Sovereign debt restructurings and international trade: The political economy of the German default in the 1930s

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Abstract

How do sovereign debt restructurings and defaults affect international trade? While creditor countries' governments may impose commercial sanctions following a default, such measures can also impair the defaulting government's ability to repay and therefore harm bondholders. In this paper, we show that international and domestic political economy considerations are key determinants of creditor countries' commercial policy response to sovereign debt defaults. We illustrate this argument using a unique historical case study: the German external debt default of the 1930s. We present an original narrative of the debt settlement and commercial negotiations surrounding this default based on a wide range of archival sources. Our analysis reveals that the German default resulted in a competitive struggle *between* and *within* creditor countries to get priority access to Germany's foreign exchange resources. Creditor governments adopted different trade policies towards defaulting Germany which translated into different outcomes for their respective bondholders. We show that each creditor country's commercial response to the debt default depended on its degree of economic leverage on Germany as well as on the relative political influence of various interest groups within its domestic economy.

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1 Introduction

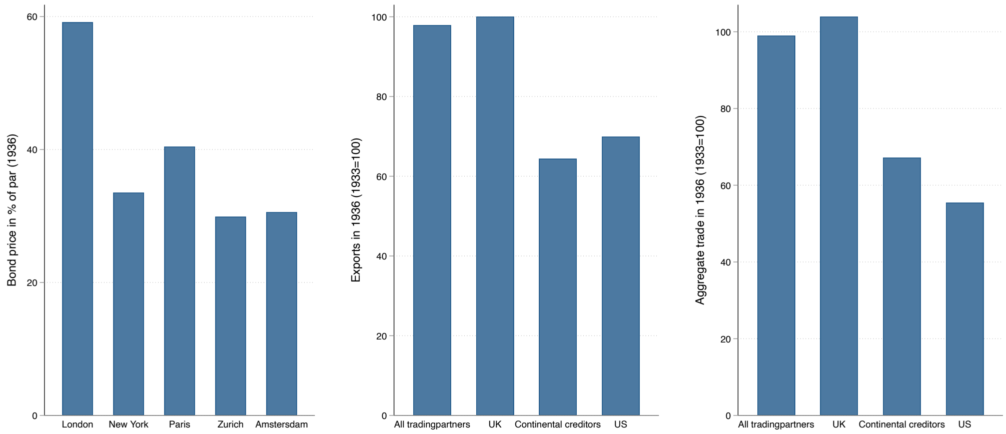
How do sovereign debt defaults and restructurings affect international trade? The empirical evidence on this question is ambiguous. While debt restructuring episodes are usually associated with a *general* decline in the defaulting countries' trade, there is no evidence that these countries experience a stronger *bilateral* trade decline with creditor than with non-creditor countries. Some even suggest that bilateral exports from the debtor to the creditor countries increase in the aftermath of a sovereign debt restructuring.[1] Theory provides some rationale for this ambiguity and highlights the trade-off faced by creditor countries' governments when responding to a sovereign default. On the one hand, these governments may decide to adopt trade-decreasing commercial sanctions in view of creating a precedent and increasing the perceived costs of default for debtor governments (Bulow and Rogoff, 1989a,b). On the other hand, creditor governments may also refrain from adopting such sanctions as commercial restrictions can impair the debtor government's ability to repay bondholders in the context of a negotiated debt settlement (Hellwig, 1986).

In this paper, we show that international and domestic political economy considerations are key determinants of creditor countries' commercial policy response to sovereign debt defaults. We illustrate this argument using a unique historical case study: the German external debt default of the 1930s. Following the global financial crisis of 1931, Germany faced increasing difficulties in servicing its external debts to private bondholders culminating in a complete moratorium on external debts in June 1934. This led creditor countries to compete with each other for Germany's scarce foreign exchange resources. In this competitive struggle, creditor governments adopted different trade policies towards defaulting Germany which translated into different outcomes for their respective bondholders. We show that each creditor country's commercial response to the debt default (and the ensuing bondholders' outcome) depended on its degree of economic leverage on Germany as well as on the relative political influence of various interest groups within its domestic economy.

While it was officially in default, Germany entered joint commercial and debt settlement negotiations separately with each creditor nation. Figure 1 illustrates the outcomes 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 against US, Swiss and Dutch bondholders while treating UK and French creditors more favorably. As investors expected this selective default 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 1(a)). 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

[1] See Rose (2005) on aggregate trade, Martinez and Sandleris (2011) on bilateral trade, and Agronovsky and Trebesch (2009) on the debtor's exports.

and 1936, exports to the United Kingdom were maintained at the pre-default level (Figures 1(b) and 1(c)).



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

Figure 1: German trade and debt with creditor countries

Notes: Panel (a) reports the Dawes bond's price relative to par in various markets (see Accominotti et al. (2023) and Papadia and Schioppa (2020) 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).

To explain this observed pattern, we present a new historical narrative of the German debt default based on a wide range of archival sources from different countries. Central to the question of Germany's debt was the so-called "transfer problem": the German government's difficulties to raise 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. The German government's main objectives during those years was to obtain foreign exchange and raw materials in order to engage in rearmament. However, since Germany was not evenly dependent on the different countries for its access to foreign exchange and raw materials, the various creditors did not have equal leverage in the bilateral debt negotiations. These differences eventually opened the way to bilateral settlements and selective defaults. At the same time, the transfer problem gave the Nazi government considerable bargaining power in the debt settlement/commercial negotiations as it attempted to secure improved commercial conditions from creditor nations in exchange for the continued servicing of its external bonds.

How the various creditor countries' governments responded to such demands depended on domestic political economy considerations. Within each creditor country, the response to the German default was the object of a distributional struggle between bondholders, exporters, and the domestic-oriented agriculture/industry. While bondholders and export-oriented firms supported measures to improve German goods' access to the domestic market so as to allow the German government to generate export revenues and to purchase more goods and repay its foreign currency debts, such measures were clearly detrimental to the domestic agriculture/industry. Depending on the relative influence of these various groups in domestic politics, creditor countries' governments either engaged in commercial appeasement towards Germany (as in the United Kingdom and, later, France) or adopted coercive measures detrimental to German exports (as in Switzerland and the Netherlands).

Overall, while the sovereign debt literature generally considers the link between sovereign default and international trade under the prism of trade sanctions, this historical episode illustrates that the trade effect of sovereign debt defaults depends on complex political economy considerations at the international and domestic level. These factors vary across time and places and this probably explains why it has been so difficult for scholars to find any clear, generalized pattern in the data regarding the effect of sovereign defaults on international trade.

The remainder of the paper is organized as follows. Section 2 provides some general background on Germany's external debt problems, the transfer problem and bilateral trading relationships in the 1930s. Section 3 describes how the distributional struggles between creditor countries unfolded around the question of Germany's external debts. 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 in the 1930s

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 reparations bill of 132 billion gold marks (£6.6 billion) imposed on Germany by the Reparations Commission on 5 May 1921 soon proved politically impossible to implement.[2] Unable to raise taxes sufficiently, the German government used the printing press as a tool to finance the 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.[3] This resulted in the adoption of the so-called 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 gov-

[2]The practice of requiring reparations was commonly accepted at the time but the amounts asked led to heated debates, even among the victors (Oosterlinck, 2010).

[3]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 a help to float a bond to allow France to pay its dues; a combination that proved successful and foreshadowed the floating the Dawes bond.

ernment 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, held the responsibility of 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). According to Ritschl (2012), the transfer protection clause effectively involved that the service of private external debts had priority over the payments of reparations and therefore prompted foreign investors to lend massively to Germany.

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 massive decline in international capital flows following the beginning of the Great Depression in 1929. In addition, the Dawes Plan's transfer protection clause, which protected foreign private investments into Germany, was abolished, and this contributed to the capital flight from Germany in 1930-1931 (Ritschl, 2012).

2.2 The German financial crisis, exchange controls, and rise of bilateral clearing systems

The sudden halt in international capital flows of 1929-1931 soon jeopardized the servicing of Germany's external debt. In summer 1931, Germany 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 on 19 August 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. However, the capital controls adopted in 1931 did not immediately jeopardize the servicing of Germany's long-term debts. Despite the exchange restrictions, interest and amortization of these debts remained fully convertible for the time being (Frech, 2001).

The suspension of the reichsmark's convertibility in July 1931 also required centrally regulating Germany's international trade. Through an import licensing system, the German government allocated foreign exchange to German importing firms so as to allow them to make foreign currency payments to exporters. The allocation of these licenses depended on previous import volumes. However, while the German exchange control aimed to interfere "as little as possible with normal import trade" (United States Tariff Commission, 1942, p. 3), it paved the way for the introduction of more restrictive bilateral clearing systems. Under such systems, all payments between two given countries are orchestrated via governmental clearing offices established on both sides. Importing firms in a given country settle their purchases of goods from the other country by making a domestic currency payment to their clearing office. The proceeds are then used to settle the claims of domestic exporters as well as of other residents who have financial claims on the other country (Vannini, 1943). Clearing systems therefore allow circumventing the use of foreign exchange and maintaining bilateral trading relationships between countries even in the absence of a free foreign exchange market. In addition, they enable creditor countries to directly seize debtor countries' export revenues and allocate a portion of them to the servicing of their debts.

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 creditor country needs to run a bilateral current account deficit vis-à-vis its debtor in order to be in a position to pay domestic exporters while enforcing debt service at the same time. With the generalization of exchange controls in the 1930s, creditor countries that had an unfavorable current account balance towards their debtors therefore had a strong incentive to implement clearing systems in order to recoup their commercial or financial claims. 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).[4] 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).

At the same time, clearing systems were often introduced at the initiative of the creditor countries in view of collecting debts. Following the introduction of exchange controls by many Eastern European countries and Germany,

[4] The restrictiveness of these arrangements varied substantially, ranging from the "rigorous imposition of bilateralism" in the case of the German-Hungarian clearing to "non-compulsory" agreements that aimed to stimulate German exports (Ellis, 1941, p. 202f).

creditor countries sought to use clearing systems as a way to protect the interests of their domestic exporters and bondholders.[5] As Germany and other eastern European countries risked defaulting on their external debts in the 1930s, creditor countries' governments typically started by negotiating a debt settlement. However, in the absence of a compromise, they could threaten or actually impose a unilateral clearing as a form of retaliation against default (Vannini, 1943, p. 18). The efficacy of such a threat naturally depended on the creditor country's bargaining power towards the debtor in the negotiations.

2.3 The bilateralization of the transfer problem

One of the recurring challenges experienced by Germany in servicing its reparations and external debts during the 1920s and 1930s was the so-called "transfer problem." This refers to the fact that a debtor country able to collect the necessary tax revenues from domestic residents to service its external debts may nevertheless face difficulties in making these payments in foreign currency. 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."[6] In *The Economic Consequences of the Peace*, Keynes (1919) provided an influential analysis of the transfer problem, arguing that the export surpluses which Germany would need to run in order to generate the foreign currency revenues required to pay reparations would only be achievable through a considerable deterioration in its terms of trade, inevitably leading to price deflation and unemployment. 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 any adjustment in the debtor country's terms-of-trade. Indeed, in the years from 1924 to 1930, the transfer problem did not affect reparations payments. In fact, the German government was able to fulfill its obligations under the Dawes Plan while running a substantial trade *deficit* as inflows of private capital made up for the difference. These private capital inflows partly resulted from the terms of the Dawes plan, which gave private debts a senior status relative to reparations debts (Ritschl, 2002, 2012).

However, Germany's financial situation changed dramatically following the fall in global capital flows and 1931 financial crisis. While the Hoover moratorium of June 1931 and Lausanne agreement of June-July 1932 exonerated the German government from its reparations obligations, it still had to service its foreign currency debts to private investors, in particular those contracted under the Dawes and Young Loans. Hence, in the absence of international lending, Germany's ability to raise foreign exchange revenues to repay external bondholders hinged on its capacity to generate export

[5]For instance, Switzerland started concluding bilateral clearing agreements as early as 1931 (Vannini, 1943, p. 2-5).

[6]Dawes Committee Report, 9 April 1924, text reproduced in *New York Times*, "Dawes Committee Report in Full by Cable", 10 April 1924.

surpluses. The transfer problem therefore suddenly returned as a binding issue for Germany. However, instead of being an issue of Germany's ability to achieve overall trade surpluses, the problem of servicing external debts was now to be addressed at the bilateral level. The introduction of exchange controls and clearing systems involved that international payments were now increasingly handled on a bilateral basis. Thus, while analysts and stakeholders had pondered for years whether Germany would have a sufficiently large *aggregate* current account 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. This bilateralization of the transfer problem opened the way for creditor discrimination and selective debt defaults as separate debt and commercial settlements were reached with the different creditor countries.

3 The distributional struggle between creditor countries

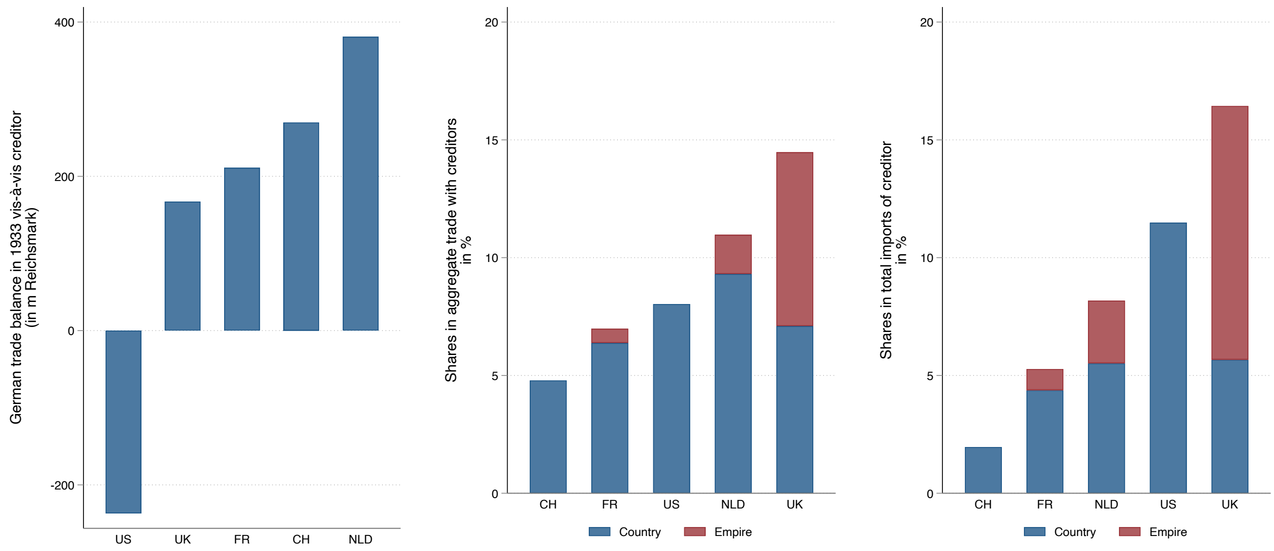
3.1 Creditor countries' leverage on Germany

What can account for creditor countries' diverging commercial policies towards Germany during the 1930s and for the differences in treatment between creditors? As the NSDAP came to power in January 1933, a default on German 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. While creditor countries could threaten to impose commercial sanctions 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). Therefore, not all creditor countries enjoyed equal leverage in the debt negotiations. 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 massive rearmament program (Ellis, 1941, p. 205). The German government therefore had stronger interest in preserving bilateral trading relationships with countries with which it ran export surpluses as they constituted sources of foreign currency income. Other things being equal, creditor countries that had a trade deficit with Germany were therefore in a more favorable bargaining position and could invoke the foreign exchange they supplied to the debtor government as an argument to request a priority claim for their bondholders.

The position of the various creditor countries varied greatly from that perspective. On the one hand, Germany was running export surpluses with all European creditor countries, and surpluses were especially large in absolute and

Figure 2: Germany's trade with creditor countries, 1933



(a) German trade balance towards creditors (b) Share of total trade with creditors (c) Share of total imports with creditors

Notes: Data are from Statistisches Reichsamt (1935).

relative terms with the Netherlands and Switzerland. On the other hand, Germany's bilateral trade balance with the United States was persistently in deficit and therefore a constant drain on its foreign exchange reserves (see Figure 2). This situation would provide a strong justification for discriminating against American bondholders in 1934.[7] In response to the US State Department's charge that the German government was discriminating against American bondholders just before Germany was ready to partially honor the October 1934 coupon payment on the Dawes Loan, 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 favourable trade balances with their countries."*[8]

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. 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

[7] 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 in view of 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.

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

producers, especially in Latin America, would not be an easy task.[9] 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."[10] 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 London 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 May 15, 1933, the Reichsbank informed its international creditors that the country's foreign exchange reserves had become so low that further orderly debt service would soon be impossible. The transfer problem resulting from the decline in global trade was explicitly invoked as the justification for opening debt settlement negotiations.[11] 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 access to Germany's foreign exchange reserves in order to repay its national bondholders.

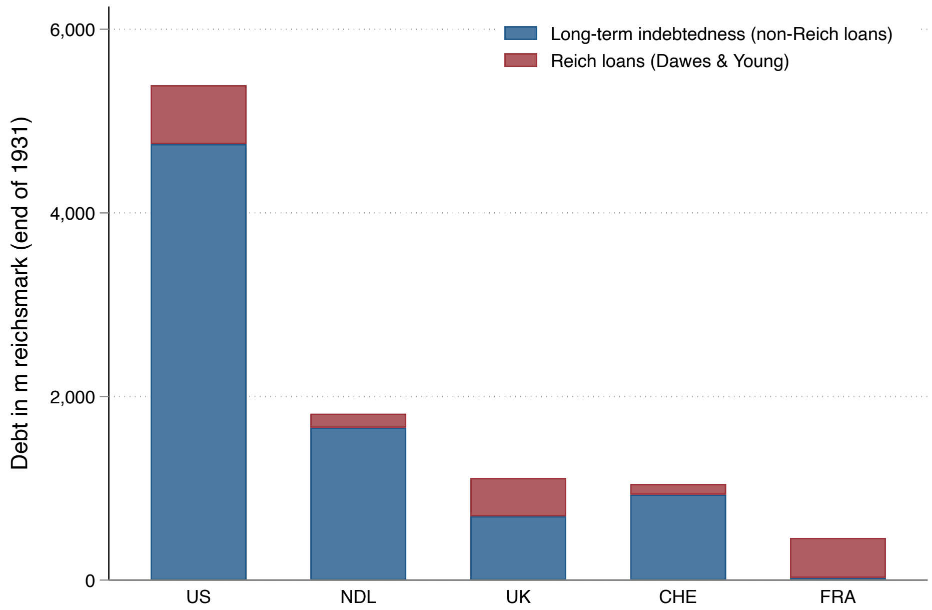
The UK government's main objective in these negotiations was to preserve the continuing service of Germany's central government bonds (the Dawes and Young bonds), which were held widely across the country, and to establish their seniority over the bonds issued by German provincial states, municipalities 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 to the Bank of England Governor Montagu Norman, BIS President Leon Fraser asked him to use his personal influence on 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 re-*

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

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

[11] 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 discussions 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.

Figure 3: Germany's long-term debt (end of 1931)



Notes: The figure reports Germany's long-term debt exclusive the Dawes loan in m reichsmark at the end of 1931. The numbers on total German indebtedness by country are 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). The data on the Dawes and Young bonds in circulation is from a (strictly confidential) publication by the German Office for Registering Debts ('Anmeldestelle für Auslandsschulden', BArch R2501.10007. The data refer to early 1934, but given the Standstill agreement the value should be close to that at the end of 1931. The pre-devaluation parities are applied to ensure comparability of the two datasets.

gards other German bonds."[12] 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 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 haircut for bondholders.[13]

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 2). However, while the arrangement was especially favorable to the UK and France whose share of Dawes and Young loans was the highest, no explicit

[12]Leon Fraser argued that such a 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 afterwards. 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).

[13]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).

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."*[14] 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.[15] 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 on Germany. This would constitute invitations to creditor groups and their governments to compete with each other in exerting such pressure."*[16] Thus, as a distributional struggle was launched between creditor countries to get priority claim on Germany's foreign exchange reserves, it appears that US bondholders were realizing that their bargaining position was especially weak.

In the following weeks, the principle of preferential treatment for not only Swiss but also Dutch bondholders with regards to non-central government bonds was enacted.[17] 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 private bonds held in the UK were small. UK authorities were not prepared to grant a tariff preference to German goods.[18] 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"*.[19] While

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

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

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

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

[18]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).

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

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%.[20] 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.[21] 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."*[22] 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.[23]

As the distributional struggle between creditor countries was intensifying in the winter and spring 1934, UK authorities were 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 favour 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 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 treat therefore a bluff: or if not that it might be a boomerang."*[26] Such

[20] 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).

[21] 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 a 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%.

[22] 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.

[23] The delegation from the United States attacked the agreements on the ground 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.

[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.

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 complete transfer moratorium on all long-term foreign liabilities 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 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 the 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

[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 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.

[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.)

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 paying 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 decision by the British and French governments attracted resentment in the United States. For example, JP Morgan's Thomas Lamont judged their actions *"inexcusable"* and criticized them *"for leaving America out on this end of the limb."*[38] Therefore, by the summer 1934, the competitive struggle between creditor countries that arose from Germany's transfer problem had reached its apex, opening the way for selective defaults on German external government debt.

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*

[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.

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 backfires 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 payments transactions would only be exercised on the German side. In addition Germany committed to spending specified shares of the foreign exchange revenue from 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 and the agreement also established a strong incentive to import more on the British side in order to satisfy the interest of exporters and bondholders. Indeed, in the years that followed the signature of the Anglo-German treaty, German exports to the United Kingdom increased considerably more than exports to other countries (see Figure 5(a)).

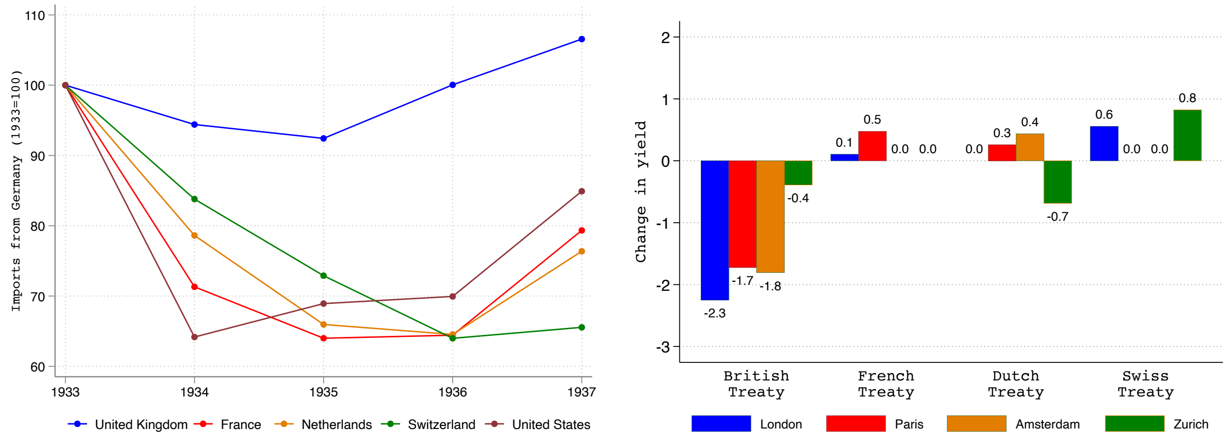
By contrast, the arrangements concluded with France, Switzerland and the Netherlands following the morato-

[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.

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

Figure 4: 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 current 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 the current yield 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).

rium 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 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 5(a)). Given the bilateralization of the transfer problem, the decline in 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 5(b) compares the reaction of the Dawes bond yield-to-maturity to the announcement of the treaties with each of the four main European creditor nations (UK, France, Netherlands and Switzerland). While bondholders reacted positively to the signature of the Anglo-German Payment Agreement which granted Germany significant trade concessions, they remained skeptical towards the other clearing treaties, even though all treaties guaranteed the full servicing of the Dawes bonds for the time being. The press also shared the market's skepticism. For example, 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 that *the regulations [introduced] … constitute barriers to international trade."*[42] A week later, the newspaper attributed the weak market reaction to the French-German treaty to bondhold-

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

ers' *"discouragement"* in view of the temporary nature and disappointing terms 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 Commercial sanctions and domestic politics

4.1 The commercial response to the German default in a political economy 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 5: Creditor governments' decision problem

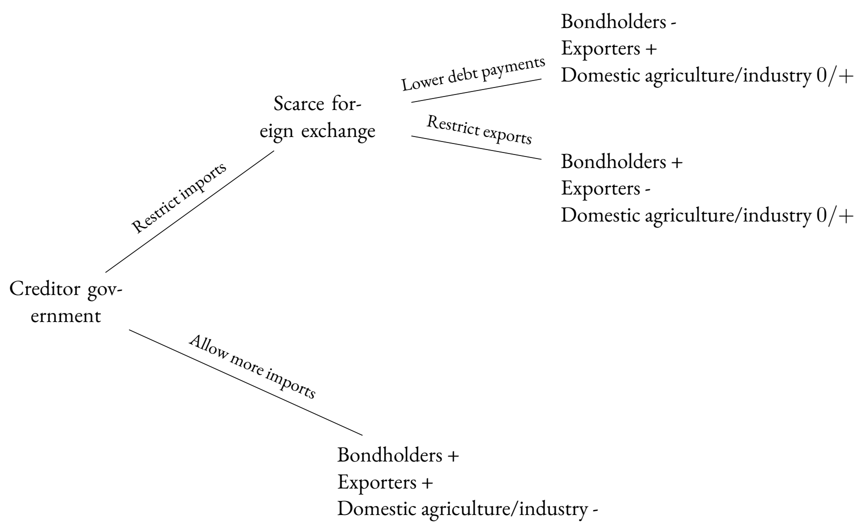


Figure 5 provides a theoretical representation of the options available to creditor countries' governments in response to the German external debt problem and of the implications of each option for the various domestic interest groups. We distinguish between three main interest groups lobbying the government: bondholders, exporters, and the domestic-oriented agriculture or industry. Each group will be impacted differently by their government's commercial

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

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

policy towards Germany. The 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 the 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 in order 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.[45]

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 5 suggests that such concessions were more likely to be granted if exporters and bondholders enjoyed relatively stronger leverage on the creditor government than the 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 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 various 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, 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[46], the British and French ones were more closely

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

[46] 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)

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 et al., 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"*.[47] 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.[48] By promoting German bonds among the 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.[49] The main motivation for the Swiss and Dutch governments to nevertheless participate in the issuance of the Dawes Loan was to maintain their financial centers' international prominence.[50] However, while Dawes

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

[48] See for Young bond for all three countries: BArch R2501.6743; for Dawes bond, see US (Costigliola, 1976, p. 495), UK ('The German Loan', *The Economist*, Oct. 18, 1924, p. 690), FR ('Die erste Reperationsanleihe', *Neue Zürcher Zeitung, 17. October 1924).* Schuker et al. (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 expresses his worry about a coupon reduction as many savers of modest means held German bonds (BArch R117.287).

[49] 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).

[50] 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)).

bond issues were oversubscribed in 1924,[51] 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.[52] Neither the Swiss nor the Dutch government appear 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.[53]

Bondholders' political influence also depended on the extent to which their interests were 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.[54] Yet, especially in the United States and 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 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 London City. For several 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).[55] 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 Commit-

[51] 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).

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

[53] 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).

[54] 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.

[55] 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.

tee of British Short-Term Creditors noted that *"the introduction of clearings reduces the favourable 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."*[56] British banks also constituted an important pressure group and were especially influential at the Bank of England (Einzig, 1941), 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 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."*[57]

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 bondholders and the administration simply acknowledged that it had little leverage to enforce debt collection given the US trade surplus with Germany (Schuker et al., 1988, p. 78). Whereas 24% of Swiss overall long-term claims on Germany were held by banks,[58] 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).[59] 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.

[56] 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."* In the event of the introduction of a clearing, Tiarks therefore suggested that *"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.

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

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

[59] 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).

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 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 is revealing of 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.[60] Labour Party MP Stafford Cripps also bemoaned that the UK government always put the interests of bodholders 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."*[61] Indeed, UK bondholders could benefit from protection at the highest level of state. 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."*[62]

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.[63] 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.[64] The interests of

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

[61] Statement by Sir S. Cripps, see 'Debts Clearing Offices And Import Restrictions Reprisals Bill', *Hansard (UK Parliament Archive)*, HC Deb 25 June 1934, vol 291 col 865.

[62] BArch R117.137

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

[64] The reassurance, that there was *"no desire to restrict exports"* was also made multiple times during the negotiations (for example, in a letter from

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.[65] 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."* 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.[66]

France France's strategy towards Germany in the summer 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, increased pressure from domestic exporters and bondholders alike pushed the French government to change 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 reduction in the interest of the Dawes and Young bonds under no circumstances.[67] 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.[68] Importers/exporters in both countries directly paid/were paid by these institutions in their own currency. In addition, 15.75 per cent of the daily value of French imports from Germany was to be credited to a special Reichsbank account with the Franco-German Office and used for the payment of the coupons of the Dawes and Young Loans.[69] 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.

Frederick Leith-Ross to the German delegate Berger (30 June 1934) outlining the British position just before conclusion of transfzer 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).

[65]See BArch R2.319.

[66]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.

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

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

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

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.[70] However, while French exports to Germany remained relatively stable, imports fell considerably and Germany's trade surplus diminished by 50% between 1933 and 1934.[71] Consequently, Germany started accumulating substantial clearing arrears with the Franco-German Office. The German government pondered an English-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 balances.[72] In late November 1934, the French government increased its quotas of imports of German goods in view of helping Germany to generate sufficient export revenues to service its debts.[73] 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 severely limit its exports to Germany in order to artificially turn Germany's bilateral trade balance into a (small) surplus and melt down the clearing arrears.[74] Through this decision, the French government effectively sacrificed the interests of the French export industry in order to safeguard those of holders of Dawes and Young bonds.

The French export industry paid the high price for this policy and French exports to Germany declined by almost 80% between February 1935 and February 1936.[75] The woolen industry must have been particularly due to its dependence on the German market.[76] In addition, despite the reduction in French exports, Germany's trade 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 clause as well as tariff and quota reductions and the clearing system was abolished.[78]

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[70]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)

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

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

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

[74]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.

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

[76]On the importance of the German market for the French woolen industry, 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.

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, a first clearing agreement was signed between Switzerland and Germany on July 26, 1934. The clearing system instored through 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 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 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 sectors over those of the bondholders and banks.[83] In this light, no substantial trade concessions were made to Germany.

[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.

[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.

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 1934, the Dutch government went as far as to impose a unilateral clearing in order to collect payment arrears and force Germany to negotiate a bilateral treaty (Harris, 1935, p. 66). In the words of a Dutch politician, the aim of this measure was 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 negotiations 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 in order to induce the German government to repay its external debts to US residents. Second, bondholders were lacking institutional and political embedding in order

[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. Dezember 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).

[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.

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, the US government 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 the domestic agriculture and industry. According to Schuker et al. (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 et al. (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 et al., 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 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.

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

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

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 the 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) negatively impacted the domestically-oriented industries and agriculture.

Table 1: Outcomes for domestic interest groups and Germany

Interest group	Creditor country						
	United Kingdom	France		Netherlands	Switzerland		United States
		pre-1937	post-1937		pre-1937	post-1937	
Creditor countries							
Financial investors	+	+	+	-	+/-	o/-	–
Exporting industries	+	–	+	+	+	+	+
Domestic industry/agriculture	-	o	-	o/-	+	+	+
Debtor country (Germany)							
Trade concessions granted	✓	–	✓	✓	–	–	–

Notes: Own representation based on the analysis in Section 4.3.

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 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 own exports to the debtor country in order to safeguard the bondholders' interests (as France did in 1935) and agreeing a reduction in debt payments to bondholders in order 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 of sovereign default: the German external default of the 1930s. We employ this case study to provide a rationale for why existing empirical studies of the effect of sovereign defaults on trade yield ambiguous results: creditor countries' trade policy responses to sovereign defaults are heterogeneous as they are shaped by both international and domestic political economy factors. In the 1930s, the various creditor countries' governments adopted markedly different commercial policy responses to the German default depending on their own economic leverage on the German government as well as on their degree of commitment to the interests of domestic bondholders versus other interest groups. Our paper suggests that theoretical and empirical studies of the relationship between sovereign debt defaults and international trade should incorporate such political economy considerations.

The theoretical literature on sovereign debt has highlighted that bondholders have limited means available to induce a sovereign to repay its debts but has emphasized how the threat of trade sanctions can nevertheless be a powerful tool to enforce sovereign debt contracts. Yet, while trade retaliation may be viewed as a means to force a defaulting government to join the negotiations table, such sanctions may also hamper its ability to generate revenues, especially foreign exchange revenues, needed to repay its debts. The negotiations that preceded and followed the German debt moratorium of June 1934 illustrate the ensuing dilemma faced by creditor countries in defining their commercial response to a default. In the 1930s, creditor countries alternated between threatening Germany of commercial sanctions and granting her trade support in order to facilitate the repayment of its external debt. In addition, the historical episode illustrates how a debtor government with foreign currency debts may use the transfer problem to its own advantage by extracting trade concessions from its creditors as well as by inciting them to compete with each other for its scarce foreign exchange resources. Creditor governments' response to such demands and their decision to support or not the defaulting government through accomodative commercial measures in turn depended on domestic political economy factors.

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 political economy of the commercial response to debt defaults in the creditor countries.

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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.

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