¹ Luther's response to prodding from the Americans, however, squarely reflected the governing consensus.

¹⁸ Deputy Governor Jay Crane memorandum for Governor George Harrison (FRBNY), Jan. 24, 1931; Luther to Ambassador Frederic Sackett, Feb. 27; Luther to Harrison, Mar. 16; and Sackett to Harrison, Mar. 17 and Apr. 10, 1931, in "Reichsbank/Dawes Committee/Young Committee 1929-31" file, FRBNY.

¹⁹ Quoted by Lutz Graf Schwerin von Krosigk, "Aufzeichnungen zur NS-Zeit," ZS/A-20/3, NL Schwerin von Krosigk, IfZ.

²⁰ Hans Schäffer to Schwerin von Krosigk, June 12, 1964, ZS/A-20/9, IfZ.

²¹ Silverberg to Stolper, July 19, 1931, ED 93/44, IfZ.

As late as February 1931, Luther had not yet grasped the magnitude of the payments problem facing him: he estimated total foreign commercial indebtedness at 19.3 milliard RM, scarcely three-quarters of the figure later ascertained. He saw no prospect that Germany could service even this sum, let alone pay future reparations, except through additional borrowing. In a long jeremiad, Luther enlarged on the theme that the Reich ran a natural trade deficit. Since there was no surplus from production, events since 1924 had obliged the country to go "deeper and deeper into debt" in order to purchase imports, finance reparations, and service the loans that made the system work. The favorable merchandise balance that had arisen in 1930 merely reflected the decline in domestic purchasing power and the "cruel compulsion" to sell goods below true cost, thus occasioning a loss of real wealth. No one knew the actual rate of capital formation—estimates ranged from zero to 6 milliard RM annually—but, whatever the figure, Luther pronounced it "by no means adequate" to offer hope of repaying the debts through growth. Nor could one tap the large sums secreted abroad by German nationals in search of safety or an escape from taxation. Those assets might return if times improved, but they were "not available for the repayment of indebtedness."

Luther could envision only one solution. Foreigners had to provide more money—preferably long-term credits at lower rates than those obtaining in the short market. The Reichsbank president had mastered his craft well enough to realize that inverted yield curves do not appear spontaneously in a depression, so he drove his point home. The creditor nations should furnish 2 milliard RM on "really bearable" terms that did "not make operating on a profit basis impossible for the debtor." So far the argument has a contemporary ring. A half century later, the finance ministers of certain developing countries could have recycled the script with little alteration to voice their own complaints about the debt overload. Luther, however, added a twist peculiar to his own time and circumstances. What the world required to escape from the vicious circle was "a thoroughgoing change of the present international system of relations"—in other words, revision of the Versailles treaty.²²

Luther's analysis called attention to an alarming development. Responsible German opinion had begun to blur the distinction between the reparations debt and the commercial debt. Nazi and Communist agitation posed a growing threat to basic social and political institutions in the Reich. In light of this menace, even officials professionally concerned with maintaining Germany's credit standing recoiled from advocating policies that would reserve a fixed slice of the shrinking economic pie to meet foreign claims of any description. Given the unpredictability of hot-money flows, holders of German commercial obligations had almost as much to fear from a sudden crisis as did govern-

²² Luther to Sackett, Feb. 27, 1931, "Reichsbank/Dawes Committee/Young Committee" file, FRBNY.

ment creditors under the Young Plan. Even before a run on the mark began in June 1931 as a sequel to the Austrian customs-union imbroglio, a foreign-payments breakdown thus seemed like an accident waiting to happen.

Banking observers had no doubt that the speculation against the mark had its origin in Berlin. Governor Harrison of the New York "Fed" immediately targeted the problem in Germany, as in Austria, as "more largely a flight from their own currencies than a withdrawal by foreign creditors." Another regional governor of the Federal Reserve observed that Germany appeared to be "playing very high stakes in connection with reparation matters."²³ Nevertheless, as soon as the emergency manifested itself, Harrison, overriding skepticism about German political aims in Washington, joined with Montagu Norman of the Bank of England in arranging a credit for the Reichsbank. He also twisted the arms of the major Wall Street private bankers, who agreed (some with better grace than others) to maintain their short-term portfolios intact.

But Harrison's mood turned to irritation when it became clear that the Reichsbank either would not or could not take effective action to stop German flight from the mark. The problem was admittedly a baffling one. As a result of the searing inflationary experience of the early 1920s, German businesses had routinely hedged against the risk of a recurrence by carrying out foreign transactions through subsidiaries or straw men in the Netherlands and Switzerland. Both businesses and financially sophisticated individuals could easily turn to an established network for sheltering their assets. The authorities in Berlin, by contrast, hesitated to court unpopularity at a critical juncture by employing the crude administrative means at their disposal to clamp down on the outward flow. Luther, after running through the first \$100 million central-bank advance, talked distractedly of needing \$500 million to \$1 billion more in order to avoid a breakdown (Clarke, 1967, pp. 189-201). Harrison now insisted: "We should not be asked to participate in another credit . . . until we have definite evidence that the Reichsbank has taken more stringent steps than it has yet taken to limit or control the export of capital by German nationals."²⁴ Yet for another month little improvement came about. A junior officer at the bank chronicled the evidence available at Liberty Street: "Not a day passes but we are called on to cash checks drawn on us by Heinies who have chosen this as an ideal time to get out of Germany and see the world. . . . Apparently they have little trouble obtaining Reichsbank checks."²⁵

²³ Harrison to Governor James B. McDougal, FRB Chicago, July 9, 1931; Governor George J. Seay, FRB Richmond, to Harrison, July 10, 1931, both in "U.S. Problems and Credits to Austria/Germany/Hungary, Jan.-July 1931" file, FRBNY.

²⁴ Harrison to McDougal, July 9, 1931, FRBNY.

²⁵ E. O. Douglas to Jay Crane, "Crane's trips 1925-33" file, FRBNY.

The fact that the capital flight came from Germany itself should have made it technically easier to reverse the flow of funds.²⁶ But Luther presented himself (perhaps accurately) as "quite helpless" during the crisis.²⁷ Negotiations for an additional central-bank credit ran aground. A bankers' advisory committee that met in Basel during August determined that the current state of international affairs rendered any consolidation of existing indebtedness "out of the question."²⁸ The external short-term creditors had no choice but to accept a Standstill Agreement that froze their assets. And when Berlin at length established exchange controls, these applied as rigorously to foreigners as to German nationals. Indeed, once the first flush of patriotic fervor had faded, the Reich government found it convenient to tolerate some bending of the regulations by its own citizens (particularly those with business connections in the Netherlands) while holding foreign banks to the letter of the law.²⁹

Discussions among the New York bankers and their Washington contacts during the crisis months underscored how deeply politicized the question of private loans had become. President Hoover harbored an obsessive grievance against the French for maneuvering to obtain special advantages out of his war-debts and reparations moratorium; he couldn't make out "what ails these French fellows." Thomas Lamont of J. P. Morgan & Co. sought repeatedly to rivet the president's attention on the main issue. The French, Lamont admitted, were "the most difficult people to deal with in the whole world." But one shouldn't forget that the Germans had brought the situation on themselves by expending money on a "reckless" scale. American banks had already sustained injury owing to the frozen banking credits indirectly used to pay reparations. American investors lugged along huge quantities of state and municipal loans far below cost price. And yet officials in Berlin naively imagined that they could continue to "unload their troubles on the rest of the world."³⁰

Former Agent General S. Parker Gilbert, now Lamont's partner at 23 Wall

²⁶ Deputy Governor W. Randolph Burgess memorandum for Harrison, July 21, 1931, "U.S. Problems and Credits" file, FRBNY.

²⁷ The judgment is that of Leon Fraser, vice president of the BIS (Clarke, 1967, p. 197).

²⁸ Albert H. Wiggin (Chase National Bank) telegram to Harrison, Aug. 11, 1931, in "Correspondence with Wiggin Committee in Basel and Bank for International Settlements, 1931-34," FRBNY.

²⁹ On operation of the Standstill agreements, see Harris (1935, pp. 22-39). For an insight into the selective enforcement policy, see the testimony of Carl-Christian Schmid, Prussian regional government chief (Regierungspräsident) in Düsseldorf, who supervised the main tax investigation unit in western Germany, in Verhandlungsprotokolle des Verfahrens gegen Dr. Fritz Thyssen, Aug. 30, 1948, MC2/H21, IfZ.

³⁰ "Memorandum of conversation between H.H. and T.W.L.," June 29; Lamont memorandum for Martin Egan (for the president), July 9; and Lamont to Hoover, July 27, 1931, all in Thomas W. Lamont Papers, Box 98/19, Harvard Business School.

Street, elaborated what ought to be done in hard-hitting memoranda for the secretary of the treasury and the New York Fed. Emphasizing the political nature of the problem, Gilbert neatly disposed of the idea that a lender of last resort could help. Germany, he noted, had apparently proceeded on the assumption that "she could go bankrupt in water-tight compartments and keep her general credit while advertising her inability to perform her international obligations under the Young Plan." Attempts to provide external assistance would thus merely call more attention to difficulties that the Reich had done the most to create. The Reichsbank, he insisted, knew how to check the outflow of capital through discount policy and the rationing of foreign exchange to German nationals. Brüning, who had bogged down in financial trivia, should then really balance the budget and curb the abuses that the Agent General's office had chronicled for six long years. If Berlin in addition employed the full amount of reparations relief under the Hoover moratorium to reduce its short-term indebtedness and raise its credit standing accordingly, a substantial volume of loans would be freed for productive business use. The time had come for the German government to "act to save itself, instead of looking to foreign loans and credits as a means of avoiding the disagreeable job of internal reform."³¹

What Parker Gilbert failed to explain was who could force Germany to adopt that advice. He, after all, had met with no success. Indeed, Brüning often described as a major frustration the fact that Gilbert's name was so closely linked with all criticism of an admittedly "wrong-headed" expenditure policy.³² With the disappearance of the Agent General's apparatus in May 1930 as stipulated by the Young Plan, could less politicized external institutions somehow find the leverage to exert useful pressure? Shepard Morgan, Gilbert's former assistant in Berlin, who now served as vice-president in charge of Central Europe at the Chase National Bank, expressed skepticism. Morgan dismissed as chimerical the theory that American bankers could turn short credits into self-liquidating credits and gradually retire from Germany. He deprecated the common notion of letting the French decide whether to intervene, either to save Germany from Hitler or Communism or more narrowly to safeguard their reparations revenues. In plain fact, most of the short-dated debt had circulated in Germany since 1927-28 and formed an integral part of that country's economic fabric. Any attempt to withdraw it would exacerbate deflationary trends and imperil the long-dated debt. The latter—which included \$1.355 billion of German securities publicly floated on U.S. markets and \$675 million in direct corporate investments or American hold-

³¹ Gilbert to Mills, July 21, 1931, Ogden Mills Papers, Box 9, Library of Congress; Gilbert memorandum, July 21, 1931, "Reichsbank/Dawes Committee/Young Committee" file, FRBNY.

³² Brüning conversation with French Prime Minister Pierre Laval, July 18, 1931, in ARK Brüning (1982, Vol. 2, p. 1390).

ings of German securities—would be lost without a “restoration of confidence.” That in turn required the scaling back of reparations and war debts, not because of doubts about German capacity to pay, but because reparations constituted a “factor of disturbance” in German politics.³³

Deputy Governor W. Randolph Burgess, the keenest economist among the New York Fed's top officers, echoed that assessment. Burgess took a relatively optimistic view of Germany's balance-of-payments prospects. From a technical point of view, he perceived no reason why the Reich could not maintain a current-account surplus and reduce its short indebtedness in an orderly fashion over time. In a period of uncertainty, however, capital movements would outweigh what happened to trade, and those movements reflected primarily social and political attitudes and the state of national feeling. He, Shepard Morgan, and W. W. Stewart, the American adviser to the Bank of England, concluded in September 1931 that the fate of the Polish Corridor, the state of German relations with Eastern Europe, and the resolution of French security fears constituted the real variables behind the German payments crisis. Their pessimism grew out of a conviction that the European nations would not tackle those political problems effectively.³⁴

The American bankers had correctly grasped the issues uppermost in the minds of German officialdom. Luther's lethargy during the negotiations for enlarging the central-bank credit in July 1931 stemmed largely from his fear that the Americans and the British might condition such aid on the continuance of token reparations. Moreover, since he expected long-term rates to fall as the Depression deepened, Luther could muster little enthusiasm for a conversion scheme that locked the Reich into high-rate obligations for an indefinite period.³⁵ With reparations suspended and a Standstill for short debts in hand, Luther and Brüning concentrated their efforts during the autumn of 1931 on making sure that the Standstill renewal carried no linkage to French demands that the Berlin government discontinue building pocket battleships and renounce its designs on Austria and Poland.³⁶ That did not, in political context, constitute a radical view. In arguing that finance should ride in tandem with diplomacy, the cabinet and the Reichsbank reflected a sentiment that had found wide expression in the business community as well as among the general public all through 1931.³⁷

³³ Shepard Morgan, “Memorandum on German short-dated debt reduction,” July 6, 1931, “Reichsbank/Dawes Committee/Young Committee” file, FRBNY.

³⁴ W. Randolph Burgess, “What does Germany require?” July 21; Burgess memorandum for Harrison, Sept. 3, 1931, in “Reichsbank/Dawes Committee/Young Committee” file, FRBNY.

³⁵ Luther to Hans Schäffer, Sept. 4, 1931, NL Luther, Nr. 337, BA.

³⁶ See esp. Niederschriften Luthers, Aug. 23-31, Sept. 2-Nov. 14, 1931, in NL Luther, Nrs. 365-366, BA.

³⁷ In private, many German bankers and businessmen argued, much as American critics did, that their country ought to take the initiative to solve its own financial mess (e.g., F. G. Steiner

Despite their political preoccupations, both Brüning and Luther sought to keep the Reich firmly anchored within the international economic system. Surveying the disorder in the world economy, Brüning declared in October that "without an international solution there is no solution." Notions of austerity or radical devaluation held no appeal for him. Latter-day critics have often asserted that Brüning erred in pushing deflation as far as he did. Actually, however, the chancellor canvassed his options extremely carefully after Britain abandoned gold. He concluded that, in a nation still traumatized from the aftereffects of the 1923 hyperinflation, a limited devaluation or a joint float with sterling coupled with reflation at home simply could not be adequately controlled.³⁸ The slightest hint of inflation would devastate public confidence; that is why the finance minister tried to keep secret the modest increase in currency circulation that he initiated in the summer of 1931.³⁹

Scholars who have studied the problem with greatest attention to the specific context tend to agree that Brüning could not have successfully implemented a reflationary policy (Borchardt, 1980; Schiemann, 1980). Germany, unlike Great Britain, had no captive imperial market. It could not but anticipate that retaliatory tariffs would vitiate the prospect of export-led growth from a lower parity for the mark. A scheme for joint devaluation of all major currencies against gold, like that promoted by General Manager Pierre Quesnay of the BIS, met political objections everywhere. Domestic reflation, furthermore, would leave the structural distortions in the German economy untouched. As Brüning saw it, the only reasonable policy was to proceed step by step with a balanced reduction of wages, prices, and public expenditure in order to achieve a sounder equilibrium. By moving slowly, the chancellor thought he had a chance to escape the class conflict and mutinous incidents that had contributed to disaster in England. Through attentive management of production costs and living costs, he hoped to maintain domestic purchasing power intact.⁴⁰

to Max Haller, July 22, 1931, SAA 4/Lp 157; also Krupp von Bohlen und Halbach et al. to Brüning, July 30, 1931, in Maurer and Wengst, 1980, Vol. 1, pp. 800-806). But not a few, both before the crisis broke and afterward, mixed sober economic analysis with complaints on a more emotional level concerning the "imbecilic" Polish Corridor and other putative injustices connected with the Versailles treaty (e.g., Haller to K. G. Frank, Jan. 16, 1931, SAA 11/Lb 120).

³⁸ "Niederschrift über die Aussprache der Reichsregierung mit den Vertretern der Länder über die neue Notverordnung am 6. Oktober 1931," in MA 103463, BHStA; an alternative version, made by the representative of Baden, is in Maurer and Wengst (1980, Vol. 2, pp. 1019-1030). The record in ARK Brüning (1982, Vol. 2, pp. 1812-1815) is incomplete. For Brüning's consultation of outside bankers regarding devaluation, see Hans Schäffer Tagebuch, Nov. 28, 1938 (retrospective Jakob Wallenberg account of 1931 events), ED 93/25, IfZ.

³⁹ Dr. von Preger, "Aus einem Gespräch mit Minister Dietrich," Aug. 14, 1931, MA 103463, BHStA.

⁴⁰ Brüning comments on Oct. 6, 1931, in MA 103463, BHStA.

This ambitious program allowed little room for miscalculation or misfortune. And it rested on a major contradiction. Brüning preached revival of the economy by setting market forces free to work. Yet in practice his emergency decrees entangled the country ever more deeply in a web of government regulation. Almost by inadvertence, a centrally controlled economy developed, with all its rigidities and inefficiencies. From the foreign investors' narrow standpoint, the chancellor seemed nonetheless in late 1931 to be moving in the right direction, albeit at a snail's pace. Brüning counted on tightening exchange controls and on perpetuating the Standstill for interbank debts to obtain the necessary turnabout time. All the same, he showed no signs of wishing to default on long-term loans contracted from abroad, because that would bolt the door to further credit—a door, as he and the Reichsbank saw the matter, that still stood slightly ajar. In November 1931, Brüning went so far as to tell John Foster Dulles, a lawyer for American creditor banks, that the German government might substitute its own notes for state, municipal, and private short-term debt in return for a final reparations writeoff when the Hoover moratorium expired.⁴¹ It seems doubtful, however, that Berlin would really have dared to assume further responsibility. Privately, the Reichsbank expressed extreme pessimism about facilitating anything more than the payment of current interest on the 23.5 milliard RM of foreign-denominated debt now outstanding. Any provision for amortization, it insisted, would have to come from a concessionary reduction in interest rates.⁴²

To the end of his chancellorship, Brüning continued to nurture unrealistic hopes that massive foreign lending would resume. As late as April 1932, he tried to "enlarge" the Lausanne Conference agenda. The Allies should not merely cancel reparations, but supply a fresh 2 milliard RM loan as well. But when Belgian Foreign Minister Paul Hymans, a key intermediary, asked what assets Germany proposed to pledge for such a loan, Brüning turned evasive. He could not pledge the German railways because the Reich needed its

⁴¹ Dulles to Sullivan and Cromwell, Nov. 8, 1931, file C 261.12, FRBNY.

⁴² Reichsbank memorandum, "Exportüberschuß und Tilgung kurzfristiger Auslandsschulden," Nov. 5, 1931, BA, NL Luther, Nr. 338. The Reichsbank adopted a "worst case" position. It discounted all revenue from Germany's external assets as no more than required to balance foreigners' earnings on their direct investments in Germany denominated in Reichsmarks. It thought the improvement in German terms of trade (owing to falling raw-material prices) would not last. It feared that currency depreciation in Britain and protectionism in France and Switzerland would cut off key markets. It believed Russia and other soft-currency partners would decline to buy except on long-term credit. And it insisted that exporters could not be obliged to repatriate their earnings. The memorandum expressed guarded optimism about renewal of a short-term capital inflow, but held that such resources provided a mere "artificial possibility of transfer" and could not be counted when calculating the sums available for retiring outstanding debt. In the Reichsbank view, if Germany consistently generated a 2 milliard RM current-account surplus—which seemed virtually impossible—the net amount left for amortization of outstanding debt would be between zero and 200 million RM!

railway revenue to balance the budget as foreign financiers demanded. Nor could he pledge industrial properties. Profits from business were "indispensable" to the nation's existence, and besides that they were small. What's more, French and American capitalists already owned too many of the big industries. Hymans got the impression that, beyond the familiar dithyrambs on German suffering, Brüning could offer nothing concrete.⁴³ New York bankers, in part perhaps because of their inadequate appreciation of German political complexities, also lost patience with Brüning in the end. Despite his brave talk about economy, so ran the complaint, he had pushed welfare payments up to 45 percent of the federal budget and generally joined the "socializing mob"—incidentally leaving nothing over for debt repayment.⁴⁴

Notwithstanding Brüning's internationalist outlook, the monetary authorities serving under him gradually put in place a battery of exchange controls that complemented the Standstill Agreement and made it impossible for foreigners to withdraw their mark-denominated assets. The exchange restrictions required all proceeds from international transactions to pass through a blocked account. In essence, that enabled the German monetary authorities to decide what imports were essential and to what extent the export surplus might be employed to diminish short credits. The Reichsbank soon began manipulating the "blocked marks" system to promote exports and to improve German terms of trade. The blocked marks owed to foreigners traded at a depreciated level. With a license, however, those marks could be used to purchase designated German exports. The Reichsbank elaborated regulations so that foreign buyers could acquire overpriced German goods with these funds. The German exporter got full value, and the foreign creditor who wished to repatriate his holdings did so at a loss. The Reichsbank also permitted exporters to repurchase depreciated German securities abroad and to resell them at home at a premium as a means to finance "additional" exports (Harris, 1935, pp. 31-39, 51-81; Child, 1958). For the moment, the servicing of long-term bonds continued. But later the Nazi regime had only to refine procedures already in place and to apply them to the holders of long-dated debt in order to separate the hapless foreign creditor from his money.

Open Default

All through 1932, an intense though quiet debate raged in the German business community. Did the country's interests lie in continuing to service foreign bonds? Or did it make more sense to declare a general moratorium? The

⁴³ Hymans note, "Conférence avec Brüning," Apr. 22, 1932, in BMAE, Nr. 11.108 bis (Conférence de Lausanne). The 2 milliard RM figure precisely equaled what Luther had requested in February 1931 (see note 22 above).

⁴⁴ L. Galantieri (chief of the Foreign Information Division) to Deputy Governor Jay Crane, June 9, 1932, file C 261.12, FRBNY.

Lausanne Conference did not formally end reparations until July 1932, yet from the moment the Hoover moratorium took effect realists had proceeded on the assumption that transfers connected with the political debt would not resume, at least so long as the economic downturn lasted. Germany's commercial obligations appeared manageable, particularly with a Standstill covering half the short-term borrowings. Table 8 compares the debt ratios for Germany at the trough of the Depression with those for non-oil-producing developing countries at key points in the present third-world payments crisis. By current standards, Germany's gross debt loomed relatively large in relation to its national income and exports. Owing to the lower nominal interest rates prevailing in the early 1930s, however, the debt-service burden remained surprisingly modest. The nation could undoubtedly have soldiered on under the Standstill, even if it failed to persuade creditors to adjust the interest rate on long-dated obligations to match the falling price level. Whether it decided to maintain faith with the lenders would reflect a political choice. On one side of the argument stood the spokesmen for export-oriented industries, who feared that default would cut them off from overseas trade accommodation and who shared the internationalist outlook of the Finance Ministry and the Reichsbank. On the other side massed a heterogeneous coalition. It included bankers who calculated that a moratorium on bond interest would allow them to scale down their short-dated liabilities, producers for the home market who hoped for recovery through domestic deflation, and nationalists who resented foreign claims of every description.

Electrical industry magnate Carl F. von Siemens, who typified exporters' preferences, bent every effort to reassure his American banking contacts that

TABLE 8
COMPARATIVE DEBT RATIOS: GERMANY, 1931-32, AND
NON-OIL DEVELOPING COUNTRIES, 1973-82
(in percent)

| External Debt Ratios | Germany | | Non-Oil Developing Countries | |
|-------------------------------|---------|-------|------------------------------|-------|
| | 1931 | 1932 | 1973 | 1982 |
| Debts/exports ^a | 211.6 | 285.8 | 115.4 | 143.3 |
| Debt service/exports | 10.7 | 12.9 | 15.9 | 23.9 |
| Debts/GDP or NNP ^b | 40.7 | 39.4 | 22.4 | 34.7 |

SOURCES: "Germany's Indebtedness," memorandum of June 26, 1934, file C 261—German government, FRBNY; Hoffmann (1965, p. 826); Cline (1984, pp. 2-3).

^a Goods and services.

^b GDP for LDCs; NNP for Germany.

even Hitlerites distinguished between "political" debts and private debts and would continue to uphold promises made on the latter. In March 1932, Siemens went so far as to charge fellow Germans who had borrowed improvidently with "dishonesty" and "errors . . . not free from fraud." The nation, he insisted heatedly, should do everything possible to regain the world's confidence instead of going around "moaning and groaning" and "acting like a beggar."⁴⁵ Other Siemens executives pointed out that the National Socialists and their fellow travelers who so glibly talked of autarky had no real conception of the role played by trade in the German economy (for confirmation, see Tables 3 and 7 above). Finance chief Max Haller conceded that, by early 1932, twenty-eight Latin American and East European countries had already gone into default. Germany, however, was not "any old predatory state." It figured rather as a key partner in the global trading network. If it declared a moratorium, the confidence requisite for world commercial revival would suffer a devastating blow.⁴⁶

Yet in the grim winter of 1932, such arguments appeared increasingly abstract. Berlin bankers passed the word to corporate customers that default would move to the top of the national agenda as soon as the credit institutions had completed their own reorganization.⁴⁷ Businessmen felt obliged to make strategic plans accordingly. The bankers naturally had their own axes to grind. Owing to cultural patterns and recruitment practices, the great banks had stood with the liberal wing of industry for most of Weimar's history. The liquidity squeeze of 1931-32 now modified traditional sympathies. Hjalmar Schacht emerged as the point man for proponents of default. Although temporarily bereft of a bureaucratic base, Schacht remained a major political and financial player. He gradually became a key bridge builder between conservative business forces and the Nazis. Most business leaders abhorred everything that National Socialism represented. Still, as the traditional bourgeois parties skidded into decline, certain executives came to see merit in Schacht's contention that it was worthwhile political insurance to cultivate the least unreasonable elements in the NSDAP in hopes of lessening their ignorance about the way the economy functioned (Turner, 1985a). For Schacht, the campaign for default served to solidify his nationalist credentials, to help his friends at the banks, to sustain his feud against Luther and Schäffer, and to advertise his quest for public office.

⁴⁵ George W. Davison (Central Hanover Bank and Trust Co.) to Siemens, Oct. 28, 1931, SAA 4/Lf 536; Siemens speech to a study conference of the Deutsche Reichsbahn, Mar. 7, 1932, SAA 4/Lf 873.

⁴⁶ Wolf von Witzleben to Siemens, Feb. 17, 1932, SAA 4/Lf 663; Max Haller to K. G. Frank, Jan. 14, 1932, SAA 11/Lb 374.

⁴⁷ Haller to Siemens, Feb. 19, 1932, reporting views of Oskar Schlitter, a principal figure at the Deutsche Bank und Discontogesellschaft, SAA 4/Lf 663.

When the Danatbank failed in July 1931, Schacht had at once advocated limiting the prospective government rescue plan to small depositors, leaving institutional lenders to twist slowly in the wind. What an exemplary way, he thought, to "expose the responsibility of foreign creditors for their irresponsible granting of credit to German banks." Hermann Dietrich and Hans Schäffer of the Finance Ministry had fought off the idea by pointing out that it would increase market aversion to all German securities and very likely set off a run by foreign depositors at other Berlin banks.⁴⁸ In April 1932, consequently, Schacht returned to the charge with a judiciously altered target. It made no sense, he observed, to keep current with long-term, mostly public-sector obligations while productive German businesses had trouble securing external accommodation because interbank credit lines remained frozen. The nation's welfare required on the contrary that "the transfer of short-term debts . . . be given preference over the transfer of long-term debts." Why not resurrect the old Transfer Committee, this time run by and for Germans, to establish suitable priorities? One might, he added cunningly, invite nominees of foreign banks to serve on the proposed body, confident that they would offer the most powerful support for "disregarding" the bondholders' interests. Would not such nominees readily agree that short-term debts represented essential bank capital and high-powered money, while long-dated investments derived from savings and typically constituted a dispensable fraction of the foreign bondholder's portfolio? The bondholder could not legitimately complain if solvent debtors continued to pay Reichsmark interest into a blocked account. Schacht foresaw that his plan would require centralizing foreign trade through a national purchasing and sales organization. But he hoped it would also allow the Reichsbank to eliminate its inefficient exchange controls, which he felt provided an undesirable incentive for foreigners to purchase German business assets at fire-sale prices.⁴⁹

Similar notions commended themselves to fellow bankers who neither trusted Schacht personally nor approved of his new political friends. In May 1932, German fixed-income securities traded in London and New York at 15 to 30 percent of face value. These figures indicated that the Reich had already lost its credit standing. Under the circumstances, argued Jakob Goldschmidt, former head of the Danatbank, it no longer served "the slightest psychological or moral purpose" to continue paying interest on the bonds. Goldschmidt would have preferred an open devaluation of the mark. But that, he acknowledged, remained politically impracticable until an "explosion" forced Amer-

⁴⁸ Schacht to Karl Blessing, Nov. 13, 1953; Hans Schäffer to Wilhelm Vocke, Oct. 14, 1953, both in NL Schäffer, ED 93/43, IfZ; also Hermann Pünder memorandum on Schacht's advice, July 12, 1931, in ARK Brüning (1982, Vol. 2, p. 1344).

⁴⁹ Schacht to Gustav Krupp von Bohlen und Halbach (chairman of the RDI), Apr. 28, 1932, also July 18 and Dec. 20, 1932, FAH IVE 1124, Krupp-Archiv.

ica off gold and facilitated a general realignment of currencies. In the meantime, default would clear the way for an expansive domestic credit policy without untoward balance-of-payments constraints.⁵⁰

Main-line industrial leaders, except for some pro-Nazi mavericks like Fritz Thyssen, did not generally go that far. To be sure, officials of the Reichsverband der deutschen Industrie bluntly rejected a suggestion made by Belgium's representative to the BIS that German industries form an investment trust to sell stock abroad and use the proceeds to liquidate the Standstill debt. German corporate executives attained a rare unanimity in ruling out the sale of depressed stock shares to foreigners, however grim the balance-of-payments position.⁵¹ Still, these same executives expressed chagrin when rumors began to circulate immediately after the Lausanne reparations settlement that the Reich already had a scheme in preparation for forced private-debt reduction. The world would never understand, cautioned Gustav Krupp von Bohlen und Halbach, chairman of the RDI, if the country now raised new financial demands. If it turned out that Germany's situation really made it impossible to service long-term bonds, time enough would remain to work out a mutually agreeable arrangement with creditors to limit transfer. Like Reichsbank President Luther, Economics Minister Warmbold, and War Minister von Schleicher (the dominant figure in government by mid-1932), Krupp and his RDI associates wished to proceed "in peace and quiet," preferably leaving the initiative to the lender nations.⁵²

General von Schleicher believed that bondholder representatives might well incline toward a reasonable compromise. Several New York bankers who had floated German bonds openly bemoaned the Hoover administration's failure to offer a "constructive program" for the relief of private international debt. Some encouraged German clients to buy back their own securities at depreciated levels.⁵³ Berlin perceived these straws in the wind as signs of flexibility. In fact, by early 1932 State Department officials had become gravely preoccupied with what would happen to all international payments once the Hoover moratorium expired. Assistant Secretary Harvey Bundy feared a "general effect throughout the world on the will of all debtors to pay" if war-debt and reparations arrangements broke down. He cast about for a practical method of avoiding a clash between the interests of the taxpayers

⁵⁰ Goldschmidt to Fritz Thyssen, May 13, 1932, FAH IVE 1124, Krupp-Archiv.

⁵¹ Charles Frérichs to Krupp, Dec. 10; Ludwig Kastl to Krupp, Dec. 16; and Krupp to Frérichs, Dec. 18, 1931, FAH IVC 259, Krupp-Archiv.

⁵² Kastl to Reichswirtschaftsministerium, July 23; Krupp to Hermann Warmbold, July 30; Schleicher to Krupp, Aug. 8; Warmbold to Krupp, Aug. 13, 1932, FAH IVE 178, Krupp-Archiv.

⁵³ K. G. Frank to Max Haller, Dec. 23, 1931, reporting views of Durrell of Field, Glorie & Co.; Frank to Haller, Sept. 30, Oct. 9, and Dec. 18, 1931, forwarding advice from Ferdinand Eberstadt of Dillon, Read & Co., all in SAA 11/Lb 374.

and those of private creditors. But he came up with nothing but platitudes. It was all very well to say that "the only way to handle this situation is by realistic appreciation of the fact that the economic and financial structure of Germany depends upon proper private credits and that the source for the payment of money must be the vitality of the economic structure out of which the payments are to be made." Secretary of the Treasury Ogden Mills did not see what further sacrifice the American government could make. Bundy had to concede that, while economists might think the United States should forget the justice of war debts, proposals for cancellation had no chance given the popular outcry against "preferring the foreign debtor to the American taxpayer and preferring the private American creditor in Europe to the American taxpayer."⁵⁴

At the end of 1932, France defaulted on its war debt. Great Britain almost followed suit. The French action rated as particularly cynical, since everyone knew that earlier in the year France had withdrawn enough gold from the New York Federal Reserve Bank to prepay its entire war-debt obligation through 1942.⁵⁵ Thomas Lamont of J. P. Morgan & Co. warned the secretary of state that within six months of a public-debt breakdown "we would see Germany eagerly grasping at private default." The lesser European nations, he predicted, would welcome a German moratorium and use it as an excuse to "fall by the waysides with the South American countries."⁵⁶ A precedent for default had thus been established prior to Hitler's seizure of power.

The ongoing machinations of Hjalmar Schacht reinforced the premonition of trouble to come that Lamont had expressed to the State Department. In October 1932, Schacht had secretly journeyed to London to discuss the financial outlook with Governor Montagu Norman of the Bank of England, his comrade-in-arms from the era of central-bank cooperation. Schacht made an impassioned plea for his now-familiar scheme of a transfer moratorium on all German long-term debt. Although without authority to speak for the Reichsbank, he conveyed the impression that Chancellor Franz von Papen and Foreign Minister Constantin von Neurath had encouraged him to float a trial balloon. Out of sympathy for Schacht and his country, Norman agreed not merely to present the idea to J. P. Morgan, a presumptive spokesman for U.S. creditors, but even more remarkably to give it a measure of support. Norman readily convinced himself that Germany was "slowly bleeding to

⁵⁴ Bundy memorandum, "Intergovernmental debts," Jan. 22, 1932, U.S. State Department file 800.51W89/475½, Record Group 59, National Archives (hereafter cited as US/file number); Feis memorandum of conversation with Mills, Mar. 17, 1932, US 800.51W89/498.

⁵⁵ Bank of France memorandum, "Note sur la liquidation des devises de la Banque de France," May 23, 1932, copy in Box 60, Flandin Papers, Bibliothèque Nationale.

⁵⁶ Telephone conversations between Secretary Stimson and Lamont, Nov. 28, 1932, US 800.51W89/598½.

death" and urgently needed additional help. Harry Siepmann, the Threadneedle Street expert on Central Europe, echoed Schacht's argument that servicing long-dated bonds weakened the Reichsbank and postponed liquidation of the short position, thus diminishing Germany's solvency and reducing the prospects for trade recovery. He praised the plan on offer as "a confident attempt to anticipate and avoid an otherwise inevitable catastrophe" and assured Norman that, far from being a declaration of bankruptcy, it could be "put over as a bull point."⁵⁷

The American bankers strenuously resisted this line of reasoning. Lamont and his partners at Morgan corner registered their shock at the notion that a government, whatever its difficulties, should "by decree force a declaration of external bankruptcy on all its nationals regardless of their individual solvency." They remonstrated that implementation of the proposal "would and should destroy the credit of that government and its nationals for an indefinite time." O. M. W. Sprague, an American adviser to the Bank of England, chimed in that default on such high-visibility obligations as the Dawes and Young loans could not but strengthen the "growing doubt of the good faith of the German government itself." The British Treasury, meanwhile, underscored the flaws in Schacht's financial analysis. While political conflict in Germany remained at a fever pitch, many indices suggested in the fall of 1932 that the Depression there as an economic phenomenon had finally bottomed out. The Reichsbank had improved its reserve position; the deposit banks had increased their liquidity; bankruptcies had fallen; production had stabilized; employment had begun to turn up. Schacht could not, in light of the latest Treasury figures, establish his case that the sky was falling. He had to bide his time for the moment. All the same, in sporadic conversations with Norman and Siepmann that dragged on through the end of the year, "Horace" (as his City of London friends called him) would abate not a jot or a tittle of his pessimism.⁵⁸

Hitler became Reich chancellor on January 30, 1933. Schacht put his campaign for debt relief into high gear after elbowing Luther aside and resuming his old post as Reichsbank president six weeks later. After three years in the political wilderness, Schacht yearned to display his authority. When Sir Walter Layton, who had devised the Standstill, inquired whether Hitler had any

⁵⁷ J. P. Morgan telegram to Lamont and R. C. Leffingwell, Oct. 13, 1932; Siepmann memoranda, Oct. 14 and 18; Norman notes, Oct. 15 and 16, 1932, G1/417, B/E.

⁵⁸ E. C. Grenfell to Siepmann, Oct. 19, 1932; J. P. Morgan to Norman, Oct. 19; Norman to Schacht, Oct. 19; J. P. Morgan & Co. to George Whitney, Oct. 21; Sprague memorandum, Oct. 17; Ernest Rowe-Dutton (financial attaché, Berlin), "The Outlook in Germany," Oct. 17, elucidated in R. V. N. Hopkins (Treasury) to Norman, Oct. 27; Siepmann memorandum of talks with Schacht at Lindow in der Mark, Oct. 21-22; Siepmann-Norman exchange, Nov. 6-7; Schacht speech in Rome, *Frankfurter Zeitung*, Nov. 21; notes of Norman-Schacht conversation at Thorpe Lodge, Dec. 7, 1932; all in G1/417, B/E.

notions about finance, Schacht replied: "Yes, he had one idea and a very good one. It was, leave it to Schacht."⁵⁹ As usual, Schacht was flattering himself. Hitler's immediate entourage continued to distrust the wily central banker as a hangover of the old order who lacked suitable receptivity to Keynesian prescriptions for fostering full employment. And while the Führer himself admired Schacht's technical competence and appreciated how helpful he might prove in reconciling business to Nazi rule, he took care to specify that his appointee would have to follow orders. Otherwise, he hinted darkly, "the Moor would have done his duty" (Turner, 1985b, pp. 260-265). Notwithstanding these undercurrents, Hitler accorded Schacht a large measure of support in the bureaucratic maneuverings of 1933. Economics Minister Alfred Hugenberg, the Nationalist Party leader in the coalition cabinet, wished to give up the Standstill and subject all foreign holdings to an interest-rate cap, to limit external remittances to a proportion of export earnings, and to shift a part of the remaining load to other nations' shoulders through an import surtax whose proceeds could be applied to the subsidy of exports (Leopold, 1977, pp. 152-156; ARK Hitler, 1983, Vol. 1, pp. 27, 71-73, 320, 373-379, 445-446). But this scheme was too radical even for Hitler. (Fifty years later, the liberal American press would find similar notions worthy of respectful consideration when advanced by the Cartagena group of debtor nations.)⁶⁰ Schacht believed that he could achieve the same relief for Germany without confrontation. The Reichsbank president confirmed to visiting Englishmen and Americans that he had resolved to suspend service on the long-dated debt, but said he hoped to do so through "negotiation." For example, the Allied governments might wish to lend Germany the necessary funds cheaply so that the private creditors could be paid off.⁶¹

Figures compiled by the State Department economic adviser, Herbert Feis, demonstrated that Schacht's program did not derive from financial exigency.⁶² Even using the most sophisticated techniques, it had become a matter of guesswork for outsiders to penetrate fully the fog of misleading statistics put out by the Reich Statistical Office. Still, it seemed apparent that Germany had by May 1933 diminished outstanding short-term debt from 13.1 milliard RM to around 8.3 milliard RM through conversion into blocked accounts and

⁵⁹ Layton Diary, Mar. 31-Apr. 3, 1933, copy sent to the prime minister, in James Ramsay MacDonald Papers, Public Record Office 30/69/282, London (hereafter cited as PRO).

⁶⁰ *New York Times* editorials, "Cool America, Boil the World," June 27, 1984; and "Stop Bullying Mexico," June 5, 1986.

⁶¹ Layton Diary, Mar. 31-Apr. 3, 1933, PRO 30/69/282; H. C. Hageman to Governor Harrison, "Germany's External Debt," Mar. 25, 1933, enclosing W. R. Gardner to Eugene Meyer (governor, Federal Reserve Board), Mar. 17, 1933, in file 261.12, FRBNY; also Schacht explanation to the German cabinet, in ARK Hitler (1983, Vol. 1, pp. 318-320).

⁶² Feis memoranda, "Estimate of Charges on the German Balance of Payments," Apr. 26, 1933, and "German Foreign Debts and the Transfer Problem," May 1, 1933, US 862.51/3636.

by discontinuing unused credit lines. The Standstill Creditors' Committee had accepted a reduced interest rate on the remainder. Moreover, the German government had already promoted the secret repurchase of an appreciable volume of long-dated bonds (although Feis's figure of 2 milliards face value for this item represented a serious overestimate).⁶³ The German surplus on current account (including the return on investment abroad) would suffice to cover all remaining foreign liabilities and leave a comfortable margin of some 630 million RM for debt retirement.

But such calculations proved beside the point. Schacht intended to husband his foreign exchange for rearmament purposes. Unfortunately for the bondholders, the administration that took office in Washington during March 1933 exhibited an extreme animus against creditor interests. That sentiment played directly into Schacht's hands. In May the Reichsbank head arrived in the United States to smooth the way for default. The Finance Ministry expert

⁶³ The German authorities began to repurchase depreciated bonds surreptitiously in the spring of 1932. These bonds fell to between 15 and 30 percent of par at the time of the Lausanne Conference in June-July of that year, then recovered to between 50 and 65 percent of par before Schacht's maneuvers drove them down again. Department of Commerce officials concluded that, by the time Hitler came to power, Germany had repurchased around \$400 million of dollar bonds and \$80 million of sterling bonds at par value, probably at an average discount above 60 percent. These figures, however, did not match up with German official statistics. The Reporting Office for Foreign Debts in Berlin (quoted in H. C. Hageman memorandum, "Germany's Indebtedness," June 26, 1934, file C 261—German government, FRBNY) published the following data on foreign-denominated debt, i. e., excluding direct investment:

GERMAN FOREIGN INDEBTEDNESS
(in milliards of RM at current rates of exchange)

| Date | Short-Term | | | Long-Term | Total |
|------------|------------|-------|-------|-----------|-------|
| | Standstill | Other | Total | | |
| July 1931 | 6.3 | 6.8 | 13.1 | 10.7 | 23.8 |
| Feb. 1932 | 5.0 | 5.1 | 10.1 | 10.5 | 20.6 |
| Sept. 1932 | 4.3 | 5.0 | 9.3 | 10.2 | 19.5 |
| Feb. 1933 | 4.1 | 4.6 | 8.7 | 10.3 | 19.0 |
| Sept. 1933 | 3.0 | 4.4 | 7.4 | 7.4 | 14.8 |
| Feb. 1934 | 2.8 | 3.9 | 6.7 | 7.2 | 13.9 |

Of the long-term debt, 55.2 percent was denominated in dollars, 11.5 percent in sterling. By February 1934, the United States had devalued the dollar by 40.94 percent, while sterling floated at a 37.5 percent discount from the 1931 par. Hence devaluation alone would have reduced the long-term debt to 7.82 milliard RM. These calculations point to a maximum repurchase of 620 million RM of bonds at face value. It would appear that either (1) German statistics are inaccurate, or (2) Americans overestimated the size of the repurchase program, or (3) Germany devoted some proportion of its available funds to repurchasing foreign-owned stock shares, domestic-issue bonds, and real estate denominated in Reichsmarks, or (4) some combination of the above occurred. By contrast, dollar and sterling devaluation reduced German short-dated liabilities by only about 4 milliard RM. Up to 2.4 milliard RM of the short-debt reduction may have represented actual repayments or credit-line discontinuance.

who accompanied the mission harbored doubts that the American government, even under New Deal auspices, would abandon the bondholders without a fuss. Schacht remained serenely confident. He thought initially he had found a kindred spirit in the Oval Office. President Roosevelt gave his thigh a resounding smack and exclaimed with a laugh, "Serves the Wall Street bankers right!"⁶⁴ The next day, however, after Roosevelt's advisers had explained to him the consequences of this display of pique, Secretary of State Hull obtained authorization to portray the president as "profoundly shocked." And Hull declared himself "utterly nonplussed."⁶⁵ Schacht, chagrined, had to reverse field temporarily. He agreed to a charade of negotiations with lender representatives in Berlin. He escaped embarrassment only because the Reich printing press broke down while reproducing the moratorium decree he had already authorized. Nevertheless, he shrewdly recognized that the first reaction from the White House figured as the important one. He dismissed Hull as unsuitable for his job. To Roosevelt he gave the highest accolade: the president reminded him "in every way of Hitler."⁶⁶ After all, an administration that repudiated the gold clause in government bonds, including those held by foreigners, could scarcely take the high moral ground regarding the sanctity of international obligations.

If the United States did not care to stand up for bondholder interests, certainly powers with less at stake had no reason to do so. British Treasury officials now hinted broadly that they considered a transfer moratorium the lesser of evils, provided the borrowers still met their nominal obligations in Reichsmarks. Whitehall expressed far greater anxiety lest Schacht resort to radical deflation and dump German goods abroad in competition with British exports.⁶⁷ At the World Economic Conference in June, Feis of the State Department attempted to mount some feeble counterpressure. He told the Reichsbank president that, if he continued servicing the Standstill debt held largely by the London City while suspending transfer on long loans owed primarily to the United States, or if he discriminated among creditor nations depending on the bilateral trade balance, Americans would interpret such policies as concessions to "British interests."⁶⁸ Schacht could simply shrug off this protest from a working-level bureaucrat. Shortly thereafter, he called

⁶⁴ *Documents on German Foreign Policy* (1957, Vol. 1, pp. 283, 394); Weinberg (1963, pp. 166-180); Weinberg (1970, pp. 135-144); Freidel (1973, pp. 397-398); recollections of Finance Ministry aide H. Fritz Berger in Berger to Krausnick, May 25, 1963, ZS 1684, IfZ.

⁶⁵ Hull memorandum, May 9, 1933, US 862.51/3988½.

⁶⁶ For details on Schacht's further maneuvers and negotiations with the lenders, see ARK Hitler (1983, Vol. 1, pp. 489-491, 547-550, 577-579; comment about Hull on p. 490). Schacht's evaluation of Roosevelt is quoted in Weinberg (1970, p. 141n); see also Berger recollections in ZS 1684, IfZ.

⁶⁷ Attaché financier Jacques Rueff to Ministère des Finances, May 26, 1933, F³⁰/1340, Ministère des Finances et de l'Économie, Paris.

⁶⁸ Feis memorandum, June 13, 1933, US 862.51/3618½.

leading export industrialists to his Berlin office to explain what he sought to achieve. By paying bondholders partly in scrip, convertible at a 50 percent discount, he expected to boost exports by some 600 million marks a year. That would enable him to counter American, British, and Japanese "dumping" without departing from the old fixed parity for the mark.⁶⁹ Max Haller of Siemens said incredulously: "They'll declare us to be swindlers!" Schacht reassured him. The American government would see to it that the bondholders didn't make serious trouble. He cautioned the assembled chief executives to shelter their foreign assets from attachment. To Haller's great surprise, it turned out that his colleagues at AEG, IG Farben, and the Vereinigte Stahlwerke had already done so.⁷⁰

A few business leaders remained skeptical that Schacht would succeed in boosting exports through his maneuvers. A handful of firms like Siemens, with worldwide reputations to maintain, continued to regret that the Reichsbank forbade them to pay hard-currency debts out of their foreign resources.⁷¹ But as risk-assessment specialists know, all international lending is general lending. There can be no such thing as a solvent firm in a bankrupt country. As time went on, practical-minded executives found it expedient to sail with the wind. It became clear, in any case, that overvaluation of the mark constituted the chief impediment to export recovery. Neither transfer restrictions nor, for that matter, the unpopularity of German policies toward the Jews appeared to have much effect on the prospects for trade.⁷² Moreover, businessmen with an internationalist outlook soon realized that they had no power to influence the Nazi regime. Indeed, in the context of the Third Reich, Schacht emerged as the champion of those who wished to preserve a sphere for the free-market economy, despite his attitude toward Germany's debts.⁷³

⁶⁹ Shortly before Schacht returned to office, the Reichsbank professional staff had again ruled out devaluation as an option for Germany, even if the United States depreciated the dollar. The experts there argued that devaluation of the mark would conjure up a fear of inflation not far short of "mass psychosis," and that could not fail to retard economic recovery. Also, most German domestic debt was payable in gold; devaluation would increase the burden it imposed. Finally, the experts considered the U.S. currency by no means overvalued in March 1933. They doubted (as it turned out incorrectly) that Roosevelt could make a devaluation stick for domestic political reasons alone. The professional consensus in the Reichsbank did not change under the Schacht regime. See Statistische und volkswirtschaftliche Abteilung der Reichsbank, "Devaluation in Deutschland im Anschluß an U.S.A.," Mar. 8, and "Auswirkungen einer Währungsverschlechterung in U.S.A. für den Fall, daß Deutschland nicht anschließt," Mar. 9, 1933, BA, NL Luther, Nr. 358.

⁷⁰ "Notiz über die Besprechung in der Reichsbank," June 23, 1933, SAA 11/Ld 752.

⁷¹ Carl F. von Siemens report of conversation with Schacht, in Aufsichtsratssitzung der Siemens & Halske, Nov. 8, 1933, SAA 4/Lt 398; Meine to Siemens, June 20, 1934, SAA 4/Lf 663; Carl Köttgen to Schacht, May 5, 1936, SAA 4/Lf 676.

⁷² See the analysis by Albert Vögler of the Vereinigte Stahlwerke in the Aufsichtsratssitzung der Siemens-Schuckertwerke, Jan. 31, 1934, SAA 4/Lt 398.

⁷³ Rudolf Blöhm to Siemens, July 23, 1934, SAA 4/Lf 676; Siemens to Schacht, Sept. 3, 1935, SAA 4/Lh 301.

Instead of defaulting at once, Schacht stretched out the process over three agonizing years, playing with the Foreign Bondholders Protective Council—the U.S. creditor-defense organization—like a cat with a ball of string. It was Schacht who seized the high moral ground. The 10.3 milliard RM of long-term loans, he told the American Chamber of Commerce in Berlin, had “never been invested in the German economy.” Instead, these loans had served only to pay reparations or interest on themselves. The Dawes Plan had assumed that payment would come from a trade surplus. Thus a violation of the plan had occurred. Germany had already liquidated all debts of a true commercial nature. Was it not obvious that “the entire remaining German foreign debt corresponded exactly to its political origins”? The liberal spirit, Schacht declared grandly, mandated the “clearing up” of intergovernmental indebtedness as the necessary precondition for the revival of world trade.⁷⁴

At the same time, the Reichsbank president did not neglect the practicalities of expropriation. He exhibited no little originality in offering various forms of scrip and promissory notes (all later to prove virtually worthless) in lieu of interest.⁷⁵ Schacht, as well as Hitler, took particular satisfaction in driving down the price of German bonds through these tactics and then buying them back for a song.⁷⁶ For several years, Schacht made special arrangements with Britain, the Netherlands, and Switzerland (countries with which the Reich traditionally ran a trade surplus) to continue preferential payment of partial interest in return for increased German exports. By 1936, however, various Berlin officials and even some business leaders grew restive and began to campaign for a frank repudiation of all long-term debt, public and private.⁷⁷ A New York Federal Reserve Bank study concluded in 1938 that, although the European nations had achieved notable success in recovering Standstill debts owed to their banks, they had profited relatively little from their efforts to recover long-dated investments through bilateral arrangements with the Reich.⁷⁸

The indifference of high Roosevelt administration officials to the despoliation of American creditors figures as the strangest part of the story. Administration leaders kept their distance from the Foreign Bondholders Protective Council, even though it had been formed with tacit government sponsorship.

⁷⁴ “Dr. Schacht über das Auslandsschuldenproblem,” Deutsche Nachrichtenbüro, Mar. 16, 1934, copy in J. C. White to State Department, Mar. 21, 1934, US 862.51/3915.

⁷⁵ For the full story, see US 862.51/3631-4795 (June 1933–Dec. 1939).

⁷⁶ Schacht’s gleeful account to an American diplomat in Wilson telegram 393, Mar. 13, 1938, US 462.00R296 BIS/585; Hitler comment in Picker (1965, p. 351).

⁷⁷ Lord Riverdale, president of Capital Steel Works, to Sir Maurice Hankey, Mar. 9, 1936, reporting conversation with Ministerialdirektor Helmuth Wohlthat of the Economics Ministry, Ernst Trendelenburg of the state-owned Vereinigte Industrie AG, industrialists Fritz Thyssen and Abraham Frowein, and Tilo Freiherr von Wilmowsky, in MacDonald Papers, PRO 30/69/640.

⁷⁸ George L. Harrison to Hull, Aug. 26, 1938, and memorandum, “Rearrangement of Germany’s Foreign Debt Service,” C 261—German government file, FRBNY.

The Republican Progressive, Senator Hiram Johnson, had campaigned from the start to exclude Wall Street bankers from any role in the bondholders' protective organization on the ground that they had "perpetuated the wrong." In the eyes of Western Progressives, the collapse of foreign bonds stood as luminous confirmation of every suspicion they had nurtured of the New York moneyed powers since the days of William Jennings Bryan. Roosevelt relied on the support of the Johnson group in the Senate. With wheat and cotton farmers unable to move their crops and millions of city folk on government relief, FDR couldn't have cared less about the bondholders' fate. Partisan Democrats began to complain, furthermore, that the Bondholders Council executive board uncannily resembled Hoover's State Department. No criticism could have proven more damaging. The newly formed Securities and Exchange Commission, purporting to protect the small investor from manipulation by the potentates of high finance, initiated a wearying two-year investigation of Bondholders Council practices. The SEC uncovered no evidence that the council had sacrificed bondholder interests to those of the banks. Nevertheless, it forbade contributions to the organization from the houses of issue. That ruling, coupled with the Treasury's denial of nonprofit tax-exempt status, paradoxically undercut the council's ability to protect the ordinary investor.⁷⁹

By 1935, some 600,000 Americans owned defaulted foreign bonds. The average holding approximated only \$3,000. As Bondholders Council spokesmen emphasized, numerous people of modest means—"including literally many widows and orphans"—had invested their life savings in these issues. But the bondholders were not generally perceived as New Deal voters. Nor did they form the natural constituency of any government agency. Secretary of the Treasury Henry Morgenthau felt free to draw the conclusion, therefore, that any return to the bondholders would come at the expense of exports and employment. Officers of the Export-Import Bank, which was formed under the aegis of George Peek, expressed themselves even more directly: "We should not let the existence of frozen balances and unliquidated debts . . . be a stumbling block to new exportations. Crying over spilt milk, in the spilling of which we were perhaps as much at fault as the foreign countries . . . involved, will not revive our export trade." Certain middle-level State Department bureaucrats, notably in the economic adviser's office, did make efforts to assist creditor representatives where they could. Yet even they placed emphasis on the "diversity of American interests." They noted that, under the

⁷⁹ Nixon (1969, Vol. 1, pp. 115-117, 152-153, 334-338, 377-382, 462-464); Parrish (1970, pp. 73-107). On the 1935-37 SEC investigation, see US 800.51/1149-1347. Francis White of the Bondholders Council and Herbert Feis of the State Department debated at length whether Commissioner James M. Landis or William O. Douglas figured as the real "fanatic" responsible for SEC demands (US 800.51/1263).

Trade Agreements Act of 1934, their first duty was to promote the resumption of trade on a multilateral basis. They could not attempt to secure a preference for creditors in the reciprocal-trade agreements under negotiation; to do so would strengthen the tendency toward bilateral clearings that had supposedly impeded the free international exchange of goods and prolonged the Depression. When Germany's bilateral arrangements turned out unexpectedly to produce larger export gains—particularly in South America—than the system advocated by Hull and his fellow fair traders, Washington officials shifted ground. The danger that the Nazis would penetrate the traditional American sphere of influence appeared so fearsome that the government could not risk alienating potential commercial partners and military allies for the sake of any parochial interest.⁸⁰

In no area of the globe did the bondholders receive less government support than in Germany. William E. Dodd, the Chicago history professor and agrarian ideologue whom Roosevelt appointed as ambassador to Berlin, nourished an obsessive hatred of businessmen and moneylenders.⁸¹ Still, whatever his personal idiosyncrasies, in debt matters Dodd took his major cue from the president. The bankers had "gotten themselves into this," Roosevelt told him. "Lend what personal, unofficial aid you can, but no more" (Dodd, 1941, p. 74). Before leaving for his post, consequently, Dodd declared that he couldn't find "the necessary time" to see lender representatives. Once settled in Berlin, Dodd limited himself to perfunctory protests addressed to third-string Foreign Office functionaries while Schacht pursued his "salami tactics" for whittling down American assets. The ambassador soon came to ad-

⁸⁰ J. Reuben Clark, president, Foreign Bondholders Protective Council, to Hull, Jan. 19, 1935, US 611.0031/1315, provides statistics on the distribution of bondholder assets and states the case for defending them. For the State Department reaction and conception of its mission under the Trade Agreements Act, see Feis memorandum for Henry Grady and Alvin Hansen, Apr. 12, and Hull to Clark, Apr. 28, 1935, US 611.0031/1315; also Livesey memorandum, Sept. 15, 1934, US 611.0031/1165. For Morgenthau's position, see Blum (1965, pp. 50-58) and Parrish (1970, pp. 103-107); for Peek's standpoint, Vice-President Charles E. Stuart, Second Export-Import Bank, to Assistant Secretary R. Walton Moore, June 21, 1934, US 611.0031/752. The consequences of German-American trade rivalry are covered in Schröder (1970, pp. 201-261); McGann (1973, pp. 148-175); Hilton (1975); and Cellman (1979, pp. 40-116).

⁸¹ Dodd's obsession took various forms. He rejoiced in the Wall Street crash as a "just punishment which immoral speculators have brought upon themselves." His solution for the Depression was to depopulate the cities and recreate a rural idyll conducive to Jeffersonian democracy; he accordingly advised Ivy League graduates seeking to enter the diplomatic service to try subsistence farming instead. In Berlin, Dodd fumed about subordinates spending too much money, while he himself rented on the cheap the home of a Jewish banker seeking political protection. He also devoted an extraordinary amount of energy to persecuting an embassy clerk because one of her relatives headed a company in which a former graduate student of his had made a failed stock-market speculation. See Vols. 40-51, William E. Dodd Papers, Library of Congress; also Dallek (1968, pp. 171-222).

mire Schacht as "a financial wizard of the highest order," and he did not bother to hide his conviction that the interest rate on U.S. loans was excessive.⁸²

Finally, the investment-banking houses complained. Parker Gilbert reported that even German officials had expressed "mystification" at Dodd's failure to protest the discrimination against American holders of the Dawes and Young loans embodied in the Anglo-German Trade and Payments Agreement of 1934. Dodd had told all comers that the United States had "no special interest" in those loans and "didn't want to get mixed up in them."⁸³ Yet departmental representatives in Washington, following the president's lead, took much the same line. As Bondholders Council spokesmen prepared for a crucial confrontation with Schacht in early 1934, Roosevelt was asked at a press conference whether the administration supported their efforts. He answered with enlightening ambiguity, "Yes and no."⁸⁴ Privately, Under Secretary of State William Phillips advised the bondholder delegates not to resist all concessions and to remember that the Dawes and Young loans particularly were "connected with intergovernmental agreements to which the American government is not a party."⁸⁵ A few weeks later, when Feis begged the Treasury to endorse a mild telegram protesting German favoritism for short over long lenders, in the hope of strengthening the bondholders' negotiating hand, Under Secretary T. Jefferson Coolidge demurred. He was "not a good judge of the effect of diplomatic communications." And while he would mention the matter to Secretary Morgenthau, he "did not think he could get more than two minutes of his time" to consider it.⁸⁶

Given the attitudes prevailing in Washington, it is hardly a surprise that American holders of foreign bonds fared so poorly in the 1930s. The diplomatic record makes clear that the incidence of default on U.S. foreign bonds turned largely on power and politics. Since the United States ran an export

⁸² J. P. Moffat memorandum for William Phillips, June 22, 1933, US 862.51/3635; Dodd to secretary of state, Jan. 6, 1934, describing a conversation with Dr. Köpke, US 862.51/3811; Dodd to Roosevelt, Feb. 8, 1934, in Nixon (1969, Vol. 1, pp. 637-638). On the Dodd-Schacht relationship, also see Dodd (1941, pp. 74, 81, 253, 274, 443).

⁸³ Gilbert memorandum for the secretary of state, July 11, 1934, US 862.51/4131.

⁸⁴ Press conference, Jan. 24, 1934, in Nixon (1969, Vol. 1, pp. 606-609).

⁸⁵ Feis memorandum on Phillips conversation with Reuben Clark and Pierre Jay, Mar. 30, 1934, US 862.51/3935. The department's institutional memory on this point was defective. J. P. Morgan & Co. had demanded, and received, a formal request from the secretary of state before floating the Dawes loan (Dwight W. Morrow to Charles Evans Hughes, Sept. 18, and Hughes to Morrow, Sept. 19, 1924, copies in US 462.00R296/611 and Morrow Papers, Amherst College Library).

⁸⁶ Feis memorandum of conversation with Under Secretary Coolidge of the Treasury Department, May 14, 1934, US 862.51/4030.

surplus with Germany as well as with the main Latin American debtor nations, it had little political leverage to compel observance of the debt. Since it wished above all to increase the export surplus in order to maximize domestic reemployment, it chose not to exercise what modest influence it could bring to bear. The relative ability of borrower and lender to bear the costs of default played no significant role in the outcome. Aggregate real output in Germany rebounded by 1938 to 154.7 percent of the 1929 level, while it languished in the United States at 98.9 percent of the 1929 level (Hoffmann, 1965, p. 828; Bureau of the Census, 1960, p. 139). The principal Latin American debtors similarly recovered from the Depression more rapidly than their North American neighbor. By 1939, aggregate real output exceeded the 1929 figure by 51.7 percent in Brazil, 44.6 percent in Colombia, and 23.0 percent in Mexico, compared with an increase of 6.3 percent in the United States (Díaz Alejandro, 1983, p. 8). But defaulting debtors proved no more eager to meet past obligations after recovery than in the depths of the Depression. The most successful debtor states (with the exception of Argentina) revived their economies with a mix of nationalistic policies including overt or disguised tariff barriers, import substitution, a reduction in comparative real wages, and fiscal and monetary stimulation in a setting judiciously insulated from the world economy (Díaz Alejandro, 1983, pp. 5-40). The political circumstances that facilitated nationalist economic strategies militated against equitable debt settlements long after those strategies had served their original purposes.

Schacht, like banking officials in the debtor countries generally, quickly sensed the priorities of the New Deal and took advantage of them to further his national objectives. He drew evident encouragement from the demand, voiced with particular insistence by British bankers, that their short-term claims ought to secure preference over those of the bondholders. As early as mid-1932, Robert H. Brand, spokesman for the Joint Committee of British Short-Term Creditors, urged his own foreign secretary to take the lead in arranging an international scheme mandating the suspension of service on all German long-dated debt. Only through such a suspension, he argued, could the Reich recover sufficient liquidity to repay the Standstill creditors and at the same time abandon exchange controls. Brand explained with unusual candor why the interests of the London City coincided with those of civilization as a whole:

The tendency of the Standstill is to ask the short-term creditors alone to make sacrifices. This is absolutely wrong. If the international monetary and banking machinery is to continue to work satisfactorily, the special position of the short-term banking debts must be recognized. . . . While any such [international] cooperation would be attacked as a sort of "Bankers' relief scheme," it is in fact of such enor-

mous importance to Governments and Nations to see a return to freedom and to increased production and trade that it would be wholly justified from the public point of view.⁸⁷

Whitehall judged it inexpedient to push the matter directly, but British banks left their German interlocutors in no doubt where they stood.⁸⁸ Karl Blessing, then Schacht's alter ego and later Bundesbank president in his own right, stated at the postwar denazification proceedings that the financial heavyweights he had dealt with at the BIS in the 1930s never uttered a word of reproach about Schacht's transfer policies; the small investors in America had no doubt grumbled, but "that lay in the nature of things."⁸⁹ Blessing's testimony represents a significant part of the story. By 1934, Brand and his City colleagues came to realize that, whatever happened to the long-term bonds, German financial policy rendered chimerical the hope of restoring freedom of exchange and rolling over the Standstill debt on substantially better terms.⁹⁰ Nonetheless, the London City continued to find it profitable to finance German foreign trade down to 1939. In Britain, unlike the United States, bankers had more political clout than exporters. The Anglo-German Trade and Payments Agreement of November 1934, although extremely complicated, constituted a victory (at least in the short run) for finance over industry. It avoided a threatened clearing and left the German authorities free to use 45 percent of their sterling exchange for the purchase of raw materials and military equipment in other markets, while employing to mutual advantage the full range of banking services offered by the London City (Wendt, 1971, pp. 260-287; James, 1986, pp. 405-408).

If American commercial bankers entertained designs comparable to those of their British counterparts, they had too keen a sense of their powerlessness under the New Deal to make representations to Washington. As a matter of fact, the great New York banks did hardly any business with Nazi Germany in the early years. Smart-money trust-department managers threw in the towel and disposed of their long German bonds for whatever they would bring over the course of 1933.⁹¹ Despite the efforts of pioneers like Paul War-

⁸⁷ R. H. Brand memorandum on the problem of the German Standstill debt, June 28, 1932, in Vol. 72, 1st Viscount Simon Papers, Bodleian Library, Oxford University.

⁸⁸ Circumstantial evidence in the NL Ludwig Kastl, BA, indicates that the substance of the Brand memorandum leaked to Gustav Schlieper, principal German negotiator on the Standstill Committee.

⁸⁹ Verhör Dr. Blessing, Protokoll der Berufungsverhandlung gegen Dr. Hjalmar Schacht, Aug. 20, 1948, pp. 487-491, Sp 1/5, IfZ.

⁹⁰ For the 1934 negotiations and the bankers' opposition to a clearing, see Vol. 190, Robert H. Brand Papers, Bodleian Library; Brand's pessimism is best expressed in his letter to P. Jaberg, Union Bank of Switzerland, Mar. 27, 1934.

⁹¹ Even at the financial center, not all banks showed equal prescience. The National City Bank, for example, did not bite the bullet and liquidate its German loan portfolio until September 1934 (Cleveland and Huertas, 1985, p. 206).

burg, New York had notably failed to develop a full-fledged acceptance market before the Depression; in any case, German-American commerce remained at a low ebb throughout the 1930s and there was comparatively little trade to finance. Banking institutions that had suffered losses on immobilized credits, moreover, had trouble evaluating the risk of accommodating customers operating under the rules of a controlled economy, and they tended to pass up opportunities that did arise.⁹²

Even so, by late 1938 American banks had managed to recover the greater part of their old Standstill advances. Individuals who held the bulk of long-term bonds, meanwhile, had lost almost their entire stake. But Schacht had tightened the noose so gradually by manipulating the blocked-marks system that certain members of the East Coast banking and legal establishment began to reflect philosophically that things could have gone worse.⁹³ At that point, some New York bankers began to look enviously again at British competitors who were still making money by financing German trade. A fortnight after the *Kristallnacht* events of November 1938, a top-drawer delegation from the National City Bank and the Chase National Bank arrived in Berlin to explore the possibilities. Winthrop Aldrich, president of the Chase, subsequently explained the group's strategy: "However much we might dislike those things which are going on in Germany, yet Germany is a fact and we must continue to do business with Germany." In Berlin, notwithstanding this mind-set, one of the bankers injudiciously asked Douglas Miller, commercial attaché at the American embassy, what he thought about new lending. Miller had followed the entire expropriation process since 1931. He reported his terse reply to Washington: "If I were in New York I would lead a mob to throw stones through their windows."⁹⁴ The lesson seemed to strike home—at least for that generation.

⁹² See the periodic reports on New York commercial-banking sentiment made by officers of the Central Hanover Bank and Trust Co. and the Manhattan Company to their German contacts, 1933-36, in SAA 4/Lf 598, 4/Lt 398, and 11/Lg 890.

⁹³ George Rublee to Robert Pell, Apr. 6, 1939, copy in NL Theo Kordt, ED 157/3, IfZ.

⁹⁴ Aldrich comment to Federal Reserve staff members in F. L. Livesey memorandum, "New York Banks Contemplating New Short Credits to Germany," Jan. 7, 1939; Miller comment in Commercial Attaché Weekly Economic Report, Nov. 26, 1938, both in US 862.51/4702. For evidence that rival institutions also eyed the German market covetously at this time, see O. Parker McComas, Bankers Trust, to his European vice-president, Frank P. Shepard, Oct. 5, 1938, BA, R111/8 (Bankers Trust Co., Vertretung in Berlin). In the end, nothing came of the initiatives by Aldrich and his competitors because the business was "not there" (L. W. Knocke to President Harrison, Feb. 24, 1939, C 261—German government file, FRBNY). Hostile critics (e.g., Higham, 1983, pp. 20-31) would later single out the Chase for particular reproach. They would charge that between 1939 and 1941 the Chase provided a variety of financial services to enterprises with German exposure, and further that following the fall of France the bank's Paris office accepted the patronage of the occupying forces. However, the revenue generated through such activity could hardly have amounted to much.

4 THREE HISTORICAL MISCONCEPTIONS

Critics may wonder whether elements of the foregoing account carry the scent of "creditors' history." Shouldn't primary emphasis still rest, they will ask, on the failure of the United States to assume its implicit responsibilities as a creditor nation after World War I? The institutional structure that had sustained trade and capital flows in the 1920s crumbled so thoroughly during the Depression that conventional analysis has naturally focused on what went wrong at the center of the system. In 1932, the Senate Finance Committee attributed the collapse in large part to misjudgments or malfeasance by American "banksters." Echoes of old political controversies, suitably transmogrified, continue to reverberate in the scholarly literature. Kahler (1986, p. 17) suggests that a hegemonic shift from London to New York placed the interwar financial regime in "inexperienced hands." The regime became less stable because merchant banks of the London City, "linked to their country clients through a web of financial and trade relations," gave way to Wall Street institutions that floated foreign bonds as a "simple variant on the placement of domestic bonds." Fishlow (1986, p. 77) does not wish to place excessive blame on the "lax morality" prevailing among newer U.S. issue houses, but he identifies the problem as "excessive competition among American banks eager to enter a growing market."

There is considerable merit, as we have seen, in the contention that American investment houses failed to make appropriate allowance for "country risk" when they priced German (or for that matter South American) issues in the late 1920s. More skilled assessment of specific risk would not have helped much; when Schacht proclaimed his transfer moratorium, the most soundly based industrial loans went into default on an equal footing with improvident municipal flotations. Underwriters could have avoided difficulty only by steering clear of German business altogether. J. P. Morgan & Co., still the pacesetter in the investment-banking community, did just that (aside from the Dawes and Young loans, which it took on as a service to the Allied governments). Less well-established firms had good reason to believe that they could scarcely afford similar selectivity in light of the fierce struggle for market share on Wall Street. No regulatory mechanism could painlessly have ameliorated their predicament.

A major contradiction exists between the traditional microeconomic and macroeconomic indictments of American foreign economic policy in the 1920s. The banks draw criticism for floating securities and granting credit without adequate controls. The United States as a whole is supposed to have

failed to recycle its surplus capital fast enough to maintain global equilibrium. Fishlow (1986, p. 78) expresses these notions by arguing that "American banks were both too much *and too little* engaged in lending abroad." One cannot really have it both ways.

The fundamental problem in the 1920s lay at the systemic level. Productive international lending should foster economic growth that will either attract additional investment capital or lead to export earnings that can serve to repay the borrowings. Historically, private investors seek a quick return; debtors enjoy only a brief respite before finding themselves obliged to generate an export surplus. From 1870 to 1914, when Europe served as "the world's banker," the transfer of dividends and interest back to the lenders exceeded the flow of new funds to the periphery over every medium-term cycle (Fishlow, 1986, pp. 41-46).

For a number of reasons, the expected adjustment did not take place in the 1920s. The onset of the Great Depression explains much but not everything. The pronounced fall in commodity prices that began in the middle 1920s may have made it more difficult for primary producers in Latin America and elsewhere to meet their obligations, but, by the same token, it improved the terms of trade for European industrial countries. Three common misconceptions have clouded analytic thinking about German payment problems during those years. The first proposition holds that Germany ran a natural trade deficit and that to eliminate it would have created insuperable *economic* problems during the Weimar Republic. The second asserts that a circular flow characterized the world balance of payments in the 1920s, with loans passing from America to Germany, reparations streaming to the Allies, and war-debt remittances completing the circuit back to the United States. The third proposition maintains that high American tariffs undermined the dynamic equilibrium of the system. The U.S. tariff, in this view, prevented debtors from developing export revenue sufficient to service their borrowings and therefore made a payments crisis inevitable. If any of these propositions held water, it might follow that the real net transfer of resources to Germany (however unexpected during an era when the Reich was supposed to produce surpluses for the reparations creditors) resulted from structural processes in which political choice played a subordinate role. But none of these claims stands up well under examination.

The Structural-Trade-Deficit Theory

The notion that Germany ran an immutable trade deficit in the 1920s was the stock in trade of Weimar politicians. The theory comes in several versions. Both Schacht and Luther advanced variants purporting to show why Germany could not pay reparations on the required scale. McNeil (1986, pp. 98-111), who typifies the approach of some contemporary historians, plots the

actual relationship between unemployment and the trade balance during the 1926 recession. He then argues that to develop a significant export surplus Germany would have had to accept a stagnant economy with sustained unemployment approaching 15 or even 20 percent. Although Weimar leaders certainly feared the consequences of throttling back domestic consumption, it seems implausible that the tradeoff would have proven anywhere near as drastic as McNeil suggests. Temin's more detailed scrutiny of the 1926 and 1929 contractions demonstrates that an autonomous fall in inventory investment better explains each downturn than does any element in the balance of payments. Moreover, while imports did correlate with the business cycle, exports expanded from 1924 through 1929 at a roughly constant rate without much relationship to the state of the domestic economy.¹

Still, over the long run German ability to export obviously depended on relative costs, of which labor represented the largest variable component. In 1929, John Maynard Keynes framed the issue as follows: "Under the Dawes scheme Germany has to pay the equivalent of her 'natural' trade surplus. We cannot obtain more, unless we give a special stimulus to German exports, either by forcing down German wages . . . or in some other way."² For his own country the question thus became how far Great Britain wished to "force down German wages in order that Germany may steal her export industries."³ Although real wages, according to his calculations, had increased 23 percent in the previous five years, Keynes held that it would not be "humanitarian" to limit them. But this constituted demonstrable special pleading. The claim that, if the German government generated an export surplus through tax or incomes policies, unemployment would necessarily rise, rests on the assumption that real wages were inflexible downward. In the post-stabilization phase of the Weimar Republic, industrial wages increasingly depended on Labor Ministry arbitration awards, and white-collar salaries correlated closely with government salaries (Hartwich, 1967, pp. 193-305). An implicit state-administered incomes policy appears to have produced both higher wages and greater unemployment than would have obtained under market conditions alone. High wage levels in turn perpetuated the "structural" trade deficit that characterized Weimar's middle period. The result reflected the outcome of a political process rather than any economic necessity.

According to the best measure we now have, real hourly wages in manufacturing and construction actually increased 26.1 percent in Germany between 1925 and 1929. Did wages rise at a pace out of line with productivity trends?

¹ Temin (1971; 1976, pp. 152-158); note, however, Falkus's (1975) objections to the argument.

² "Allied Debts and Reparations," *Daily Express*; Apr. 22, 1929, in Johnson (1978, pp. 322-329).

³ "Prof. [Irving] Fisher discusses reparations problems with John M. Keynes," *New York Evening World*, Mar. 25, 1929, in Johnson (1978, pp. 313-318).

No question led to fiercer social strife at the time, and the debate rumbles on among scholars unto the third generation. The answer depends upon the baseline chosen and whether one makes international or merely domestic comparisons. Starting from a 1925 base, hourly wages exceeded productivity gains by 13.2 percent when the disparity peaked in 1929. Using a 1913 base, however, hourly wages had nosed ahead of productivity gains by only 2.2 percent in 1929 (calculated from Holtfrerich, 1984, p. 131).

Labor spokesmen indignantly protested the use of 1925 wages as a standard of comparison. They insisted that wages had stabilized after the end of the great inflation at so low a level that they constituted a form of "social dumping." The wage push began, in their view, as a mere effort to catch up.⁴ Subsequently, Socialist theoreticians like Rudolf Hilferding developed the notion that wages were inevitably "political," so that the working class need have no qualms about using its influence over the parliamentary system and the bureaucracy in order to secure its economic goals (Hartwich, 1967, p. 379; James, 1986, p. 191). The Labor Ministry subdivision that oversaw the compulsory arbitration of industrial disputes became the primary forum for the exercise of worker power. As early as 1925, 75 percent of labor conflicts went to arbitration, with the union side asking for a compulsory ruling 83 percent of the time. Increasingly, arbitrators tended to follow the ministry's guidelines instead of making independent judgments. Employers so feared union muscle that they too sometimes preferred government intervention to collective bargaining, but they looked wistfully to the British model of neutral arbitration rather than the political wage setting that occurred in their own country. Employer attempts to initiate reform led nowhere, however, and in January 1929, Labor Minister Rudolf Wissell openly admitted that he sought to use the system to raise wages and to shorten the work week.⁵

Significantly, the issue of working hours led to almost as much controversy as did wages. Unionists defended the schematic eight-hour working day as the great symbolic achievement of the 1918 revolution. Since every exception to the legislatively mandated cap on hours required bureaucratic approval, steady Labor Ministry pressure to shorten the work week proved extremely vexing for employers in industries requiring round-the-clock plant operation. Carl Köttgen of the Siemens-Schuckert-Werke, while protesting that he too

⁴ See the enlightening debate between sociologist Frieda Wunderlich and Siemens director Carl Köttgen regarding wage dumping in *Soziale Praxis und Archiv für Volkswohlfahrt*, Aug. 2, 1923, and Mar. 20, 1924, copies in SAA 11/Lf 488; for union rejection of a 1925 base, see Aufsichtsratssitzung von S&H und SSW, Oct. 30, 1930, SAA 4/Lt 398.

⁵ See the files "Schlichtungswesen," SAA 11/Lf 394 and 398, and "Vereinigung der Deutschen Arbeitgeberverbände" (VDA), SAA 11/Lf 141-143; Wissell policy discussed at a VDA meeting on Feb. 19, 1929; employer attitudes also analyzed in Hans Schäffer to Jakob Goldschmidt, Mar. 18, 1928, copy in SAA 4/Lf 513.

considered the eight-hour workday a desirable long-term goal, circulated National Industrial Conference Board figures showing that in 1927 even the favored Americans still labored fifty to fifty-five hours a week in continuous-process industries like chemicals and steel. And Deputy Chairman Ernst Poensgen of the Vereinigte Stahlwerke commented in frustration shortly thereafter that Labor Ministry measures to force "a continual increase in wages, albeit at a slow tempo, and a continual reduction in hours of work, the latter unfortunately at a rapid tempo," had vitiated all the steel industry's efforts to remain competitive with other West European producers through capital investment and rationalized methods of management.⁶

Moderate union leaders and forward-looking executives who had established good relations after the war in the so-called *Zentralarbeitsgemeinschaft* (a private-sector working group for solving national-level labor problems while maintaining social peace) occasionally met in the mid-1920s to discuss what ailed the German economy. But they could agree neither on the diagnosis nor on the prescription for cure. Less ideological unionists like Theodor Leipart, Fritz Tarnow, and Peter Graßmann conceded that government controls had reduced the adaptability of the economy. But they insisted that the essential drag on growth came from a disproportionate increase in the number of white-collar personnel, government officials, and trade and service employees rather than from reduced productivity by assembly-line operatives. The German economy, they held, suffered above all from underconsumption. If German workers were accorded the purchasing power of their American counterparts, domestic demand would surge and so would employment. Millions of employees would become small savers and furnish the capital that the *rentier* class used to provide before the war. By contrast, a policy of cost compression and export-led growth was bound to fail because foreign competitors would retaliate. They would raise tariffs, squeeze wages, and lengthen hours of labor in their own countries. Respective export shares would remain the same, but at lower levels of profitability all around. Only the domestic market could expand. The unions rejected the idea that the need to service the foreign debt justified downward pressure on wages. On the contrary, "salvation could come only . . . through a general increase in wages."

Employer spokesmen like Ernst von Borsig replied that Germany's fundamental problems revolved around an "extraordinary deficit in capital formation." Profits had sunk so low that business could not hope to finance renovation through retained earnings. The volume of capital required for plant modernization and product innovation could be secured nowhere but abroad.

⁶ Köttgen to Herkner, July 20, 1925, SAA 11/Lf 368; Schriftwechsel betr. National Industrial Conference Board (Feb. 1927), SAA 11/Lf 355; Poensgen to Felix Pinner, Aug. 23, 1927, P 7 55 68, Mannesmann-Archiv.

This meant that Germany had to sell abroad as well. While the ratio of white-collar to production workers had indeed grown unacceptably, the intensity of work rhythms on the assembly line had also slackened. Germany's comparative advantage had traditionally lain in rapid technological innovation and the manufacture of high-quality finished goods. Only the imprudent would dare sacrifice the producer-goods sectors for consumer-led growth on the American model. The population would have to face facts and "accept the consequences of our position after the lost war." No hidden sources of capital existed. For the moment, Germans could not realistically aspire to live on the American or even the British level. Of course the tax burden, management techniques, and industrial organization had an impact on production costs. But for the high-value-added items at which Germany had heretofore excelled, wages remained the key to cost containment. Disproportionate wage inflation might spark a temporary consumer boom, but it would eventually wreak havoc in the capital-goods and export sectors and lead to greater unemployment with an attendant collapse of purchasing power.⁷

The participants in this debate soon realized that they were engaged in a dialogue of the deaf. No consensus emerged. Political power alone prevailed. Wages soared; exports increased comparatively slowly. The "natural" trade deficit did not disappear until a painful realignment of relative costs began under the Brüning regime in 1930 (see Table 7 above). By then, the deepening Depression made the reconquest of export markets ever more difficult. The problem during the good years, as Carl F. von Siemens observed in 1929, was not that production had fallen but that it had tended to stagnate—even in favorably situated industries at early points in their product cycles.⁸

In retrospect, it is evident that this state of affairs derived in large part from Germany's flagging competitiveness on international markets. Merchandise trade (exports plus imports) amounted to almost a third of German national income in 1925-29. Underconsumption theorists and advocates of a "political" wage calibrated according to the dictates of social justice could not easily wish away this heavy involvement in the international economy. It mattered a great deal that German unit-wage costs were steadily increasing during this period while unit-wage costs of other industrial nations were just as surely declining. The data in Table 9 indicate that the Reich came out of the 1924 stabilization with a certain competitive edge, had forfeited it by 1927, and thereafter fell ever further behind.

German industrialists had particular reason to worry about competition from America. The United States accounted for 42.2 percent of world man-

⁷ Vereinigung der Deutschen Arbeitgeberverbände, "Niederschrift über die Verhandlungen mit den Vertretern des Allgemeinen Deutschen Gewerkschaftsbundes (ADGB)," Dec. 10, 1925, SAA 11/Lf 141.

⁸ W. D. von Witzleben memorandum of Siemens's views, Aug. 10, 1929, SAA 4/Lf 811.

TABLE 9
INDEX OF COMPARATIVE UNIT-WAGE COSTS IN MANUFACTURING, 1913-38^a
(1925-29 = 100)

| Year | Germany | United States | United Kingdom | Sweden |
|------|---------|---------------|----------------|--------|
| 1913 | 65 | 64 | — | 64 |
| 1924 | — | 111 | 103 | 111 |
| 1925 | 96 | 105 | 102 | 112 |
| 1926 | 98 | 103 | 102 | 101 |
| 1927 | 97 | 101 | 99 | 98 |
| 1928 | 102 | 98 | 99 | 99 |
| 1929 | 108 | 95 | 97 | 90 |
| 1930 | 109 | 92 | 94 | 81 |
| 1931 | 104 | 83 | 92 | 78 |
| 1932 | 87 | 76 | 91 | 77 |
| 1938 | 78 | 86 | 88 | 69 |

SOURCE: Phelps Brown and Brown (1968, Appendix 3).

^a Index of average annual money wages in current units of account, divided by the index of productivity in manufacturing (real output per occupied person).

ufacturing production in 1926-29, compared with 11.5 percent for Germany, the second largest producer. Despite the insular character of the American economy, the United States had since 1913 doubled its share of global manufacturing exports to 16.3 percent, in the process overtaking Germany and closing fast on Great Britain (League of Nations, 1945, pp. 13, 128, 157-159). In the 1920s, the United States played a role in the world economy in some respects resembling that of Japan half a century later. Advances in productivity outpaced the traditional expectations of workers and consumers for improvements in the standard of living. Real wages in America during the post-war decade continued to rise at about the rate that had come to seem normal over the previous generation. But labor claimed only an 81.2 percent share of the total productivity gain (Kendrick, 1961, pp. 128-130). That gave a tremendous advantage to U.S. exporters in sectors where technology had progressed the fastest. American companies could also draw on greater internal savings and obtain access to cheaper outside capital than could their German

counterparts. The capital and labor disadvantages for German business reinforced each other. Even those firms in the Reich that boasted technological sophistication on a par with the best America had to offer could not avoid tremendous pressure on foreign market-share and profit margins owing to the high wage bill.⁹

Not only did wages rise faster in Germany than in America; working hours in the Reich decreased more rapidly too (see Table 10). The authorities still dispute precise figures (compare Bry, 1960, p. 48; Hoffmann, 1965, p. 214; Skiba, 1974, p. 193; and H. A. Winkler, 1985, p. 61). But by any measure it seems clear that the German worker made substantially greater gains in leisure time from 1910 to 1929 than did his American or British confreres (Phelps Brown and Browne, 1968, p. 210; Bry, 1960, p. 275), and that this curtailment in hours of labor was not sustainable without an adverse effect on economic growth. The subsequent economic successes of the Nazi regime derived in part from the removal of labor bottlenecks in key industries; it is noteworthy that normal hours of work in Germany did not again fall to their late-Weimar level until the end of the 1950s (Skiba, 1974, p. 193).

Worker-compensation patterns in the Weimar period undoubtedly made it harder for the country to carry its external debt load. All the same, the trend in wages and hours followed a compelling political logic. From its inception, the Weimar Republic had a shaky hold on the loyalties of the population. It faced formidable enemies on both the right and the left. Possibly, as Krue-

TABLE 10
AVERAGE WEEKLY HOURS OF WORK IN MANUFACTURING,
GERMANY AND THE UNITED STATES, 1913-38

| Year | Germany ^a | Germany ^b | U.S. ^c |
|---------|----------------------|----------------------|-------------------|
| 1913/14 | 57 | 55.1 | 49.4 |
| 1925 | 50.5 | 46.3 | 44.5 |
| 1926 | 50.5 | 45.2 | 45.0 |
| 1927 | 50 | 46.5 | 45.0 |
| 1928 | 49 | 47.5 | 44.4 |
| 1929 | 46 | 46.4 | 44.2 |
| 1930 | 44 | 44.0 | 42.1 |
| 1938 | 48 | 48.6 | 35.6 |

^a Estimate by Hoffmann (1965, p. 214). Base figure is for 1910-14.

^b Estimate by Skiba (1974, p. 193). Base figure is for 1913-14.

^c Bureau of the Census (1975, Vol. 1, pp. 169-170). Base figure is for 1914.

⁹ For instructive case studies of Siemens-Schuckert-Werke-GE competition in Russia and Siemens & Halske-ITT rivalry in Latin America illustrating these points, see SAA 11/Lf 140 and 4/Lt 398.

dener maintains (1985), only demonstrably rising living standards and steady advances in social welfare could have conferred on the Weimar state the legitimacy it needed to survive. The question remains how long the political leadership should have expected foreign capital markets to fund current-account deficits in order to achieve that worthy aim.¹⁰

The Circular-Flow-of-Funds Theory

John Maynard Keynes, inventive as ever, developed the classic argument that the effective capital transfer necessary to make the international financial system work smoothly in the 1920s never took place. According to this theory, Washington's shortsighted demand that its wartime allies repay the borrowings expended in a common struggle resulted in a mere circular flow of funds:

Reparations and inter-Allied debts are being mainly settled in paper and not in goods. The United States lends money to Germany. Germany transfers its equivalent to the Allies, and the Allies pay it back to the United States government. Nothing really passes—no one is a penny the worse. The engravers' dies, the printers' forms are busier. But no one eats less, no one works more.

Although interest on German private loans theoretically continued to mount, Keynes insisted in 1926, the "game" could go on only so long as the American investor tolerated it. He issued an ominous warning: "It will be for the American investor in due course to give the word—and for the American public to find a solution."¹¹

Keynes's analysis of the problem held great appeal for European nations that sought to embarrass the United States into the unilateral cancellation of war debts. The issue led to such bitter feeling and generated so much partisan propaganda in the interwar period that to this day only specialists have a clear idea of what the American government actually required and what the debt-

¹⁰ Germany, of course, had no monopoly on underconsumption theory or political wage setting. A similar process appears to have operated to retard economic growth in the United States under the New Deal. In 1933, Roosevelt's National Recovery Administration established un-economic wage minima for reasons of social justice and as a crude method of demand stimulation. The tradeoff between wages and unemployment worsened, aggravating the Depression. As labor's share of total productivity gains rose to 135 percent in the 1930s, the U.S. share of world manufacturing output slipped from 42.2 percent to 32.2 percent. Diminution of output and real wealth outweighed the multiplier effect of increased consumer spending. New Dealers then began to talk about the economy's "structural" problems. See the analysis by Weinstein (1980; 1981); figures from League of Nations (1945, p. 13); and Kendrick (1961, p. 129). Eichengreen and Sachs (1985, pp. 938-939) adduce evidence suggesting that, in European countries as well, real wage gains were negatively correlated with the degree to which industrial production recovered from the Depression.

¹¹ "The Progress of the Dawes Scheme," *The Nation and Athenaeum*, Sept. 11, 1926, in Johnson (1978, pp. 281-288).

ors really paid. Twenty nations borrowed close to \$10.4 billion from the United States on official account during and after World War I (relief and rehabilitation loans subsequent to the Armistice comprised almost a third of the total). Fifteen European nations had agreed to fund their debts by 1926, although not before compound interest had inflated the amount they owed to \$13.2 billion.¹² This was a substantial sum by contemporary standards—some 13.6 percent of U.S. gross national product at a time when American national income (in dollar terms, if not in purchasing power) equaled that of the next twenty-three most prosperous countries in the world combined (Lary, 1943, p. 29). Had Washington insisted that the borrowers repay their obligations at 5 percent interest over a twenty-five-year period, as wartime agreements had stipulated, the flow of funds to the United States would undoubtedly have become a disturbing factor in the world balance of payments. But nothing like that occurred.

The American authorities could not flout public opinion, which demanded a show of debt collection. And they remained mindful that they had to service the underlying Liberty Bond issues from which the money for overseas loans had come. Still, in no case did they seek the proverbial pound of flesh. The World War Foreign Debt Commission offered a series of negotiated settlements based on data presented by the debtors concerning their capacity to pay. The arrangements all ran for sixty-two years; each featured a concessionary interest rate and an annuity schedule that began modestly and mounted by degrees. Great Britain, France, Italy, and Belgium made the only four agreements that mattered, accounting together for 94.7 percent of the whole. The present value of the British settlement implied right from the start a 35.1 percent cancellation of prior obligations; France received 64.8 percent forgiveness; and Italy and Belgium obtained, respectively, 81.5 percent and 63.3 percent off the bill.¹³ Actually, the structure of the payment schedules—with the heavier transfers postponed to later years—virtually guaranteed an even larger discount. No insider expected the settlements to last for more than one generation, and Secretary of the Treasury Andrew Mellon hinted to foreign diplomats that his department would likely abandon war-debt collection altogether once it had retired the Liberty Bonds in 1942 (Costigliola, 1984, p. 339).

American balance-of-payments figures accordingly provide no support for Keynes's claims about the relative importance of war debts (see Table 11). During the years 1919-30, new foreign capital issues in the United States plus

¹² Soviet Russia refused to settle, and four small U.S. client states outside Europe secured exemption from payment. For a breakdown of the figures by country, see Commerce Department, "Memorandum on War Debt Settlement," June 1926, copy in US 800.51W89/283; also Rhodes (1965, pp. 402-403).

¹³ US 800.51W89/283.

TABLE 11
THE BALANCE OF PAYMENTS OF THE UNITED STATES, 1919-35 ^a
(in millions of dollars)

| | 1919 | 1920 | 1921 | 1922 | 1923 | 1924 | 1925 | 1926 | 1927 |
|--|---------|---------|---------|-------|-------|-------|-------|-------|-------|
| I The problem and the adjustment, first statement | | | | | | | | | |
| 1 Commodity trade (net) | + 4,016 | + 2,950 | + 1,976 | + 719 | + 375 | + 981 | + 683 | + 378 | + 681 |
| 2 Current invisibles | - 1,244 | - 849 | - 729 | - 651 | - 716 | - 756 | - 839 | - 884 | - 899 |
| (1 + 2) | + 2,772 | + 2,101 | + 1,247 | + 68 | - 341 | + 225 | - 156 | - 506 | - 218 |
| 3 Int. + div. (incl. war debts) | + 293 | + 103 | + 167 | + 382 | + 508 | + 487 | + 542 | + 662 | + 725 |
| The problem (1 + 2 + 3) | + 3,065 | + 2,204 | + 1,414 | + 450 | + 167 | + 712 | + 386 | + 156 | + 507 |
| 4 Long-term capital | - 2,157 | - 1,069 | - 757 | - 717 | + 1 | - 602 | - 487 | - 602 | - 723 |
| 5 Short-term capital | | - 985 | - 435 | + 375 | + 3 | + 216 | - 61 | + 350 | + 900 |
| Net capital movements (4 + 5) | - 2,157 | - 2,054 | - 1,192 | - 342 | + 4 | - 386 | - 548 | - 252 | + 177 |
| 6 Gold + currency | + 250 | + 50 | - 786 | - 235 | - 245 | - 266 | + 42 | - 112 | + 99 |
| The adjustment (4 + 5 + 6) | - 1,907 | - 2,004 | - 1,978 | - 577 | - 241 | - 652 | - 506 | - 364 | + 276 |
| 7 Error | - 1,158 | - 200 | + 564 | + 127 | + 74 | - 60 | + 120 | + 208 | - 783 |
| Net adjustment | - 3,065 | - 2,204 | - 1,414 | - 450 | - 167 | - 712 | - 386 | - 156 | - 507 |
| II The problem and the adjustment, second statement | | | | | | | | | |
| 1 Commodity trade + current invisibles | + 2,772 | + 2,101 | + 1,247 | + 68 | - 341 | - 225 | - 156 | - 506 | - 218 |
| 2 Int. + div. (incl. war debts) | + 293 | + 103 | + 167 | + 382 | + 508 | + 487 | + 542 | + 662 | + 725 |
| 3 Long-term private capital (excl. new issues) | - 19 | - 368 | - 124 | - 32 | + 381 | + 250 | + 461 | + 397 | + 478 |
| The problem (1 + 2 + 3) | + 3,046 | + 1,836 | + 1,290 | + 418 | + 548 | + 962 | + 748 | + 553 | + 985 |

| | | | | | | | | | |
|--------------------------------|--------|--------|--------|------|------|------|--------|------|--------|
| 4 New foreign issues | - 357 | - 461 | - 547 | -685 | -380 | -852 | - 948 | -999 | -1,201 |
| 5 Short-term capital | | - 985 | - 435 | +375 | + 3 | +216 | - 61 | +350 | + 900 |
| 6 Government loans | -1,781 | - 240 | - 86 | | | | | | |
| (4 + 5 + 6) | -2,138 | -1,686 | -1,068 | -310 | -377 | -636 | -1,009 | -649 | - 301 |
| 7 Gold + currency | + 250 | + 50 | - 786 | -235 | -245 | -266 | + 42 | -112 | + 99 |
| The adjustment (4 + 5 + 6 + 7) | -1,888 | -1,636 | -1,854 | -545 | -622 | -902 | - 967 | -761 | - 202 |
| 8 Error | -1,158 | - 200 | + 564 | +127 | + 74 | - 60 | + 120 | +208 | - 783 |
| Net adjustment | -3,046 | -1,836 | -1,290 | -418 | -548 | -962 | - 847 | -553 | - 985 |

III Subsidiary tables

Interest and dividends

| | | | | | | | | | |
|-------------------------------------|-------|-------|-------|------|------|------|-------|------|--------|
| 1 War-debt receipts | + 243 | + 53 | + 87 | +157 | +258 | +182 | + 187 | +195 | + 206 |
| 2 Int. + div. rec'd from foreigners | + 150 | + 150 | + 180 | +350 | +400 | +455 | + 520 | +735 | + 800 |
| (1 + 2) | + 393 | + 203 | + 267 | +507 | +658 | +637 | + 707 | +930 | +1,006 |
| 3 Int. + div. paid to foreigners | - 100 | - 100 | - 100 | -125 | -150 | -150 | - 165 | -268 | - 281 |
| Net int. + div. (incl. war debts) | | | | | | | | | |
| (1 + 2 + 3) | + 293 | + 103 | + 167 | +382 | +508 | +487 | + 542 | +662 | + 725 |

Long-term capital

| | | | | | | | | | |
|---------------------------------|--------|--------|-------|------|-----|------|-------|------|-------|
| 1 Government capital | -1,781 | - 240 | - 86 | | | | | | |
| 2 Private capital | - 376 | - 829 | - 671 | -717 | + 1 | -602 | - 487 | -602 | - 723 |
| Net long-term capital movements | | | | | | | | | |
| (1 + 2) | -2,157 | -1,067 | - 757 | -717 | + 1 | -602 | - 487 | -602 | - 723 |

Private long-term capital

| | | | | | | | | | |
|---------------------------------------|-------|-------|-------|------|------|------|-------|------|--------|
| 1 New foreign issues | - 357 | - 461 | - 547 | -685 | -380 | -852 | - 948 | -999 | -1,201 |
| 2 Other private capital movements | - 19 | - 368 | - 124 | - 32 | +381 | +250 | + 461 | +397 | + 478 |
| Net private long-term capital (1 + 2) | - 376 | - 829 | - 671 | -717 | + 1 | -602 | - 487 | -602 | - 723 |

^a Exports (credits) +, imports (debits) -.

Continued on next page

Table 11—Continued

| | 1928 | 1929 | 1930 | 1931 | 1932 | 1933 | 1934 | 1935 |
|--|--------|--------|--------|-------|------|------|--------|--------|
| I The problem and the adjustment, first statement | | | | | | | | |
| 1 Commodity trade (net) | +1,037 | + 841 | + 782 | +334 | +289 | +225 | + 478 | + 236 |
| 2 Current invisibles | -1,053 | -1,166 | -1,010 | - 823 | -650 | -414 | - 385 | - 403 |
| (1 + 2) | - 16 | - 325 | - 228 | -489 | -361 | -189 | + 93 | - 167 |
| 3 Int. + div. (incl. war debts) | + 741 | + 772 | + 857 | +649 | +492 | +404 | + 368 | + 350 |
| The problem (1 + 2 + 3) | + 725 | + 447 | + 629 | +160 | +131 | +215 | + 461 | + 183 |
| 4 Long-term capital | - 662 | - 137 | - 267 | +219 | +217 | + 49 | + 202 | + 462 |
| 5 Short-term capital | - 188 | - 80 | - 485 | -709 | -409 | -385 | + 184 | +1,075 |
| Net capital movements (4 + 5) | - 850 | - 217 | - 752 | -490 | -192 | -336 | + 386 | +1,537 |
| 6 Gold + currency | + 232 | - 135 | - 258 | +166 | - 91 | + 83 | -1,329 | -2,075 |
| The adjustment (4 + 5 + 6) | - 618 | - 352 | -1,010 | -324 | -283 | -253 | - 943 | - 538 |
| 7 Error | - 107 | - 95 | + 381 | +164 | +152 | + 38 | + 482 | + 355 |
| Net adjustment | - 725 | - 447 | - 629 | -160 | -131 | -215 | - 416 | - 183 |
| II The problem and the adjustment, second statement | | | | | | | | |
| 1 Commodity trade + current invisibles | - 16 | - 325 | - 228 | -489 | -361 | -189 | + 93 | - 167 |
| 2 Int. + div. (incl. war debts) | + 741 | + 772 | + 857 | +649 | +492 | +404 | + 368 | + 350 |
| 3 Long-term private capital (excl. new issues) | + 449 | + 494 | + 555 | +431 | +244 | + 59 | + 202 | + 506 |
| The problem (1 + 2 + 3) | +1,174 | + 941 | +1,184 | +591 | +375 | +274 | + 663 | + 689 |

| | | | | | | | | |
|-----------------------------------|---------|-------|---------|-------|-------|-------|---------|---------|
| 4 New foreign issues | - 1,111 | - 631 | - 822 | - 212 | - 27 | - 10 | 0 | - 44 |
| 5 Short-term capital | - 188 | - 80 | - 485 | - 709 | - 409 | - 355 | + 184 | + 1,075 |
| 6 Government loans (4 + 5 + 6) | - 1,299 | - 711 | - 1,307 | - 921 | - 436 | - 395 | + 184 | + 1,031 |
| 7 Gold + currency | + 232 | - 135 | - 258 | + 166 | - 91 | + 83 | - 1,329 | - 2,075 |
| The adjustment (4 + 5 + 6 + 7) | - 1,067 | - 846 | - 1,565 | - 755 | - 527 | - 312 | - 1,245 | - 1,044 |
| 8 Error | - 107 | - 95 | + 381 | + 164 | + 152 | + 38 | + 482 | + 355 |
| Net adjustment | - 1,174 | - 941 | - 1,184 | - 591 | - 375 | - 274 | - 663 | - 689 |

III Subsidiary tables

Interest and dividends

| | | | | | | | | |
|--|-------|-------|-------|-------|-------|-------|-------|-------|
| 1 War-debt receipts | + 207 | + 207 | + 241 | + 113 | + 99 | + 20 | + 1 | 0 |
| 2 Int. + div. rec'd from foreigners (1 + 2) | + 893 | + 979 | + 916 | + 662 | + 461 | + 452 | + 493 | + 521 |
| 3 Int. + div. paid to foreigners | - 359 | - 414 | - 300 | - 126 | - 68 | - 63 | - 126 | - 171 |
| Net int. + div. (incl. war debts) (1 + 2 + 3) | + 741 | + 772 | + 857 | + 649 | + 492 | + 409 | + 368 | + 350 |

Long-term capital

| | | | | | | | | |
|--|-------|-------|-------|-------|-------|------|-------|-------|
| 1 Government capital | | | | | | | | |
| 2 Private capital | - 662 | - 137 | - 267 | + 219 | + 217 | + 49 | + 202 | + 462 |
| Net long-term capital movements (1 + 2) | - 662 | - 137 | - 267 | + 219 | + 217 | + 49 | + 202 | + 462 |

Private long-term capital

| | | | | | | | | |
|---------------------------------------|---------|-------|-------|-------|-------|------|-------|-------|
| 1 New foreign issues | - 1,111 | - 631 | - 822 | - 212 | - 27 | - 10 | 0 | - 44 |
| 2 Other private capital movements | + 449 | + 494 | + 555 | + 431 | + 244 | + 59 | + 202 | + 506 |
| Net private long-term capital (1 + 2) | - 662 | - 137 | - 267 | + 219 | + 217 | + 49 | + 202 | + 462 |

SOURCES: Brown (1940, Vol. 1, pp. 542-543); Department of Commerce (1937, pp. 93-95).

* Exports (credits) +, imports (debits) -.

government loans averaged \$925 million annually. During the peak years 1924-28, American foreign lending, including refunding, averaged \$1.63 billion (Brown, 1940, Vol. 1, p. 586). By contrast, Allied remittances on war-debt account averaged only \$185 million a year during 1919-30. Great Britain furnished the lion's share of this amount with an annuity hovering around \$160 million from 1923 onward. The Debt Commission felt justified in claiming that much from Great Britain because that nation had emerged from World War I with its overseas investment portfolio essentially intact. The sums paid to America represented a levy of no more than 0.8 percent a year on existing British holdings. Since the British were in any case redeploying their external investment portfolio from foreign countries toward the Empire in the 1920s, the war-debt bill could be financed without technical impediment entirely outside Europe (in point of fact, by a small amount of disinvestment in Latin America). The London City was also engaged in additional foreign lending throughout the postwar decade. New capital issues floated on the London market for overseas account, excluding refunding, averaged some \$577 million annually (£118.8 million sterling) between 1920 and 1930, despite the fact that during three periods the British Treasury placed a partial embargo on the outward flow (RIIA, 1937, p. 134). Whitehall could hardly plead for war-debt remission on the ground that the London City wished to expand its commercial portfolio even faster than that.

France, the second-ranking debtor, paid nothing until 1926, and in the next five years disbursed on average just \$32 million a year to the United States government. The French resented having to surrender a single centime to a people who had appeared on the battlefield belatedly and made such a small human sacrifice compared with their own. But the payment itself registered only minimally in French national accounts. To put the matter into perspective, by 1929 American tourists alone spent \$137 million on holiday in France (Costigliola, 1984, p. 173). Moreover, during the 1920s France reimbursed its wartime neutral suppliers (the Netherlands, Norway, Switzerland, and Spain) almost ten times what it paid to America and Britain combined without those commercial-debt repayments ever reaching the threshold of public consciousness (Artaud, 1978, p. 927). When, after three years of foot dragging, French parliamentarians confidentially discussed the ratification of the war-debt accords, they wasted no breath on economic obstacles to payment. They focused exclusively on the difficulty of "enlightening" public opinion.¹⁴

As for the other official debtors, none of them paid more than a token sum to the United States. War debts, in short, may have poisoned the atmosphere

¹⁴ Procès-verbal, Commission des Finances, July 17, 1929, pp. 343-366, Archives du Sénat, Paris.

of international economic relations in the 1920s. But, before 1932 at least, they occasioned no payment problems. They accounted for no circular flow of funds.

If Europeans had reason to complain of a dollar shortage in the later 1920s, at a time when central banks (aside from the French) increasingly wished to keep reserves in dollars rather than in gold or sterling, the problem lay on the private side. As a direct consequence of the upsurge in American foreign investment, net interest and dividends received in the United States from abroad (less interest and dividends paid to foreigners) averaged \$358 million a year from 1919 to 1930. Nevertheless, from 1922 to 1930 (leaving out of consideration the abnormal immediate postwar years) that amount did not do much more than cover the \$216 million average U.S. deficit on commodity trade and invisibles (see Table 11). The quite extraordinary boom in American tourist travel and the continued high level of remittances home by immigrants more than compensated for the rising trend in U.S. exports (Lary, 1943, pp. 54-79). Scrutiny of the balance-of-payments statistics, however, reveals another remarkable phenomenon. From 1923 through 1930, private investment by foreigners in the United States (mostly in securities) exceeded by \$3.465 billion—or \$433 million annually—the very substantial investment, exclusive of capital issues, by Americans abroad. The desire of Europeans to invest in American securities thus emerged as the chief source of disequilibrium in the balance of payments (Brown, 1940, Vol. 1, pp. 539-551). No reliable figures for German capital exports in 1923 exist, but from 1924 to 1930 capital exports from the Reich totaled 10.884 milliard RM, or \$370 million annually (see Table 7 above). Much of this went to the United States, some directly though more by virtue of Swiss or Dutch intermediation (Lary, 1943, pp. 107-110; James, 1986, pp. 298-301). In short, of U.S. long-term capital exports during this period, the equivalent of two-fifths came back in a form representing real claims on American assets, and of that segment Germans held an appreciable part.

The Insuperable-Tariff-Barrier Theory

A third misconception perpetuated in the scholarly literature holds that the United States erected an insuperable tariff barrier in the 1920s, making it impossible for Europeans to service their debts. The war-debts specialist Benjamin Rhodes (1965, p. 389; also 1969) typically faults American policymakers for having failed to comprehend the importance of the country's shift to creditor status and for having formulated tariff policy in a "nineteenth-century frame of reference." Even Kindleberger (1973, pp. 291-294) propagates a variant of the argument and complains that the United States failed to maintain a market for distress goods in a crisis. This interpretation may find continuing resonance in scholarship because it figured so prominently in political

debate at the time. Franklin Roosevelt satirized Republican tariff policy this way during the 1932 presidential campaign:

A puzzled, somewhat skeptical Alice asked the Republican leadership some simple questions:

"Will not the printing and selling of more stocks and bonds, the building of new plants, and the increase of efficiency produce more goods than we can buy?"

"No," shouted Humpty Dumpty. "The more we produce, the more we can buy."

"What if we produce a surplus?"

"Oh, we can sell it to foreign consumers."

"How can the foreigners pay for it?"

"Why, we will lend them the money."

"I see," said little Alice, "they will buy our surplus with our money. Of course, these foreigners will pay us back by selling us their goods?"

"Oh, not at all," said Humpty Dumpty. "We set up a high wall called the tariff."

"And," said Alice at last, "how will the foreigners pay off these loans?"

"That is easy," said Humpty Dumpty, "did you ever hear of a moratorium?"¹⁵

Despite the cleverness of this passage, the evidence points to a less categorical conclusion about the consequences of U.S. tariff policy. Trade issues between the wars did not lend themselves to tidy solutions insulated from the political process any more easily than they do today. Even then, judgments about fair-trade practices involved considerable subjectivity. The Fordney-McCumber Tariff Act of 1922 owed its genesis to a combination of old-fashioned protectionism and a legitimate desire to shelter the home market from dumping by nations with depreciated currencies. While this legislation raised rates on dutiable items substantially, it also left a large free list. Hence the overall effective level of protection rose only a few percentage points over that obtaining by virtue of the "low" Underwood tariff of 1913 (Pastor, 1980, p. 78).

Tariff reformers, moreover, managed to insert in the 1922 act a clause authorizing the president to reduce the applicable levies by half through negotiation. The flexible provisions of the tariff, as it turned out, did not come into wide use. Yet the reasons for this failure were complex. Protectionist obstruction by economic pressure groups naturally played a role. The Tariff Commission found it exceedingly difficult to determine relative costs of production, which were supposed to figure as the basis for rate adjustment under the law. And where investigation did prove conclusive, the commission usually found that the cost-of-production standard obliged it to raise duties rather than to reduce them. The administration unfortunately did not gain authority to lower the barriers applying to one category of goods in return for foreign concessions on another (say, a bargain encompassing German chemicals and

¹⁵ Columbus speech, Aug. 20, 1932, text in Rosenman (1938, Vol. 1, pp. 669-684); drafting history in Tugwell (1968, pp. 386-399).

American automobiles). Nevertheless, it remained almost equally important that European nations showed little interest in mutual reductions that would apply to all under the unconditional most-favored-nation method of rate setting adopted in 1922. U.S. tariff specialists like William C. Culbertson, who as much as anyone had provided the conceptual framework for the Fordney-McCumber bill, had expected the unconditional most-favored-nation clause to mitigate the impact of higher *ad valorem* duties and gradually lead to freer trade.¹⁶ But German and other Continental experts became convinced that the generalization of negotiated preferences in practice worked against them. Toward the end of the 1920s, they increasingly complained that the "Open Door" merely conferred advantages on efficient American manufacturers at the expense of their own in third markets.¹⁷

The 1930 Smoot-Hawley Tariff Act, the outcome of a Congressional logrolling process that got out of hand, admittedly raised rates (at least on dutiable items) back toward the levels that had prevailed before the United States became a creditor nation. It either provoked or provided the rationalization for a round of increases by other countries as the Great Depression got under way (Jones, 1934; Schattschneider, 1935). Ultimately, the chain of retaliation may well have reduced incomes everywhere, offsetting the immediate stimulus to home production. All the same, it seems farfetched to think that the American legislation alone had much to do with bond defaults in the early 1930s. As State Department authorities pointed out at the time, the act imposed not so much prohibitive rates as erratic ones—in a few cases applying duties to goods that the United States did not produce at all—and in the final analysis actually worsened the merchandise balance from the American point of view.¹⁸

Significantly, imports to the United States continued to grow under the high-tariff regime—both absolutely and as a percentage of national income—until the Depression struck. In other words, Americans bought somewhat more from abroad under the Fordney-McCumber Act than they had (except during the abnormal period right after World War I) under the lower Under-

¹⁶ William C. Culbertson Papers, Boxes 4, 46-51, Library of Congress. The interpretation here rests also on material in the State Department trade files US 611.003 and 611.0031, as well as the principal European "country" trade files. On the wider issues, see also Kelly (1963, pp. 3-68); and Leffler (1979, pp. 29-30, 43-54, 168-173, 192-202, 295-300).

¹⁷ For evidence of German disillusionment with the results of the unconditional most-favored-nation clause embodied in the 1923 German-American trade treaty, see Wallace McClure memorandum of a conversation with commercial attaché Emil L. Baer, May 5, 1929, US 611.6231/270. For the French refusal to negotiate trade concessions on the most-favored-nation basis, see US 611.5131/455, 468, 500, 509-510 et seq.

¹⁸ Assistant Secretary J. G. Rogers memorandum, "Temporary Commercial Policies," Sept. 11, 1931, US 611.0031/374; Economic Adviser Herbert Feis memorandum, "The Economic Interdependence of the United States," Sept. 29, 1932, US 611.003/3068.

wood tariff. Tariff policy, furthermore, constituted only one factor among many in determining the balance of imports and exports (Lary, 1943, pp. 37-71). Table 11 demonstrates that, in the entire twelve-year span when Republican tariff legislation applied, the merchandise surplus only twice sufficed to cover the deficit on tourism, personal remittances, and other invisibles. These combined accounts registered a deficit from 1922 to 1933 averaging \$211 million annually.

It seems altogether improbable that a downward adjustment of import duties alone would have resulted in a major broadening of the American market for European manufactures. The U.S. Tariff Commission did not study the German case specifically. But in 1928 it investigated the complaints vociferously lodged by Paris against transatlantic trade barriers, and it concluded that the Fordney-McCumber Act had not substantially affected the volume of French exports to the United States.¹⁹ In the interwar period, America could boast a remarkable degree of self-sufficiency. Finished manufactures represented less than 15 percent of all imports.²⁰ The price elasticity in the demand for most manufactured imports remained notably low (Falkus, 1971, pp. 600-603). And in certain sectors (e.g., crude steel and electrical goods), formidable nontariff obstacles had long since impelled European producers to write off domestic U.S. prospects in the hope of inducing their American competitors to strike a more or less explicit bargain on worldwide market share. In consequence, West Europeans generally and Germans in particular had little chance of penetrating the American market on a grand scale with their principal exports, even in the absence of high tariff walls.

The two Republican tariffs imposed relatively preclusive duties on certain products in which the Reich excelled (e.g., chemicals, machine tools, and optics) and thereby undoubtedly distorted the bilateral trade balance somewhat. But only the multilateral figures provide a true measure of how American tariff legislation affected global German export opportunities. The logical growth market for German manufactures lay in developing nations with higher marginal propensities to import than the United States. Those nations could afford to buy largely because they sold raw materials to the North American economic powerhouse.

German businessmen voiced frequent complaints about U.S. foreign economic policy in the late 1920s. Typically, however, they failed to distinguish between the consequences of the American tariff *per se* and the effects of ri-

¹⁹ U.S. Tariff Commission, "How far are the French justified in attributing to the American tariff the decline in their exports to the United States?" Jan. 2, 1929, copy in US 611.5131/757. Of course, the demand for German manufactures would probably have proven somewhat more price-sensitive than that for French luxury goods.

²⁰ Lary (1943, p. 40). This percentage excludes newsprint and jute, which fall technically under the rubric of finished goods.

valry with U.S. firms on their total global sales. Max Haller of Siemens—a firm that experienced the hot breath of Yankee competition in Russia, Latin America, and on the German home market—characteristically jumbled together the grounds for his dismay in June 1929: “America protects itself through gigantic tariff walls against imports while on the world market it practices dumping in a wholly unbelievable way.” Haller resented his transatlantic nemeses for accepting lower profit margins on overseas than domestic sales, for using their financial strength to offer unbeatable credit terms, and even for exploiting their technological prowess to compensate for higher wages. It is hard to tell what disturbed him the most. He could only express the hope that “even in America trees will not grow to the sky.”²¹

Similarly, Ernst Poensgen of the Vereinigte Stahlwerke lobbied vigorously against the Smoot-Hawley tariff, which cut off a heretofore profitable East Coast niche market for specialty steels from the Reich. Yet in his eyes that formed just part of a larger difficulty. American steel producers had earlier participated (through a subterfuge designed to avoid domestic antitrust penalties) in a division of the international market for rails and crude steel. But the variation in production costs impeded agreement on extending such sales cartels to semiproducts and specialty steels. In 1929, U.S. firms did not simply bring pressure to bear to exclude Ruhr steel from their own markets; they also showed alarming aggressiveness in undercutting German metallurgical exports to Latin America.²² The macroeconomic data suggest that German businessmen in a number of fields had ample reason to worry. The fundamental problem derived from the pace of productivity gains in the U.S. manufacturing sector. Not only did the price of American manufactured exports fall in absolute terms during the 1920s, but the ratio of export to import prices in manufactures declined by 18.1 percent from 1913 to the 1928 low (Lipsey, 1963, pp. 143, 473-474). That advantage was entirely dissipated during the Depression. While it lasted, however, genuine competition evidently constituted a greater impediment to German trade expansion than did the American tariff.

Looking Backward from the New Deal

Debtor states can meet their obligations more easily when a hegemonic power prepared to run large deficits on merchandise and service accounts co-

²¹ See Haller to K. G. Frank, June 17, 1929 (discussing in particular the business practices of General Electric and Westinghouse), SAA 11/Lb 374; further evidence in SAA 4/Lt 398 and 11/Lf 140.

²² See the file “Bestrebungen Poensgens in Verbindung mit Aloys Meyer, Arbed [Aciéries Réunies de Burbach-Eich-Dudelange, Luxemburg], eine Zollerhöhung in den USA zu verhindern,” Oct. 1928–Apr. 1929, NL Poensgen, P 7 55 70; also the “European Rail Makers Association” files, P 7 55 55-57 and P 7 55 62, Mannesmann-Archiv.

ordinates international exchanges. Great Britain played that stabilizing role before World War I. After the war, the United States, sheltered by its self-sufficient economy, failed to don Britain's commodious mantle. The most one can claim for American trade policies is that, contrary to received opinion, they did not impose particular strains on other countries' current accounts in the 1920s and that, even under the Depression-era Smoot-Hawley tariff, the quantity of imports fell somewhat less rapidly than domestic industrial production (Lary, 1943, pp. 162, 172). An ideal hegemon would no doubt have shown greater altruism. Devotees of hegemonic theory have yet to make clear, however, whether in the real world stabilizers generally perform the functions ascribed to them because of a commitment to systemic equilibrium or because of a faltering manufacturing sector.

The popular impression that between the wars the United States followed trade and monetary policies inimical to the achievement of global economic balance does have a modicum of justification. But it applies more properly to the New Deal years, when foreign countries had already defaulted on their borrowings from America, than to the earlier period when those loans were being made. In the Bretton Woods era after 1944, Washington officials would strive to build a domestic consensus favorable to American leadership of a cooperative world economy. For politically comprehensible reasons, they found it convenient to identify the nationalist policies they repudiated with the discredited Coolidge and Hoover administrations. In fact, during his first presidential term particularly, Franklin Roosevelt had outclassed his predecessors in the fervor of his economic nationalism. The Good Neighbor policy did not extend to foreign economic affairs.

In 1933-34, Roosevelt executed a classic beggar-thy-neighbor currency devaluation. Acting with a good measure of personal caprice, he reduced the dollar's external value by 40.94 percent, bringing it well below purchasing-power parity against the gold bloc and, to a lesser extent, against sterling-area countries for the rest of the decade.²³ The devaluation had the effect of increasing the effective rate of tariff protection above Smoot-Hawley levels against imports from European hard-currency nations (though not against those from nations in Latin America and elsewhere that let their currencies depreciate further than the dollar). Starting from this lofty benchmark, the Reciprocal Trade Agreements Act of 1934 authorized the chief executive to reduce tariffs through negotiation by up to half and to generalize the prefer-

²³ For evidence of Roosevelt's lighthearted indifference to the international repercussions of his monetary policies, see the diary-memoranda of agricultural economist George F. Warren, his chief adviser on the subject, Sept. 20, Oct. 20-Nov. 2, Nov. 8, 9, 27, Dec. 19-20, 1933, and Jan. 30-31, 1934, George F. Warren Papers, Cornell University Library. For estimates of purchasing-power parity, see Friedman and Schwartz (1963, pp. 482, 586), and the confirmatory judgment of Drummond (1981, pp. 256-259).

ences thereby achieved. But reciprocal trade involved more public relations than substance, at least at first. Secretary of State Hull and his staff of true believers considered the tariff the "king of evils." They genuinely hoped that liberalized commercial policies would pave the way to human progress and peace (Hull, 1948, Vol. 1, pp. 52, 352-377, 525). Roosevelt's brain trusters, however, thought Hull's ideas "grossly naive" and completely contrary to the New Deal strategy of emphasizing domestic recovery (Moley, 1966, p. 92). The president himself had no pronounced interest in trade issues, except insofar as they might help unite his fissiparous coalition and redound to the benefit of the Democratic party. Still, he told Ambassador Dodd in 1933 that, if European states refused to offer concessions, he intended to "make special arrangements with Canada and Latin America and develop a mutual trade policy which will give us markets for our surplus products" (Dodd, 1941, p. 6). And that is exactly what he did.

In the five years before the outbreak of World War II, the administration negotiated new trade treaties with only twenty nations, most of them Western Hemisphere countries or weaker states elsewhere that would buy American exports but would not offer aggressive competition on U.S. domestic markets. The policy aimed principally to undercut European barter agreements with Latin America and to tear asunder the web of trade preferences surrounding the British Empire. Nations that might undersell American agricultural, industrial, or mineral products found themselves excluded from the benefits of reciprocal trade (Gardner, 1964; Kottman, 1968; Hathaway, 1984, pp. 286-299). Roosevelt could accordingly explain to his isolationist supporters that the system of generalized preferences functioned as a figleaf. "In actual practice," he wrote confidentially in late 1935, "we are making bilateral treaties insofar as 90% of the articles affected are concerned" (Moley, 1966, p. 535). No doubt Steward (1975, p. viii) underweights the pragmatic determinants of administration policy when he argues that the philosophy of liberal trade "engendered the rhetoric of idealism and the diplomacy of imperialism." New Dealers saw no logical contradiction between aspirations to promote commercial freedom as an ultimate goal and the advisability of pursuing neomercantilist tactics for the moment in a world beset by the twin scourges of economic adversity and fascism. All the same, the results of the government's artfully contrived export-promotion program, coming on top of a competitive devaluation, are patent. From 1934-35 to 1938-39, U.S. exports to trade-agreement nations shot up 62.8 percent; imports from those same nations increased only 21.6 percent. Exports to nonagreement nations ballooned by 31.7 percent; imports from those nations rose a mere 12.5 percent (Steward, 1975, p. viii).

After a few difficult years, Washington policymakers could thus take satisfaction by the end of the 1930s in the resumption of large trade surpluses.

Given the external environment, this achievement seems remarkable. The world economy had fragmented into trading blocs. Other nations had imposed a host of discriminatory restrictions against American-made products. U.S. unit labor costs, moreover, had risen sharply relative to those prevailing elsewhere, reversing the pattern of the 1920s. Trade, nonetheless, made at most a subsidiary contribution to the extraordinary disequilibrium in U.S. economic relations with the rest of the world that developed during the New Deal years.

Other countries encountered vastly greater difficulty in balancing payment flows to the United States in 1934-39 than they had in 1921-32 (Lary, 1943, pp. 183-200; Friedman and Schwartz, 1963, pp. 462-483). Not only did the Reciprocal Trade legislation promote a small-scale American export boom, but the tourism and personal remittances by U.S. citizens that had earlier helped balance the current account faded away during the Depression. And while income from portfolio investments remained abysmally low because of overseas defaults, income from direct investments recovered smartly from 1934 onward. Still, all this paled into insignificance compared with what happened on the capital account. New American long-term investment overseas virtually disappeared after 1932. Owing to their experience with default on existing long-term capital issues, Americans also hastened to withdraw their short-dated assets from abroad just as fast as foreign restrictions permitted them to do so. Meanwhile, foreigners, who in 1930-33 had drastically run down their short-dated American holdings, reversed themselves abruptly after devaluation of the dollar. From 1934 to 1939, they transferred unprecedented amounts of short-term capital to the United States. By the end of 1939, the inflow (two-thirds of it from Europe) had become so large that on a net basis the United States had almost ceased to be a creditor nation (Lary, 1943, pp. 123, 191).

It appears impossible to tell how much of this inflow derived from undervaluation of the dollar and how much from a perception of the United States as a safe haven as war clouds gathered elsewhere. Whatever the weighting of causes, the resulting imbalance in U.S. relations with the rest of the world led to a massive gold inflow. Gold figured as the ultimate means of settlement when no other way to pay remained. Between the devaluation of January 1934 and the end of 1939, foreigners found themselves compelled to ship almost \$10 billion of gold to the United States (exclusive of sums earmarked for government account). During the "high tariff" period of 1922-33, by contrast, net shipments of gold (again excluding earmarked amounts) had totaled just \$350 million (Lary, 1943, Table 1). At the moment of devaluation, the United States held one-third of world monetary gold stocks; it had amassed two-thirds of a much expanded supply by December 1939 (Lary, 1943, p. 134). The maldistribution of gold at the latter juncture helps to explain why after

World War II the international monetary system would inevitably have to rest upon an implicit dollar standard.²⁴

Even if Germany and other debtor states had faithfully sought to fulfill their obligations during the early part of the Depression, the aggregation of New Deal foreign economic policies would have made it increasingly difficult for them to do so after 1934. While devaluation of the U.S. currency reduced the real weight of dollar-denominated debts, the borrowing countries as a whole could not have easily serviced the residuum under existing conditions without further depleting their hard-currency and gold reserves. Germany stands as something of an anomaly, because continued debt service by that country would have had the beneficial consequence (at least from the standpoint of potential victims of Nazi aggression) of limiting the foreign exchange available to the Reich for war-material procurement. Overall, however, a more rapid drain of gold to the United States would have had a deleterious effect on the world economy. Yet one cannot read history backward. What happened from the mid-1930s onward has no bearing on the case. By that time Germany and other European debtors, as well as those from Latin America, had already defaulted on their external obligations for reasons of politics and convenience.

²⁴ As late as March 1939, U.S. Treasury officials denied the charge—later echoed by Friedman and Schwartz (1963, pp. 480-482)—that undervaluation of the dollar or a fixed price-support program for gold had contributed to the inflow. The Treasury claimed that the current-account surplus up to 1937 remained too small to prove the case for undervaluation, and that a domestic recession with an attendant import slump accounted for the bulge in the American merchandise surplus thereafter. The Treasury suggested with a hint of self-satisfaction that “the only sense in which . . . we give more for gold than other countries is that in addition to \$35 an ounce we also give peace, security, prospects of higher returns on investment, and better speculative opportunities.” At any rate, policymakers saw “no acceptable alternative” to letting the gold inflow continue. A small dollar revaluation would merely spur capital imports in anticipation of further appreciation, while a large revaluation would have disastrous effects on U.S. export trade and ultimately on domestic business activity. Gold leaving the United States, moreover, would flow to the country’s main industrial rivals rather than to deficit lands in Latin America, the Far East, or the Balkans and would not therefore correct the maldistribution of global monetary reserves. The Treasury conceded that the further drain of gold from abroad would increase world currency instability and that financial uncertainty elsewhere might adversely affect the United States. But it considered such a development the lesser of evils. See Henry Morgenthau, Jr., to Robert F. Wagner, chairman of the Senate Banking and Currency Committee, Mar. 22, 1939, Box 51, Office of the Secretary of the Treasury, 1933-56, RG 56 (Accession NN 370-52), National Archives.

5 EXAMINING THE NUMBERS

One final problem remains: to determine the magnitude of the "reparations" obtained by Germany between 1919 and 1933. At first glance, the task appears straightforward. One should be able to calculate the net capital inflow to the Reich and then subtract the amount of German outpayments to the Allies. In practice, it proves difficult to ascertain either of those sums, not only because the data are incomplete, but because the statistics lend themselves to subjective interpretation. An attempt to look behind the numbers published by official bodies and subsequently enshrined in the scholarly literature makes clear how little can be taken at face value. An accurate judgment concerning figures generated with political aims in mind requires at least as much art as science.

The controversy over the size of German reparations payments under the Versailles treaty involves less than meets the eye. For propaganda purposes, the German government argued that by 1924 it had paid over 50 milliard gold marks (\$12.5 billion), and even so meticulous a scholar as Holtfrerich (1980, pp. 144-146) credits it with half that amount. The German figures, however, are purely fanciful. They include, for example, claims for the fleet deliberately scuttled at Scapa Flow and for the imputed value of labor by German prisoners of war, as well as arbitrary overvaluations of German property in ceded areas. The calculations of the Allied Reparation Commission, by contrast, do not reflect any gross distortions. The mutual-compensation arrangements among the Allies became so complex that some of the commission's procedures may not bear rigorous scrutiny from an accountant's point of view. Nevertheless, the commission's figures—summarized in Table 12 with emendations suggested by Etienne Weill-Raynal on the basis of his contemporary experience—portray the order of magnitude of German payments with reasonable accuracy.

As Table 12 indicates, total German reparations from the November 1918 Armistice through the June 1931 suspension of payments amounted to 22.891 milliard RM.¹ Yet by no means all of this constituted a charge on the balance of payments. Actual cash transfers or cash equivalents (including proceeds of the Rhineland customs, the British Reparation Recovery Act to 1924, and the mixed-claims and Belgian-marks agreements) came to

¹ Grounds persist for limited controversy concerning the precise amounts with which the Reich should be credited. The accounting here resolves certain minor disputes in Germany's favor. So scrupulous an authority as Sally Marks (1978) acknowledges total reparations payments of only 20.598 milliard RM.

TABLE 12
GERMAN REPARATIONS PAYMENTS, 1918-32
(in millions of gold marks/Reichsmarks)

| | |
|--|--------------|
| I. Post-Armistice and treaty payments, payments under the London Schedule, November 1918–August 1924: | |
| Cash payments under the London Schedule of Payments | 1,700 |
| Other cash payments (clearings, etc.) | 160 |
| Cash equivalents (Rhineland customs revenue, British Reparation Recovery Act yield) | 376 |
| Post-Armistice deliveries (railway rolling stock, agricultural machines, abandoned war materiel, trucks) | 1,295 |
| Reparations in kind (ships, port material, coal, coke, coal derivatives, dyestuffs, livestock, cables, return of stolen art objects) | 2,393 |
| Less cash advanced by the Allies for coal deliveries under the Spa Agreement of 1920 | <u>- 392</u> |
| Net reparations in kind | 2,001 |
| State property in ceded territories (including Chinese concessions, parts of public debt ascribable to ceded territories, and private property abroad) | 2,809 |
| Sale of destroyed German war materiel | 52 |
| Requisitions during the 1923-24 Ruhr occupation in paper marks and in kind (gross German payments less nominal agreed administrative and occupation costs) [Actual transferable receipts: 153 million] | 930 |
| Payments credited for costs of occupation armies and commissions (does not include housing, transport, and communications facilities furnished without charge under the Rhineland Agreement) | <u>811</u> |
| Total payments (1918-24) | 10,134 |
| II. Payments under the Dawes Plan, September 1924–August 1929: | |
| Cash transfers by the Agent General | 1,736 |
| Reparations in kind | 3,612 |
| Material for public works (special contract arrangements) | 578 |
| Reparation Recovery Acts and miscellaneous payments | 1,166 |
| Armies of occupation and Allied commission costs | <u>461</u> |
| Total payments (1924–29) | 7,553 |
| III. Payments under the Young Plan, September 1929–June 1931: | |
| Cash payments (including interest and exchange profits on the German annuities) | 2,655 |
| German-American mixed claims and the Belgian mark agreement | 192 |
| Net yield of the Young loan transferred to the Allies | 845 |
| Armies of occupation and Allied commission costs | <u>36</u> |
| Total payments (1929-31) | 3,718 |
| Total payments (1918-31) | 21,415 |

Continued on next page

Table 12—Continued

IV. Rectifications:

| | |
|---|--------------|
| Undercrediting of Germany for delivery of wood and ships in 1918-24 | 310 |
| Undercrediting of Germany for occupation costs paid (value of housing, transport, and communications facilities provided without charge to the Allied armies under the Rhineland Agreement) | 1,307 |
| Repurchase of the Saar mines by Germany in 1935 | (141) |
| Total rectifications | 1,476 |
| Total payments including rectifications | 22,891 |
| Recapitulation: | |
| Cash transfers or cash equivalents | 6,819 |
| Normal reparations in kind | 6,779 |
| Segment of the Young loan transferred to the Allies | 845 |
| Reparations not transferred across the exchanges | <u>6,060</u> |
| Total | 22,891 |

SOURCES: Agent General (1925-30); Bank for International Settlements (1931-34); Weill-Raynal (1947, Vol. 3, pp. 219-346, 753-791).

6.819 milliards. Ordinary reparations in kind (ordinary in the sense that they might just as easily have given rise to a cash transfer) totaled 6.779 milliards. "Hothoused" reparations in kind (a category that lumps together Armistice deliveries, surrendered war materiel, public-works development contracts under the Dawes Plan, transferable requisitions during the Ruhr occupation, and a rectification for the undercrediting of wood and ship deliveries) adds 2.388 milliards more. The true charge on the German balance of payments therefore comes to 15.986 milliard RM. The segment of the 1930 Young loan that went directly to the creditor powers falls into an anomalous category, but for accounting purposes it seems best to classify the 845 million RM involved as a cash transfer also. That boosts the grand total to 16.831 milliard RM. The rest of the reparations credited, some 6.060 milliards (including state property in ceded territory, costs of the Allied occupation armies and commissions, and supplies utilized by the Franco-Belgian authorities in the Ruhr during the military incursion of 1923-24), represented a burden on the German economy but did not encumber the balance of payments.

According to the best estimates available, German national income at factor cost over the period 1919-31 amounted in aggregate to 842 milliard RM.²

² Formidable problems arise in ascertaining German national income during the hyperinflation after World War I. See the comparison of the two most plausible approaches in Holtfrerich (1980, pp. 220-224); also the discussion in Chap. 2, note 7, above. Henning's reconstruction of the data, based on production quantities, and Witt's, developed inductively from tax statistics,

Thus, even if given credit for the Young loan, Germany transferred during these thirteen years no more than 0.91 percent of national income in cash reparations, and just under 2.00 percent in cash and kind together. The gross burden on the German economy of all amounts credited works out to 2.72 percent of national income.

Analysis of the capital transfer to Germany between 1919 and 1931 proves more complicated. Economists who scrutinize the capital inflow during 1919-23 must rely on guesswork. The German government at the time had no reliable statistics, despite the reams of material that it churned out for public-relations purposes emphasizing the penury of the Reich. Chancellor Wirth declared himself "simply amazed and aghast" upon discovering in October 1922 that the Reich Statistical Office had wildly miscalculated the trade deficit since the Armistice and still had only a vague idea where the truth really lay. Wirth blamed the breakdown on the technically unsophisticated, old-fashioned career employees manning that agency, who had failed to develop methods for coping with currency instability.³ Yet no improvement took place after the scandal reached the cabinet's notice: down to the end of the inflation, the bureaucrats continued to reckon in paper marks, oblivious to the daily or even hourly changes in real values. In consequence, German government records shed more heat than light on the matter. All those who have subsequently studied the problem begin with the figures generated in 1924 by the Second Committee of Experts appointed by the Reparation Commission. While the Dawes Committee drew up a reparations payments plan, the Second Committee under former British Chancellor of the Exchequer Reginald McKenna was supposed to estimate the amount of exported German capital and to suggest ways of ensuring its repatriation. The latter committee did not succeed in turning up data reliable enough to facilitate a scientific determination of the important elements in the German balance sheet. But international economic inquiries conducted in the glare of publicity are expected to lead to conclusive results. As happens so often in such cases, the prevailing political circumstances made it inexpedient to admit publicly the messiness of the real world with which the investigators had to deal.⁴

differ for individual years. Both investigations, however, point to total national income of 365 milliard gold marks over the six-year period 1919-24. (The respective findings, expressed as percentages of the accepted national income figures for 1913, can easily be converted into real values.) By contrast, the commonly cited national income figure of 477 milliard RM for 1925-31 has occasioned little controversy, despite unresolved difficulties in obtaining reliable statistics about capital disinvestment and inventory changes during the Depression years 1929-31 (Hoffmann, 1965, pp. 166-167, 509).

³ Joseph Wirth to Economics Minister Robert Schmidt, Oct. 24, 1922, R 43 I/31 (Alte Reichskanzlei), BA.

⁴ Minutes of the Second Committee of Experts, Jan.-Apr. 1924, MS in the Hoover Institution, Stanford University.

The German trade deficit between 1919 and 1923 constituted the most significant variable on which the McKenna Committee hoped to construct its reckoning. However, the two staff members designated to work out figures, Leonard Ayres of the Cleveland Trust Company and Raffaele Pilotti of the Committee of Guarantees Export Section in Berlin, could not remotely agree. Ayres, a trained statistician who took a rigorously mathematical approach, estimated the trade deficit at 7.0 to 8.9 milliard gold marks. Pilotti, a practical-minded commerce specialist who considered the available German data systematically distorted, included an intuitive correction in his calculations and put up a figure of 5.5 to 6.5 milliards. McKenna and his colleagues did not wish to leave so wide a margin of difference because that might "cause doubts" about the quality of the committee's work. They therefore fastened on an arbitrary compromise figure of 6.3 to 7.3 milliards and with all due fanfare broadcast it to the world.⁵

Similar confusion marked the committee's deliberations on other issues. Ayres found the memoranda presented by the Latin countries' representatives "full of tricks, misquoted data, and sly transference of items from one side of the account to the other." But when he worked up precise information about German capital balances, his principal, the banker Henry M. Robinson, complained that he had shown "too clearly just what we had done" and called for something "more obscure." Ayres commented privately about the final decision to announce 5.7 to 7.8 milliard gold marks as the total amount of German capital abroad:

This is in no sense a statistical, economic, or financial finding. It is the result of numberless compromises between the conflicting claims of the English and Americans

⁵ Minutes of the Second Committee of Experts, Mar. 21-22, 1924. Pilotti, who would later rise to prominence as a mainstay of the Italian Ministry of Corporations, derived his skepticism about the official statistics from his field experience with the Committee of Guarantees, the Reparation Commission's branch office in Berlin. Pilotti knew, for example, that before the war the Rhineland had accounted for 10 percent of Germany's exports and 9.8 percent of its imports. In the postwar period, however, the Rhineland seemed to account for 27 percent of Germany's exports but only 6.6 percent of its imports. One political phenomenon explained much of this apparent shift. After the war, Rhineland merchants had to apply to the High Commission Economic Service at Bad Ems for foreign-trade licenses. They operated under Allied supervision and could not understate their exports. Outside the occupied zone, German officials connived at such understatement because the Reich was obliged to make a reparations payment equivalent to 26 percent of exports. After making various statistical corrections, Pilotti and his colleagues on the Committee of Guarantees staff concluded that official figures might understate German exports by as much as 40-50 percent. See Section du Contrôle des Exportations, "Le Commerce extérieur de l'Allemagne et celui des territoires rhénans occupés," Aug. 1, 1923, Haute Commission Interalliée des Territoires Rhénans, AJ⁹3824, Archives Nationales, Paris. For Pilotti's reports to the McKenna Committee, see "Estimation of the Amount of German Capital Abroad," Berlin Doc. 3062, Jan. 19, 1924, and "The Value of German Imports and Exports from 1919 to 1923," Doc. 9131, Feb. 16, 1924, in Box 10 (Reports), Leonard P. Ayres Papers, Library of Congress.

on one side, and the Latins on the other. The final figures are not even the result of adding up both sides of the balance sheet and finding the difference. . . . The final figures simply represent the result agreed upon, so as to have some result, after neither side would concede anything more.⁶

The McKenna Committee made one true economic contribution by investigating foreign holdings of paper-mark balances in German banks that had lost their value as the result of inflation. At first Ayres and his fellow specialists thought this whole inquiry "ridiculous." They discovered that the German bankers themselves had only a "very hazy idea" of what had happened. Eventually, however, the accountants agreed upon a method for converting the paper balances into gold values and persuaded officials of the eight leading financial institutions in Berlin to cooperate. The accountants concluded that foreigners had forfeited almost 8 milliard gold marks owing to the devaluation of bank balances alone—about twice what McKenna had expected. Ayres pronounced this a "fairly real figure."⁷

For political reasons, the British refused to admit that the actual figure for German capital flight might be higher, and the Latins likewise declined to concede that the actual figure for the German trade deficit might be higher. The accounts would therefore not balance unless the McKenna Committee reported low figures for paper currency held abroad and for foreigners' losses on mark-denominated securities and other investments. The committee estimated the maximum proceeds accruing to Germany from currency depreciation at 700 million gold marks and the gain on securities and property at 1.5 milliards. Yet these figures appear impossibly low. As Keynes observed in September 1922: "Everyone in Europe and America has bought mark notes. They have been hawked by itinerant Jews in the streets of the capitals, and handled by barbers' assistants in the remotest townships of Spain and South America." Keynes contended that the German exchange profit just on currency devaluation up to mid-1922 might have reached 3.5 milliard gold marks, and that foreign losses on securities and property might account together for another 2.5 milliards.⁸

Economists like precision, but a much more accurate determination than this does not fall within the realm of possibility, even today. Certainly, neither the research analysts at the New York Fed nor their counterparts at the Bank of England had enough confidence in the available data to make a defin-

⁶ Leonard P. Ayres Diary, Feb. 20 and 25, Mar. 17 and 23, 1924, Box 1, Ayres Papers.

⁷ Ayres Diary, Jan. 31–Feb. 12, 1924. The accountants admitted that their conclusions rested on an extrapolation from partial figures, drawn exclusively from the money-center banks. See Deloitte, Plender, Griffiths & Co. et al. to McKenna Committee, "Report on the Value in Gold Marks of Net Paper Mark Balances Standing to the Credit of Foreigners in the Books of German Banks," Feb. 20, 1924, Box 10, Ayres Papers.

⁸ "Speculation in the Mark and Germany's Balances Abroad," *Manchester Guardian Commercial*, Sept. 28, 1922, in Johnson (1978), pp. 47–58).

itive judgment at the time.⁹ Among economists who studied the question in the interwar period, Frank Graham (1930, pp. 251-259) reached particularly noteworthy conclusions. Graham first corrected the McKenna Committee's assumptions on the basis of information and suppositions drawn from an earlier independent inquiry by Moulton and McGuire (1923) of the Brookings Institution. Graham's wide-ranging investigation suggests that the Reich's total gains from unredeemed currency or its equivalent amounted to between 15 and 17 milliard gold marks; he himself settled on the suspiciously precise sum of 15.665 milliards. This correlates fairly well with the figure of 15 milliard gold marks that comes from a direct calculation of the German import surplus between 1914 and 1923 for which no other explanation turns up in the balance of payments.

Among modern students of the problem, Holtfrerich (1977a; 1977b) has shown unusual resourcefulness in reevaluating foreign losses on securities and property. His inquiries suggest that American purchases of (and losses on) mark-denominated bonds amounted to some \$300 million for the years 1919-22. Since Ayres's examination of the German banks indicated that Americans held 40 percent of the devalued bank balances, it seems reasonable to infer that their bond holdings also constituted approximately two-fifths of the whole. That would point to a total German gain on bonds of at least \$750 million (3.15 milliard gold marks) and a gain on securities and property together exceeding 3.5 milliards.

Except for his endorsement of Ayres's findings about devalued bank balances, Holtfrerich does not offer detailed discussion of other individual items in German foreign accounts. But his soundings generally confirm Graham's judgment that gross German exchange profits during the inflation years exceeded 15 milliard gold marks.¹⁰ Given the gaps in the data, that figure appears likely to stand as the most plausible approach one can make to the truth.

Holtfrerich (1977a, p. 526) probably errs on the low side, however, in estimating the American contribution to this sum at 4.5 milliard gold marks. That figure comprises only identifiable American losses on mark balances in German banks (some \$770 million, according to Ayres's calculations) and

⁹ See memoranda sent by the New York Fed research chief, Carl Snyder, to Governor Benjamin Strong, Oct. 1920-Oct. 1923, in Strong Papers 320.451-453 (1 and 2), FRBNY; and for perplexity within the British government on the issue, Montagu Norman to D. R. Crissinger (U.S. comptroller of the currency), Nov. 14, 1922, summarizing memoranda provided to him by R. G. Hawtrey of the Treasury, Gilbert Layton of the *Economist*, and the Bank of England staff, in C30/8, B/E.

¹⁰ Graham (1930, pp. 260-276) contends that one should subtract from the gross proceeds an amount to compensate for the worsening in German terms of trade owing to inflation. But he advances highly conjectural figures on this score. In particular, he computes the putative losses from selling goods below world-market prices without taking into account the effects on domestic employment and factory utilization. Holtfrerich (1980, pp. 193-217) offers a useful corrective.

\$300 million in mark-denominated securities known to be circulating in the United States. Yet those who suffered losses on their mark holdings fell into five categories: exporters who left their earnings on deposit in Germany, bondholders, purchasers of stock shares and properties, speculators (including veterans of the occupation army) who actually held currency, and importers who bought forward marks to cover themselves against exchange risk.

Holtfrerich's methods of inquiry do not fully capture the multifarious ways in which Americans sustained reverses on the mark. Owing to the weakness of the New York acceptance market in the early 1920s, for example, many traders still had to execute foreign transactions through London or Amsterdam. In fact, since the United States turned down the Versailles treaty and failed to sign a separate peace with the Reich until late August 1921, prudent German exporters and importers almost always insisted before that date on settling accounts in Europe.¹¹ While a British or Dutch bank would normally cover exchange risk through a compensatory transaction in Berlin, forward-mark purchases made through those channels would not show up as American in Holtfrerich's calculations. In all likelihood, Americans also held a larger quantity of bank notes than commonly presumed. It is instructive to recall that in the spring of 1919, when foreigners came to possess half the entire German note issue (i.e., the equivalent of some 4.5 milliard gold marks), the United States maintained for a time a well-paid occupation army numbering 240,000 men in the midst of the financially distressed Rhineland population (Holtfrerich, 1982, pp. 121-122). Finally, German-Americans undoubtedly sustained greater reverses on long-term investments in the old country than they cared to admit publicly. In light of the furious hostility to "hyphenates" that developed in middle America during World War I, members of the immigrant community had every reason to hide their subscriptions to Reich treasury bonds, particularly those dating back to 1914-17. For what it is worth, Wall Street bankers generally believed that German-Americans alone may have suffered aggregate losses amounting to \$1 billion by the time the inflation came to an end.¹²

Taking one thing with another, it seems entirely possible that total American losses attributable to the German inflation approached 6 milliard gold marks (or \$1.4 billion), although it would be rash to insist on a precise sum. The exchange gain certainly sufficed to finance fully the import of American foodstuffs and raw materials that proved so crucial to the economy of the Reich after the war. Holtfrerich notes that the official bilateral trade deficit for 1919-22 amounted to \$951 million. But since a significant proportion of

¹¹ For a graphic explanation of German traders' fears that money deposited in New York might be immobilized, see Max Haller to K. G. Frank, Feb. 7, 1920, SAA 11/Lb 359.

¹² Report of Dr. Kuhlo to Bayerischer Industriellen-Verband, Sept. 13, 1924, MA 101096, BHStA.

American exports to Germany passed through the Netherlands or other neutrals prior to August 1921, the actual figure must stand higher.

Determination of net capital imports into Germany during the period 1924-30 ought to prove fairly simple. The official balance-of-payments accounts (see Table 7 above) show gross capital imports of 28.254 milliard RM and gross capital exports of 10.884 milliard RM over that period. The net capital import figure thus appears to be 17.370 milliards, or 18.215 milliards counting the Young loan. But, in fact, up to the summer of 1931 no one possessed really accurate information about the movement of short-term capital in and out of Germany.

The confusion took some time to clear. The Wiggin-Layton Committee appointed in connection with the Standstill in August 1931 estimated short-term debts at 10.3 milliard RM, long-term debts at 9.2 milliards, and foreign investments in mark-denominated securities and property at another 6 milliards. Yet those calculations were soon revealed as incomplete. During the fall of 1931, internal Reichsbank memoranda used the figure of 12.3 milliard RM for short-term debts and 23.5 milliards for all debts denominated in foreign currencies. The Special Consultative Committee that met in Basel in December 1931 adopted these numbers with some emendations. Not until 1934 did the German government publish retrospective statistics endorsed by the Bank for International Settlements as definitive, and even those statistics represented a political as much as an economic judgment. This final determination indicated that, as of July 1931, Germany owed 13.1 milliard RM in short-term debts and 10.7 milliards in long-term debts, and that mark-denominated investments amounted to an additional 5.9 milliards.¹³

¹³ Privately, leading German bankers considered the successive official estimates of 10.3 to 13.1 milliard RM for the short-dated debts to be rather misleading. Such figures lumped together trade acceptances secured by commodities in transit with finance credits, and included in the latter both local borrowing by the foreign subsidiaries of German firms and loans by those same subsidiaries to the controlling enterprises at home. Some double counting may have taken place. The Reichsbank insisted, however, and the private bankers agreed, that it would be unwise to make these distinctions publicly. See Carl Goetz of the Dresdner Bank to Hans Kraemer, Dec. 2, 1931, and the attached memorandum prepared for (but not shown to) George Davison, president of the Central Hanover Trust Co., in NL Ludwig Kastl, Nr. 11, BA; also the revealing comments by Gustav Schlieper and Oscar Wassermann of the Deutsche Bank and by Otto Jeidels of the Berliner Handels-Gesellschaft, in "Aufzeichnung über eine Besprechung in der Reichsbank betr. Vorbereitung der Stillhalterverhandlungen am 9.12.31," NL Kastl, Nr. 12. For the texts of the Wiggin-Layton Committee and Special Consultative Committee reports, see *The Economist*, Special Supplements of Aug. 22, 1931, and Jan. 2 and 23, 1932. For generation of the official German figures, see Statistische Abteilung der Reichsbank, "Aufgliederung der kurzfristigen Auslandsverschuldung Deutschlands per 28. Juli 1931," Nov. 2, 1931, and "Exportüberschuß und Tilgung kurzfristiger Auslandsschulden," Nov. 5, 1931, both in NL Luther, Nr. 338, BA; also Statistisches Reichsamts (1932b; 1933a; 1933b; 1934a); and Bank for International Settlements (1935).

Even if one takes on faith the relative accuracy of the latter figures, there remains some scope for interpretive variance concerning the real benefits that Germany drew from capital imports over the period 1919-31. The considerations presented here suggest that total capital imports for those years, calculated conservatively, amounted to 44.7 milliard RM—more than 5.3 percent of German national income. That would not quite equal the 5.5 percent of national income that the Reich received as an indemnity from France in 1872-75, but it exceeds any other unilateral transfer among major nations carried out across the exchanges before the oil crises of the 1970s.¹⁴ If one subtracts 16.8 milliard RM for reparations transferred to the Allies, the net capital flow to Germany still comes to a substantial 3.3 percent of national income.

The impact of these funds on German prosperity in the 1920s significantly exceeded their simple fractional contribution to national income. Keese (1967, Table 5, p. 51) shows that the net capital inflow—after subtracting reparations payments—amounted to no less than 17.5 percent of all gross domestic investment in 1925-30. When adjusted, this finding exactly confirms Harris's earlier computation (1935, Appendix 2, p. 94) that long-term capital provided by foreigners accounted for 18.7 percent of all stocks, bonds, and mortgages issued in Germany from January 1924 through April 1929.¹⁵ Holtfrerich (1980, p. 286) and Born (1967, pp. 20-22) demonstrate that foreigners provided 36 percent of German bank deposits in 1919-21, and again 38 percent in 1929.¹⁶ Since foreigners, unlike domestic depositors, did not ordinarily figure as debtors of the institutions in which they placed their money, the importance of foreign funds in assuring the liquidity of the banking system is even greater than these percentages indicate at first glance. Depositors from abroad tended to concentrate their holdings in money-center banks. This phenomenon illuminates the standing complaints of the provinces that loans were far easier to obtain in Berlin than elsewhere during the Weimar era.

It is only fair to recognize, however, that some assets originally of German origin showed up under the rubric "capital imports" in the national accounts

¹⁴ The much larger transfers from conquered nations to Nazi Germany during World War II and from East Germany to the Soviet Union thereafter involved the removal of capital equipment and the mobilization of slave labor; they were thus not accomplished through the normal mechanisms of foreign trade and investment. For an imaginative study of several unilateral transfers (dealing with the Franco-Prussian War case and reparations in the 1920s, but not with the capital flow the other way), see Machlup (1964, pp. 374-395).

¹⁵ Keese's calculations assume 9.9 milliard RM in gross reparations payments from 1925 to 1930. If one counts only the 9.0 milliards actually transferred according to German figures, the share of long-term capital formation provided by foreigners rises to 18.7 percent.

¹⁶ Holtfrerich's figures for 1919-21 are drawn from a survey of the large Berlin banks; Born's figure for 1929 refers to all joint stock banks.

for 1924-30.¹⁷ What happened to the 10.9 milliard RM of capital supposedly exported from Germany in those years? The official German statistics admit to revenue of 325 million RM from foreign investments in 1924. Assuming an average return of 5 to 6 percent, that would point to external holdings in the range of 5.4 to 6.5 milliard gold marks at the time. German assets abroad at the end of the war amounted reliably to 5.8 milliards, so that the official reckoning obviously represents a minimum figure taking no account whatever of exporters' well-known propensity to leave their earnings abroad during the inflation. In fact, those who followed the question closely considered the McKenna Committee's "political" estimate of 5.7 to 7.8 milliards for assets abroad in 1924 implausibly low (Weill-Raynal, 1947, Vol. 2, pp. 565-568). Yet German statistics show revenue from foreign investments of only 400 million RM in 1930. This figure implies that the assets in question had hardly increased at all over the intervening six years and now stood at only 6.6 to 8.0 milliards. The discrepancy between the foreign holdings one might reasonably expect and the maximum figure acknowledged by the German government amounts to 8.3 milliards. Admittedly, the normal ebb and flow of short-term money (including that of foreigners) may have inflated both sides of the capital balance sheet. Equally clearly, many German citizens fearful of renewed inflation acquired life insurance denominated in foreign currencies and property located outside the Reich that did not pay an immediate return (James, 1986, pp. 296-301). Still, the main explanation for the discrepancy must lie in some combination of underreporting of assets held and reinvestment of the funds in Germany with the protective umbrella that a foreign bond issuer or a foreign corporate identity could provide.

The 1920s witnessed the increasing integration of world capital markets. Money moved freely in and out of the United States throughout the decade. Berlin maintained vestigial capital controls during the postwar inflation, but even then they were more honored in the breach than the observance. After stabilization, such controls proved wholly impracticable. The government of the Reich could not logically differentiate between expansion by German business abroad, which it sought to encourage, and less patriotic forms of capital flight. German individuals who purchased units in the Dutch or Swiss *tranches* of American loans, or who invested funds directly in such issues on Wall Street, might hope to evade both the turnover tax and the income tax on bonds at home. Most sophisticated German businesses, furthermore, had

¹⁷ Board Chairman Franz Urbig of the Disconto-Gesellschaft suggested to the expert accountants attached to the McKenna Committee that some proportion of the mark balances nominally held by foreigners in the period 1919-23 actually belonged to German nationals. But he could not quantify that supposition, and the accountants found no way to explore it further. (See the preliminary report of Deloitte, Plender, Griffiths & Co. to Reginald McKenna, Feb. 15, 1924, Box 10, Ayres Papers.) The discussion here therefore focuses exclusively on 1924-30.

found it expedient to establish Dutch or Swiss subsidiaries during the inflation. Afterward, they continued to have recourse to these legally independent entities to shelter profits from the unusually high corporate taxation in the Reich, as well as for legitimate trade and investment purposes. When necessary, a subsidiary could alleviate a parent firm's liquidity problems by borrowing cheaply abroad and relending the proceeds to the home office. It proves extremely difficult to gauge the impact of these multiple transactions accurately.

The Young Committee examined these issues in 1929 but did not progress beyond anecdotal information. Dillon, Read & Co., which carried out a survey of where bond coupons were presented for payment, found that as much as two-thirds of some earlier high-coupon German loans for which the firm had served as principal underwriter had passed into the hands of German nationals by 1929. Reichsbank staff assistants also conceded privately to Young Committee members that the proceeds of much recent short-dated borrowing had been employed to repatriate the most burdensome long-dated paper.¹⁸ But these straws in the wind lead to no quantifiable conclusions. After all, Germans shunned the Dawes and Young loans and held relatively little of some others.

Some further intimations of the realities behind the formal statistics on capital movements derive from data gathered by the Reich Foreign Debts Office concerning the distribution of the country's foreign liabilities. According to an analysis conducted by that agency shortly after its formation in February 1932, financial institutions, businesses, and households in the Netherlands and Switzerland together held 32.2 percent of outstanding German short-term debt and 29.2 percent of the long-dated debt (Statistisches Reichsamt, 1932b, p. 492). While qualified foreign observers had reservations about the way the figures were compiled, they nevertheless thought it probable that at least half (i.e., 3 milliard RM or more) of the putative Dutch and Swiss holdings actually represented the funds of German nationals.¹⁹ Taking one indication with another, it seems altogether credible that almost 40 percent of nominal German capital exports (say, 4.15 milliard RM) came back to Germany somehow and appeared in camouflaged form under the rubric of capital imports.

Little information exists about the disposition of Germany's remaining assets abroad. In 1936 the U.S. Office of Naval Intelligence asserted that, not-

¹⁸ Lord Revelstoke memorandum, "Two Points in Dr. Schacht's Response," Feb. 14, 1929, 2nd Baron Revelstoke Papers, DPP 2.4.5, Baring Brothers & Co., Ltd. Archive, London.

¹⁹ See the extended discussion of the statistics and their possible interpretation by Louis Gaillet-Billoteau, French financial attaché in Berlin, "La Dette extérieure de l'Allemagne au 30 septembre 1932," May 30, 1933, F³⁰/1413 (dossier "Crédits gélés"), Ministère des Finances et de l'Economie, Paris.

withstanding Berlin's professed need to trade through barter because of a hard-currency shortage, German nationals still held \$2 billion (5 milliard RM after devaluation of the dollar) in secret assets outside the Reich.²⁰ But with all the evidence available after World War II, Lewis (1948, pp. 306-307) could identify only \$697 million (1.7 milliard RM) of specific German holdings as of 1938. The losses suffered by investors in all industrial countries during the 1930s point to the greater plausibility of the latter figure. A German citizen who had invested a sum in foreign securities in September 1929 corresponding to the stock-market indexes would, by June 1932, have lost 84.3 percent of his money in the United States, 63.2 percent in Switzerland, 78.8 percent in the Netherlands, and 61.5 percent (including exchange depreciation) in Great Britain. If the same investor had held his American portfolio intact until Wall Street recovered in 1938, he would still have lost 74.4 percent of his principal.²¹ In short, most German assets abroad simply disappeared in the maelstrom of the Depression.

To sum up, a minimum calculation of Allied "reparations" to Germany during the Weimar Republic might rest on the limiting assumption that some 4.15 milliard RM of net capital imports actually came from funds of German origin. Germany would also receive credit for the eventual repayment of 6 milliard RM of the short-term loans. (This computation does not count the gain accruing to the Reich from dollar and sterling depreciation.) That would still leave German proceeds from the net transfer at no less than 17.75 milliard RM, or 2.1 percent of national income for the whole period 1919-31.

Americans had floated 55.2 percent of the long-term debt and had supplied 48 percent of direct investment. Almost all of that was lost or at least immobilized until after World War II (the London Debt Agreement of 1953 provided for very partial retrospective compensation).²² American banks held ap-

²⁰ Office of Naval Intelligence, "Effect of Germany's Latest Step toward Obtaining Foreign Credit," Nov. 24, 1936, in US 862.51/4459.

²¹ Stock-market figures from Kindleberger (1973, pp. 111, 122-123); monthly figures for sterling depreciation from Brown (1940, Vol. 2, p. 1089). The 1938 figure for the New York exchange is a monthly average, corrected for depreciation of the dollar.

²² The fate of individual U.S. corporate investments in the Third Reich turned more on luck than strategy. Two examples among many must suffice. Owen Young and Gerard Swope, the leading executives at General Electric, abhorred Nazi Germany and gradually wound down their company's ties to AEG and Siemens. The latter firm, however, anxious to preserve its reputation for fair dealing in the postwar world, won special permission in November 1940 to refund the \$10 million that GE had invested in a 1930 Siemens private placement of "participating debentures" (Vorstandssitzung der Siemens & Halske AG, Nov. 21, 1940, SAA 4/Lt 398; also E. Waller, ed., "Studien zur Finanzgeschichte des Hauses Siemens," Pt. 5, pp. 170-180, SAA 20/Ld 366). Colonel Sosthenes Behn of ITT, by contrast, did everything possible to appease the new masters of the Reich and directed his Lorenz and Standard-Elektrizitäts-Gesellschaft subsidiaries to cooperate with every appearance of enthusiasm in the Nazi rearmament effort.

proximately a third of German short-term debt and eventually recovered nine-tenths of their principal, although they too lost considerable interest and the use of the money for up to a decade.²³ Total American losses for 1924-31, following this reasoning, might exceed 8 milliard RM after making the necessary correction for the pass-through of funds of German origin. American losses for the entire Weimar Republic, consequently, may have run as high as 14 milliard RM (\$3.5 billion). In price-adjusted terms, this sum approached four times the total assistance that the United States government would provide to West Germany from 1948 to 1952 under the much-heralded Marshall Plan.²⁴ Between the wars, Washington received only negligible amounts in direct reparations and precious little in war-debt repayments to offset the losses of its citizens. Hence the major burden of the capital transfer to Germany in that earlier period fell in one way or another on the American investor and taxpayer.

During the war, the Reich Economics Ministry nevertheless expropriated a majority interest in ITT's German holdings through a judicial trick (details in the war-crimes investigation of Standard board member Kurt Freiherr von Schröder, Interrogations of Nov. 14 and 19, 1945, MC4, IfZ). On the London Debt Agreement of 1953, see Abs (1955, pp. 167-173); and Schwarz (1982).

²³ The 1931 Wiggin-Layton Committee estimated American holdings at 55.2 percent of the long-term loans and 37 percent of the short-term loans. State Department balance sheets drawn up subsequently accepted the long-term figures, but gave varying figures for the short-term loans down to 30 percent. Estimates by the German Foreign Debts Office (Statistisches Reichsamt, 1932b, p. 492; 1933a, p. 274) ran closer to the latter computation. The sum of \$675 million (48 percent) for direct investment comes from Commerce Department figures as cited by Shepard Morgan, "Memorandum on German short-dated indebtedness," July 6, 1931, "Reichsbank/Dawes Committee/Young Committee 1929-31" file, FRBNY.

²⁴ In current dollars, disbursements to West Germany under the European Recovery Program totaled \$1.389 billion (Mayne, 1973, p. 144).

6 CONCLUSION

Reflections on Interwar Debt Experience

The flow of capital from the United States and certain European countries to Weimar Germany in the 1920s gave rise to one of the greatest proportional transfers of real wealth in modern history. Foreigners who speculated on the mark, who bought German bonds, or who advanced bank loans to correspondents in the Reich had originally expected a positive return on investment. The payment of "reverse reparations" took place after the fact. The process resembled what was to occur in the 1970s, when the high-powered bankers who sought to recycle petrodollars creatively through the Eurocurrency market failed to realize that they were setting the stage for a massive and continuing subsidy of the third world by the industrial West.

Had the sorely tried Berlin government drawn up a master plan in 1919 to make the victorious powers subsidize consumption and leisure time in the Reich over the next thirteen years, it could scarcely have hoped for more dazzling success than that which resulted from inadvertence. No master plan existed. Yet the wellsprings of nationalist *ressentiment* ran deep in the Weimar era. From the reactionary right to the socialist and communist left, almost everyone in political life wished to liberate Germany from the reparations burden imposed by the hated Versailles treaty. The unanimity of German public opinion on this score conditioned the choices open to policymakers in dealing with a range of other financial and economic issues, both foreign and domestic.

Looking back from exile in 1938, former State Secretary Hans Schäffer—for some years the most important professional in the Berlin bureaucracy concerned with economic policy—speculated that it might always have been a pipe dream to try to loosen the fetters of Versailles gradually while keeping Germany financially and politically integrated with the West.¹ It is easier to square the circle in finance and diplomacy than in Euclidean geometry, but rarely very much easier. Still, nothing indicates that responsible figures in either the public or the private sector anticipated, when Germany began borrowing abroad in late 1924, that the country might eventually default on private obligations. On the contrary, as ex-Agent General Gilbert later put it, most German leaders continued to assume until a crisis erupted in 1931 that they could "go bankrupt in water-tight compartments."

Although Germany's maneuvers to force through a customs union with Austria in violation of treaty stipulations precipitated the crisis of 1931, the

¹ Schäffer Tagebuch, July 17, 1938, ED 93/25, IfZ.

liquidity squeeze which developed that July had all the earmarks of authenticity. A Standstill arrangement for short-term debts offered the only prospect of immediate relief. Nevertheless, the country's unwillingness to adopt appropriate adjustment policies and its slide toward ostensible insolvency over the next two years reflected political priorities more than economic exigencies. Businesses with substantial foreign exposure on the whole opposed further steps toward general default. But a heterogeneous coalition comprised of Nazis, Nationalists, agrarians, domestic reflationists, and bankers became convinced that default lay in the national interest and that divisions within the creditor camp made serious retaliation improbable.

Moreover, the distinctions between German policymakers who openly advocated default and those who in principle preferred to fulfill the country's commercial obligations despite the severity of the Depression tended to blur over time. Chancellor Brüning, for example, did what he reasonably could to curb the consumptionist excesses of the 1920s and to make the Reich more competitive on world markets. He always spoke as if he hoped to maintain faith with private lenders, if only to keep open the prospect of new loans. Yet, first and foremost, he remained a politician out to steal the Nazis' thunder. That led him into inevitable contradictions. He had to weigh prospective improvements in the balance of payments against other considerations. Hence, while arguing abroad for cancellation of reparations on grounds of German poverty, he characteristically moved to assure Reichswehr commanders in April 1932 that, as soon as he had achieved that aim, he would devote a share of the resources saved to tripling the secret armaments budget and would authorize an expensive five-year program to create a battle-ready army of a million men (Bennett, 1979, pp. 59-62, 151-152).

Some German leaders found themselves borne along by the current of events. Hjalmar Schacht, the once and future Reichsbank president, navigated the rapids with uncanny concentration on his ultimate goal. Strong circumstantial evidence suggests that Schacht encouraged the shift from long- to short-term financing in 1927-29 with a view to making the reparations settlement unstable. Out of office, he promoted various schemes for default from mid-1931 on with the transparent intention of shifting the commercial-debt burden abroad. And when restored to the Reichsbank presidency on the morrow of the Nazi takeover, he put his proposals into practice forthwith. Yet even after the German debt default, Schacht continued to have admirers among his fellow central bankers. Governor Montagu Norman of the Bank of England insisted to his unbelieving friends at J. P. Morgan & Co. in 1934 that "Hitler and Schacht are the bulwarks of civilization in Germany and the only friends we have. . . . If they fail, Communism will follow in Germany, and anything may follow in Europe."²

² Russell C. Leffingwell to Thomas Lamont, July 25, 1934, Leffingwell Papers 4/96, Yale University Library, New Haven.

Schacht carefully burnished his reputation as a moderate, particularly after he developed a suspicion that autarky might not work and also that he might lose out to Hermann Göring in the internal Nazi power struggle.³ In October 1934, he confided to the American ambassador:

The whole modern world is crazy. The system of closed national barriers is suicidal and we must all collapse here and the standard of living everywhere be reduced. . . . Five years ago I would have said it would be impossible to make me so crazy. But I am compelled to be crazy. We are excluding raw materials all the time and must in time be ruined if we cannot export goods and the exports decline all the time. We have no money to pay our debts and soon shall have no credit anywhere (Dodd, 1941, p. 175).

This lament could not fail to remind the uncharitable of the concern lavished on the oysters in "The Walrus and the Carpenter."⁴ All the same, at his post-war trial and denazification hearings, from which he emerged without judicial taint, Schacht embellished the theme with a flourish of sincerity. He had always negotiated in an "absolutely honorable" fashion and sought to regulate the interest question with creditors in "a practical and reasonable way."⁵ He had aspired to "change the default" and "become an honest debtor again" by 1937; alas, he lost the power to slow down the rearmament program and fell short of his goal.⁶

At the London Debt Conference of 1952-53, the representatives of the Federal Republic squirmed in embarrassment as the American bondholders' spokesman rehearsed the events of the 1930s with greater attention to the facts. The world financial press relayed the graphic details of "Schachtage"—the technique of driving down bond prices by not paying interest and then buying back the obligations at a penny ante price. Schacht had the last laugh nonetheless. When he applied for renewal of his banker's license in Hamburg, no one mounted a challenge. As Hans Schäffer informed the administrative court: "The untrustworthiness of Schacht, who did more harm to German credit than anyone else, was famous round the world. . . . Any serious German banker whom you ask will confirm this confidentially if he dares. But not a single one will place himself at your disposal for a court battle with a man so unscrupulous as Hjalmar Schacht."⁷

³ See the analysis by H. Fritz Berger, Schacht's associate at the Nazi Economics Ministry, in Berger to Dietmar Petzina, May 20, 1960, ZS 1684, IfZ.

⁴ " 'I weep for you,' the Walrus said; / 'I deeply sympathize.' / With sobs and tears he sorted out / Those of the largest size, / Holding his pocket handkerchief / Before his streaming eyes" (Carroll, 1946, p. 198).

⁵ Verhör Schacht, Protokoll der Berufungsverhandlung gegen Dr. Hjalmar Schacht, Aug. 5, 1948, p. 118, Sp 1/3, IfZ.

⁶ Schacht testimony at Nuremberg, Oct. 16, 1945, copy in ZS 135, Bd. 3, IfZ.

⁷ Schäffer to Herbert Weichmann, president of the Hamburg *Rechnungshof*, Aug. 28, 1952, ED 93/42, IfZ.

Although Schacht's personal foibles thus continued to engender controversy among his contemporaries, the root causes of the German default lay deeper. Neither the inclinations of a single official after 1933 nor even the exceptional character of the Nazi regime explains why the Reich encountered intractable balance-of-payments problems in the first place. The fundamental difficulties arose (despite a remarkable improvement in the current account from 1930 onward) as a result of capital flight and, to a lesser extent, capital withdrawals. Foreign investors declined to lend further after mid-1930 not simply because of the Depression, but because they accurately perceived a heightened political risk. The Reich was singularly vulnerable to the reverse flow of capital. It had overborrowed in the 1920s and squandered much of the proceeds on public or private consumption, and it had persistently failed in the early years to adjust tax, budgetary, labor, and trade policies to take account of reparations requirements added to a growing commercial debt.

Schacht bore relatively little responsibility for the total volume of loans contracted abroad between 1924 and 1930. During those years, he and his Reichsbank associates had repeatedly sought to discourage long-term issues unlikely to improve the country's export position. In the face of intense political pressures, they had struggled in the *Beratungsstelle für Auslandskredite* to moderate the pace of unproductive municipal borrowing. Ironically, the forces that shaped a political structure conducive to injudicious foreign borrowing were precisely those most committed in principle to making the republican regime of Weimar a success. Mayors who crafted lavish capital budgets as a means to attenuate social unrest, Reichstag strategists who boosted transfer payments with a view to promoting a more equitable society, and labor leaders who pushed for compensation packages that in effect prevented industry from financing rationalization out of retained earnings did not usually consider balance-of-payments consequences. Yet, so long as Germany remained legally bound to a fixed-rate parity under the gold-exchange standard, the nation's monetary managers ignored those consequences at their peril.

Realists could not have expected that other countries would enable Germany to run large current-account deficits forever, particularly if economic growth remained sluggish. The cumulative impact of previous borrowing would raise the perceived risk for new lenders and increase the country's vulnerability to external shocks. At some point, foreign investors would take fright. They would realize that the rate of return on capital invested in German corporations generally fell short of the borrowing rate and that the present accumulation of public debt implied the probable constriction of future consumption. Even if the Great Depression had not supervened, it seems unlikely that the Reich, given its reparations obligations, could have continued to finance through international loans a standard of living not justified by pro-

ductivity. In the long view, therefore, the deepening economic downturn of 1931 provided the contingent setting rather than the essential cause of the German payments crisis.

Under the prodding of Chancellor Brüning in 1930-32, local governments, the unions, and the democratic left in the Reichstag recognized that major structural distortions had crept into the economy and acquiesced in the emergency decrees that cut back social-welfare gains. But they gave ground grudgingly, and, in light of the progressive political breakdown across the land, too late to reassure the lenders of capital. The slowness of political accommodation to balance-of-payments constraints in this case should occasion no surprise. Invariably, foreign loans are quickly assimilated into the credit structure of a debtor country. The innumerable economic interest groups in a pluralist society all seek to ensure that adjustments, when required to implement a reverse transfer, do not come at the expense of their respective sectors. Without effective pressure on the part of external creditors, governments that rely upon popular approval for legitimacy have a hard time imposing contractionary policies on a sustained basis in order to service foreign debts.

Under these conditions, the political risks of international lending are invariably greater than they seem. In the 1920s, discriminating foreign lenders to Germany should have required a political-risk premium well above the normal cost of borrowing within the Reich. They did not do so. Domestic lenders, scarred by their experiences in 1919-23, exacted an inflation-risk premium that subsequently kept long-term rates in German money markets as much as 300 basis points higher on average than equivalent rates in London or New York. This differential explains why the yield to maturity on German domestic bonds issued in 1924-30, when adjusted for the circumstances in which particular flotations appeared, actually exceeded the corresponding yield on Wall Street's German loans (Eicher, 1932, p. 678). While Americans could earn a somewhat higher return in Germany than at home, they obtained a negative political-risk premium on such investments relative to German domestic rates. American bankers and investors evidently committed a serious error in judgment. That error prefigured a similar miscalculation by leading U.S. financial institutions half a century later (not coincidentally, soon after the retirement of the last executives who might have had direct personal knowledge of the earlier disappointments with international lending). In the 1970s, major U.S. commercial banks advanced large sums to Latin American and East European nations with notorious records of previous default at a spread less than 1 percent over the cost of funds and a mere 50 basis points above the rate charged to industrial member states of the Organization for Economic Cooperation and Development (Lever and Huhne, 1986, pp. 49-50). Once again, the banks in question made inadequate allow-

ance for potential political problems. Perhaps Americans, with their long tradition of institutional and economic stability, are temperamentally inclined to underestimate political risk abroad.

In his classic analysis of Latin American default experience in the 1930s, Díaz Alejandro (1983, pp. 29-33) also lays emphasis on the delicacy of the reverse-transfer mechanism. But he reserves his admonitions chiefly for the creditors. When creditors tolerate prolonged depression, resort to protection, or countenance extravagant increases in real interest rates, he contends, they may make it virtually impossible for debtor nations to pay. The impression persists today in many quarters that the peculiar severity of the 1930s downturn and the collapse of an integrated global economy fully suffice to account for the unusually high incidence of default everywhere in that decade. Undoubtedly, disturbances in the expectations prevailing when borrowing took place (for instance, regarding the future range of commodity prices) and the absence of serious policy coordination among countries had some impact on debt delinquency. The question remains, how much? Internationally minded economists, acutely conscious of the benefits that foreign lending can confer in a world awash with idle resources, began early on to give Latin American defaulters the benefit of the doubt. Henry Wallich (1943, p. 328) argued philosophically, " 'Tis better to have lent and lost than never to have lent at all." Actually, however, the principal creditor nations had radically different degrees of success in preserving the assets that they had lent abroad in the 1920s. And debtors did not live up to their obligations strictly in proportion to their luck in the "commodity lottery."

Differences in the default experience of creditors in the 1930s, as contemporaries recognized clearly, derived mainly from variations in the geographic distribution of their external assets (RIIA, 1937, p. 322). While individual companies or municipalities ran into trouble all over the world, systematic national default took place only in Central and Eastern Europe, China, and Latin America. Six East European countries (Bulgaria, Greece, Hungary, Poland, Romania, and Yugoslavia) joined Germany in default; all had suffered a variety of financial ills long prior to the Depression. China labored under the cumulative disabilities of invasion, political chaos, and hyperinflation. Every Latin American and Caribbean nation found some reason to default, with the exception of Argentina (which obtained the compensating advantage of a preferential trade agreement with Britain) and Haiti and the Dominican Republic (which remained under direct U.S. fiscal supervision).⁸ Low commodity prices provided the initial motivation for most Western Hemisphere defaults. But the well-advertised reluctance of New Deal officials to consider sanctions

⁸ At one point, the Dominican Republic temporarily suspended sinking-fund payments, but the 1934 renegotiation of amortization schedules met with the approval of the Foreign Bondholders Protective Council.

for fear of jeopardizing U.S. export-trade and security interests goes far to explain why defaulters south of the border declined to come to terms when the economic indices improved.

Great Britain survived the 1930s without grave losses on its overseas investments for one essential reason. By the beginning of the decade, it had concentrated 58.7 percent of its portfolio within its own Empire, and the Empire proved wholly immune to the temptations of debt delinquency. Britain stood at general risk only on the 19 percent of its holdings located in Europe, China, and Latin America exclusive of Argentina. The United States, by contrast, had placed 59.7 percent of its foreign investments in the affected areas, and it sustained losses proportionately. A cursory examination suggests that the default experiences of the two main creditors ran reasonably close together on comparable classes of securities. For example, by 1935 default had touched 35.4 percent of the capital sunk into publicly issued dollar bonds for foreign governments and municipalities (the figure rises to 48.7 percent if Canadian issues are omitted from the calculation). Concomitantly, 35 percent of the funds committed on the London Stock Exchange for public-authority flotations outside the British Commonwealth stood in default. Yet since foreign-government bonds comprised a mere 10.4 percent of British overseas holdings, compared with 36.7 percent of total American offshore investments, the defaults in question had far greater resonance in the United States.⁹

A number of economists have speculated that "loan pushing" by inexperienced U.S. banking houses may have magnified the specific risk attending individual Wall Street flotations in the 1920s (Basevi and Toniolo, 1986, pp. 643-644). But the evidence connecting that practice with the spectacular collapse of American external portfolio investment in the Depression does not appear strong. By 1935, some 72.9 percent of the value of U.S. publicly traded bonds for foreign companies outside Canada had gone into default (RIIA, 1937, p. 307). With two notable exceptions, however, the respective national decisions to suspend debt service wholly accounts for this dismal record. As the German example demonstrates, a solvent firm cannot keep its obligations in a country that declines to do so. Country risk envelops business risk. The British obtained an unexpectedly satisfactory return on fixed-income investments in the Commonwealth through the worst years of the Depression precisely because political risk played no significant role. By 1935, London Stock Exchange loans issued seven years earlier for Empire governments stood at 119 percent of par; loans for Empire corporations stood at 116 percent of par; and even loans for commodity production overseas had on average held 84 percent of their initial value (RIIA, 1937, pp. 356-363).

⁹ See the full discussion in RIIA (1937); the figures presented here are calculated from tables on pp. 142, 153-154, 166, 186-187, 300-301, 306-307, 326.

These results appear even more impressive when adjusted for the 24 percent price deflation over the intervening period. The skills of the London City in minimizing specific risk could not have achieved this outcome in the absence of the multiple linkages of interest and sentiment that bound the Commonwealth together and militated against interruptions of debt service on grounds of political expediency.

It is notable that the divergence in the returns on American and British overseas investments from this era persisted long after the economic crises of the 1930s had faded into history. Eichengreen and Portes (1986, pp. 623-636) have calculated the internal rate of return to maturity on a representative sample of dollar bonds issued for public and private borrowers excluding Canada from 1924 to 1930 and on a similar, though not identical, sample of sterling bonds floated for foreign and colonial public borrowers from 1923 to 1930. The internal rate of return to maturity on the American bonds averaged 0.72 percent a year; the comparable rate of return on the British bonds averaged 5.41 percent a year. Numerous despairing American bondholders sold defaulted securities to speculators or back to the defaulting governments at deep discounts during the Depression, while British holders characteristically saw their later returns reduced adventitiously by World War II interruptions in servicing. Thus, even these figures understate the purely economic impact of default in the 1930s on the typical U.S. investor.

The political nature of the German default turns out on close inspection not to be an exception to the general pattern in the 1930s, but merely a variant on it. How else can one explain why hard-hit commodity producers in the British Commonwealth like Australia and New Zealand stumbled along somehow without renegeing on debt-service requirements, while South American states with the highest economic growth rates in the world like Brazil led bondholders a merry dance? Admittedly, Great Britain ran a substantial trade deficit all through the 1930s, and in most years a modest current-account deficit as well. It thereby furnished some of the sterling that enabled its debtors to pay. What is often overlooked, however, is that Britain had traditionally registered an export surplus with the Empire, while almost the whole of its trade deficit derived from transactions with Europe and the United States (RIIA, 1937, pp. 324-327).

The Ottawa Agreements of 1932 accorded preferences to Commonwealth agricultural products and somewhat reshaped trade flows. Still, the British market proved far too restricted to absorb all the wheat, meat, and dairy surpluses that the Dominions and other members of the sterling bloc wished to sell (Holland, 1981, pp. 121-151). Argentina earned enough hard currency through privileged access to British markets under the 1933 Roca-Runciman treaty to cover its sterling debts; the benefits of bilateralism in that case proved large enough so that Buenos Aires economic planners could withstand

bitter complaints from Washington and from default-minded nationalists at home. In general, however, Britain's Commonwealth partners managed in the mid-1930s to cover no more than half their interest and amortization obligations through a surplus in direct trade with the mother country. The Dominions had some incentive not to risk their special position in British markets through debt delinquency, especially given the dearth of alternative customers for primary products. But long before Whitehall threw in the towel and opened negotiations for an Anglo-American trade agreement in 1937, it became patent that the Empire by itself could not provide a sufficiently large or balanced trading unit to solve the economic problems of any of its members. Imperial preference alone cannot explain why Commonwealth countries paid their debts.

Other considerations proved at least as important (Drummond, 1981, pp. 1-118, 252-261). Bondholders in England retained tremendous political clout. The City of London had the power to employ both stick and carrot, and it did not hesitate to use either instrument. To begin with, the Colonial Stock Act gave creditors a legal claim on certain export revenues of delinquent debtors. The fact that sterling-bloc countries kept their reserves in the British capital further raised the costs of potential default. Quite aside from such constraints, a perceived community of interest held narrow calculations of advantage in check. The major Dominion banks all had close connections in London; their officers shared the outlook of the City that obligations should be kept. The personnel of the nascent Commonwealth central banks came mostly from the Bank of England and reflected underlying attitudes at the parent institution.

The Bank of England itself spared no effort in managing the flow of capital to the Empire. While new loans remained of modest size, the Dominions could count on vital assistance in refunding outstanding long-dated debt at lower interest rates. After the initial Commonwealth devaluations of 1931-33, the Bank of England also stood prepared to extend temporary financing to help sterling-bloc countries with liquidity problems and to hold exchange rates steady. At the same time, Threadneedle Street had no compunctions about refusing accommodation when it disapproved of Dominion policies. Moreover, the ministries in Whitehall applied their influence to strengthen the Bank's negotiating hand. The Treasury facilitated Empire finance through its own domestic strategy of easy money, cheap credit for commercial purposes, and a reasonably balanced budget. And it exerted moral suasion against extreme forms of deficit finance or fiat-money creation by sterling-bloc debtors.

Of course, the most strenuous endeavors to bring about policy coordination could not obviate some angry confrontations. After all, Australia and New

Zealand, along with Canada, labored under the highest per capita debt burden in the world, six times greater than that of Germany, twice that of any South American defaulter (RIIA, 1937, p. 233). Australia, under duress, waffled on its Ottawa promises and resorted to prohibitory import duties and the bilateral balancing of trade. New Zealand elected a radical Labour government that embarked on a reckless program of public expenditure and eventually needed to be bailed out; Whitehall granted an emergency export credit only on terms that left a bitter aftertaste. Still, imperial relationships remained intimate enough to compose all differences in the end. No breakdown in debt servicing took place.

Eichengreen and Portes (1986, pp. 613-617) present an illuminating regression analysis of the covariates of default in the middle 1930s. They find statistical confirmation for the intuitive expectation that, within a given region, countries experiencing the greatest deterioration in terms of trade or that raised domestic absorption through deficit spending would have a higher propensity to default. They find, conversely, that open economies vulnerable to sanctions showed less inclination to default. Yet, as they admit, a straightforward debt-capacity model cannot explain why countries in the antipodes eventually made the economic adjustments required to fulfill their obligations, while South American nations that suffered less from the Depression did not. Cultural attitudes of the debtors, the relative willingness of the predominant creditor states to support bondholder claims and when necessary to facilitate bridge financing, and the general character of regional political relationships provided the margin of difference.

It is worth recalling that the principal Latin American nations did not rate as particularly underdeveloped in the 1930s. In terms of gross domestic product per capita, they ranked in the same league with such middle-income countries as Austria, Finland, Italy, Portugal, and Japan (Balassa et al., 1986, p. 52). Brazil, the largest and most important of the South American defaulters, lagged behind the income pacesetters somewhat, but, aside from an early drop in coffee prices, it scarcely experienced the Depression at all. Gross domestic product rose 51.7 percent from 1929 to 1939, and real industrial production boomed upward by 86.2 percent (Díaz Alejandro, 1983, p. 8). Nevertheless, Brazil first truncated its foreign debts unilaterally through the so-called Aranha plan, next obliged its customers to subsidize the balance through targeted export taxes, then set current foreign suppliers and bondholders to squabbling among themselves about disposition of the revenue made available, and finally suspended payments altogether so that the army budget could increase. Leading diplomats under the Gétulio Vargas regime articulated the view that "no nation plays a clean game" and that "each one pursues only its own interests" (Hilton, 1975, p. 10). Accordingly, they ruth-

lessly exploited the competition of the United States, Germany, and Great Britain for access to Brazilian raw materials and markets in order to achieve domestic economic goals (Hilton, 1975, pp. 1-228).

Brazilian decisionmakers perceived a serendipitous opportunity to take advantage of Northern Hemisphere quarrels and lift themselves out of economic dependency. Supremely pragmatic, they stood happily remote from the strategic and ideological perils posed by the Third Reich. They aimed to get the rival capitalist powers to share the burden of Brazil's rapid industrialization and to subsidize the country's accelerated social and infrastructure investment. They hoped that, following hothouse economic development, Brazil would emerge as the arbiter of Latin America's destinies. The Vargas regime did not hazard a confrontation by debt repudiation or, for that matter, by open denunciation of the Brazilian-American trade treaty. It proceeded instead by polite evasions and, on the whole, succeeded brilliantly. New Deal officials did not care to defend bondholder interests any more vigorously in Brazil than in Germany. And by 1938, Washington became so frightened of Nazi penetration of Latin America that it also passively tolerated Brazil's erection of import barriers that violated prior agreements. In the interests of hemispheric defense, the U.S. government supplied new loans to Brazil from 1940 onward without much concern for what happened to the old. As President Vargas presciently observed, "The United States has a plethora of money and demonstrates good will toward us. We need to take advantage of that special situation" (Hilton, 1975, p. 218).

In negotiations with Latin American countries as in dealings with Germany, some State Department officials favored cautious verbal support for bondholders, particularly when commodity prices rebounded in the later 1930s and the borrowers' capacity to resume debt service manifestly improved. Even then, the State Department vetoed any linkage of debts with trade. But in 1939 its special envoy to Lima went so far as to threaten the Peruvian president that "neither the American government nor American private investors were prepared to play the role of Santa Claus"; until Peru agreed to scaled-down payments on its old debt in line with its economic capacities, "the prospects of future loans or credits was nil." President Roosevelt and his chief advisers, however, generally proscribed that sort of approach. Secretary of the Interior Harold Ickes expressed the characteristic administration view: "There is no compulsion to invest money in foreign enterprises and it ought to be at the risk of the investor." Treasury Secretary Morgenthau made clear to bondholders in 1940 that they should settle for what they could get. For purposes of hemispheric security, the U.S. government needed to promote financial stability in Latin America. It could tolerate no obstruction for the sake of private gain (Gellman, 1979, pp. 40-44, 160-161).

Implications for the Current Debt Crisis

If history has any heuristic value, these stories from the 1930s suggest that political choice may also play an important part in resolving the debt crises of the 1980s. The external indebtedness of the third world (excluding traditional oil-producing states) rose from \$130 billion in 1973 to \$612 billion in 1982 and topped the \$1 trillion mark in 1987. The borrowings of the Latin American nations alone approached \$400 billion by the latter date. Although earlier bursts of overseas investment had witnessed larger resource transfers relative to the size of the lending economies, the volume of international lending in the 1970s surpassed all previous episodes in absolute terms.¹⁰ Until the late 1960s, while recollections of the political circumstances attending Depression-era defaults remained fresh, most third-world countries found themselves restricted to development loans from multilateral agencies (usually concessional in nature but limited in amount) and trade-linked credits from the export-guarantee facilities of industrial countries. Then, quite suddenly, the climate of expert opinion changed. Commercial bankers "discovered," as Henry Wallich of the Federal Reserve Board expressed it (1982, p. 247), that middle-income developing countries had become creditworthy. If the premise held, it followed that international investors had too little third-world paper in their portfolios. They needed to carry out a "one-time stock adjustment" (Díaz Alejandro, 1984, pp. 348-349) to make up for the forty years during which private nonequity capital flows had largely bypassed Latin America, mainland Asia, Eastern Europe, and Africa.

The resultant investment boom and its dolorous collapse in the 1980s now forms the subject of a large and growing literature (Sachs, 1982; Cline, 1983 and 1984; Díaz Alejandro, 1984; Delamaide, 1984; Makin, 1984; Lever and Huhne, 1986; Balassa et al., 1986; Kahler, 1986; Lomax, 1986). The current debt crisis naturally differs in many details from that of the 1930s. But the essential political problem remains fundamentally the same: how should debtors and creditors apportion the sacrifices when perceived needs outrun available resources?

It appeared during the 1970s, to analysts who judged solely from economic indicators, that the leading international banks were performing a signal service by moving capital to those who could make the best use of it. Between 1970 and 1978, according to World Bank data, middle-income countries grew

¹⁰ See the figures on the growth of net overseas long-term assets, 1855-1938, in Fishlow (1986, pp. 42-43). Between 1900 and 1913, Great Britain increased its net overseas assets by 61 percent of 1913 GNP; France acquired new overseas assets equivalent to 41 percent of 1913 GNP (calculated from Mitchell, 1978, pp. 411, 416, 424). Neither American offshore lending in the 1920s nor lending by OECD countries to the developing countries in the 1970s approached that torrid pace.

at an average annual rate of 5.7 percent, almost as fast as the capital-surplus oil-exporting countries, which achieved an average annual growth rate of 6.0 percent. Even the habitually laggard low-income countries, with their assortment of intractable problems, managed an average annual growth rate of 3.6 percent. In contrast, the advanced industrial countries, hobbled by soaring oil and raw-material prices, a serious recession, and destabilizing inflation, attained a comparatively anemic 3.2 percent average annual growth rate from 1970 to 1978 (Heller, 1982, p. 262).

The impressive economic progress of the third world before the second oil shock of 1979 did not derive from the availability of foreign capital alone. The influential "dependency school" of economists had long prophesied a continuing secular decline in the relative prices received by primary producers. Yet, remarkably, the terms of trade for most developing countries, although volatile, generally improved through the 1970s. Producers of coffee, cocoa, and sugar reaped particularly large windfall profits, and other nations, not so lucky in the commodity lottery, gained through higher export volumes (Cline and associates, 1981, pp. 11-19, 48-49). In consequence, the leading middle-income countries in Asia and Latin America succeeded in boosting domestic savings and investment, often in dramatic fashion, as well as in attracting foreign loans (Sachs, 1982, pp. 233-235; Balassa et al., 1986, pp. 98-100).

When the newly qualified borrowers solidified their credit standing, they found it possible to obtain funds for financing current-account deficits and smoothing domestic consumption as well as for investment. By pushing up oil prices without any relation to production costs in the 1970s, the Organization of Petroleum Exporting Countries in effect imposed the equivalent of a gigantic reparations levy on those who imported oil. The developing countries bore part of this charge, and they greatly increased other imports as well. Still, the real debt-service burden on most developing countries did not rise alarmingly before 1980 because inflation continuously eroded the value of existing dollar-denominated obligations (Cline, 1984, pp. 1-11; Díaz Alejandro, 1984, pp. 337-349). As the United States turned to monetary expansion and external currency depreciation as a means of solving domestic problems, third-world leaders began to bank on low or even negative real interest rates. In August 1979, Philippine President Marcos typically declared it "axiomatic . . . to borrow when the prices are still down and then to repay five [or] ten years from now when everybody says the dollar will be cheaper and prices may be higher" (Cline and associates, 1981, p. 29).

In retrospect, borrowing predicated on such assumptions looks like the riskiest of speculations. Neither lenders nor borrowers should have expected commodity prices to remain high or the dollar to float below purchasing-power parity indefinitely. Apparently some experts, particularly in Latin America, had the notion even then that, in the event of crisis, debtor coun-

tries could use their political bargaining power to whittle away foreign obligations, much as they had done in the 1930s (Díaz Alejandro, 1984, pp. 347-348). More importantly, the modest inflation-adjusted debt-service ratios seem to have produced everywhere a false sense of security. So prescient an observer as Chairman Paul Volcker of the Federal Reserve Board stated reassuringly in March 1980 that "the recycling process has not yet pushed exposure of either borrowers or lenders to an unsustainable point in the aggregate" (Lever and Huhne, 1986, p. 49).

In the interwar period, individual bondholders had borne the principal risks of long-term lending overseas; financial institutions had functioned primarily as underwriters. In the 1970s, commercial banks granted loans directly. Bankers thought they could protect themselves by employing a new financial instrument, the medium-term syndicated rollover credit. This product facilitated diversification of loan portfolios, and it transferred the risk of interest-rate volatility to the borrower. The prevailing wisdom held that bank credit offered considerable advantages over the issue of bonds: it provided the continuity of a banker-client relationship and the prospect of a more flexible response in the event of servicing problems. Yet the syndicated rollover credit carried perils of its own. The usual five- to twelve-year maturity allowed insufficient time for infrastructure investment to yield a positive payback, and the shift of contractual interest-rate risk to the borrower did not ensure that the borrower would actually pay in the event of wide rate swings.

As in the 1920s, bankers had a tendency to minimize prospective difficulties because of short-term preoccupations. Lending institutions in the five key industrial nations faced low domestic profit margins. They could, however, earn lucrative up-front management fees by serving as intermediaries in the recycling of oil revenues. The petroleum-exporting countries could not spend their new wealth as fast as they acquired it. Between 1973 and 1980, they placed much of their \$366 billion current-account surplus in Western banks, while at the same time the non-oil-producing developing countries needed to finance a \$287 billion current-account deficit (Saint-Etienne, 1984, p. 73). Given the rapid geographical diversification of multinational corporations and the advancing globalization of financial markets, money-center banks that declined to join the syndication game had good reason to fear that they would be left behind in the scramble for other business (Wallich, 1982, pp. 249-252). Furthermore, since major banks now competed all over the world on fine price differentials, they found themselves increasingly dependent on the favor of home-market regulators. The latter often promoted politically useful lending abroad by applying prudential rules selectively, structuring market incentives, and channeling tax funds to international agencies that could bail out floundering debtors for a while with a minimum of public accountability (Wellons, 1986; Wellons, 1987).

Many bankers credulously believed that they had obtained an extra margin of safety because more than three-quarters of post-1970 loans went directly to sovereign governments or carried an official guarantee. According to Walter Wriston of Citibank, at once a pioneer and a booster of the new international lending, nations might experience temporary cash-flow problems, but they could never go bankrupt. Given sound programs and time to let them work, sovereign borrowers could always resume payment (Lever and Huhne, 1986, p. 45). American bankers had vigorously debated this "sovereign-risk hypothesis" in the 1920s (Delamaide, 1984, pp. 97-98). The defaults of the following decade ought to have settled the question conclusively. In practice, nations do become insolvent or at any rate choose to appear so, and the penalties visited upon them rarely cut very deep or last very long.¹¹ But the system through which bankers are recruited and promoted, at least in the United States, does not foster an acute historical sensibility. Bankers tend to be present-minded. Evidently, the computer models used to judge debt-service capacity in the 1970s took no special notice of prewar default experience (Heller, 1982).

The palmy days for borrowers came to an end between 1979 and 1982, for reasons only some of which prudent planners could reasonably have foreseen. The OPEC cartel hiked international oil prices again, in this round to eighteen times the 1970 dollar level. The industrial countries toppled into recession and temporarily curtailed their purchases from abroad. An era of commodity-price deflation began. Non-oil-producing developing countries experienced a decline in their terms of trade and, in some cases, even in the absolute value of their exports. Meanwhile, the American monetary authorities realized that the accommodative strategies through which they had coped with domestic social pressures as well as the OPEC oil bill in earlier years might finally cause inflation to spin out of control. They raised interest rates sharply. This had consequences for debtors overseas as well as at home. From 1971 through 1980, the London Interbank Offered Rate (LIBOR)—the benchmark for international lending—had lagged on average 0.8 percent behind U.S. wholesale-price inflation. In 1981-82, by contrast, LIBOR exceeded U.S. inflation on average by 9.2 percent (Cline, 1983, pp. 22-23). The true cost of funds had rarely risen so high. In addition, the dollar began its recovery relative to other currencies, so that the real weight of dollar-denominated principal increased. Third-world policymakers had accustomed themselves for a decade to borrowing with no effective cost at all. They had not reckoned on disinflation. No wonder that, by the end of 1982, thirty-four countries had fallen behind on their payments. Debtors wishing to honor their obligations would have to make major adjustments.

¹¹ See Max Winkler's (1933, esp. pp. 12-46) historical review of sovereign default through the ages, which received wide popular circulation when it appeared.

Sovereign borrowers that limited domestic consumption, pruned extravagant state subsidies, encouraged private-sector savings and investment, avoided an overvalued exchange rate, cracked down on capital flight, and channeled national energies into exports soon found their external accounts moving back toward balance. The capital markets rewarded their compliance. South Korea, Singapore, Taiwan, and their Pacific Rim neighbors experienced little trouble in obtaining additional foreign investment on a voluntary basis in the 1980s. Despite some social strains, these countries resumed their economic growth paths and shortly reached new heights of prosperity. The less open and flexible economies of Eastern Europe that sought to avoid prolonged delinquency—Romania and Hungary, for example—had to pay the penalty of greater austerity. Nonetheless, these cases too reinforced the demonstration that, when decisionmakers possess the political muscle to impose appropriate policies, the technical economic difficulties involved in adjusting the current account invariably yield to solution. Many important debtors, however, in Latin America, Africa, and elsewhere, hesitated to make the indicated domestic-policy changes or carried them through belatedly and halfheartedly. They and their sympathizers in the advanced countries began instead to bemoan the prospective “negative resource transfer”—that is, the reluctance of foreign banks to provide new loans in excess of the interest due on the old (Lever and Huhne, 1986, pp. 56-75). Yet as Krugman (1984, p. 391) has sagaciously remarked, if countries follow irresponsible policies and lose the confidence of lenders as a result, the falloff in available funding scarcely constitutes an exogenous event.

With few exceptions, countries that failed to surmount the liquidity crisis of 1982-83 within a reasonable period of time had either squandered their resources during the “fat” years or deliberately evaded adjustment thereafter for reasons of political expediency. In contrast to the situation prevailing in the 1930s, delinquent debtors half a century later did not have the excuse of a prolonged world depression. By the mid-1980s, objective economic circumstances for most debtors had improved or at least stabilized. Industrial countries had begun to grow fairly satisfactorily again. While certain commodities did better than others, export markets for the developing countries generally revived. The United States, in particular, helped by running a trade deficit of unprecedented size. The dollar once more declined precipitously, in the process shrinking the real developing-country debt burden. Interest rates eased. And oil prices fell back. Notwithstanding these favorable trends, few debtors acknowledged that they had received adequate relief. On the contrary, the litany of complaints and the list of coerced reschedulings grew ever longer. International debt became a political football in the so-called North-South conflict. In the early 1970s, spokesmen for the poor countries in the United Nations Conference on Trade and Development and similar forums had called for a “new international economic order” comprising vast unilat-

eral transfers of wealth from the richer parts of the world to the less developed ones. Now many third-world rulers saw an opportunity to achieve that goal by forcing the concessionary treatment of existing debt.

What had the borrowers of a trillion dollars done with the money? Some had invested it, more or less wisely. The answer for the more troubled debtor nations involved variations on one of three themes: unproductive use of funds, overconsumption, and appropriation of the proceeds by local elites. Many Latin American nations, caught up in ideological enthusiasm, had practiced inefficient import substitution in the 1970s. They created bloated state-run enterprises with no reference to comparative advantage, dissipated borrowings on infrastructure development in excess of foreseeable needs, raised both tariffs and obstacles to direct foreign investment in order to eliminate competition, and discriminated against agricultural and other exports. This inward-looking economic strategy caused marginal capital-output ratios to rise; investment efficiency deteriorated (Balassa et al., 1986, pp. 65-74; Sanders, 1986, pp. 33-49). The emergent nations of sub-Saharan Africa had also shunned a strategy of export-led growth. They too dribbled away development funds on show projects. They particularly penalized market agriculture, subsidized foodstuffs for city dwellers who had no prospect of gainful employment, and let population growth get out of hand (Ravenhill, 1986). In many parts of the world, developing-country planners aspiring to provide a better life for their peoples had allowed consumption to outrun productivity gains and failed utterly to take into consideration the higher cost of energy. Even Brazil, in certain respects a model for third-world development, had gambled perilously by fostering the hothouse growth of domestic demand (Cline, 1984, pp. 262-268; Fraga, 1986, pp. 11-19; Frieden, 1987, pp. 97-116).

Inexperience and overoptimism accounted for some of these policy errors. In other cases, perfervid nationalism and corruption passed beyond the bounds of venial miscalculation. Argentina, for example, wasted billions in its attempt to wrest the Falklands from Great Britain. Peru acquired a formidable air force for which it had little demonstrable external need (Delamaide, 1984, pp. 62-65, 113-114). All around the globe, sovereign debtors frittered away scarce hard-currency resources arming against their neighbors. Numerous third-world potentates, moreover, succeeded in blurring the distinction between public assets and private ones. Marcos of the Philippines, Mobutu Sese Seko of Zaire, and López Portillo of Mexico stood out only by the amount of fungible investment capital that they managed to sequester under their own names. In large parts of Latin America and Africa, speculation became systemic rather than individual. Several Latin American countries slid into a crisis of governability recalling the formative years of nineteenth-century nation building, when *caudillo* elites regularly plundered an impoverished state while deflecting popular discontent through the contrivances of nationalism (Gootenberg, 1987, Chap. 1).

The Latin American upper classes enriched themselves in the 1970s through a fairly standard set of government policies: overvalued exchange rates in tandem with rudimentary taxation, outsized budget deficits, unsound monetary expansion, and negative real interest rates. As low-cost foreign capital became available for business purposes, the favored strata of Latin American society shifted their private household wealth abroad. Public authorities abetted this maneuver by maintaining free convertibility and facilitating dirt-cheap loans for domestic corporations. When a liquidity squeeze developed in 1981-83, Latin governments then bailed out failing corporations, in effect socializing entrepreneurial losses while leaving entrepreneurs with their personal assets comfortably sheltered from attachment or taxation in London, Zurich, Miami, and New York. By the mid-1980s, flight capital amounted on average to 43.9 percent of the borrowings of eighteen key debtor nations around the world.¹² Flight capital equaled fully one-half the external debt of Mexico and Argentina and the whole external debt of Venezuela (Balassa et al., 1986, pp. 80-81). Díaz Alejandro (1984, p. 379) describes this situation as "a crisis of legitimacy for the role of the private sector in Latin American development." The U.S. bankers left holding the bag no doubt had less delicate ways of expressing themselves.

A formula that would allow third-world governments to service, if not repay, their borrowings drew on no arcane economic knowledge. In the early 1930s, a genuine controversy had raged about optimal strategies for dealing with external debt. Half a century later, economists had reached a broad consensus about the consequences of various policy options. The underlying political nature of the dispute became all the more apparent. Nations that elected to keep current on their debt would have to begin with fiscal and monetary discipline. They would have to curb the instability caused by inflation, encourage savings through positive real interest rates, and end the crowding out of private investment resulting from uncontrolled budget deficits. They would have to commit themselves to an outward orientation. They needed to maintain a competitive exchange rate so that the increased production of tradables compensated for the diminished output of nontradables attendant on fiscal contraction. And they needed to promote greater investment efficiency. That, in turn, required reducing the role of the state both in direct production and in the awarding of subsidies, freeing the market sector from excessive regulation and bureaucratic red tape, and opening the economy to the competition inherent in a foreign-capital inflow in equity form (Balassa et al., 1986, pp. 24-43; Sachs, 1984a; Cline, 1984, pp. 123-201).

The essential items on this agenda appeared in every International Monetary Fund adjustment plan. But how could the community of lenders induce compliance? The IMF, which bankers had long counted upon to orchestrate

¹² Morgan Guaranty Trust Co. figures, cited in *New York Times*, June 9, 1986.

the process of accommodation, turned out to be a paper tiger in the face of debtor intransigence. Of thirty adjustment programs initiated under the auspices of the IMF Extended Fund Facility between 1978 and 1984, twenty-four broke down. The IMF staff attributed the failures in 60 percent of the cases to "political constraints" or "weak administrative systems" (Haggard, 1986, pp. 157-158). More recently, nations as different as Peru and Brazil have refused to deal with the IMF at all.

In the middle 1980s, the reluctance of numerous sovereign borrowers to make serious sacrifices became manifest. The new debt crisis raised political issues quite different from those that had agitated the interwar era. Yet a striking parallel developed in the endeavors of debtors during both periods to throw the adjustment burden largely on creditors. If anything, debtors and their champions during the latest cycle enjoyed greater success in seizing the high moral ground than had their counterparts half a century earlier. Pope John Paul II, who became widely admired in Latin America precisely because of his talent for voicing the aspirations of the disadvantaged within a framework carrying transcendent ethical appeal, offered this perception of the international debt problem in 1984:

Christ is speaking of the whole universal dimension of injustice and evil. He is speaking of what today we are accustomed to call the North-South contrast. Yes, the South, becoming always poorer, and the North, becoming always richer. In the light of Christ's words, . . . the poor people and the poor nations . . . will judge those people who take these goods away from them, amassing to themselves the imperialistic monopoly of economic and political supremacy at the expense of others.¹³

The pope's pronouncement skirted some awkward facts. For two decades, the so-called poor countries had grown more rapidly than the rich ones. International loans before 1980 had carried negative real interest rates and conferred important benefits on prudent borrowers. Given the unequal distribution of income and access to government largesse in most developing societies, the chief beneficiaries frequently possessed substantial means already. To complicate the matter further, the bank stockholders who had the most to lose if sovereign debtors defaulted bore no resemblance to caricature monopolists battenning on the misery of the overseas poor. They comprised, in the main, people of modest station who had invested their pension funds

¹³ *New York Times*, Sept. 18, 1984. The pope formally codified his views on international debt in the 1988 encyclical letter, *Sollicitudo Rei Socialis* [The Social Concerns of the Church], excerpted in the *New York Times*, Feb. 20, 1988. See also the November 1986 pastoral letter of U.S. Catholic bishops, which demanded "immediate relief" for third-world debtor nations and specifically urged a moratorium on interest payments, a write-down of principal, the conversion of some loans to local-currency obligations, and "perhaps" outright cancellation (*New York Times*, Nov. 14, 1986).

through institutions. At least in the United States, they recalled the sorts of individuals who had bought foreign bonds in the 1920s. Under these circumstances, if sovereign borrowers mustered the political clout to escape adjustment, people with limited assets in well-off countries would end up surprisingly often subsidizing wealthy people in poor countries.

In short, the moral rights and wrongs of the matter turned out to be more complicated than they appeared at first glance. Conflicts over debt did not really lend themselves to clear-cut ethical resolution. Certainly, the borrowers could not make a compelling argument for global leniency on grounds of equity alone. The best-informed specialists preferred to steer around that aspect of the problem and to examine the capacity of each debtor to pay on a case-by-case basis (Cline, 1984, pp. 199-201). But public opinion in the advanced industrial countries suffered from a troubled conscience. A climate developed, especially in the United States, in which creditor banks faced heavy pressure to show patience and flexibility. Several forces that had militated against vigorous debt collection in the 1930s surfaced again. Manufacturers fretted about slumping exports if debtors abruptly had to balance their current accounts. The foreign-policy establishment worried lest a tough line undermine political stability in strategically located lands. (Had not the failure to make timely concessions to Brüning, so went the analogy among the historically minded, led to the advent of Hitler the last time around?) And articulate liberals waxed indignant at the prospect that debt servicing might require a slowdown, however temporary, in the growth of third-world living standards.

Thus Lord Lever of Manchester, writing in a journal that at once molded and reflected the convictions of East Coast intellectuals, inquired rhetorically, "Can it be seriously expected that hundreds of millions of the world's poorest populations would be content for long to toil away in order to transfer resources to their rich rentier creditors?"¹⁴ Richard E. Feinberg of the Overseas Development Council rehearsed the same argument with yet greater emotional affect. "In a perversion of economics and ethics," he complained, "the third world is now assisting the industrialized nations."¹⁵ Anthony Lewis, the *New York Times* columnist, emphasized possible diplomatic linkages: "The trend toward democracy, now evident in Latin America and welcome to us, could be reversed. . . . It will be hard for democracy to survive if the financial screw is tightened."¹⁶ As the 1988 election campaign got under way, Senator Bill Bradley, point man for Congressional Democrats on the issue, recapitulated these converging sentiments as he appealed for interna-

¹⁴ Harold Lever, "The Debt Won't Be Paid," *New York Review of Books*, June 28, 1984.

¹⁵ Interview in the *Boston Globe*, Mar. 8, 1987; identical claim in his *New York Times* "Op Ed," Sept. 19, 1984; further elaboration in Feinberg and French-Davis (1987).

¹⁶ *New York Times*, June 25, 1984.

tional coordination to provide both interest relief and some debt forgiveness: "Money allocated for interest is money not spent on our exports. . . . The debt issue gives the Soviet Union an opening for influence in Latin America. . . . In effect, there is a referendum in the third world about the ability of democracy to fight poverty. We cannot permit it to lose."¹⁷

The steady reiteration of such views could not help but shape the judgments of the financial community about the political constraints in operation. Given the size of the Eurocurrency market, even hegemonic powers cannot control their banks directly. Nevertheless, creditor institutions involved in multiple sensitive reschedulings inevitably had to fashion a negotiating position that government departments and the wider public at home considered reasonable. As one banker plaintively observed during talks with Argentina, "We don't want to look like the bad guys" (Cohen, 1986, p. 144). Wall Street harbored doubts from the start whether the banks could muster the requisite domestic support to prevail in a knockdown struggle with defaulting debtor regimes. Barton Biggs of Morgan Stanley & Co. gave voice to the prevailing pessimism: "Somehow the conventional wisdom of 200 million sullen South Americans sweating away in the hot sun for the next decade to earn the interest on their debt so Citicorp can raise its dividend twice a year does not square with my image of political reality" (Delamaide, 1984, pp. 228-229).

In the 1930s, Hjalmar Schacht and his Latin American counterparts had quickly learned to exploit the divisions among their creditors. They had pushed their advantage after recognizing the Roosevelt administration's fundamental indifference to bondholder concerns. Half a century later, debtor governments, whether more or less genuinely hard pressed, once again made shrewd political calculations about the pros and cons of delinquency on foreign obligations. Precisely because international financial arrangements now rested on built-in stabilizers unavailable in the Depression, prospective free riders had greater room to maneuver. A crash like that of 1931 could not easily recur. Developed nations understood the functions of the lender of last resort too well. The IMF, the Paris Club of official creditors, the multilateral development banks, the U.S. Treasury and the Group of 7 finance ministers, the Federal Reserve and OECD central banks, and the Federal Deposit Insurance Corporation formed a veritable hierarchy of lenders of last resort, all resolved to ensure that no single failure to pay, or even a succession of them, upset the monetary system.

Yet this layered defense against the last depression had the defect implicit in its virtues. Debtors had no need to fear that any delinquency of theirs might imperil the money-center banks on which the world depended for trade accommodation. During the early stages of the debt crisis in 1982-83,

¹⁷ *New York Times* "Op Ed," June 9, 1987.

IMF Managing Director Jacques de Larosière had spoken optimistically of assisting nations caught in a liquidity squeeze by "bailing them in" through re-scheduling operations (Makin, 1984, p. 164). In those innocent days, economists characteristically drew a sharp distinction between an outright failure to pay, on the one hand, and the capitalization of arrears while preserving the book value of existing obligations, on the other. "In no sense is private debt rescheduling merely a polite name for default," contended Sachs (1982, p. 226). Within a few years, however, it became clear that, in the absence of durable reforms that increased a debtor's capacity to pay, repeated restructuring offered hardly greater promise than a Ponzi scheme. Such operations might postpone the day of reckoning while banks built up their primary capital and loan-loss reserves. They did not solve the underlying problem from the creditor's point of view. Indeed, borrowers managed to secure a tacit reduction of their obligations by hard bargaining over the terms of rescheduling. At a time when Latin American debt instruments traded in the secondary market at anywhere from a 20 to 85 percent discount from their face value, the nations in question still aimed to renegotiate their debts at an interest rate no more than 1 percent over LIBOR, and generally they succeeded.¹⁸

Notwithstanding the amelioration of world economic conditions after 1982-83, the public clamor in debtor countries for permanent relief grew louder by degrees. Delicately balanced governments subject to popular approval found it particularly difficult to advocate adjustment to the external environment and to impose austerity policies. In mid-1984, the eleven Latin American nations forming the so-called Cartagena group took the lead in demanding various forms of compensatory financing free of IMF restrictions. While the Cartagena bloc never turned into a debtors' cartel or threatened organized default, it contributed to the intense politicization of the debt controversy and propagated the notion that regional development ought to take precedence over the satisfaction of creditor claims. Sovereign borrowers on other continents avidly followed the progress of this campaign, fully conscious of its implications for their own position. "We'd like to take a hard line like that," one West African official admitted candidly, "but we just don't owe enough money for anyone to be frightened of us."¹⁹

In 1985, matters began to take a radical turn. The socialist president of Peru, Alan García Pérez, unilaterally implemented one of the Cartagena group's principal recommendations. Declaring, "We cannot pay the banks by sacrificing the people," García limited external remittances to 10 percent of Peru's "official" exports. The idea had no more economic merit than when Hugenberg had proposed it to Hitler back in 1933. The level of exports is not an independent variable. It obviously depends, given a constant level of

¹⁸ Discount figures from the *Financial Times*, Sept. 26, 1986.

¹⁹ *New York Times*, July 1, 1984.

world demand, on the structuring of domestic incentives and on fiscal and monetary policy. García increased absorption at home by raising wages, hiking agricultural-support prices, and slashing interest rates, and he virtually condemned the country's main legal export to stagnation by canceling foreign oil-development contracts. Adding injury to insult, García offset the resulting current-account deficit with almost \$1 billion of revenue from the officially unrecorded foreign sale of coca leaf and its derivatives (enough by itself to cover some two-thirds of the current interest owed abroad). Yet creditor powers reacted mildly, in part because Peru ranks as a relatively small borrower. The Andean nation lost its access to additional loans, but it faced no serious impediments to external trade or alternative sanctions of consequence. It even retained its accustomed share of the U. S. sugar quota.²⁰ The immediate outcome of the Peruvian experiment did not serve as a deterrent to other sovereign borrowers tempted to try their luck with various formulae linking debt payments to exports. By early 1987, only five other countries—Bolivia, Nicaragua, Poland, Sudan, and Zaire—had fallen into formal default, and in none of these except Poland (whose troubles reflected special political circumstances) did the leading money-center banks have substantial exposure.²¹ Still, a dangerous precedent had been set.

Then, in February 1987, Brazil, the largest of the third-world borrowers, elected to suspend payment (at least temporarily) on the bulk of its long-dated debt. It also preemptorily froze short-term credits from foreign commercial banks in order to forestall reprisals. By no stretch of the imagination could Brazil qualify as a hardship case. Economists, in fact, had habitually regarded

²⁰ See the *Financial Times* supplement on Peru, Sept. 26, 1986. In the summer of 1987, the Peruvian government tried to restore its tarnished image by undertaking to deliver copper and other hard-to-sell commodities to two favored creditors that agreed in return to discount overdue interest. Bank regulators took a frosty view of these "countertrade" arrangements. They expressed the fear that debt-for-exports swaps, like debt-equity swaps generally, risked saddling banks with nonnegotiable assets that they had little competence to manage. One expert compared those sorts of transactions to "a man buying a dog for \$1 million, realizing it was a bad deal, and swapping the dog for two cats." The willingness of such highly regarded institutions as the Midland Bank and the First Interstate Bank to proceed in the face of this criticism offered eloquent testimony to the lenders' continuing lack of solidarity in dealing with Peru. See "Dogs or Cats? First Interstate's Recent Debt-for-Exports Swap with Peru," *The Banker*, Aug. 1987, p. 18; also *International Herald-Tribune*, Sept. 18, 1987.

²¹ See *Barron's*, Mar. 16, 1987. All five defaulting nations had suffered genuine economic reverses. Yet their leaders, in most cases, grounded a refusal to continue payment at least partially in political choice. Prime Minister Sadiq al-Mahdi of the Sudan, for example, explicitly declined to deal with debts on the "customary commercial basis." Instead, he proposed to distinguish between "that which is legitimate and that which is not legitimate." He elaborated for the benefit of the United Nations General Assembly: "We will pay what we can in a manner that does not disturb the norms of life of our people while bearing in mind the need to provide them with the necessities of keeping up with the *requested* level of development" (italics supplied). See the *New York Times*, Oct. 8, 1986.

it as an exemplar of material progress in the Latin world. Brazil had experienced three years of unaccustomed stagnation—and in the capital-goods sector genuine depression—at the beginning of the 1980s. But it had bounced back strongly and once again boasted a growth rate far higher than that of its principal creditors. The widespread perception of a continuing economic crunch in the Southern Hemisphere, however, presented the politicians in Brasília with an opportunity to recycle the old stratagems that had served the Vargas regime so well in the 1930s and to pass the bill for the country's rapid expansion to lenders overseas.²²

Finance Minister Ernane Galvêas let the cat part way out of the bag as early as July 1984: "We're not going to pay off our debt. The bankers know it, the official financial institutions know it, and the governments know it. We're going to pay our interest to the extent of our possibilities, and when we cannot, the bankers will lend us the money."²³ Candor carried to this extreme seemed poorly designed to capture the hearts and minds of potential sympathizers abroad. Yet Galvêas represented precisely those outwardly focused banking circles that, under the umbrella of military rule, had fashioned the Brazilian "economic miracle" of 1967-80 by tapping the Eurodollar market. His group still hoped to regain the magic touch by preserving at least correct relations with foreign financiers. In March 1985, however, an anti-austerity coalition supplanted the military and took over the seals of office. The new team had the support of domestic-oriented manufacturers, industrial workers, bureaucrats, and the urban middle class generally. All these forces had reason to favor rapid growth at home over international respectability.

Paradoxically, because the civilian government rested on a broad popular base, it could win a tolerant hearing abroad for what amounted to an inward-looking economic strategy. President José Sarney lost little time in devising rhetoric to suit the purpose. In September 1985, he made a ringing declaration to the UN General Assembly: "A debt paid for with poverty is an account paid for with democracy."²⁴ Although personally a moderate, Sarney turned out to be an irresolute leader who did not dare offend the Brazilian Democratic Movement, the majority political party, which deprecated cuts in social spending and rigid curbs on wages. The president's economic advisers accordingly turned to the "Cruzado plan," a scheme for consumption-led growth that combined a price freeze with fiat-money inflation. Over the three previous years, Brazil had enjoyed a trade surplus that largely sufficed to cover its external debts. The uncontrolled consumer boom set off by the Cru-

²² *New York Times* and *Wall Street Journal*, Feb. 21-28, 1987.

²³ *New York Times*, July 30, 1984.

²⁴ Quoted in Roett (1986, p. 37); note also Sarney's repetition of the slogan in his address to the Brazilian people justifying the 1987 delinquency (*New York Times*, Feb. 22, 1987). For a political analysis of the Sarney coalition, see Frieden (1987, pp. 120-122).

zado plan, as numerous observers had predicted from the outset, dissipated that surplus and ran down the country's hard-currency reserves to dangerous levels.²⁵ "There was no external factor to justify Brazil's insolvency," admitted former planning minister Roberto Campos. The result derived entirely from "management incompetence and imprudence."²⁶

As a rising tide of acrimony over debt issues threatened to submerge the procedural dikes that had preserved financial comity in the postwar world, many academic economists in the United States placed their hopes for relief in some sort of lender of last resort. The plans that attracted the greatest public attention involved the creation of an international agency empowered to purchase at a discount developing-country obligations held by banks. The schemes most in vogue proposed a mechanism for inducing the banks to mark down loans to present market value and elaborated a method for apportioning the losses among the taxpayers of lending countries and the banking institutions concerned. Some variants called for a quid pro quo from developing-country beneficiaries, which would have to promise to stop trafficking in narcotics, to allow freer trade, or to negotiate a modest volume of debt-equity swaps.²⁷

Generally, these plans simply assumed that, if debtor nations were granted

²⁵ For early warnings, see Anatole Kaletsky and Andrew Whitley, "A Boom that Makes Bankers Uneasy," *Financial Times*, Nov. 13, 1985.

²⁶ *New York Times*, Feb. 21, 1987. In November 1987, Brazil agreed to cover the year's back interest out of fresh money to be advanced by a lenders' syndicate. That temporary arrangement enabled the banks to avoid classifying Brazilian loans as formally delinquent for regulatory purposes. Subsequently, in early 1988, a newly appointed and more moderate Brazilian finance minister, Mailson Ferreira da Nóbrega, made a token remittance from his country's own funds, resumed relations with the IMF, and spoke of wishing to "return to normalcy." After a few weeks' bargaining, Nóbrega's representatives reached a preliminary understanding with the Bank Advisory Committee for Brazil. The creditor institutions consented to lend another \$5.8 billion to help defray 1988-89 interest on Brazil's existing \$113 billion foreign debt; in return, that country signaled an intention to drop its payments moratorium. The contractual interest rate on the new funds, a mere $\frac{13}{16}$ of 1 percent over LIBOR, underscored the strength of Brazil's position after a year of voluntary delinquency. The creditor group, moreover, had no way of predicting how long Nóbrega and his allies at Brazil's central bank were likely to keep their footing in the shifting sands of domestic politics. Its members could therefore nurture no more than a measured degree of confidence that the modus vivendi, however welcome, would lead to resolution of the underlying conflict (*New York Times*, Feb. 2, 19, 22, and 29, 1988).

²⁷ For a summary of thirty-three of the best-known proposals, along with an explanation why no scheme requiring concessional financing on a global scale falls within the realm of practical politics, see Lomax (1986, pp. 255-280). Remarkably, hardly any authorities think it feasible to insist that third-world countries mobilize the private foreign assets of their own nationals for purposes of debt service. Great Britain demonstrated during both world wars that a strong government can oblige its citizens in an emergency to exchange their external holdings for local-currency bonds. But nationalist militancy and the concentration of political power in third-world states seemingly rule out significant foreign-asset mobilization under present conditions (Felix, 1987, pp. 40-41).

a one-time reduction in the principal owed in accordance with capacity to pay, they would have more incentive to keep current on the remainder. In a world where political facility often prevails over economic rationality, it is hard to predict whether the recipients of such largesse would accept reduced obligations in good faith or, after a decent interval, merely fire up a campaign for additional concessions. The reaction of other sovereign debtors to the 1987 Brazilian delinquency suggests few grounds for optimism. In neighboring Argentina, for instance, Economy Minister Juan Sourrouille, by no means an extremist by Southern Cone standards, shortly began to echo the Sarney line: "Attacking inflation through recession and a decline in real salaries does not form part of the methodology of this democratic government."²⁸ And Uruguayan Foreign Minister Enrique Iglesias (soon to win designation as president of the Inter-American Development Bank) discerned a "growing consensus" among his hemispheric counterparts in favor of limiting interest payments by fiat on all existing debt to not more than 2 or 3 percent annually.²⁹ The rumblings from other third-world nations became so ominous that, in the spring and summer of 1987, many major banks in the United States, Europe, and Japan deemed it necessary to dramatically increase their loan-loss reserves.

In a mood of intensified militancy, eight Latin American presidents met at Acapulco toward the end of that year and compiled an ambitious shopping list of demands for debt reform. They called in particular for the creation of "mechanisms" that would permit their countries to "benefit from discounts in the value of their debts" on secondary markets. In face of the barrage coming from south of the Rio Grande, the Morgan Guaranty Trust Co.—the international bank best situated by virtue of its capital position to withstand losses—made a potentially fateful concession. A Morgan-led syndicate proposed to swap up to \$20 billion of Mexican paper for new instruments at a rate to be fixed at auction, by implication one just modestly above the discounted market value of existing obligations. In return for forgiveness of, say, a third of the current debt, Mexico would supposedly guarantee the reduced sum by purchasing twenty-year zero-coupon U.S. Treasury bonds of an equivalent face amount. In fact, the underlying U.S. securities would have a present value scarcely over 20 percent of their nominal worth, and would be nonnegotiable in the bargain. The world had witnessed no more transparent use of deep-discount funny money since creation of the reparations C-bonds sixty-seven years before. The president-elect of Mexico, moreover, issued a reminder that the observance of external commitments, old or new, depended on the resumption of economic growth satisfactory to himself. Although the Eastern liberal press chorused its approval of the Morgan Guaranty plan, the

²⁸ *New York Times*, Feb. 26, 1987.

²⁹ *New York Times*, May 29, 1987.

private reaction of other money-center bankers reportedly ranged from cautious to rude. It did not escape them that the marginal enhancement in the security of new bonds would almost surely come at the expense of present creditors. On its face, the proposal seemed better designed to meet the needs of regional banks looking for disguised "exit bonds" than those of larger institutions concerned to maximize the value of a geographically diversified loan portfolio. Not surprisingly, an auction held in March 1988 elicited bids acceptable to the Mexican government for the exchange of a mere \$3.67 billion of current obligations, less than one-fifth the amount originally projected, and the highly touted new bonds quickly sold off to a sizable discount from par. But, whatever the ultimate outcome in Mexico, the Morgan Guaranty plan had changed the ground rules for future rescheduling operations. Never again could the banks credibly maintain that they expected to recover all of their money.³⁰

The debt crises of the 1980s have yet to run their course. Perhaps the institutional arrangements devised since World War II to promote cooperative solutions to sovereign-borrower liquidity problems will in the end avert a chain of sequential defaults. The stakes are high, for borrowers as well as lenders. Another collapse of international lending comparable to that of the 1930s would have a catastrophic effect on, among other things, the prospects for third-world growth. Yet the evidence thus far reinforces the sobering conclusions that emerge from studying the interwar debt experience. Borrowed funds are quickly assimilated into the credit structure of recipient lands. All lending, however closely targeted to specific projects, therefore becomes general lending. Such capital inflows create political expectations for a rising standard of living. Governments that depend upon popular approval invariably meet with difficulties if they seek to restrain consumption when a reverse flow becomes necessary. Since the world economy fluctuates, at some point debtor governments will find it tempting to equivocate rather than to make domestic adjustments. Unless they encounter severe external constraints, sovereign borrowers in a squeeze have every incentive to rank social requirements at home above financial obligations abroad. Historical precedent suggests that, when a conflict erupts, the governments of capital-exporting nations usually place the dictates of national security first, the need to sustain exports and domestic employment second, and the interests of creditors a distant third. Lenders, accordingly, cannot always count on their home governments to provide effective backing for sanctions. Under these circumstances, international lending, save between states with longstanding political and

³⁰ *New York Times*, Nov. 28-30, Dec. 31, 1987, Jan. 10-12, 20, Feb. 26, Mar. 5, 1988; *Wall Street Journal*, Dec. 30-31, 1987, Jan. 5, 1988; *The Economist*, Feb. 6, 1988; *Financial Times*, Mar. 5/6, 1988.

cultural affinities, carries hazards that do not appear in medium-term charge-off data.

It does not necessarily follow, as George Champion, sometime chairman of the Chase Manhattan Bank, has argued in disillusionment, that commercial banks have no business at all making loans to developing countries (Dela- maide, 1984, pp. 235-236). As a practical matter, money-center institutions must sustain a worldwide presence in order to provide a full range of services to corporate clients. They could not withdraw completely from direct inter- national lending, even if they wanted to do so. Still, bank lending officers would do well in the future to factor into the computer model by which they judge debtor capacity the maxim with which La Rochefoucauld (1678, No. 38) titillated the salon of Madame de Sablé three hundred years ago: "We promise on the basis of our hopes. We perform in accordance with our fears."

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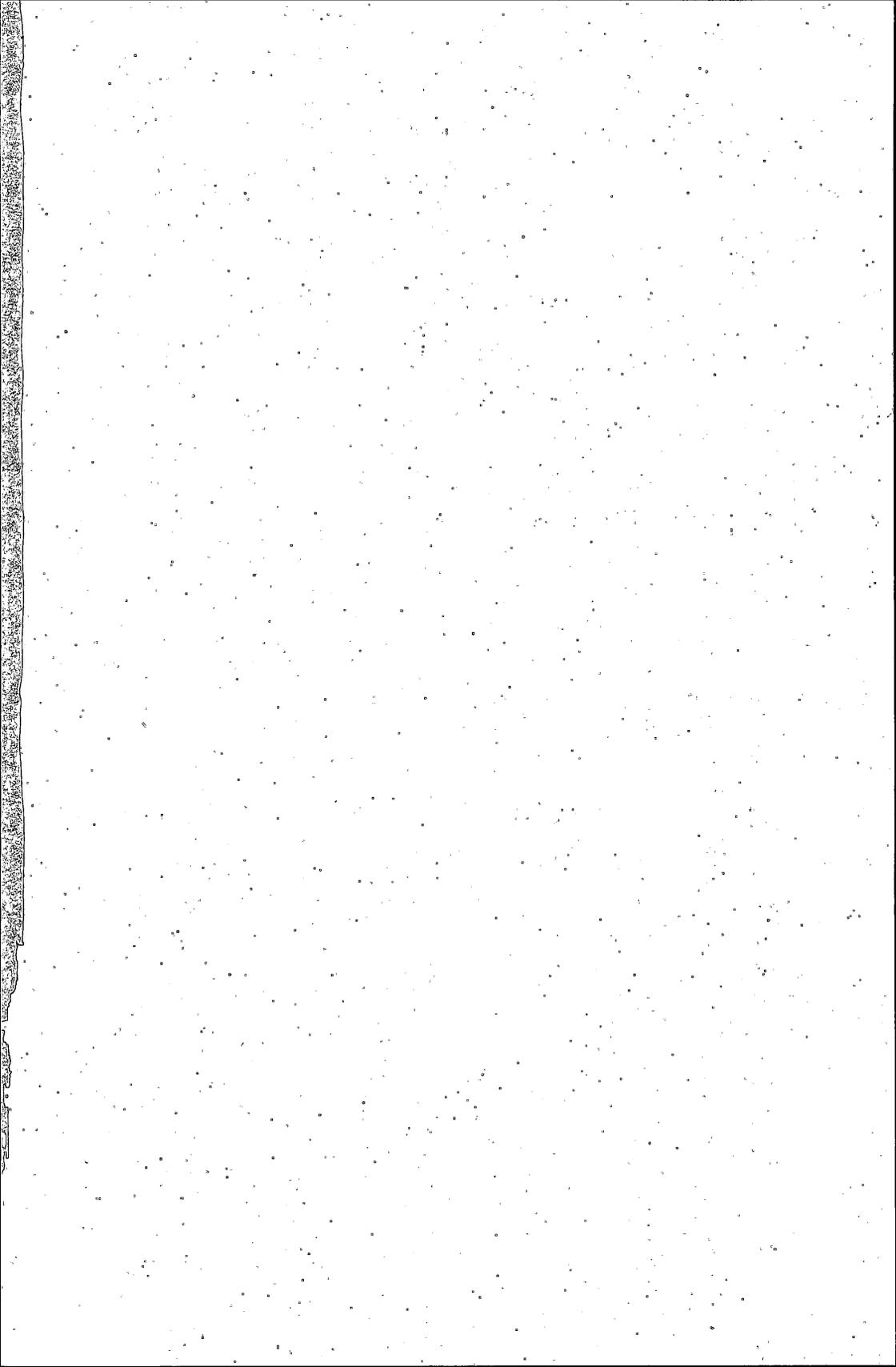
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ISBN 0-88165-233-4