Sovereign defaults and international trade: Germany and its creditors in the 1930s [*]

Olivier Accominotti[†] Thilo N. H. Albers[‡] Philipp Kessler[§] Kim Oosterlinck[¶]

12th December 2023

Abstract

This paper argues that international and domestic political economy factors are key determinants of creditor countries' commercial policy responses to sovereign debt defaults. We illustrate this argument using a unique historical case study: the German external default of the 1930s. Our new historical narrative of this episode reveals that the various creditor countries adopted markedly different trade policy responses to the default depending on their degree of economic leverage on Germany and on the relative political influence of various interest groups within their domestic economy. These factors account for the pattern of Germany's bilateral trade with the different creditor countries during the 1930s as well as for the differential treatment of various countries' bondholders by the German government.

Keywords: sovereign risk, trade, creditor discrimination, commercial policy.

[*]We are especially grateful to Tine N. Paulsen for helpful comments on an earlier draft. We also thank Robert Gulotty, Juan Herrero, Sebastian Saiegh and participants at the Political Economy of the Interwar Period conference at the University of South California for comments. The research leading to these results has received funding from the People Programme (Marie Curie Actions) of the European Union's Seventh Framework Programme FP7/2007-2013/ under REA grant agreement n° 608129. Albers gratefully acknowledges the financial support by the Deutsche Forschungsgemeinschaft through CRC TRR 190 (project number 280092119). All errors are ours.

[†]Department of Economic History, London School of Economics and Political Science, Houghton Street, London WC2A 2AE, UK; o.accominotti@lse.ac.uk (corresponding author).

[‡]Department of Economics, Humboldt University Berlin, Spandauer Straße 1, 10178 Berlin, Germany; alberstn@hu-berlin.de.

[§]Statistisches Bundesamt, Gustav-Stresemann-Ring 11, 65189 Wiesbaden, Germany.

[¶]Solvay Brussels School of Economics & Management, Université libre de Bruxelles, Avenue F.D. Roosevelt 42, B-1050 Brussels, Belgium; kim.oosterlinck@ulb.be.

1 Introduction

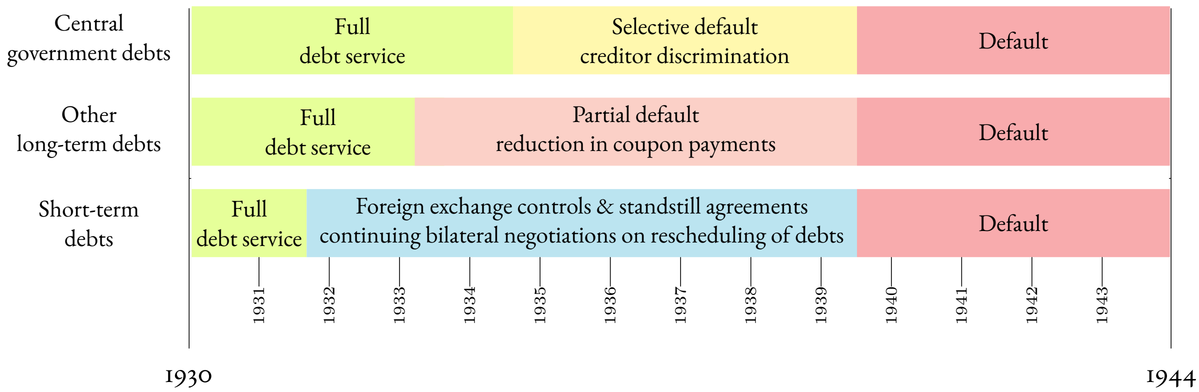
How do sovereign debt defaults and restructurings affect international trade? On the one hand, creditor countries' governments may decide to adopt trade-decreasing commercial sanctions against defaulting countries to increase the perceived cost of default for sovereign debtors (Bulow and Rogoff, 1989a,b). On the other hand, however, such commercial restrictions may harm the creditor countries' own economy as well as impair the debtor government's ability to repay bondholders in the context of a negotiated debt settlement (Hellwig, 1986). Hence, creditor countries' governments may refrain from imposing sanctions or even prefer to support defaulting countries through accommodative trade policies.

In this paper, we show that international and domestic political economy factors are key determinants of creditor countries' commercial policy responses to sovereign debt defaults. We illustrate this argument through a new historical narrative of the commercial policy response to the German external debt default of the 1930s. This episode constitutes a unique case study of the relationship between sovereign default and international trade because, during the 1930s, creditor countries adopted various trade policies towards defaulting Germany, which translated into different outcomes for their respective bondholders. Our paper explores the economic and political determinants of these decisions. We focus on Germany's five main creditor countries: the United States, the United Kingdom, France, the Netherlands, and Switzerland. We show that each creditor country's trade policy response to the German default (and the ensuing bondholders' outcome) depended on its degree of economic leverage on the debtor country as well as on the relative political influence of various interest groups within its domestic economy.

Figure 1 presents a simplified timeline of the German external default of the 1930s. During the global financial crisis of 1931, Germany was confronted with a massive capital fight and faced increasing difficulties in servicing its external debts to private bondholders (Ritschl, 2002, 2012). The German government responded in the summer of 1931 by adopting foreign exchange restrictions and negotiating a standstill agreement with foreign banks, prolonging German residents' short-term foreign currency debts. In July 1933, Germany partially defaulted on its long-term, external obligations. Still, it continued to service the bonds issued by the central government during the 1920s (the so-called Dawes and Young bonds). In June 1934, the German government eventually announced a moratorium on all external debts.

Whilst the June 1934 moratorium involved a large-scale default, Germany in fact soon negotiated bilateral debt settlements and continued to service central government bonds to certain creditors. These negotiations were conducted separately with each creditor nation and resulted in a series of bilateral trade and debt settlement treaties signed over the summer and fall of 1934. Figure 2 illustrates the outcome of these negotiations for bondholders in each respective country as well as for Germany's bilateral trading relationships with its creditors. The outcomes varied greatly across creditor countries. On the one hand, the German government engaged in selective defaults that involved discriminating

Figure 1: Timeline of the German external debt default, 1930-1944



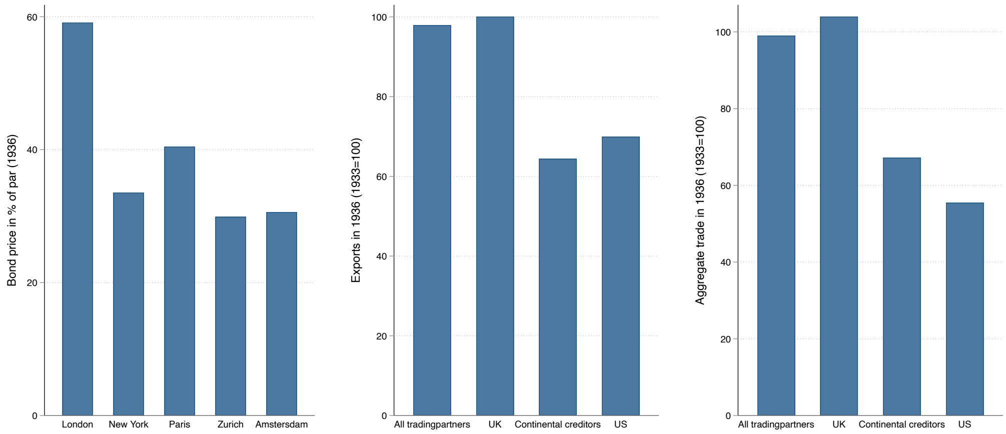
Notes: This figure presents a simplified timeline of the major changes in the service of Germany's external debts in 1930-1944. We consider the external debts of Germany to the main creditor countries (the United States, the United Kingdom, France, the Netherlands, and Switzerland). "Short-term debts" refer to the short-term foreign liabilities of the German government and German private firms and banks. These debts were rescheduled following Germany's introduction of foreign exchange controls on 15 July 1931 and the Standstill agreements with banking creditors of September 1931. These agreements were then renewed every year until 1939. "Other long-term debts" refer to the long-term foreign bonds issued by German sub-sovereign entities and corporations. Germany reduced coupon payments on these debts on 1 July 1933. "Central government debts" refer to the foreign bonds issued by the German central government (ie., the Dawes and Young Loans). These bonds remained preserved from default until the external debt moratorium of 14 June 1934. The German government then selectively defaulted -through a reduction in coupon payments - on US bondholders (15 June 1934), Swiss bondholders (17 April 1935) and Dutch bondholders (14 June 1935). Coupon payments on Dawes and Young bonds held by French and UK residents were reduced in July/August 1938. During the Second World War, the German government fully suspended the interest service of Dawes and Young bonds held by UK and French residents (June 1939), Dutch residents (June 1941), US residents (June 1941), and Swiss residents (December 1944). *Sources:* Clement (2004); Accominotti et al. (2023).

against US, Swiss, and Dutch bondholders while treating UK and French creditors more favorably. As investors expected these selective defaults following the 1934 moratorium (Accominotti et al., 2023), German government bonds traded at a substantially lower price on the US and continental European markets than in London (see Figure 2a). On the other hand, Germany's bilateral exports with the various creditor countries also diverged following the negotiated debt settlements. While bilateral exports to the United States and continental Europe decreased substantially between 1933 and 1936, exports to the United Kingdom were maintained at the pre-default level (Figures 2b and 2c).

To explain this observed pattern, we present a new historical narrative of the German debt default based on a wide range of archival sources. Central to the question of Germany's debt was the so-called "transfer problem": the German government's difficulties in raising sufficient foreign exchange revenues through export surpluses in order to service its foreign currency debts. We argue that this transfer problem resulted in distributional struggles *between* and *within* creditor countries. Creditor countries' commercial response to the German default and the ensuing evolution in international trade hinged on the outcome of these two types of struggles.

On the international level, trade was at the heart of a distributional struggle between the different creditor countries, which competed with each other for Germany's scarce foreign exchange resources. The German government's main objective during those years was to obtain foreign exchange (through export surpluses) in order to import the raw materials it needed for rearmament. From that perspective, Germany was not equally dependent on all its creditors. In

Figure 2: German bilateral trade with creditor countries and government bond prices



(a) Bond prices (b) German exports to creditors (c) Aggregate trade

Notes: Panel (a) reports the Dawes bond's price relative to par in various markets (see Accominotti et al. (2023) and Papadia and Schioppa (2023) for the European and American data, respectively). Panels (b) and (c) report exports and aggregate trade based on the German trade statistics (Statistisches Reichsamt, 1935, 1939).

particular, the Nazi government was more interested in maintaining its commercial relationship with European creditor countries (the United Kingdom, France, the Netherlands, and Switzerland) - with whom Germany was running trade surpluses and earning foreign exchange - than with the United States - with whom its bilateral trade balance was in deficit. Germany was also especially dependent on the United Kingdom as most of its raw material imports came from the British Empire and access to the London trading and financial center was key in obtaining such products. Thus, while all creditor countries threatened to impose commercial sanctions in retaliation to the 1934 debt moratorium, they in fact greatly differed in their capacity to inflict economic harm on Germany. These differences opened the way for creditor discrimination and selective defaults. By October 1934, the German government had unilaterally defaulted on US bondholders but had kept fully servicing the Dawes and Young bonds held by European residents. At the same time, the transfer problem gave the Nazi government considerable bargaining power in debt settlement/commercial negotiations as it attempted to secure improved commercial conditions from its various creditors in exchange for the continued service of its external debts.

How the different creditor countries' governments responded to such demands in turn depended on domestic political economy considerations. During the 1930s, international capital flows were at a minimal level and the general adoption of clearing arrangements resulted in a bilateralization of commercial relationships (League of Nations, 1935).[1] In that context, the servicing of Germany's external debts to each foreign creditor country and its ability to purchase goods from firms located in these countries was conditional on its achieving a sufficient level of bilateral exports. An increase in German bilateral exports to the creditor countries was therefore in the interest of these countries' bondholders and export-oriented firms but was potentially detrimental to their domestic-oriented agriculture/industry (due to in-

[1] See below for a more complete description of bilateral clearing arrangements.

creased foreign competition). Creditor countries' commercial response to the German default eventually hinged on the relative influence of these various economic groups in domestic politics. In the United Kingdom, where bondholders' interests were well represented, the government granted Germany significant trade concessions as of 1934, resulting in an increase in imports of German goods. France's trade policy towards Germany evolved during the 1930s but, from 1937 onwards, the French government also granted the German government commercial concessions. As a result, French and UK holders of German central government bonds enjoyed preferential treatment throughout the 1930s and were preserved from any default until the summer of 1938. By contrast, after the debt moratorium of 1934, the Swiss and Dutch governments resisted granting Germany further trade concessions that could be detrimental to domestic-oriented agriculture and industry. Consequently, the German government selectively defaulted on Swiss and Dutch bondholders in the spring of 1935. Last, in the United States, the Roosevelt administration considered the interests of bondholders as second compared to those of domestic agriculture and industry. Hence, US bondholders received the least favorable treatment from the German government throughout the 1930s.

Our paper builds on the historical literature on the German debt default of the 1930s. Previous scholars have described the different stages of the default and analyzed its causes (Ritschl, 2002; Clement, 2004; Ritschl, 2012). Historians have also discussed the economic policies of each creditor country separately towards Germany during the 1930s (Schuker, 1988; Frech, 2001; Lussy et al., 2001; Klemann, 2008) and have especially focused on the British policy of 'economic appeasement' (Einzig, 1941a; Wendt, 1971; Forbes, 1987, 2000). We contribute to this literature by analyzing creditor countries' commercial policies towards defaulting Germany from an international perspective and by providing a comprehensive framework that can account for the variety of trade responses to the German default and its selective nature.

Our paper also relates to the general literature on sovereign debt defaults and international trade. This literature has explored whether the threat of trade sanctions provides a plausible explanation for why sovereign governments repay their external debts. The empirical evidence for this mechanism is ambiguous. On the one hand, Rose (2005) shows that debt restructuring episodes are associated with a decline in the defaulting countries' trade, and Borensztein and Panizza (2010) report evidence that they negatively impact export-oriented firms' performance. On the other hand however, Martinez and Sandleris (2011) find that defaulting countries do not experience a stronger bilateral trade decline with creditor than with non-creditor countries, which indicates that the fall in trade they undergo may not be due to creditors' sanctions. Agronovsky and Trebesch (2009) even show that bilateral exports from the debtor to the creditor countries increase in the aftermath of a sovereign debt restructuring suggesting that creditor countries may engage in trade support rather than retaliation. One potential methodological issue with such empirical studies of the effect of defaults on trade is that they leave out cases where the threat of commercial sanctions did successfully deter sovereign governments from defaulting, therefore resulting in a selection bias (Drezner, 2003; Kaempfer and Lowenberg, 2007).

Other scholars have thus attempted to shed light on this question by focusing on specific historical case studies. For example, Weidenmier (2005) shows that the threat of a trade embargo prompted the Confederate States to honor their Cotton Bonds floated in London during the US Civil War. Tomz (2007) however concludes that the Argentinean government's reluctance to default on its external debts during the 1930s was motivated by its fear of exclusion from capital markets rather than the fear of trade sanctions. Our paper differs from this literature as our main aim is not to assess the effectiveness of commercial sanctions as a mechanism to enforce sovereign debt contracts but to uncover under what conditions creditor countries engage in trade retaliation or trade support towards defaulting countries. We argue that political economy factors are key to understanding these decisions. Since these factors vary across time and place, the trade response to sovereign defaults is not uniform across creditor countries and periods, which may explain the mixed evidence reported in the existing empirical literature on defaults and trade. Our approach therefore shares similarities with that of Kaempfer and Lowenberg (1988) who develop a political economy theory of economic sanctions.

The remainder of the paper is organized as follows. Section 2 provides some general background on Germany's external debts, the transfer problem, and bilateral trading relationships in the 1930s. Section 3 describes how a distributional struggle between creditor countries unfolded around the question of Germany's external debts and foreign exchange resources. Section 4 describes how the German debt default resulted in a distributional struggle between various interest groups within each creditor country and explains its outcome. Section 5 concludes.

2 Germany's external debt, the transfer problem, and bilateral clearing systems

2.1 Germany's external debt and the transfer problem

The German external default of the 1930s had its roots in the WW1 reparations problem which haunted international financial and political relations for most of the interwar years. The question of Germany's capacity to pay reparations was at the heart of an intense debate among economists and policymakers following the peace settlement of 1919.[2] This debate mainly revolved around the so-called "transfer problem": the fact that a debtor country able to collect the necessary tax revenues in domestic currency to service its external debts may nevertheless face difficulties in making these payments in foreign currency.[3] Keynes (1919) famously argued that, in order to transfer the requested reparation amounts to the Allies in foreign exchange, Germany would need to run large export surpluses which would only be achievable through

[2]The practice of requiring reparations was commonly accepted at the time but the amounts asked from Germany were strongly debated (Oosterlinck, 2010).

[3]As stated by the Dawes Committee in its 1924 report regarding war reparations, *"The funds raised and transferred to the Allies on the reparation account cannot in the long run exceed the sums which the balance of payments makes it possible to transfer without currency and budget instability ensuing."* (Dawes Committee Report, 9 April 1924, text reproduced in *New York Times*, "Dawes Committee Report in Full by Cable", 10 April 1924).

a considerable deterioration in its terms of trade, inevitably leading to price deflation and unemployment.[4]

On 5 May 1921, the Reparations Commission established by the Treaty of Versailles set the German reparations bill at 132 billion gold marks (£6.6 billion). In the following months, the German government was unable to raise taxes sufficiently and used the printing press as a tool to finance its budget deficit, therefore largely contributing to the hyperinflation of 1922-1923 (Ritschl, 2012). After the failure of the Ruhr occupation by French and Belgian troops in 1923, the French government made a military evacuation conditional on a settlement of Germany's reparations issue.[5] This resulted in the adoption of the Dawes Plan, which rescheduled Germany's reparation annuities.

The main aim of the Dawes Plan was to allow the German economy to recover so as to enable the German government to pay reparations to the Allies. To this end, an international loan was floated that would facilitate Germany's return to the gold standard. The German External Loan of October 1924 (known as the Dawes Loan) was issued in five currencies (US dollars, Pounds sterling, Swiss francs, lire and Swedish krona) and floated in nine different markets (Belgium, France, Germany, Italy, Sweden, Switzerland, the Netherlands, the United Kingdom and the United States of America). The Dawes Plan initially appeared successful at getting the German financial situation back on track. In the following five years, Germany not only managed to pay reparations but also attracted large amounts of investment from abroad. A large number of public and private entities which had been unable to borrow before the stabilization began to do so (Ritschl, 2002). This situation was facilitated by a special clause of the Dawes Plan – the transfer protection clause – according to which Germany was only compelled to make reparation payments in reichsmarks. The appointed Agent General for Reparation Payments, Seymour Parker Gilbert, was responsible for converting the sums collected in reichsmarks into foreign currencies but could also suspend such transfers if judging that they represented a threat to Germany's foreign exchange reserves and to the reichsmark's gold parity (Bergmann, 1930, p. 591). The transfer protection clause implied that Germany's private external debts would be serviced in priority and that those debts were effectively senior compared to reparations debts. This clause therefore prompted private, foreign investors to lend massively to Germany (Ritschl, 2012).

[4] Ohlin (1929) however argued that Keynes' analysis ignored the general equilibrium effects of external payments. Especially, due to their effect on income in the receiving countries, external transfers could boost the demand for the debtor country's goods and/or result in capital inflows into that country that could equilibrate the balance of payments. Hence, external debt payments may be achieved without a significant adjustment in the debtor country's terms-of-trade.

[5] In a joint statement addressed to the German Chancellor in August 1924, the French and Belgian governments explicitly linked the Dawes Plan to the evacuation of the Rhineland (see BoE C5-105, Letter from Herriot, Theunis and Hymans to Dr Marx, 16 August, 1924. See also Bergmann 1930, p. 584-585). The occupation of the Rhineland was not the first episode during which occupation forces were used to force a defeated country to pay war reparations. When France missed a payment of its 'Waterloo-reparations' in 1816, Allied troops reinforced their occupation of parts of the country (Oosterlinck et al., 2014). They also coupled the occupation with support for the floating of a bond to allow France to pay its dues; a combination that proved successful and foreshadowed the floating of the Dawes bond.

2.2 The German financial crisis, clearing systems, and the bilateralization of the transfer problem

The Dawes Plan, however, only constituted a partial and temporary settlement of the reparations issue. A more comprehensive arrangement – the Young Plan – was proposed in June 1929 and eventually ratified by Germany in March 1930. The new plan further reduced Germany's annual reparations payments. In order to implement it, a new German government loan (the Young Loan) was floated in June 1930 in nine different countries in their respective currencies. The Bank for International Settlements acted as a trustee of this loan and a large part of its proceeds were directly used to pay the French and British governments. This had the effect of transferring these governments' reparations claims on Germany to private bondholders.

The Young Loan was floated in the context of a dramatic decline in global capital flows following the beginning of the Great Depression in 1929 (Accominotti and Eichengreen, 2016). This capital flow sudden stop affected Germany's external financial position and soon jeopardized the servicing of its external debt. In addition, the Dawes Plan's transfer protection clause, which protected foreign private investments, was abolished and this contributed to the capital flight from Germany in 1930-1931 (Ritschl, 2012). In the summer of 1931, the country faced an acute financial crisis that led to a rapid depletion of the Reichsbank's foreign currency reserves. In response, the German government suspended the reichsmark's unrestricted convertibility and introduced capital controls by decree on July 15, 1931 (United States Tariff Commission, 1942, p. 3). The goal of these capital controls was to stop capital flight, especially the rapid repatriation of short-term assets held in Germany. The ensuing international negotiations with foreign creditors were successful in leading to a standstill agreement in September 1931 (Rombeck-Jaschinski 2011, p. 34f). In order to avoid a default on short-term loans to Germany, foreign banking creditors agreed to maintain and constantly roll over these credits. This resulted in the freezing of German short-term assets held by foreign banks. At the same time, the Hoover moratorium of June 1931 and the Lausanne agreement of June-July 1932 exonerated the German government from its reparations obligations. However, despite the foreign exchange restrictions, interest and amortization of long-term external debts to private investors (in particular, the Dawes and Young bonds) remained fully convertible for the time being (Frech, 2001).

The collapse of global capital flows also marked the return of the transfer problem. In the absence of international lending, Germany's ability to raise foreign exchange revenues and service external bonds now hinged on its capacity to generate export surpluses. With the introduction of exchange control, international payments were increasingly handled on a bilateral basis. The suspension of the reichsmark's convertibility had required the German government to centrally regulate international trade. Through an import licensing system, the government allocated foreign exchange to German importing firms so as to allow them to make foreign currency payments to exporters.[6] This system paved the way for

[6] The allocation of these licenses depended on previous import volumes. German authorities claimed that the German exchange control aimed to interfere "as little as possible with normal import trade" (United States Tariff Commission, 1942, p. 3)

the introduction of bilateral clearing systems. Under such systems, all payments between two given countries were orchestrated via governmental clearing offices established on both sides. Importing firms in a given country settled their purchases of goods from the other country by making a domestic currency payment to their clearing office. The proceeds were then used to settle the claims of domestic exporters as well as of other residents who had financial claims on the other country (Vannini, 1943). Clearing systems therefore allowed circumventing the use of foreign exchange and maintaining bilateral trading relationships between countries even in the absence of a free foreign exchange market.

Under a clearing system, the balance-of-payments is expected to clear not at the multilateral but at the bilateral level. This means that a debtor country needs to run a bilateral trade surplus vis-à-vis each creditor country in order to service its debts to these countries' residents. Thus, while analysts and stakeholders had pondered for years whether Germany would have a sufficiently large *aggregate* trade surplus to service its external debts, the generalization of clearing systems progressively shifted the attention towards its *bilateral* trade balance vis-à-vis each creditor country, resulting in a bilateralization of the transfer problem.

At the same time, clearing systems could enable creditor countries to directly seize debtor countries' export revenues and allocate a portion of them to the servicing of their debts. Creditor countries that had an unfavorable current account balance towards their debtors could therefore introduce such systems in order to recoup their commercial or financial claims so as to protect the interests of their domestic exporters and bondholders.[7] A creditor country could therefore threaten or actually impose a unilateral clearing as a form of retaliation against a government unwilling to repay its debts (Vannini, 1943, p. 18). The efficacy of such a threat naturally depended on the creditor country's bargaining power towards the debtor.

3 The distributional struggle between creditor countries

3.1 Creditor countries' leverage on Germany

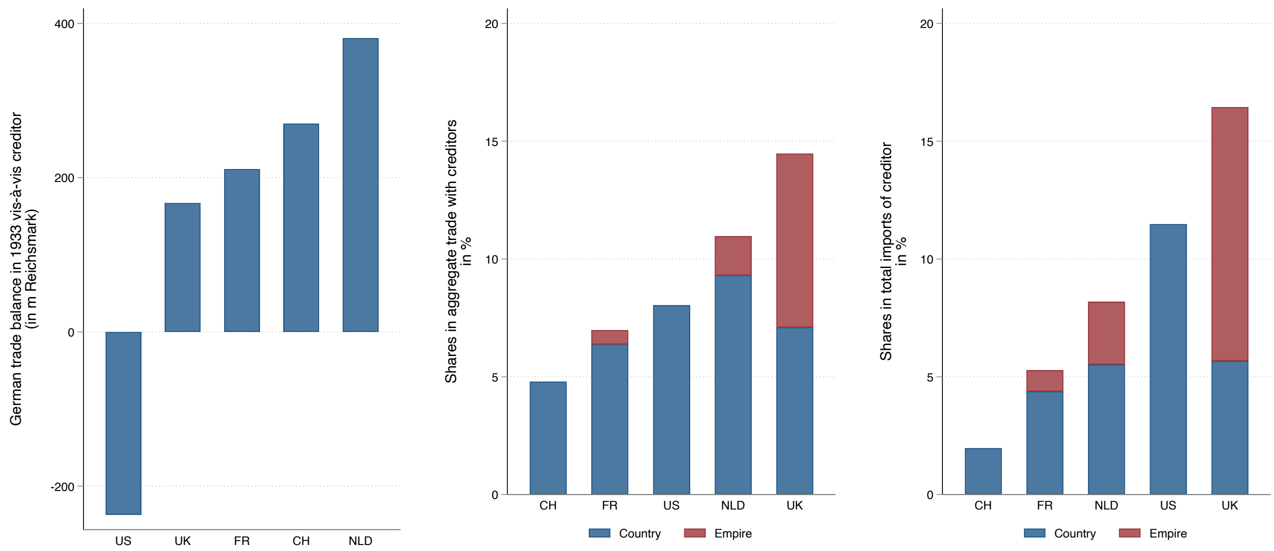
As the NSDAP came to power in January 1933, a default on German long-term external debt became increasingly likely. The scarcity of Germany's foreign exchange reserves was used by the German government as a justification for not repaying creditors in full. This situation gave rise to a competitive struggle between creditor countries in 1933-1934 for securing repayment ahead of the others and obtaining preferential treatment from Germany.

The outcome of this struggle first hinged on Germany's economic dependence on the various creditor countries.

[7] For instance, Switzerland started concluding bilateral clearing agreements as early as 1931 (Vannini, 1943, p. 2-5). Through a series of bilateral treaties, Germany herself introduced clearing systems with Eastern European countries in 1932 (in order to collect its debts in the region) as well as with certain Western European countries in 1933 (Ellis, 1941, p. 202f). In 1934, Schacht's 'New Plan' solidified this development towards total state control of bilateral trading relationships by introducing mandatory permission for acquiring foreign exchange for all types of imports or, in Ellis' words, "exchange control as a totalitarian institution" (Ellis, 1941, p. 211)

While creditor countries could threaten to impose commercial sanctions (or a unilateral clearing) in case the German government defaulted on their national bondholders, a creditor's bargaining position always depends on the debtor country's gains from trading with it (Bulow and Rogoff, 1989a; Diwan, 1990; Aizenman, 1991). One of the main aims of the Nazi government at that time was to secure access to foreign exchange revenues, which it needed in order to import the raw materials required for its rearmament program (Ellis, 1941, p. 205). The German government therefore had a stronger interest in preserving its bilateral trading relationships with countries with whom it was running bilateral export surpluses as these surpluses constituted sources of foreign currency income.

Figure 3: Germany's trade with creditor countries, 1933



(a) Germany's trade balance towards various creditor countries

(b) Share of various creditor countries in Germany's total trade (imports + exports)

(c) Share of various creditor countries in Germany's total imports

Notes: Data are from Statistisches Reichsamt (1935).

Governments of creditor countries that had a bilateral trade deficit with Germany were in a more favorable bargaining position in the debt negotiations of 1933-1934 as they could invoke the foreign exchange they supplied to the debtor government as an argument to request a priority claim for their bondholders. This was the case for all European creditor countries (the United Kingdom, France, Switzerland, and the Netherlands, see Figure 3a). By contrast, Germany's bilateral trade deficit with the United States constituted a drain on its foreign exchange reserves and provided a strong justification for defaulting selectively on US bondholders in 1934.[8] In response to the US State Department's charge that the German government was discriminating against American bondholders as Germany was about to only

[8] Tomz (2007) argues that the fear of trade sanctions had little bearing on Germany as the German government treated UK bondholders better than US ones even as its bilateral trade volume (the sum of exports and imports) with the US was superior to that with the UK. This view ignores that, from the German government's viewpoint, one key objective of international commerce was to generate foreign exchange revenues which allowed for purchasing raw materials. From that perspective, Germany had little to gain from trading with the USA as its bilateral trade balance with that country was negative.

partially honor the October 1934 coupon payment on Dawes bonds issued in the United States, the German ambassador in Washington responded that no such discrimination was intended but that *"special arrangements had been made with regard to European holders of the bonds because Germany had favorable trade balances with their countries."*[9]

Among the European creditor countries, the United Kingdom's central position in the global trading and financial system also conferred it significant bargaining power in the debt negotiations (Accominotti et al., 2023). Although the United Kingdom was not Germany's main source of foreign exchange reserves, it was, through its Empire, its main supplier of raw material imports (see Figure 3b and Figure 3c). According to a note of the German Finance Ministry, in the event of a default on British bondholders and of trade retaliation by the UK government, Germany would have difficulties obtaining access to the raw material products it imported from the British Empire. Diverting these purchases towards other raw material producers, especially in Latin America, would not be an easy task.[10] In addition, raw materials imports from outside the British Empire generally transited through London and were also in large part financed by British banks through so-called "standstill credits."[11] These credits consisted of short-term sterling loans - usually, granted through bills of exchange guaranteed by London banks - to German firms and banks. British banks had been compelled to maintain these short-term credits in Germany during the financial crisis of 1931 in order to avoid a complete financial collapse as well as banking failures in the City (Accominotti, 2012, 2019). The "frozen" credits had since been constantly rolled over and were used to finance German trade. Therefore, the United Kingdom was at the center of a web of commercial and financial links which were difficult for Germany to circumvent when completing its objectives of accessing raw materials.

3.2 The transfer problem and debt negotiations, 1933-1934

On 15 May 1933, the Reichsbank communicated its doubts about Germany's future ability to service its debts given the state of the currency reserves. It explicitly invoked the transfer problem resulting from the decline in global trade as a justification for opening debt settlement negotiations.[12] The Reichsbank invited representatives of the creditor countries to a meeting held in Berlin to address the question of Germany's ability to service its foreign currency debts. The negotiations that ensued opened a distributional struggle during which each creditor country aimed to secure priority

[9] *Financial Times*, 15 October 1934,"U.S. Investors and the Dawes Loan."

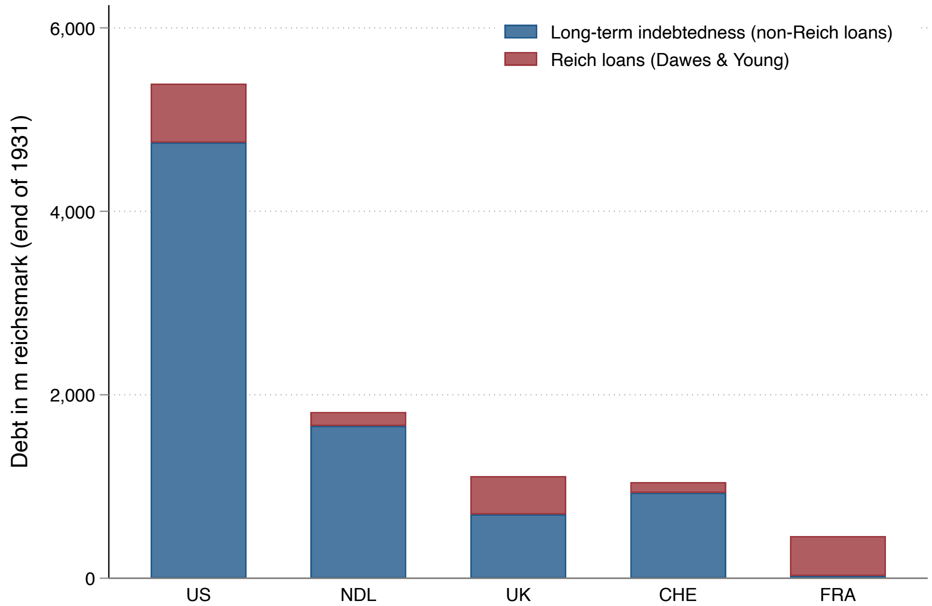
[10] BArch, R2.318. "Handakten des Min. R. Dr. Koenning betr. Transferverhandlungen mit Grossbritannien." Of particular concern were wool, wheat, and cacao, which were mostly imported from Australia, Canada, and the British Gold Coast, respectively.

[11] PA AA, R117.265, "Vermerk zur englischen Note." 23 June 1934.

[12] BoE G1-445, Telegram from the Reichsbank to the Bank of England. 15 May 1933. The telegram directly linked Germany's repayment difficulties to the transfer problem: *"We regret to have to inform you that the German foreign exchange position is so unfavorable and the question of the further transfer of funds for the debt service is so seriously affected thereby, that a direct discussion with the creditors is necessary."* In a subsequent communication the Reichsbank highlighted its willingness to service the debts in Mark stressing again that: *"The only problem is the conversion of the Marks into foreign exchange lacking in consequence of the continued decline in foreign commerce"* (BoE, G1-445, Extract from the *Agence economique et financiere*, 16 May 1933).

access to Germany's foreign exchange reserves in order to repay its national bondholders.

Figure 4: Estimate of Germany's long-term central government and non-central government debt by creditor country (ca. end of 1931)



Notes: The figure reports the amounts of Germany's long-term debts held in the various creditor countries in million reichsmarks at the end of 1931. The total amount of German long-term debts held in each country is taken from a communication of the 'German Committee' to the Foreign Creditor Committees (FRBNY 261.12, Committee on German Foreign Credits. German indebtedness as of November 30th, 1931). To distinguish between central government bonds (Reich loans) and non-central government bonds, we use data on the amount of Dawes and Young bonds in circulation obtained from a (strictly confidential) publication by the German Office for Registering Debts ('Anmeldestelle für Auslandsschulden', BArch R2501.10007). These data refer to early 1934 and not November 1931. For the purpose of the estimation, we assume that the amounts of Reich loans held in the various creditor countries remained stable between these two dates. Additionally, we apply pre-devaluation parities to convert the foreign currency amounts of non-Reich loans into RM.

The UK government's main objective in these negotiations was to preserve the continuing service of Germany's central government bonds (the Dawes and Young bonds), which were held widely across the country, and to establish their seniority over the bonds issued by German provincial states, municipalities or the private sector. In achieving this goal, the UK government could count on the support of the Bank for International Settlements (BIS) itself, which acted as the trustee of the Young Loan. In a confidential letter, the President of the BIS Leon Fraser asked the Bank of England Governor Montagu Norman to use his personal influence on Reichsbank President Hjalmach Schacht to persuade him to *"continue the service of the Dawes and Young Loans in the regular manner, irrespective of what action it may become necessary to take as regards other German bonds."*[13] After lengthy negotiations, a two-stage compromise was reached in June 1933: Germany's central government bonds were granted a special status involving that they would continue to be serviced in full for the time being (although the amortization of the Young Loan was suspended). For all

[13]Leon Fraser argued that such discrimination between creditors could be justified on the grounds of seniority but also on the grounds that Schacht had fought against the expansion of private and municipal loans. A similar view was held by Parker Gilbert, at the time working from JP Morgan (BoE G1-445, Cable from Parker Gilbert to Leon Fraser 20 May 1933). Objections from other parties were voiced shortly afterward. Lazard Brothers and Co, which had acted as the issuing house for German municipal bonds, recognized a special status should be granted to the Dawes loan but objected to the fact that it would be granted similarly to the Young loan on the grounds that the latter had been issued well after many other loans and that the protection of bondholders was less explicit in the prospectus. This did not impress the person who penciled a note reading "a weak case" on the letter (BoE G1-445, Letter from G. Tyser to E. R. Peacock, 24 May 1933).

other bonds however, from 1 July to 31 December 1933, only 50% of the coupon would be paid in foreign currency, with the remainder being paid in reichsmark scrips. From September onwards, reichsmark scrips could be converted into the owner's currency at the German Golddiskontbank at 50% of their nominal value and the arrangement therefore involved a 25% overall coupon reduction for bondholders.[14]

This first default did not impact all creditor countries in the same way as the distribution of holdings between German central government bonds and other bonds varied across countries (see Figure 4). However, while the arrangement was especially favorable to the UK and France whose share of Dawes and Young loans was the highest, no explicit discrimination between the various creditor countries had been enacted at that stage. The Committee representing British Long-term and Medium Term creditors noted in a report that the negotiations had been conducted under the principle that *"no concession should be made to anybody of creditors, without the offer of a corresponding concession to all other similar creditors."*[15] However, this principle was soon infringed as the Swiss government approached the German one in September 1933 in order to negotiate preferential treatment for Swiss bondholders. The Swiss government asked that its nationals be allowed to convert reichsmark scrips into Swiss francs at par, thus preserving them from the effect of the default. In exchange, Swiss authorities proposed to increase imports of German goods.[16] Having heard of the arrangement, the US bondholders' representative John Foster Dulles protested that it would trigger competition between creditor countries on the basis of their leverage on Germany: *"Germany would be making evident her willingness to treat her creditors differently according to their ability and determination to exert special pressure against Germany. This would constitute invitations to creditor groups and their governments to compete with each other in exerting such pressure."*[17]

In the following weeks, however, the principle of preferential treatment for not only Swiss but also Dutch bondholders with regard to non-central government bonds was enacted.[18] Representatives of British creditors urged UK authorities to intervene in their favor. However, despite the leverage it could potentially exercise on Germany, the UK government refrained from issuing a formal protest to the Dutch and Swiss governments and to the Reichsbank and did not attempt to negotiate a similar arrangement to those obtained by these governments. The Treasury was unwilling to directly confront the Reichsbank on this issue as preferential arrangements with Swiss and Dutch creditors did not involve the Dawes and Young bonds and the amounts of provincial, municipal, and corporate bonds held in the UK

[14]BoE G1-455, Letter from the Chairman of the British Long Term and Medium Term Creditor Committee to the Treasury, 19 October 1933. This committee was composed of the Council of Foreign Bondholders, the Association of Investment Trusts and the British Insurance Association. See also *The Times*, 1 July 1933, "German debt transfers", p. 11 and Clement (2004, p. 39). The German government implemented the terms of the default, first by passing a law on 9 June stating that a payment in reichsmark by a German debtor was as good as a payment in foreign currency, and then by publishing the terms of application of the law on 30 June (Clement, 2004, p. 39).

[15]BoE G1-455, Letter from the Chairman of the British Long Term and Medium Term Creditors Committee to the Treasury, 19 October 1933.

[16]BoE G1-445, Telegram from the Reichsbank to M. Dulles, 9 October 1933.

[17]BoE G1-445, Telegram from M. Dulles to Dr. Schacht, 6 October 1933.

[18]BoE G1-455, Letter from the Chairman of the British Long Term and Medium Term Creditors Committee to the Treasury, 19 October 1933.

were small. UK authorities were not prepared at that stage to grant a tariff preference to German goods.[19] It is only a year later, when the service of central government bonds was in turn at threat, that the UK government decided to put all its weight into obtaining a preferential deal for its nationals.

As the June 1933 arrangement was soon to expire, the Reichsbank invited its creditors via a telegram sent on 13 November to again join the negotiations table as *"grounds for transfer moratorium continue[d] to exist"*.[20] While Germany did not for the time being renege on the special status of the Young and Dawes bonds, from 1 January 1934, the share of other bonds' coupons paid in foreign currency was reduced from 50% to 30%.[21] Following negotiations held in Berlin at the end of January, the Dutch and Swiss governments obtained the maintenance of the preferential arrangement for their national bondholders.[22] In response to US and UK protests against the inequity of treatment of bondholders, the Swiss Delegation stated that *"those who are supplying Germany with a huge surplus of foreign exchange have a perfect right to demand that such foreign exchange should first and foremost be applied in settlement of their own claims."*[23]

As the distributional struggle between creditor countries was intensifying in the winter and spring of 1934, UK authorities were however determined to play their cards right. In preparation for the next round of debt discussions to be held in Basel in April, the Chief Economic Advisor to H. M. Government Frederick Leith-Ross set the aims of the UK Treasury in the following terms: *"(a) get an equal treatment for all the creditors if possible; but (b) if that is not possible, press Germany for a special agreement in favor of the United Kingdom by which British citizens get as good treatment as the Swiss and Dutch and to make our acceptance to any special Swiss and Dutch arrangement conditional on Germany giving us equal terms."*[24] The Treasury also insisted on the continued full service of Dawes and Young bonds, which was especially advantageous to UK creditors. At the same time, UK creditors became prepared to exercise their leverage on the German

---

[19] BoE G1-455, Draft letter, Under-Secretary of State Foreign Office, undated. Note that even creditors' representatives were cautious regarding an official protest. The Long Term and Medium-Term Creditors Committee noted that *"the form of intervention should be such that it is not likely to prejudice the advantages already secured for the British creditors and in particular the priority of the Dawes and Young Loans. It is the general feeling that from the British point of view, the arrangements concerning these Loans are quite satisfactory."* (BoE G1-455, Letter from the Chairman of the British Long Term and Medium Term Creditors Committee to the Treasury, 19 October 1933).

[20] BoE G1-455, Translation of telegram from Reichsbank, Berlin, 13 November 1933.

[21] BoE G1-455, Speech by Dr Posse of the Reichswirtschaftsministerium at the opening of the conference in Berlin, January 1934, reprinted as Annex 1 in the Memorandum of Conference held in Berlin January 25 to January 31 1934 (communicated by the Treasury on February 5).

[22] BoE G1-455, Telegram from the Reichsbank to the Bank of England, 6 January 1934. See also the article from the *Financial News*, "Anglo-US Triumph in Berlin", 1 February 1934, reproduced in BoE G1-455. As compensation, other creditor countries' bondholders obtained a revaluation of the price of reichsmark scrips, which allowed for a reduction of the overall coupon reduction to 23%.

[23] BoE G1-455, Arguments in favor of the special arrangement governing the transfer from Germany to Switzerland put forward by the Swiss delegation reprinted as Annex 2 of the Memorandum of Conference held in Berlin from January 25 to January 31 1934 (communicated by the Treasury February 5). p. 8. Dutch delegates also justified the preferential deal in favor of their nationals on the basis that the excess foreign exchange the Netherlands allowed the Reichsbank to generate through its trade deficit was used to repay other bondholders as well. The US delegation attacked the agreements on the grounds that the additional imports mentioned in the agreements were hard to prove and that there were ways to cheat this system and thus denounced the agreements as discriminatory. Laird Bell, John Foster Dulles, "Comments by American Delegates on certain Technical aspects of the Swiss and Dutch Agreements" reprinted as Annex 4 in the Memorandum of Conference held in Berlin January 25 to January 31, 1934 (communicated by the Treasury February 5). P. 11 (BoE, G1-445).

[24] BoE G1-446, Letter from Frederick Leith-Ross to Montagu Norman, 4 April 1934.

government and explicitly mentioned the threat of a coercive clearing on German exports, although with some caution. While the negotiations of January 1934 had taken place under such a threat,[25] the Chairman of the Long Term and Medium Term Creditors Committee E. H. Lever noted in February 1934 that he *"appreciated the difficulties i. e. that a Clearing might be unworkable and the threat therefore a bluff: or if not, that it might be a boomerang."*[26] Such skepticism towards coercive commercial measures found echo in the British press: according to *The Times*, *"all experience has shown that such restrictions always lead to a further shrinkage of trade, so that, while German exports might suffer, the prospects for the creditors would not necessarily be improved."*[27] Lever however noted that, following the February agreement, he was *"glad to have got rid of menaces but not quite willing to repudiate their future use."*[28]

On 14 June 1934, Reichsbank President Hjalmar Schacht eventually announced a moratorium on all long-term foreign debts for six months. This moratorium included the Dawes and Young Loans and was to take effect at the beginning of July. Again, Schacht stressed in his statement that this was *"no case of inability to pay, but merely a transfer problem."*[29] Yet, this unilateral move was followed by a wave of protests and triggered harsh reactions abroad (Wendt, 1971). The US Secretary of State declared the relations with Germany *"impaired"* and stressed that *"the spectacle not only to accept losses but to perceive payments to investors of other nationalities at their expense would arouse a sense of mistreatment among numerous American investors."*[30] European creditor countries unanimously threatened Germany of trade sanctions if the moratorium was actually implemented. In particular, with the prospect of a default on Dawes and Young bonds, the UK government became prepared to use its leverage on Germany to obtain a preferential deal for its creditors. Following Schacht's declaration, the Chancellor of the Exchequer Neville Chamberlain stated in the House of Commons that, if a positive arrangement was not found for British bondholders before July 1st, his government was prepared to impose a clearing on Anglo-German trade and thereby directly seize the proceeds of German exports to the UK to repay British bondholders.[31] The threat was soon followed by actions and, on 28 June, the British Parliament voted the "Debts Clearing Offices and Import Restrictions Bill" (Forbes, 2000, p. 90). The Act authorized *"the setting up of Clearing Offices for collecting and dealing with certain debts"* and *"the imposition of restrictions on imports from certain foreign countries."*[32] The French government adopted a similar attitude. On 26 May 1934, as a moratorium became

[25]In a telephone message to Montagu Norman dated 1 February 1934, Hjalmar Schacht mentioned that negotiations with creditors were conducted in a *"very friendly atmosphere"*. Yet, a penciled note on the transcript of the message written by Bank of England Harry Arthur Siepmann reads *"but under threat of a clearing."* (BoE G1-445, Telephone message for the Governor from Dr Schacht, 1st February 1934.

[26]BoE G1-446, "Conversation with F.C.T. and E.H.L., 19 February, 1934", signed H.A.S., in all likelihood a meeting between Harry Arthur Siepmann, and E. H. Lever.

[27]*The Times*, "German debt payments", 4 January 1934.

[28]BoE G1-446, "Conversation with F.C.T. and E.H.L., 19 February, 1934"

[29]*Financial Times*, "Germany decides to default", 15 June 1934.

[30]BoE G1-446, Text of the announcement issued by the Secretary of State, 18 June 1934.

[31]*Financial Times*, "Clearing office will follow default", 16 June 1934.

[32]BArch, R2.318, Handakten des Min. R. Dr. Koenning betr. Transferverhandlungen mit Grossbritanien.

increasingly likely, the French Ambassador in Berlin had threatened the German Foreign Minister Von Neurath with *"reprisals"* and, especially, with the *"introduction of a surtax on all German exports to France"* in case it was put into place.[33]

The June 1934 moratorium only intensified the competitive struggle between creditor countries. While previous rounds of debt negotiations had been run jointly with representatives of the different creditor countries, the negotiations of the summer 1934 were conducted on a bilateral basis. Such bilateralism served the interests of the German government, which could implement defaults more easily.[34] The UK government was determined to use its bargaining power over Germany to the advantage of British bondholders. As noted by Montagu Norman, the British reaction to the German moratorium, *"though intentionally stiff"*, left *"the room open to negotiations."*[35] A German delegation was therefore sent to London to negotiate with UK authorities. German negotiators were taking the threat of a clearing on Anglo-German trade very seriously and had no doubt that the UK government was prepared to act in case the German government failed to fully service Dawes and Young bonds held by British bondholders.[36] They also considered that British negotiators were in a favorable bargaining position[37] and the German government therefore quickly conformed to English demands. Through the Anglo-German Transfer Agreement of 4 July 1934, it agreed to fully pay interest to British holders of Dawes and Young bonds for the following six months (Wendt 1971, p. 213; Forbes 2000, p. 90). By contrast, no arrangement was found with the US government and, on 15 October 1934, US holders of Dawes bonds only received 75% of the coupon due at that date. The acceptance of creditor discrimination by European governments attracted resentment in the United States. In May 1935, JP Morgan's Thomas Lamont noted that US authorities considered foreign governments as *"guilty of a breach of faith"* and that the Department of State regarded *"as inexcusable the action of the British and French Governments in entering clearing arrangements a year ago and leaving America out on the end of the limb."* [38] Therefore, by the summer of 1934, the competitive struggle between creditor countries that arose from Germany's transfer problem had reached its apex, opening the way for selective defaults.

---

[33]PA AA, R117.123, Note by Von Neurath, 26 May 1934. The German ambassador in Paris Roland Koester reported to Berlin that the French government was determined to ensure the full service of Dawes and Young coupons "under any circumstances" and was prepared to impose a unilateral clearing on Germany (See PA AA, R117.136, Telegram by Koester, 16 June 1934).

[34]BArch, R2.320, P1570770-72: Aide-mémoire by Koenning, dated Berlin, December 22, 1937. This document from the German Finance Ministry states that *"an all-round regulation vis-à-vis all creditor countries is not in Germany's interest as: a) the differentiated treatment of creditors in accordance with the principle of the positive commercial balance established in 1934 would be abandoned b) some countries would even have to be better off than before in terms of interest rates."* The note also highlights that with the principle of bilateral negotiations, *"interest rate regulations can be attacked more easily if necessary"* (our translation).

[35]BoE G1-446, Letter from Montagu Norman to Leith-Ross, 20 June 1934.

[36]In a letter addressed to the German Foreign Office on 28 June 1934, Dr. Berger, a member of the German delegation was adamant that the British government was prepared to enforce a clearing: *"There is no doubt that, in the absence of an agreement, the English will bring the Clearing Act into force with an implementing order against Germany in the form announced in the House of Commons on Monday."* (PA AA, R117.265, Berger to Foreign Office, 28 June 1934).

[37]For example, Dr. Berger noted that: *"The English, based on their position of power and the Clearing Act, demanded that the payments for Dawes and Young be continued."* (BArch, R2.318, P1570648-52, "Report by Berger on negotiations, dated London, June 28, 1934")

[38]BoE G1-512, Letter from Thomas Lamont, 23 May 1935.

3.3 Germany's demands for trade concessions

While the transfer problem had given the German government the main justification for requesting a reduction in its debt payments, it was also used to obtain trade concessions from the creditor countries. During the negotiations that preceded and followed the June 1934 moratorium, the German government aimed to make further payments to each respective creditor country contingent on its bilateral export revenues. As Thomas Lamont clearly described when explaining why US-German negotiations regarding the Dawes and Young Loans were at a deadlock: *"Schacht always comes back to the idea that either he is under no obligation to pay his service on these bonds to American holders, or at any rate he will not attempt to pay them, until America gives trade concessions to Germany which will lead to greatly increased American imports of German goods."*[39] Creditor countries' governments keen to serve the interests of their domestic bondholders may have been tempted to respond positively to such demands and grant improved market access to German goods in order to facilitate repayment to bondholders. This position was shared, for example, by the President of the Dutch central bank Leonardus Trip, according to whom the German debt problem *"takes its root in the refusal of important creditor countries to accept goods in payment of their claims on Germany. The only sound and effectual remedy would therefore, in my opinion, be to assist Germany in increasing its exports."*[40]

An alternative option for creditor countries' governments was to impose or negotiate a clearing on German exports allowing them to directly take hold of its export revenues and distribute them to bondholders. However, that solution was only available to countries that had a trade deficit with Germany and, therefore, not to the United States. In addition, due to their heavy bureaucracy, clearing systems generally result in a rise in bilateral trade costs and a general decline in trade flows that backfire on bondholders. Last, despite its coercive nature, a clearing system is not an efficient tool to deal with a debtor country's *unwillingness* to pay as a sovereign government may strategically reduce its bilateral exports to a given creditor country in order to ensure that the seized revenues are insufficient to repay that country's bondholders.

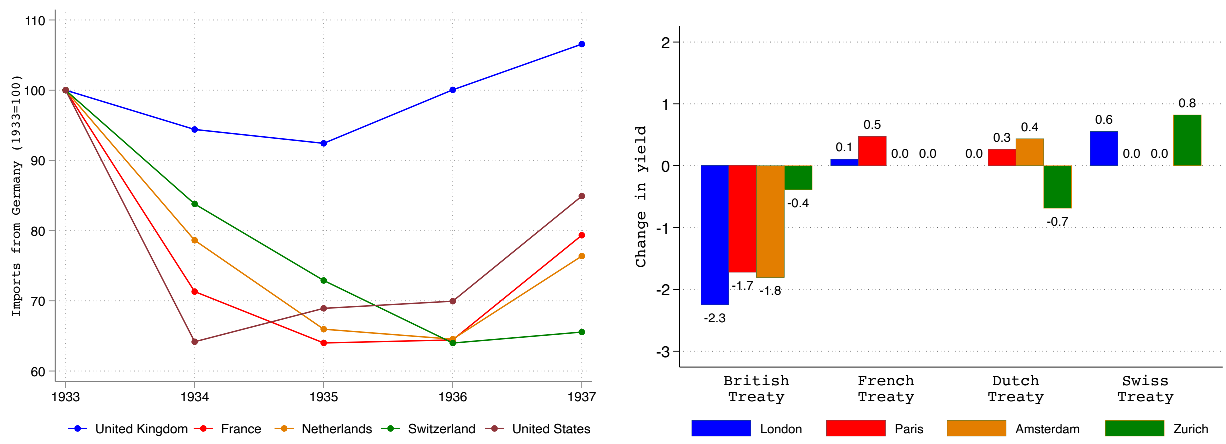
In the aftermath of the 1934 moratorium, the bilateral deals concluded between Germany and its various European creditors differed greatly in their provisions. On the one hand, after having threatened to impose a unilateral clearing in July, the UK government eventually signed the Anglo-German Payments Agreement on 1 November 1934. Through this agreement, UK authorities granted Germany improved access to the UK's import market in exchange for the permanent transfer of the full amount of interest payments on the Dawes and Young Loans to British investors. The treaty established that comprehensive control over all bilateral payment transactions would only be exercised on the German side. In addition, Germany committed to spending specified shares of the foreign exchange revenue from

[39] BoE G1-512, Letter from Thomas Lamont to E.C. Grenfell, 23 May 1935.

[40] BoE G1-446, Letter from Leonardus Trip to Montagu Norman, 26 February 1934.

German exports to Britain on individual categories of British claims, ie. 55% on British exports and another 10% for reducing outstanding commercial debt.[41] As pointed out by Forbes (2000), these provisions meant that the UK could determine the level of trade between the two countries through imports. The agreement also established a strong incentive to import more on the British side in order to satisfy the interests of exporters and bondholders. Indeed, in the years that followed the signing of the Anglo-German treaty, German exports to the United Kingdom increased considerably more than exports to other countries (see Figure 5a).

Figure 5: Market reaction to trade treaties



(a) Imports into creditor countries from Germany (b) Market reaction to trade treaties

Notes: Panel (a) reports the imports from Germany by creditor country from 1933 to 1937, with the data being indexed to 1933. The underlying sources are the German trade statistics (Statistisches Reichsamt, 1935, 1939). Panel (b) reports the change in the Dawes bond's yield consecutive to (i) the Anglo-German Payments Agreement of 1 November 1934; (ii) the French-German Agreement on Commercial Payments of 28 July 1934; (iii) the Dutch-German Agreement on Compensation Traffic of 13 October 1934; and (iv) the Swiss-German Agreement on Compensation Traffic of 26 July 1934. The dates of the various treaties are from Huhle (1937). The measure reported is the difference in yield-to-maturity between the two trading days before and after the announcement of the signature of each treaty. Zeros are reported when no change was recorded between the two dates. Although the Franco-German treaty was concluded on July 25th and signed on July 28th, *The Economist* reported as early as July 21st that a Franco-German agreement had been reached (see *The Economist*, 'Investment Notes', July 21, 1934, p. 122). We therefore use this date as the event date for that treaty. For sources of the bond price data, see Accominotti et al. (2023).

By contrast, the arrangements concluded with France, Switzerland, and the Netherlands following the moratorium all involved the establishment of a bilateral clearing system. These governments thus preferred to adopt a more coercive system to recoup coupon payments than to grant Germany significant trade concessions. However, while these bilateral treaties safeguarded the full service of Reich bonds held by continental European bondholders for the time being, the clearing systems they installed involved higher bilateral trade costs and German exports to these creditor countries stagnated as a result (Figure 5a). Given the bilateralization of the transfer problem, low exports in turn jeopardized the service of German bonds held by these countries' nationals as their claims could only be paid to the extent that importers of German goods paid into the system.

Market assessment of the effect of the bilateral clearing treaties on the likelihood of bond repayment was therefore negative. Figure 5b explores the bond market reaction to the treaties concluded between Germany and each of the four

[41] See Harris (1935, 69f) for a comprehensive description of the treaty.

main European creditor nations (the UK, France, the Netherlands, and Switzerland). The figure displays the change in the Dawes bond's yield-to-maturity on each European market (London, Paris, Amsterdam, and Zurich) between the two trading days before and after the signature of each bilateral treaty. While bondholders reacted positively to the signature of the Anglo-German Payment Agreement which granted Germany significant trade concessions (as evidenced by the decline in German government bond yields in all markets on the following day), they remained skeptical towards the other three deals, even though all treaties guaranteed the full servicing of the Dawes bonds to European creditors for the time being. The press also shared the market's skepticism. For example, an analyst for the French weekly *Journal des Finances* commented on 3 August 1934 that *"at a first glance, the [French-German] deal appears beneficial to holders of Dawes and Young bonds"* but also noted that the service of these bonds was guaranteed for six months only and that the commercial regulations introduced constituted *"barriers to international trade."*[42] A week later, the same newspaper attributed the weak market reaction to the French-German treaty to bondholders' *"discouragement"* in view of the temporary nature of the deal.[43] The British weekly *The Economist* also considered that the treaty establishing a Swiss-German clearing *"provided for the full transfer of the interest on the Dawes loans, but traders very soon recognized that it only benefited Germany."*[44]

4 The domestic politics of trade retaliation and support

4.1 An interest group framework

The above narrative of the bilateral debt and commercial negotiations reveals that the fate of each creditor country's bondholders eventually hinged on the evolution of Germany's bilateral trade balance with this country. But why did certain creditor countries give in to Germany's demands and grant her trade concessions facilitating bond repayments while others opted for clearing systems detrimental to bilateral trade and, ultimately, to bondholders? In order to explain this, it is important to take account of the redistributional consequences of changes in commercial policy towards Germany. Germany's transfer problem and external debt problem resulted in a competitive struggle not only *between* but also *within* creditor countries. Hence, understanding the different commercial policies adopted after 1934 requires analyzing the domestic political economy of the trade response to Germany's debt default in each creditor country.

Figure 6 provides a theoretical representation of the options available to creditor countries' governments in response to the German external debt problem and of the implications of each option for the various domestic interest groups. We distinguish between three main interest groups lobbying the government: bondholders, exporters, and the

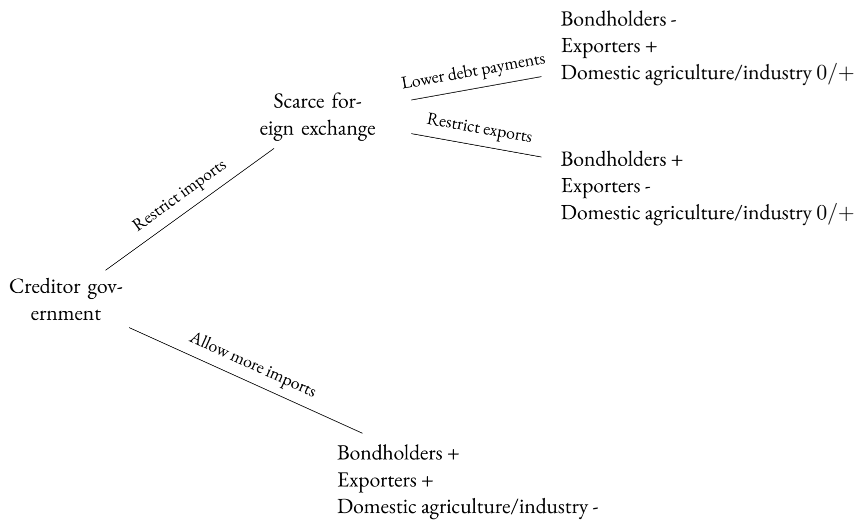
[42] *Journal des Finances*, "L'accord franco-allemand", Gaston Jèze, 3 August 1934.

[43] *Journal des Finances*, "Revue de la Semaine", 10 August 1934.

[44] *The Economist*, "Switzerland", 24 November 1934, p. 981.

domestic-oriented agriculture or industry.[45] Each group will be impacted differently by their government's commercial policy towards Germany. Domestic agriculture and industry benefit from tariffs and quotas on imported goods as such restrictions grant them protection from foreign competition. By contrast, bondholders and exporters both benefit from an increase in imports of German goods. Indeed, in the absence of international capital flows, the transfer problem constitutes a binding constraint for the debtor country and an increase in exports is the only way for that country to generate the foreign exchange needed to purchase additional goods from creditor countries and service its external debts to foreign bondholders. If, by contrast, the creditor government gives in to domestic agriculture and industry and restricts imports of German goods, Germany's foreign exchange revenues will be scarce and the government will have to decide whether to allocate them in priority to domestic exporters (through agreeing to a reduction in debt payments to bondholders) or to bondholders (through imposing a reduction in exports to maintain Germany's bilateral trade surplus). The government's decision between the three different options therefore depends on the relative strength of the three interest groups.[46]

Figure 6: Creditor governments' decision problem in responding to the German default



Notes: Authors' analytical framework (see text for details).

As shown in the previous section, the German government also attempted to use the transfer problem as a justification for obtaining trade concessions from its creditors. Figure 6 suggests that such concessions were more likely to be granted if exporters and bondholders enjoyed relatively stronger leverage on the creditor government than domestic agriculture or industry. In the following, we use this decision tree as a framework to explain the various trade policies adopted by creditor countries vis-á-vis Germany following the announcement of the external debt moratorium of June 1934. We first explore how bondholders' organizational capacity and entanglement with the government determined

[45]This is of course a simplified framework. In practice, actors may not always be differentiated so clearly into groups and these groups may overlap. In particular, firms may produce goods for both the domestic and foreign markets.

[46]Kaempfer and Lowenberg (1988) provide a more general formal public choice model to analyze the political economy of sanctions.

their degree of political clout within each creditor country. Second, we discuss how bondholders' resulting political influence (relative to that of the two other groups, ie. the exporters and domestic agriculture/industry) determined the commercial response to the German default in each country.

4.2 Bondholders' political influence in the creditor countries

Bondholders' influence on the government varied greatly across creditor countries depending on institutional and historical factors. Their leverage also depended on the alignment of their interests with those of the banking sector.

In all countries, bondholders' interests were organized in so-called bondholder associations. The political clout of these associations depended on their age and composition as well as on the history and importance of foreign lending in each creditor country. In particular, it appears that bondholders were more closely entangled with the government in Britain and France than in the Netherlands, Switzerland, and the United States. Whereas, the Dutch and Swiss bondholders' organizations were mostly linked to the financial industry[47], the British and French ones were more closely embedded in domestic politics. They included members in leading positions other than those from the stock exchange or banks. The French and British Parliaments had converted these once-private organizations into 'quasi-official' ones in 1898 (Great Britain) and in 1919 (France) (Ronald, 1934). In the United States, by contrast, defaults were typically dealt with on a case-by-case basis through the institution of ad hoc committees (Ronald, 1934). While the US government eventually aimed to emulate the British model through the establishment of the *Foreign Bondholders Protective Council* in 1933, this institution lacked comparable institutional embedding and political support and the Securities and Exchange Commission prevented banks from funding it. This in addition to the fact that its board was mostly filled with former members of Herbert Hoover's administration made the *Council* a toothless tiger and its views were largely ignored by the Roosevelt administration (Schuker, 1988, p. 75f).

Governments' political accountability towards holders of German government bonds also differed between the allied and neutral countries of World War I. In the allied countries (the United States, United Kingdom, and France), governments had been particularly keen to advertise the Dawes and Young bonds upon flotation. In the United States, President Coolidge urged American investors to subscribe to the Dawes Loan and a campaign led by public and business leaders was launched to increase its attractiveness (Costigliola, 1976, p. 494f). The French government also promoted the *"Dawes and Young bonds among savers with all available strategies as having first-class character"*.[48] These efforts proved successful as Dawes and Young bond issues were largely oversubscribed in the allied countries. Most of the bonds had been purchased by retail investors, many of whom were of modest means.[49] By promoting German bonds among the

[47] In the Netherlands, bondholders' interests were protected by a sub-committee of the stock exchange and Switzerland's bondholders organization reported directly to the Bankers association (Ronald, 1934, p. 433 & 435)

[48] BArch R117.287: P1570243-45; (own translation).

[49] See for Young bond for all three countries: BArch R2501.6743; for Dawes bond, see US (Costigliola, 1976, p. 495), UK ('The German Loan',

population as a way to facilitate the payment of WW1 reparations, governments in the allied countries had therefore created a political liability towards bondholders in case of default.

No such implicit political responsibility of the government towards bondholders was forged in the neutral countries (the Netherlands and Switzerland). At the time of its flotation, these countries' bondholders associations and newspapers had both expressed skepticism towards the Dawes bond due to the recent German hyperinflation and domestic capital shortage.[50] The main motivation for the Swiss and Dutch governments to participate in the issuance of the Dawes Loan was to maintain their financial centers' international prominence.[51] However, while Dawes bond issues were oversubscribed in 1924,[52] the 1930 issue of the Young Loan was under-subscribed by 40% on the Amsterdam market. This failure was partly due to the bond's negative press coverage. The Dutch press pointed out that, by holding Young bonds, capitalists in the neutral countries would carry the credit risk of a loan that benefited the Allies without getting any special guarantees.[53] Neither the Swiss nor the Dutch government appears to have done much to interfere with such perceptions or to actively promote the Young Loan among the public. Consequently, as a German default on central government bonds came closer, Swiss and Dutch retail investors only held small amounts of Dawes and Young bonds in comparison to other German bonds.[54]

Bondholders' political influence also depended on the extent to which their interests aligned with those of the domestic financial industry. Within the allied countries, banks held minimal amounts of German long-term bonds. In France, the United States, and the United Kingdom, only 1%, 5% and 8% (respectively) of the total amount of long-term claims on Germany were held by banking creditors in November 1931.[55] Yet, especially in the United States and the United Kingdom, banks held substantial amounts of short-term assets in Germany. These credits were "frozen" since the Standstill Agreement of 1931 and, although banks could not liquidate or repatriate them, they could keep them on their balance sheets and receive interest payments on them from German debtors. The introduction of a restrictive clearing

The Economist, Oct. 18, 1924, p. 690), FR ('Die erste Reperationsanleihe', *Neue Zürcher Zeitung, 17. October 1924)*. Schuker (1988, p. 76) reports that *"600,000 Americans owned defaulted foreign bonds."* According to a spokesperson of the Bondholders Council, many of those were of modest means. In a Franco-German communication, the Bank of France governor expressed his worry about a coupon reduction as many savers of modest means held German bonds (BArch R117.287).

[50]For the Netherlands, see Lotz (1928, p. 97). In Switzerland, skepticism was shared by social democratic newspapers (e.g. 'Dawes-Gefahr', *Berner Tagwacht*, September 29, 1924) as well as by the economic press ('Deutsche Kreditsuche im Ausland' *Neue Zürcher Zeitung*, September 19, 1924 (evening issue).

[51]In the Netherlands, the government considered that the floating of the Dawes loan was important to secure the importance of Amsterdam as an international financial center (Lotz, 1928, p. 97). Such considerations also played a role in Switzerland where harboring the German flotation appeared 'only natural' for the banks ('Die erste Reparationsanleihe', *Neue Zürcher Zeitung*, 12. October 1924 (noon issue).

[52]In Switzerland with large orders from abroad and a substantial institutional uptake not offered for public subscription: See 'Die deutsche Anleihe in der Schweiz überzeichnet', *Der Bund*, October 23, 1924; 'Die erste Reparationsanleihe', *Neue Zürcher Zeitung*, 12. October 1924 (noon issue).

[53]BArch R2501.6743, P1550975-86.

[54]A survey by the Dutch central bank revealed that Dawes and Young loans made up less than 10% of all German bonds, themselves only a part of the Dutch claims against Germany ('De Duitsche Debiteur. En het Nederlandsche Belang',*Algemeen Handelsblad*, 29 June 1933).

[55]FRBNY 261-12, Committee on German Foreign Credits. German indebtedness as of November 30th, 1931. We thank Alain Naef for sending us a scan of this document.

system in 1934 could however have jeopardized the status of these credits. The issue was of the utmost importance for the acceptance houses of the City. For several of these relatively small but nevertheless systemic investment banks, which had long specialized in the financing of international commerce for foreign firms, standstill claims represented a large share of their balance sheets (Accominotti, 2012). As the prospect of a default on the Dawes and Young Loans was getting nearer in 1934, fears arose among the City that potential UK trade retaliation would lead to the definitive cancellation of the Standstill Agreements and to the write-off of London banks' frozen German credits, which could severely affect their solvency (Leith-Ross 1968, p. 185; Wendt 1971, p. 219; Forbes 2000, pp. 107-109).[56] These banks' interests were therefore aligned with those of retail bondholders as both groups had an interest in the maintenance of Germany's bilateral export surplus towards the United Kingdom and would have been clear losers of a restrictive clearing system. In a letter to Montagu Norman dated October 1934, Frank Cyril Tiarks, partner at the merchant bank J. Henry Schröder and Co. (a merchant bank with significant exposure to German standstill credits) and Chairman of the Joint Committee of British Short-Term Creditors noted that *"the introduction of clearings reduces the favorable balance of payments, which the clearing is designed to intercept and thus reduces the total surplus, out of which all their [ie. German authorities'] essential foreign payments, including the service of the Standstill must be made."*[57] British banks also constituted an important pressure group and were especially influential at the Bank of England (Einzig, 1941b), where Tiarks himself had been a director since 1912. This may at least partly explain the Bank of England's skepticism towards commercial retaliation in the summer of 1934. For example, when Montagu Norman was asked to comment on the UK Treasury's draft note threatening Germany of a clearing in June 1934, he stated that, although he found the draft *"reasonable"*, the note impelled him *"first of all to protest against the unfortunate policy of limiting international trade by restrictions or impediments of one kind or another."*[58]

While the interests of banks and bondholders were closely entangled in the United Kingdom, the situation was less clear in the United States. The continuation of the Standstill Agreement was a less acute issue for US banks as those credits were mostly concentrated among the largest commercial banks' balance sheets and those banks were in a better position to absorb the losses arising from a potential write-down of these assets (Accominotti, 2019). In addition, since Franklin D. Roosevelt's election as President, the banks' interests found little echo among the US government. In 1934, the Roosevelt administration largely ignored the protests of US investment banks against the selective default on US

[56] Forbes (2000, p.109) reports how Neville Chamberlain himself was severely concerned about the potential failure of several English banks in case of a German default.

[57] Rothschild Archive XI/111/513, Copy of a personal letter from Mr. Tiarks to the Governor of the Bank of England, 10 October 1934. Tiarks also noted that German authorities feared that *"the interception of their daily sterling receipts and the consequent delay, however slight, in placing at their disposal the surplus of the clearing, may lead to a breakdown of the service of the Standstill through the absence, however temporary, of the necessary foreign exchange to meet that service when it is due."* Therefore, Tiarks suggested that in the event of the introduction of a clearing *"it may be necessary, especially during the early stages of a British clearing, to provide a credit in favor of the Reichsbank as a 'cushion' to enable it to meet the temporary demands which the service of the Standstill entails."* We thank Robert Yee for pointing us towards this document.

[58] BoE G1-446, Morgan's letter to Leith-Ross, 20 June 1934.

bondholders and the administration simply acknowledged that it had little leverage to enforce debt collection given the US trade surplus with Germany (Schuker, 1988, p. 78). Whereas 24% of Swiss overall long-term claims on Germany were held by banks,[59] Swiss banks had obtained from the German government that the service of their German credits be settled outside any clearing system (Frech 2001, p. 83). In particular, the banks successfully lobbied to keep standstill credits and so-called 'Frankengrundschulden' (ie., mortgage credits mostly granted by Swiss insurances and banks) out of the clearing agreement (Frech, 2001, p. 61).[60] The privileged position of banking creditors - notable in the distinction between the so-called "clearing-creditors" and other creditors common at the time - continued to play against the interest of Dawes and Young bondholders (Lussy et al., 2001, p. 60f) and left those bondholders politically isolated.

4.3 Political influence in action: the negotiations following the default

How did the relative political influence of bondholders within each creditor country affect the outcome of the 1934 debt and commercial negotiations with Germany and the decision of whether to grant Germany trade concessions? Below, we tackle this question on a country-by-country basis. We then summarize the main results and discuss their wider implications for the default-trade nexus.

United Kingdom As shown above, bondholders constituted a particularly influential interest group in the United Kingdom. Bond yield data also indicate that UK holders of Dawes and Young bonds were thought to be Germany's most senior creditors and they effectively received the most preferential treatment from the German government in the 1930s. Among all creditor countries, the United Kingdom also ended up granting Germany the most generous trade concessions in 1934 through the Anglo-German Payments Agreement. The path toward this bilateral agreement reflects the strong influence of bondholders within the UK economy.

During the discussions surrounding the passage of the Debts Clearing Offices And Import Restrictions bill in June 1934, which gave the UK government authority to engage in commercial retaliation in the event of a German default, multiple members of parliament voiced concerns about the potential repercussions of such measures on exporting firms in their respective constituencies.[61] Labour Party MP Stafford Cripps also bemoaned that the UK government always put the interests of bondholders and banks over those of domestic producers: *"It appears that the present Government always takes the view that it is the rentier who must be protected first regardless of what happens to the interests of the manufacturers or producers."*[62] Indeed, UK bondholders could benefit from protection at the highest level of the state.

[59] FRBNY 261-12, Committee on German Foreign Credits. German indebtedness as of November 30th, 1931.

[60] Together, these credits accounted for around one-third of Germany's total debt obligations to Switzerland (Vannini, 1943, p. 85). In return, Germany obtained free exchange which it partly used to pay the interest on these debts (Vannini, 1943, p. 88f).

[61] For example, MP Henderson Stewart of the National-Liberal Party, expressed concerns for the coal and fishing industry in his constituency. See 'Debts Clearing Offices And Import Restrictions Reprisals Bill', *Hansard (UK Parliament Archive)*, HC Deb 25 June 1934, vol 291 col 831.

[62] Statement by Sir S. Cripps, see 'Debts Clearing Offices And Import Restrictions Reprisals Bill', *Hansard (UK Parliament Archive)*, HC Deb

In a personal meeting with the German Ambassador, no one less than King George V urged the German government to intervene in favor of the continued service of the Dawes and Young bonds, which were *"held here in all parts of the population as important investment paper."*[63]

Given Germany's economic dependence on the United Kingdom, the threat of a British clearing worked as an effective tool in the negotiations towards the temporary Anglo-German Transfer Agreement of July 4, 1934.[64] The preamble of this agreement highlighted that Germany had a positive bilateral trade balance with the United Kingdom and contained an expression of interest to maintain high levels of trade between the two countries.[65] The interests of both UK exporters and bondholders had been preserved. The negotiations towards a permanent agreement -the Anglo-German Payments Agreement signed in November 1934- were conducted in the same spirit. On the one hand, the British Delegation used the introduction of a clearing as a threat to protect the interests of British holders of Dawes and Young bonds. The head of the British Delegation Leith-Ross explicitly stated in a letter to Schacht (October 27, 1934) that: *"If we are to avoid a Clearing, my Government will require to be assured that the full payment of all coupons of the Dawes and Young loans belonging to British holders will be continued."*[66] On the other hand, to preserve the interests of British bondholders, UK authorities committed through this bilateral agreement to promote the imports of German goods into Britain (Section 3.3). While exporters also benefited from the deal, the main condition placed by UK authorities to any bilateral agreement was that Germany continued to fully service the Dawes and Young bonds held in Britain.[67]

France France's strategy towards Germany in the summer of 1934 differed significantly from that of the United Kingdom. The French government initially took a strict approach towards debt collection and sought to recoup the service of the Dawes and Young bonds held in France through a clearing system. However, the system proved detrimental to bilateral commerce and, in the years that followed, pressure from domestic exporters and bondholders pushed the French government to change its stance, abandon the clearing, and give in to German demands for trade concessions.

During the debt settlement negotiations of 1934, the French government made it clear that it would accept a

25 June 1934, vol 291 col 865.

[63]BArch R117.137.

[64]See a report by the Security and Exchange Commission (1937, p. 426) and Forbes (2000, p. 90) for this interpretation. For multiple exchanges between German negotiators with Berlin, see BArch R2.318.

[65]The reassurance, that there was *"no desire to restrict exports"* was also made multiple times during the negotiations (for example, in a letter from Frederick Leith-Ross to the German delegate Berger (30 June 1934) outlining the British position just before the conclusion of transfer agreement (BArch R117.266). The articles of the agreement made provisions for the continuance of the service of German central government bonds held by UK residents in exchange for the UK government's commitment not to impose a clearing (see BArch R2.318 for the agreement's text).

[66]BArch R2.319.

[67]Interestingly, the director of the British firm Brandon & Company Limited with large investments in German companies wrote to their MP to complain that, while holders Dawes and Young bonds could obtain the payment of their coupon in sterling, there was no guarantee that the company would be able to transfer the dividends it perceived in reichsmarks from its share investments in German firms. See NatArch T160-744, 13999-09-01, Letter from Brandon & Company to T. Vansittart Bowater MP, 2 November 1934.

reduction in the interest of the Dawes and Young bonds under no circumstances.[68] Following the German moratorium of June 1934, France and Germany signed a clearing agreement in Berlin on 28 July 1934. Under the terms of this new treaty, payment of all commercial transactions between the two countries was centralized through the Reichsbank and the Franco-German Office for Commercial Payments.[69] Importers/exporters in both countries directly paid/were paid by these institutions in their own currency. In addition, 15.75 percent of the daily value of French imports from Germany was paid into a special account and earmarked for servicing the coupon of the Dawes and Young Loans.[70] Through this mechanism, the French government sought to secure maintenance of the full service of the Reich loans to French bondholders.

Yet, the French-German clearing system did not turn out to work in the way French authorities had anticipated. Given the constraints of the transfer problem, a clearing system could only preserve the service of French bondholders if Germany maintained a large enough bilateral trade surplus.[71] However, while French exports to Germany remained relatively stable, imports fell considerably and Germany's trade surplus diminished by 50% between 1933 and 1934.[72] Consequently, Germany started accumulating substantial clearing arrears with the Franco-German Office. The German government pondered a British-style agreement but the French one remained hesitant for the time being as the amortization of arrears had utmost priority and it was unclear how the upcoming Saar plebiscite would affect the bilateral trade balance.[73] In late November 1934, the French government increased its quotas of imports of German goods to enable Germany to generate sufficient export revenues to service its debts.[74] These measures however did little to restore Germany's trade surplus and, by 1935, clearing arrears had become so large (700 million francs by August 1935) that the French government decided to activate the liquidation clause of the 1934 treaty (Auswärtiges Amt, 1966, p. 908). Under this clause, France could drastically limit its exports to Germany in order to artificially turn Germany's bilateral trade balance into surplus and melt down the clearing arrears.[75] Through this decision, the French government effectively sacrificed the interests of the French export industry to safeguard those of holders of Dawes and Young bonds.

The French export industry paid a high price for this policy and French exports to Germany declined by almost 80% between February 1935 and February 1936.[76] In addition, despite the reduction in French exports, Germany's trade

[68]See the exchanges between the Governor of the Banque de France Moret and the German Ambassador in Paris Köster (BArch R117.287).

[69]BdF 1069199005/49, "French-German Agreement on Commercial Payments", July 1934, article 1.

[70]BdF 1069199005/49, "French-German Agreement on Commercial Payments", July 1934, article 1.

[71]While France had granted some smaller concessions on quotas in a trade treaty negotiated at around the same time, she maintained strict import control (United States Tariff Commission, 1942, p. 212)

[72]Own calculation based on Statistisches Reichsamt (1937).

[73]BArch R117.291, "Aide-mémoire Richter", 24 November 1934.

[74]'France', *The Economist*, Dec. 8, 1934. p.11-12.

[75]BdF 1370200008/178, "L'accord commercial franco-allemand", 12 July 1937. The decision was taken to limit French exports to Germany to 25% of the amount of French imports of German goods.

[76]Own calculation based on the monthly bilateral export figures reported in BdF, 1370200008/178, "Office de compensation", December 1937.

surplus was still not large enough in absolute terms to ensure the payments of all French claims. As new clearing arrears emerged,[77] the situation eventually became unsustainable. Negotiations resumed between both governments and resulted in a new trade treaty signed on 10 July 1937. Both countries granted each other the most favored nation status as well as tariff and quota reductions and the clearing system was abolished.[78]

France's commercial response to the default illustrates how Germany's transfer problem resulted in a distributional struggle between domestic interest groups. The policy turn of 1937 appears to have been inspired by French authorities' realization of the necessity to grant Germany favorable trade conditions in order to support the French export industry while at the same time guaranteeing the servicing of German debts to French bondholders. French holders of Dawes and Young bonds eventually received the same favorable treatment from Germany as UK ones.

Switzerland In contrast to the UK and France, holders of German bonds had limited political influence in Switzerland. In the aftermath of the German default, the Swiss government decided to support the export and tourism industry at the expense of the bondholders. Hence, Swiss holders of Dawes and Young bonds suffered a reduction in their coupon as Germany selectively defaulted on them several times over 1935-1937. At the same time, imports of German goods into Switzerland declined by 35% between 1933 and 1936.

Following the German moratorium, the first clearing agreement was signed between Switzerland and Germany on July 26, 1934. The clearing system created by this treaty governed trade, services, and financial relations between the two countries. At that time, German exports into Switzerland appeared to be large enough to fulfill both the Swiss exporters' and bondholders' claims on Germany. Nevertheless, the treaty established that exporters and the tourism industry would have a priority claim on Germany's foreign exchange revenues under the clearing system (Ferralli, 1934, p. 12).[79] Swiss bondholders initially continued to receive the full coupon on their Dawes and Young holdings.[80] It was only in April 1935, following the so-called Easter agreement that holders of Dawes and Young bonds had to accept a first coupon reduction. At the same time, Swiss banks also experienced a cut in the interest rate on their standstill

The French woolen industry is likely to have been particularly affected due to its dependence on the German market (see *Financial Times*, 24 July 1934, "Franco-German commerce.")

[77] These were estimated at 226 million francs in August 1937; see BdF 1370200008/178, "Mobilisation par la Banque de France. Les arriérés du clearing franco-allemand", 10 August 1937.

[78] French importers could now directly pay their German exporters in francs and the latter had to convert the foreign exchange so acquired into marks at the Reichsbank. Payment of commercial transactions remained centralized on the German side as the Reichsbank stayed in charge of allocating available foreign exchange to German importers (See BdF, 1370200008/178, "Le traité de commerce franco-allemand", *L'Information*, 13 July 1937)). Under the new treaty, any positive balance of foreign exchange was to be allocated in priority to the service of the Dawes and Young bonds (BdF, 1370200008/178, "Les accords financiers franco-allemands. Emprunts extérieurs et créances privées", *Agence Economique et Financière*, 13 July 1937.

[79] At first glance, this was a surprising outcome, as leading figures from both the banking sector and industry had participated in the negotiations (in particular, Jöhr from the banking association and Homberger from the Swiss industrial association *Vorort* (Frech, 2001, p. 58)). However, the banks had already sorted out most of their interest in the standstill agreements and much of the capital flows were excluded from the clearing.

[80] The governor of the Swiss central bank (Bachmann) had communicated to his British counterpart (Norman) in March 1934 that the Swiss government's position was that the service of the Dawes and Young creditors chiefly depended on the total amount of transfers made by Germany such that other creditors could be served. See BoE G1-446, "Letter from G. Bachmann to Montagu Norman", 5 March 1934.

credits.[81] While the financial industry protested against the loss of their privileged position among creditors (Vannini, 1943, 87f), politicians were decided for the time being to put the *"workers' interest over that of capital"* (Frech, 2001, p. 74). While a new clearing agreement concluded in 1937 put financial interests on equal footing with those of the export and tourism sector, the agreement still involved substantial cuts in the interest service of German debts.[82] Overall, the Swiss government continued to favor the interests of the non-financial sector over those of the bondholders and banks.[83] In this light, no substantial trade concessions were made to Germany.

Netherlands The political leverage of bondholders was comparable in the Netherlands and Switzerland. Hence, following the German default, Dutch bondholders' interests were sacrificed to those of the domestic export industry and German bilateral exports to the Netherlands declined considerably.

In the summer of 1934, the Dutch government went as far as to impose a unilateral clearing to collect payment arrears and force Germany to negotiate a bilateral treaty (Harris, 1935, p. 66). In the words of a Dutch politician, this measure aimed to break the *"dictatorship of the debtor."*[84] A new treaty was eventually signed with Germany in early September 1934, only to be canceled in early November and a revised treaty was negotiated in December. Both the September and December treaties made commitments for additional imports of German goods into the Netherlands, to be enforced through public orders by the Dutch government.[85]

While the clearing treaty aimed to fulfill all Dutch residents' claims on Germany, this objective soon proved illusory under the clearing system. As German exports to the Netherlands declined and clearing arrears accumulated, the Dutch government was unwilling to follow the French example and restrict exports. Instead, it asked for new negotiations with Germany in April 1935.[88] The new bilateral treaty that came out of these negotiations in early July foresaw a reduction in the interest service of Dawes and Young bonds held by Dutch residents. The cash component of the Dawes bond's interest payment was cut by half, while the other half was paid in registermark—a German shadow currency that could be traded on European exchanges at a substantial discount (Accominotti et al., 2023).[89] The outcome of these ne-

[81]The agreement also solidified the privileged position of the tourism and exporting industries with a more strict and binding pecking order in the distribution of foreign exchange (Vannini, 1943, 87f)

[82]As such, the financial industry's "Germany Committee" was dissatisfied with the outcome of these negotiations (Vannini, 1943, 95-97)

[83]While import restrictions were somewhat loosened at the end of 1936 in order to increase clearing income (Frech, 2001, p. 93), the protection of the domestic and export-oriented industries took precedence throughout the period under consideration.

[84]'Het zestig millionen plan in de Eerste Kamer', *De Volkskrant*, 28 June 1934.

[85]'Die Regelung des deutschholländischen Zinsentransfers', *Neue Zürcher Zeitung*, 2. September 1934; 'Deutsch-holländisches Verrechnungsabkommen', *Neue Zürcher Zeitung*, 7. December 1934. .[86] The main goal of these treaties and, presumably, the reason for their frequent revision, was to liquidate the large commercial debts owed by Germany to Dutch exporters.[87] At the same time, the treaties promoted agricultural exports as a large share of the agreed German import quota had to be used for imports of agricultural products from the Netherlands (Klemann, 2008). By contrast, Dutch holders of German non-central government bonds had to agree for the first time to a coupon reduction.

[88]Deutsch-holländische Transferverhandlungen, *Neue Zürcher Zeitung*, 1. Mai 1935. 'Im Dickicht der Clearingverträge', *Der Bund*, 9. October 1935.

[89]At the stock exchange in Amsterdam, investors had expected an even worse outcome (see 'Amsterdamer Börse',*Neue Zürcher Zeitung*, 11. July 1935).

gotiations was certainly more favorable to exporters than bondholders. Over the following years, the treaty was renewed multiple times in slightly amended versions until coupon payments on Dawes and Young loans were reduced further in 1938.[90]

United States Compared to their European counterparts, American bondholders were in a precarious position even before the negotiations with Germany had even started. First, the positive US trade balance towards Germany involved that US authorities could not use the threat of a unilateral clearing to induce the German government to repay its external debts to US residents. Second, bondholders lacked the institutional and political embedding to efficiently lobby the government. Finally, the transition from the Hoover to the Roosevelt administration in 1933 reduced the influence of banks and bondholders within the US political system. These combined factors paved the way for a selective default on US bondholders. As early as October 1934, the German government unilaterally reduced coupon payments on Dawes bonds held by US residents. While the US government protested against the European creditor countries' accommodating attitude towards Germany and their strategy to obtain preferential treatment, US authorities never gave in to German demands that commercial concessions be made in exchange for the renewed service of government bonds held in the United States.

As Germany defaulted in 1934, US bondholders found it hard to get representation from their government at any level. The default came less than one year after the US economy had started recovering from the Great Depression. With the Wall Street Crash and ensuing economic hardship still fresh in their mind, US policymakers had little sympathy for the demands of bondholders as they prioritized employment as well as the interests of domestic agriculture and industry. According to Schuker (1988, p. 77), the new US Ambassador to Germany William E. Dodd, appointed by Roosevelt in June 1933, was *"an agrarian ideologue"* who *"nourished an obsessive hatred of businessmen and moneylenders."* The Roosevelt administration's attitude towards the interests of the financial sector and bondholders was also generally negative. Roosevelt himself considered that *"the bankers had gotten themselves into this"* and debt recovery was not the priority of the economic adviser's office, whose main aim was to reestablish multilateral trade (Schuker, 1988, p. 75-80). Roosevelt's main economic goal was to foster domestic employment and exports and his administration *"chose not to exercise what modest influence it could bring to bear"* (Schuker, 1988, p. 79).

The weak organization of the bondholders' interests also contributed to their limited leverage. As the issuer of the Dawes Loan in the United States, JP Morgan represented the bondholders' interests. In an exchange of letters with Schacht, the firm's partner Thomas W. Lamont complained that the US State Department's protests following the implementation of discrimination against US bondholders had been *"watered down"* when transmitted to Berlin. While

[90] See 'Das deutsch-holländische Transferabkommen', *Neue Zürcher Zeitung*, 19 September 1938. See Reichsstelle fuer Devisenbewirtschaftung (1936, p. 678), Müller (1938, p. 1014), and Reichsstelle fuer Devisenbewirtschaftung (1937, p.787) for the treaty extensions and changes between 1935 and 1938. The balance between the interest of the exporters and financial creditors tipped even further in favor of the former. See discussion of the Dutch press and investors in '', *Neue Zürcher Nachrichten*, 21 September 1938.

Lamont tried to persuade Schacht to grant better conditions to US bondholders, he also acknowledged that the Secretary of State had made it clear that the United States *"could not in any commercial treaty negotiations undertake to absorb any given quantity of German exports."*[91] In April 1935, the President of the relatively powerless Foreign Bondholders Protective Council J. Reuben Clark, also sent a short note of protest to the Reichsbank, bemoaning discrimination against US holders of Dawes and Young bonds.[92] However, without the US government's full backing, these protests proved unsuccessful in altering the German government's stance towards US bondholders.

4.4 Overview of results

Table 1 provides a summary of the conclusions of our country-by-country analysis. For each creditor country, the table reports the outcome of the government's decision problem and the implications of its decisions for the various lobby groups. The table's final row also reports whether Germany was successful in obtaining trade concessions from creditor countries in the bilateral negotiations. This in turn determined the outcome of these negotiations for the domestic agriculture and industry. In the United States and Switzerland, the objective of protecting domestic agriculture and industry was explicitly mentioned by governments and took precedence over the objective of protecting the bondholders' interests. By contrast, in the United Kingdom, France, and the Netherlands, the granting of trade concessions to Germany (in order to facilitate payments to bondholders and/or exporters) negatively impacted the domestically oriented industries and agriculture.

Table 1: Outcomes of bilateral debt/trade negotiations for domestic interest groups and Germany

Interest group	Creditor country					
	United Kingdom	France pre-1937	France post-1937	Netherlands	Switzerland	United States
Creditor countries						
Bondholders	+	+	+	–	–	–
Exporters	+	–	+	+	+	+
Domestic industry/agriculture	-	0/+	-	0/+	+	+
Debtor country (Germany)						
Trade concessions granted	✓	–	✓	✓	–	–

Notes: Own representation based on the historical analysis in Section 4.3. A + sign refers to a positive outcome for the corresponding domestic interest group. - and 0 refer to a negative and neutral outcome, respectively.

Our analysis suggests that the effect of default on international trade relations depends heavily on domestic political economy factors and on the relative political influence of various interest groups within the creditor countries. The cases of the United Kingdom and France post-1937 illustrate how the alignment of exporters' and bondholders' interests

[91] BArch R117.131, "Memorandum for Dr. Schacht", 11 July 1935.

[92] BArch R117.130, "Telegramm-Abschrift", 26 April 1935.

can create a situation in which the creditor government finds it advantageous to boost the debtor country's exports. In some cases such a coalition may not be needed as the interests of a single group - such as the exporters in the Netherlands - are sufficient to convince the government to increase imports from the debtor country (in order to facilitate exports).

One alternative for creditor countries' governments is not to grant any trade concessions to the debtor. In that case, the debtor government's ability to run a trade surplus and generate the corresponding foreign exchange revenues is impaired. The creditor country therefore has to decide between reducing its exports to the debtor country to safeguard the bondholders' interests (as France did in 1935) and agreeing on a reduction in debt payments to bondholders to protect the interest of the export industry (as the Swiss government eventually opted to do).

5 Conclusion

This paper revisits an important historical episode - the German external default of the 1930s - and uses it as a case study to analyze the effect of sovereign debt defaults on international trade. We argue that creditor countries' trade policy response to sovereign defaults is shaped by both international and domestic political economy factors. Since these factors vary across countries and time, creditor countries adopt different commercial policies towards defaulting governments depending on the economic and political context. This may explain why general empirical studies have found inconclusive results about the effect of defaults on trade. Our paper suggests that theoretical and empirical work on the relationship between sovereign debt defaults and international trade should incorporate such political economy considerations.

In the 1930s, the various creditor countries' governments adopted markedly different commercial responses to the German default depending on their own economic leverage on the debtor government as well as on their degree of commitment to the interests of domestic bondholders versus other interest groups. These countries' trade policies of course need to be analyzed in the specific historical context of the interwar period. In particular, the global economic environment of the 1930s characterized by minimal private capital flows between countries, foreign exchange controls, and bilateral clearing arrangements, made the transfer problem a central issue in the trade and debt settlement negotiations with Germany. Nevertheless, important insights can be drawn from this historical case study. Our argument that different creditors may compete for a debtor country's scarce foreign exchange resources is potentially applicable to all cases where sovereign governments have large amounts of external debts but limited foreign exchange to service them. In the absence of further foreign borrowing, a debtor country's ability to service these debts in foreign currency is closely linked to its export capacity. This may lead creditor countries to support defaulting governments with accommodative commercial policies in order to facilitate external debt repayment rather than to impose trade sanctions. At the same time, our case study shows that any trade policy response to a sovereign default has redistributive consequences between domestic interest groups. Governments need to take these consequences into account when deciding whether to engage in trade retaliation or trade support. Our analysis therefore shows that the nexus between sovereign default and international trade is a complex one and that disentangling it requires uncovering the distributional effects of commercial and debt settlement deals as well as the relative influence of various economic groups in domestic politics.

Archival sources

Government, central bank, and other archives

BArch: Bundesarchiv, Berlin, Germany.

BdF: Banque de France archives, Paris, France.

BoE: Bank of England archives, London, United Kingdom.

FRBNY: Federal Reserve Bank of New York Archives, United States.

NatArch: UK National Archives, London, United Kingdom.

PA AA: Politisches Archiv des Auswärtigen Amts, Berlin, Germany.

Rothschild Archive, London.

Newspapers

Algemeen Handelsblad, Amsterdam.

Berner Tagwacht, Bern.

De Volkskrant, Amsterdam.

Der Bund, Bern.

Financial Times, London.

Journal des Finances, Paris.

New York Times, New York.

Neue Zürcher Zeitung, Zurich.

The Economist, London.

The Times, London.

References

Accominotti, Olivier (2012). London merchant banks, the central european panic, and the sterling crisis of 1931. *The Journal of Economic History 72*(1), 1–43.

Accominotti, Olivier (2019). International banking and transmission of the 1931 financial crisis. *The Economic History Review 72*(1), 260–285.

Accominotti, Olivier, Thilo Nils Hendrik Albers, and Kim Oosterlinck (2023). Selective default expectations. *The Review of Financial Studies*, forthcoming.

Accominotti, Olivier and Barry Eichengreen (2016). The mother of all sudden stops: Capital flows and reversals in europe, 1919-32. *The Economic History Review 69*(2), 469–492.

Agronovsky, Alexander and Christoph Trebesch (2009). Trade credit during financial crises: do negotiated agreements work? In M. G. Papaioannou and J. J. Choi (Eds.), *Credit, Currency, or Derivatives: Instruments of Global Financial Stability or Crisis?*, pp. 439–475. Emerald Group Publishing Limited.

Aizenman, Joshua (1991). Trade dependency, bargaining and external debt. *Journal of International Economics 31*(1), 101–120.

Auswärtiges Amt (1966). *Documents on German Foreign Policy 1918-1945: March-Oct. 1936*. Documents on German Foreign Policy 1918-1945: Series C (1933-1937) The Third Reich: First Phase. U.S. Government Printing Office.

Bergmann, Carl (1930). Germany and the Young Plan. *Foreign Affairs 8*(4), 583–597.

Borensztein, Eduardo and Ugo Panizza (2010). Do sovereign defaults hurt exporters? *Open Economies Review 21*(3), 393–412.

Bulow, Jeremy and Kenneth Rogoff (1989a). A constant recontracting model of sovereign debt. *Journal of Political Economy 97*(1), 155–178.

Bulow, Jeremy and Kenneth Rogoff (1989b). Sovereign debt: Is to forgive to forget? *The American Economic Review 79*(1), 43–50.

Clement, Piet (2004). 'The touchstone of German credit': Nazi Germany and the service of the Dawes and Young Loans. *Financial History Review 11*(1), 33–50.

Costigliola, Frank (1976). The United States and the reconstruction of Germany in the 1920s. *Business History Review 50*(4), 477–502.

Diwan, Ishac (1990). Linking trade and external debt strategies. *Journal of International Economics 29*(3), 293–310.

Drezner, Daniel W. (2003). The hidden hand of economic coercion. *International Organization 57*(3), 643–659.

Einzig, Paul (1941a). *Appeasement before, during and after the war*. London: Macmillan Co.

Einzig, Paul (1941b). *Appeasement before, during and after the war*. London: Macmillan & Co.

Ellis, Howard S. (1941). *Exchange Control in Central Europe*. Harvard University Press (Reprinted by Kraus Reprint Corporation, New York 1964).

Ferralli, Marcel (1934). *Der deutsch-schweizerische Verrechnungsverkehr*. Hochrheinische Buchdruckerei, Brombach.

Forbes, Neil (1987). London banks, the German standstill agreements, and 'economic appeasement' in the 1930s. *The Economic History Review 40*(4), 571–587.

Forbes, Neil (2000). *Doing business with the Nazis: Britain's economic and financial relations with Germany 1931-1939*. Frank Cass Publishers.

Frech, S. (2001). *Clearing: der Zahlungsverkehr der Schweiz mit den Achsenmächten*. Veröffentlichungen der Unabhängigen Expertenkommission Schweiz–Zweiter Weltkrieg. Chronos.

Harris, Charles Reginald Schiller (1935). *Germany's foreign indebtedness*. Oxford University Press. Oxford.

Hellwig, Martin (1986). " 'The pure theory of country risk' by J. Eaton, M. Gersovitz and J. Stiglitz". *European Economic Review 30*(3), 521–527.

Huhle, Fritz (1937). Das Clearingwesen im Außenhandel vom deutschen Standpunkt aus. *Jahrbücher für Nationalökonomie und Statistik 146*(1), 171–205.

Kaempfer, William H. and Anton D Lowenberg (1988). The theory of international economic sanctions: A public choice approach. *The American Economic Review 78*(4), 786–793.

Kaempfer, William H. and Anton D. Lowenberg (2007). The political economy of economic sanctions. In K. Hartley and T. Sandler (Eds.), *Handbook of Defense Economics*, pp. 867–911. Elsevier.

Keynes, John M. (1919). *The Economic Consequences of the Peace*. MacMillan and Company.

Klemann, Hein (2008). Political development and international trade: The Netherlands 1929-1941. In M. Müller and T. Myllyntaus (Eds.), *Pathbreakers. Small European Countries Responding to Globalisation and Deglobalisation*, pp. 297–322. Bern: Peter Lang.

League of Nations (1935). *Enquiry into clearing agreements*. League of Nations.

Leith-Ross, Frederick (1968). *Money talks. Fifty years of international finance: the autobiography of Sir Frederick Leith-Ross*. London: Hutchinson.

Lotz, W. (1928). *Die Auslandskredite in ihrer finanziellen, wirtschaftlichen und sozialen Bedeutung: Finanzwissenschaftliche Untersuchungen, dritter Teil. Wissenschaftliche Gutachten. (Schriften des Vereins für Sozialpolitik 174/III)*. Duncker & Humblot reprints. Duncker & Humblot.

Lussy, Hans Peter, Barbara Bonhage, and Christian Horn (2001). *Schweizerische Wertpapiergeschäfte mit dem 'Dritten Reich', Handel, Raub und Restitution*. Chronos.

Martinez, Jose Vicente and Guido Sandleris (2011). Is it punishment? sovereign defaults and the decline in trade. *Journal of International Money and Finance 30*(6), 909–930.

Ohlin, Bertil (1929). Mr. Keynes' views on the transfer problem. ii. a rejoinder from professor Ohlin. *The Economic Journal 39*, 400–4.

Oosterlinck, Kim (2010). Reparations. In Steve Durlauf and Lawrence E. Blume (Eds.), *The New Palgrave Dictionary of Economics Online*. Palgrave Macmillan.

Oosterlinck, Kim, Loredana Ureche-Rangau, and Jacques-Marie Vaslin (2014). Baring, Wellington and the resurrection of French public finances following Waterloo. *The Journal of Economic History 74*(4), 1072–1102.

Papadia, Andrea and Claudio A. Schioppa (2023). Foreign debt, capital controls, and secondary markets: Theory and evidence from Nazi Germany. *The Journal of Political Economy*, forthcoming.

Ritschl, Albrecht (2002). *Deutschlands Krise und Konjunktur 1924–1934: Binnenkonjunktur, Auslandsverschuldung und Reparationsproblem zwischen Dawes-Plan und Transfersperre*. Walter de Gruyter GmbH & Co KG.

Ritschl, Albrecht (2012). The German transfer problem, 1920-33: A sovereign-debt perspective. *European Review of History: Revue europeenne d'histoire 19*(6), 943–964.

Rombeck-Jaschinski, U. (2011). *Das Londoner Schuldenabkommen: Die Regelung der deutschen Auslandsschulden nach dem Zweiten Weltkrieg*. Veröffentlichungen des Deutschen Historischen Instituts London/ Publications of the German Historical Institute London. De Gruyter.

Ronald, James H (1934). National organizations for the protection of holders of foreign bonds. *Geo. Wash. L. Rev. 3*, 411.

Rose, Andrew K. (2005). One reason countries pay their debts: renegotiation and international trade. *Journal of Development Economics 77*(1), 189 – 206.

Schuker, Stephen (1988). American 'reparations' to Germany, 1919-33: implications for the Third-World debt crisis. *Princeton Studies in International Finance 61*.

Security and Exchange Commission (1937). *Report on the study and investigation of the work, activities, personnel and funcitons of protective and reorganization commitees.*, Volume 5. Government Printing Office. Washington.

Statistisches Reichsamt (Ed.) (1935). *Monatliche Nachweise über den auswärtigen Handel Deutschlands 1936. Ergänzungsheft I*. Paul Schmidt.

Statistisches Reichsamt (Ed.) (1937). *Monatliche Nachweise über den auswärtigen Handel Deutschlands 1936. Ergänzungsheft I*. Paul Schmidt.

Statistisches Reichsamt (Ed.) (1939). *Statistisches Jahrbuch für das Deutsche Reich*. Schmidt.

Tomz, Michael (2007). *Reputation and international cooperation: Sovereign debt across three centuries*. Princeton University Press.

United States Tariff Commission (1942). *Foreign-trade and Exchange Controls in Germany: A Report on the Methods and Policies of German Foreign-trade Control, with Special Reference to the Period 1931 to 1939*. Report no. 150. Second Series. U.S. Government Printing Office.

Vannini, Curt (1943). Der zwischenstaatliche Clearingverkehr der Schweiz in den Jahren 1931-1939 (dissertation, Universität Bern).

Weidenmier, Marc D. (2005). Gunboats, reputation, and sovereign repayment: Lessons from the Southern Confederacy. *Journal of International Economics 66*(2), 407 – 422.

Wendt, Bernd-Jürgen (1971). *Economic Appeasement, Handel und Finanz in der britischen Deutschlandpolitik, 1933-1939*. Bertelsmann Universitätsverlag.