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American "Reparations" to Germany, 1919-33:

Implications for the Third-World Debt Crisis

Stephen A. Schuker

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"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

1 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 "revulsion" 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 refunding 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