The International Debt Problem in the Interwar Period *

1. The history of international debt is the history of international finance. It is many centuries old and it is closely linked to international political history. The political element was seldom absent from international finance for the very simple reason that in many cases, and for a long time in the majority of cases, although creditors were mostly private financial houses, debtors were political authorities. The purely economic international loan incurred by the individual or firm in order to be used for productive purposes and dispensed by another firm in order to maximize profits, can be safely assigned to a minority shelf, with most episodes belonging either to the pre-1914 or post-1960 periods of world history.

The inter-war period is perhaps the high-noon of politicized international finance. The variety of cases of political and economic interaction in the field of international debt is so great that one can be sure he can find in that period a precedent for whatever case of politicized international economics he is studying.

The years that follow the First World War could be read, for what international financial and monetary affairs are concerned, in the light of continuity with the pre-1914 period. The substitution of British hegemony with American hegemony in the world economy was taking shape in the decade before the war. The International gold standard was a fast degenerating international monetary regime before the war destroyed it. The European major powers had already managed to make their disturbing presence felt in the previously British-dominated world financial market.

The international telegraph had already been introduced and transcontinental cables had been a reality for several decades. Financial

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* This paper was written while the author was a member of The Institute for Advanced Study, Princeton and presented at a Study Group on International Debt of the Lehrman Institute, New York.

markets had moved fast into a new bank-dominated structure in most countries, and direct financing had begun to replace the bill on London.

All these trends continued after the war. But the pace of movement increased and quantitative changes along the lines I have mentioned were so large after the war that quantity definitely became quality.

Moreover, for what concerns the art of government, the First World War marked a transition to a type of generalized control and of mass politics which was not present before and which was to characterize the age that followed, in which we live. What was defined as war-time controls, war-time political mobilization, by a public opinion which hoped they would recede and even disappear after the end of hostilities, was to become the mark of every day life in the following decades.

Referring ourselves back to mercantilism would be no help, if we try to understand the transformation of the art of government during and after the First World War. Governments had never abandoned mercantilism. As the National Monetary Commission found, perhaps to its surprise, when asking the directors of the Bank of England on the operation of Bank Rate Mechanism, those supposed upholders of the highest form of laissez-faire raised bank rate when reserves fell but did not lower it when they rose. They were, like every other monetary authority of the day, convinced believers in the Bagehot opinion that money would not manage itself.[1]

Still, proving the mercantilist spirit of even the high priests of English laissez-faire does not mean that the level of regimentation and control introduced by countries to fight total war was in any way comparable to what had been experienced before. And mobilizing the masses to fight total war proved such a successful experiment that politicians found it impossible to revert to the easy world of pre-war parliamentary usage. A new rationality in political policy-making and economic policy-making began to emerge, which would dismay Keynes, one of its earliest chroniclers, but would not go away even after he exorcized it in the fulminations of "The Economic Consequences of Peace".[2]

[1] See *U.S. Monetary Commission: Interviews on Banking*, Publications of the N.M.C.I., Washington, 1910, p. 26.

[2] Keynes's own candor, however, has been seriously doubted by S. SCHUCKER, who has done extensive archival research in Germany. See his review of Keynes's works in *Journal of Economic Literature*, 1980.

2. It was, in fact, with the reparations to be exacted from the vanquished nations and in particular from Germany, that the stage of inter-war international finance was set. This is a basic element that must never be forgotten. In the whole period, international financial transactions, even those involving countries not in the least involved with reparations, were powerfully influenced by the reparation problem. Reparations set the agenda for the next twenty years, and gave the whole period the character of high politization, precarious balance, or open crisis which students of international finance invariably detect and remark upon.

Before the First World War individuals, firms and governments had defaulted on their debts. They had done so quite often, leaving their domestic or international creditors in the lurch. But debts had never been considered deprived of legal or moral legitimacy. After the 1870 defeat, the French had paid the huge sum imposed by the victorious Prussians.[3] They now expected the Germans would do the same. Recent evidence unearthed in German archives, however, proves that the Germans did not consider their reparations obligations as sanctioned by legal legitimacy for a variety of reasons, and that several among the Allies, in particular the British and above all the Americans, shared their conviction, and saw reparations as a big public relations exercise to convince public opinion in the victorious countries that the conclusion of an armistice with Germany did not mean millions of people had fought and died for nothing. The Germans entered, as a result, a heavy financial obligation with the profound conviction that they would not be held to it by the other side. And some of their creditors shared their view, partially or totally. As was patronizingly indicated by "well informed circles" when Keynes' book came out and took the world by storm, the poor economist was taking the issue too seriously. The Germans, of course, would not be asked to pay the exorbitant sums specified at Versailles. It was all necessary to rally public opinion around the Peace Treaty.[4]

Taking the devil out of the bottle, however, proved to be much easier than putting it back into it. Once the sums specified in the

[3] On French reparations to Germany after the Franco-German War of 1870, see the careful compilation made by C.P. KINDLEBERGER in his *Financial History of Europe*, London, 1984.

[4] On the German attitude to reparations, see KEYNES's, *Collected Writings*, Vol. XVII, Activities 1920-22, London, 1977 and S. SCHUCKER, *The End of French Predominance in Europe*, Chapel Hill, 1976. Also E.W. BENNETT, *Germany and the Diplomacy of Financial Crisis*, Cambridge, Mass., 1972.

Peace Treaty were totalled up, they began to be counted upon to offset the huge debts the allies had incurred to fight the war. These were real debts, sanctioned by traditional legal procedures, and Britain and the United States let it be clearly known they expected them to be repaid.

It is very difficult not to understand the bitter feelings the asymmetrical behaviour of Britain and the United States aroused in countries like France and Italy. They were asked to honor their war debts while at the same time a deal seemed to have been concluded over their heads by Britain and the U.S. to consider the German reparations as unrealistic and exhorbitant. The fact, which Keynes pointed out so eloquently, that Germany would be potentially unable to honor reparations, could only contribute to inflame French and Italian opinion further as the possibility to offset their own debts was shown to have existed only on the parchment of the Peace Treaty.

The reparation issue thus introduced into post-war international finance a strong element of illegality which had not existed before 1916. It introduced, mainly because of the ill-considered actions of Woodrow Wilson and David Lloyd George, the legitimacy of repudiation and default as a means of legitimate international economic policy-making. Countries had defaulted before, but the reparation issue introduced the feeling that default on foreign loans had become a legitimate instrument of the art of government.

This is not the place to inquire why the English and American statesmen opened this Pandora's box. Arno Mayer has convincingly written that they did so in an attempt to roll back or at least contain, the Soviet Revolution.[5] What is relevant for our purposes is the legimitation of financial illegality and irresponsibility it induced.

Saddled with the objectively exorbitant sums the Peace Treaty obliged them to pay, the German political and economic authorities, who had been led to believe they would not be called upon to honor them, responded by flooding Europe with an avalanche of Mark-notes, which the credulous European middle classes, still convinced that the Mark would be stabilized at its pre-war level, happily accepted in payment for goods and services or against other currencies. This behavior is not often stigmatized in works on the subject of inter-war international finance, while much space is dedicated to the "irresponsibility" of the French monetary authorities, who responded in kind by maneuvering their foreign exchange balances between the various

[5] See, ARNO MAYER's classic, *Politics and Diplomacy of Peace Making*, New York, 1967.

financial centers to further French foreign policy objectives, instead of cooperating with the supposedly "apolitical" actions of the British and American monetary authorities.[6].

Nor has the idea that the great German inflation was a deliberate policy strategy completely conquered the economic historians of this period, although enough abundant archival evidence has been found to validate it. Its sudden stop, however, and the equally sudden restoration of monetary order which followed, ought to have showed economists the light a long time ago.

3. In spite of Arno Mayer's interpretation of British and America's motives with reference to the armistice and the Peace Treaty, one of the most glaring differences between the inter-war period and the decades following the Second World War is the non-existence, in the inter-war years, of an all encompassing military alliance against a perceived enemy, like the post-war NATO alliance. In the inter-war years, as the German behavior with respect to reparations and inflation, abetted by some of the allies, legitimized international illegality, the Western countries began to consider international financial policy as an extension of foreign policy in a way they had not done before, and the scope of the policy would be "à tout azimut" to repeat an expression coined by General de Gaulle's strategists. This has not happened after the Second World War. The existence of the NATO alliance has firmly prevented the Western countries from contemplating and realizing policies, with respect to international finance, which would be inspired by the logic of zero-sum games, of static power redistribution. This is perhaps too marked a distinction, as some policies, like the French policies with respect to gold, the U.S. unpegging of the dollar in 1971, Japan's hurried disposal of huge dollar reserves soon after, could be considered as being inspired by a non-cooperative zero-sum games philosophy. More examples could be provided. However, the fact of being all in the same strategic camp has meant that, on the whole, Western countries have behaved in a basically cooperative fashion for what concerns the maintenance of some semblance of international financial order. The same cannot be said of the behavior of the same countries in the inter-war period. Real-politik of the most traditional type seems to have triumphed in the international financial relations of

[6] The best known vindication of French motives is ETIENNE MANTOUX, *The Carthaginian Peace*, New York, 1952. See also, S. SCHUCKER, *op. cit.*

those two decades, and to have informed even some episodes which could be interpreted as attempts at cooperative behavior. The return on the part of the major countries, followed by a large number of other ones, to the gold standard, is one of these episodes.

If we look at the chain of events which led to the British return to the gold standard, we can derive from it the superficial conclusion that a high level of cooperation among British and American central bankers rendered the British return to gold possible. But the wealth of research that this episode has elicited does not allow us to reach that conclusion. On the contrary, the return to gold can be seen as an important British defeat in the open fight for international financial supremacy American financiers and politicians (who have rarely again formed such a homogenous bloc as they did in the 1920s) engaged during and after the First World War.[7]

Britain's postwar policy objective after the end of hostilities had been to extend the pre-war transformation of the international gold standard into a gold exchange standard. And, under heavy British pressure, the Genoa Conference, in 1922, was concluded with such a recommendation. The philosophy which inspired the British policy stance was clear. Even in the last decade before the war, the Bank of England had experienced a continuous pressure on its gold reserve, and the matter of reserves had become an extremely divisive issue in British financial circles. I have shown elsewhere how Britain's giant banks had threatened to go their own way and establish a cooperative gold fund, separate from the Bank of England's reserve, which they considered far too low to support the huge pyramid of credit centered on London.[8] Stop gap measures to solve the problem had been found, in the last pre-war decade, by using India's export surplus. Rather than being transformed into gold, the latter was held in sterling balances, earning an interest. In his book on Indian currency and finance, Keynes had theorized this temporary expedient into a new international monetary system, and hailed it as the way of the future. But a major weakness of the "new system" had not escaped the attention of an early reviewer of Keynes's book, Gustavo del Vecchio. He had noticed that the pre-war experience with the gold exchange standard had involved colonial territories, not sovereign countries, and that the possibility of political

[7] See FRANK COSTIGLIOLA, "Anglo-American Financial Rivalry in the 1920s", in *Journal of Economic History*, 1977. Also the relevant parts in KINDLEBERGER, *op. cit.*, for further references.

[8] MARCELLO DE CECCO, *Money and Empire*, St. Martin's Press, 1984.

management of the foreign exchange balances had not been available, but that it would be once the system was extended to sovereign countries.[9]

Events in the 1920s were to prove Del Vecchio's *clairvoyance* only too accurately. It would be, however, too superficial to think that the British had not adverted to the danger. Theirs was a policy of despair, as they knew a pure gold standard could not be managed from London. The Bank of England had never controlled the international gold market by the power of a formally owned stock. It had controlled it through the management of South African gold supplies and by compelling the India office to invest the Indian trade surplus in sterling balances. After the war those two instruments were both gone. As it would be unthinkable that the Bank could build up a sufficient buffer stock of gold, keeping a free gold market in London was clearly impossible, while it would be quite possible that the United States, who had ended the war with a huge gold stock, would succeed London as manager of the gold standard, and that the dollar would replace sterling as the world's premier store of value currency.

Inherent in the British reasoning was, of course, a marked pessimism on the functioning of bank rate as an international monetary policy instrument. This went against the conclusions of the Cunliffe Committee, but not against the considerations the Cunliffe Committee had made on how bank rate operated. It was exactly because bank rate was seen by the committee as operating through employment and output changes that the British authorities attempted not to go back to a gold standard where the slimness of the Bank of England's reserve would involve a semi-permanent deflation of the British economy through punitive bank rate levels. They thus tried the gold exchange standard card as a last resort. While the Conference of Genoa resolved to recommend the gold exchange standard and the main European countries went along with it, the United States, who was on the gold standard since 1919, embarked upon a policy to extend that system to as many countries as possible. Through the unofficial good works of Edwin Kemmerer, the "Princeton Money Doctor", the gold standard was adopted by several Latin American countries. But the really crucial victory was obtained when, upon Kemmerer's advice, the Union of South Africa rejected sterling and adopted the gold standard.[10]

[9] GUSTAVO DEL VECCHIO's review of Keynes's book is in *Giornale degli Economisti*, 1914.

[10] Although South Africa went officially on the Gold Standard *after* Britain, E. Kemmerer and G. Vissering submitted a report commissioned by the Hertzog Government, advocating South

After that England had no choice but to play the game according to the new rules. It was the only chance she had not to decline to second rank financial power. Given her social structure, and the structure of her foreign trade, the possibility that Britain would not follow the course she did was never really there. As to the parity, it is quite reasonable that Britain's authorities had foremost in their minds the fact that a lower parity would mean that the world's banker would be partially defaulting on its sterling debts. And that would certainly be seen as another plus in favor of New York and of dollar-dominated international transactions.

Once we become convinced that Britain and the United States were fighting for the same cake, the international financial history of the inter-war period becomes much easier to understand. The fatal mistake is to interpret it with the values of the 1950s or 1960s. We must realize that the inter-war years, and in particular the 1920s, were the period when the transition from the sterling standard to the dollar standard was made. And it was not an abdication but a fight to the finish, with no holds barred, which involved all levels of political activity and probably contributed in a substantial way to plunge the world into the Great Depression.

4. The history of international debts in the inter-war period, now that the backdrop of international finance is in place, can be seen as an important part in the transition from a sterling-dominated to a dollar-dominated international finance.

We have already commented on reparations, the most blatantly politicized part of the inter-war international finance. It is now time to deal with the other most important episode of inter-war international finance, the huge flood of American investments which invaded the world in the 1920s and abruptly receded at the end of the decade.

The surge of American international investment, and of international loans in particular, is a phenomenon usually approached by focusing on the demand side of it. Students of the problem have thus focused on the borrowers, who they were, what they did with the money, why they defaulted. This is in accordance with recent monetary theory, which tends to analyze the demand for money much more than the conditions attendant upon its supply.

Africa's return to gold on January 8, 1925. This crucial episode is well treated in B.R. DALGAARD, *South Africa's Impact on Britain's Return to Gold*, New York, 1981. It is also dealt with in COSTIGLIOLA, *op. cit.*

But the surge of American foreign lending was so abrupt, so undiscriminating, so well circumscribed in time that it is impossible not to switch the analytical focus from the debtors to the lenders. An inquiry into the census of American foreign lending is rendered easier by the recent output of research on the American credit market in the inter-war years.

In order to dispel any lingering doubts that focusing on American foreign lending might be biased and exaggerated it is useful to analyze the relative size of the phenomenon. Before the First World War, although France and Germany, and more recently the United States, had been engaged in international lending, international bond flotations had been an activity centered in the City of London and performed in sterling. It had been performed through underwriting and issuing houses which were autonomous from the great English clearing banks. Experience in the issue of foreign bonds had been accumulated by the leading English merchant banks in the course of more than a century. Foreign bond issues had come in great spates, in cycles crowned by booms and busts. After the Baring crisis, however, the foreign bond market had grown to a size which would not be regained after the war. The amount of money annually accruing to Britain in the form of interest and the total new foreign capital issues as a percentage of British domestic investment would never be equalled again.

Though the apolitical nature of pre-war British foreign lending has been somewhat exaggerated, it is still true that, by comparison with French and German pre-war lending, British lending was motivated by and large by private profit maximization, and that very few overt and even covert strings were attached to it, even for what concerns the tying of lending to purchases of British-made capital goods. In fact, it can be said that in order to maintain its foreign lending activities on the massive scale they had reached, the City was able to impose upon the rest of the country a monetary policy of semi-permanent deflation, which had, already before the war, seriously undermined Britain's status as a first class international producer and exporter. Preference for higher yielding foreign bonds on the part of British finance and the British public had gone to the detriment of capital intensive modern industry, so that Britain was, by 1914, seriously lagging behind Germany and the United States in the modern sectors of industry, where the "second industrial revolution" was taking place.

After the war, with the disappearance of the captive Indian trade surplus, with the "liberation" of the South African monetary system,

and the liquidation of British foreign assets to pay for the war effort, it was evident that London's role in international lending would be seriously impaired. As to Germany and France, an even more pessimistic forecast could be made about their ability to reacquire their pre-war positions in international lending.

Those who have focused on the demand side of the foreign lending problem have, therefore, been partially justified in explaining the surge of American lending by the pressure of the whole world demand for credit on the U.S. financial system. Having amassed huge gold reserves, and in the forced absence of traditional pre-war lenders, it seemed inevitable that the U.S. would step into this activity, so to speak, by general request.

It would be simplistic, however, to hold such an automatic, deterministic, view of the international adjustment process. After all, when in the 1970s the OPEC countries were suddenly transformed into the world's largest savers, this did not magically transform them into the world's bankers. Bankers and financiers are, after all, called financial intermediaries because they work with their capital but especially with other people's capital. Had the United States, as was the case with the OPEC countries, not possessed a financial system that could rise to the challenge, inter-war financial history would have been written in a very different way. In addition, the fact that Britain's circumstances had been drastically reduced by the war did not mean that the huge apparatus of the City of London had been destroyed. On the contrary, it was still there, ready, like any other industrial sector which has not seen its capacity reduced, to regain its former output levels. The fight was therefore between London, which had the capacity, and New York, which had the "raw material" and was confident it could also build up its productive capacity.

A very important favorable element on New York's side was represented by the world's permanent hunger for dollars, which had developed in the war years. The United States had, in those five years, become the world's emporium. It had supplied belligerent as well as neutral countries with primary commodities, intermediate products and manufactures. Many primary producers like the Latin American countries and manufacture exporters like Japan had also shared in the bonanza, but only the U.S. was self-sufficient in raw-materials *and* manufactures. As had been the case with Britain in the first half of the nineteenth century, the United States had become everybody's supplier. A great "dollar gap" had thus developed, making the dollar the most

sought after currency in the world. The dollar having risen to challenge sterling as the most important trading currency, it was up to the American credit system to facilitate its international use. The task was to intermediate between American savers who had profited from the war bonanza and foreign borrowers who needed finance for the most various purposes.

Here again a comparison with nineteenth-century Britain is useful. The great British foreign lending experience crucially depended on the rise of the Victorian middle class. Although British issuing houses sold bonds to a great number of foreign savers, it is undoubted that the bulk of their sales went to British savers. It was therefore a largely *domestic* market.

The situation was very similar in the United States after the war. The potential ultimate lenders were American middle class families, who would reckon their lending in their own national currency. Again, it was a *domestic* market with foreign borrowers.[11]

Still, if anybody in 1913 had ventured to offer a scenario where the U.S. financial system would replace London as the main intermediary in the issue of foreign bonds, he would have been greeted with disbelief. And the disbelief would have been well founded, on a static view of the "technology" of international finance. New York had none of the facilities which constituted the pre-war network of production of international financial assets and liabilities. It was utterly dependent on London for the finance of American foreign trade. It had no issuing houses, no commodities markets, no practice with bills of exchange. It did not even have a central bank. And the law did not allow American banks to establish branches abroad.

But all this reasoning assumed a "static" technology for the "production" of foreign bonds. The secret of the large New York banks' astonishing success in floating huge amounts of foreign bonds is that they treated them exactly as if they had been domestic bonds.

But, granted that this was so, the traditional "technology" postulated an international financial center, whose main features recalled more a mercantile past than an industrial future. The City of London was, and still to a surprising extent is, a financial bazaar, even physically resemblant of one in Lloyd's or in the Commodities Exchanges, and almost completely based on specialization and pluralism, and united by the pervasive class homogeneity a pluricentennial continuous inter-

[11] For an inquiry on who were the ultimate lenders of foreign dollar bonds, see, D.E. MORROW, "Who Buys Foreign Bonds?", *Foreign Affairs*, Jan. 1927.

change had permitted. The New York banks' success in managing the huge inter-war foreign lending depended fundamentally on their refusal to ape London. The British example had been forced upon them by the Gold Standard Act of 1900 and by the Federal Reserve Act of 1913. The latter, in particular, had as one of its fundamental propositions that a money market ought to be built on British-type bills of exchange. This never happened. Bills of exchange had been on the retreat as an instrument of domestic finance even in England. What the New York large banks marched decisively towards was the concept of the Universal Bank or, in the local banks jargon, the "financial supermarket".

In fact, what the New York banks did was to cut through the whole structure of British type finance, to intermediate, in only one step, between the ultimate lenders and the ultimate borrowers.

Thus, they extended the potential foreign bond markets lending clientele by substituting a non-existent international financial center, which could not be created in New York in the short-run, with a firm-based structure to link demand and supply. In the language of Oliver Williamson, they used hierarchies rather than markets in the sale of foreign bonds as well as other international, and domestic financial activities.[12]

Substantial help in this activity came to them from their recent experience as salesmen of American government war bonds. It is in fact quite possible that the organizational structure they had built for this purpose was the same they used to reserve foreign bonds. And it has been suggested that foreign bonds were the logical follow-up of the government bonds activity, as they would increase the productivity of an otherwise half-employed sales force, after government bonds issues dried up.[13]

For the banks, foreign bonds issues were also a profitable business. This was highlighted in an early book by Robert Kuczynski.[14] But the availability of a sales force, well-tried by government bonds sales,

[12] On the micro and macroeconomic reasons for the U.S. large banks' ability to expand their international operations in the inter-war period, much can be learned from EUGENE N. WHITE's excellent book, *The Regulation and Reform of the American Banking System*, 1900-1929, Princeton, 1981. I have had the privilege of also seeing WHITE's unpublished paper "Banking Innovation in the 1920s," which he presented at the Business History Conference at Hartford, in March, 1984. White's findings coincide with those of THOMAS HUERTAS and H. VAN B. CLEVELAND, whose *History of City Bank* I have been fortunate to read in its pre-publication edition.

[13] This view is confirmed by White and Huertas-Cleveland. It was also advanced by WILLIAM A. BROWN in *The International Gold Standard*, NBER, Princeton, 1943.

[14] R. KUCZYNSKI, *Bankers' Profits from German Loans*, Washington, 1932.

and the high profits to be reaped in foreign bonds sales would not be enough to explain the incredible fervor with which the large New York banks solicited new issues from all kinds of prospective foreign borrowers and sold them to American middle class savers. A good part of the explanation for that fervor must be found in the dearth of alternative sectors of activity open to the large New York banks in the 1920s. It has been authoritatively suggested that in the 1920s a profound revolution took place in American corporate finance. Firms experienced a new abundance of funds and began a massive practice of trade credit and discount sales. New equity issues were preferred to bank loans.[15]

The large New York banks, which had relied on wholesale banking also expected a rapid falling-off of correspondent balances, which had flourished under the pre-war national banking system. They had been held responsible for the crisis of 1907, as they were considered the main element of the American banking system's structural instability. The Federal Reserve Act had devised a new system under which banks would keep their reserves at Federal Reserve Banks, rather than in the form of balances at money center's banks.

For these reasons, the New York large banks foresaw a series of lean years in wholesale and industrial banking, and jumped on the new bandwagon of retail banking. They were, as I said above, induced to do so by the rise of the American middle class, and by the financial affluence which went with it. These new financially affluent people had recently acquired savings which they had to dispose of. The banks began by selling them war bonds. After those dried out, they offered them foreign bonds.

The potential market proved to be so large, and so eager, that the banks had actually to solicit loans from all kinds of foreign borrowers. The image of American banks' representatives sitting at the doorstep of public authorities all over the world, waiting to be received to offer them loans, has been evoked so often that it is not necessary to do it again. It is perhaps a worn, but still a realistic image. It was a phenomenon that had not happened before, and would not happen again for another fifty years.

An equally worn, and still realistic image is that evoked in the Hearings on the Sales of Foreign Securities Inquiry the Congress of the United States set up in the wake of the disastrous defaults of a great

[15] This view is based on WHITE and HUERTAS-CLEVELAND, *op. cit.*.

number of those bonds.[16] It is the image of embezzlement and graft which these huge sums of money, so liberally disbursed, had caused in the receiving countries, and of the wasteful purposes to which much of the money had been offered. Again, the phenomenon had not been known to have occurred on such a scale before, and it would take another 50 years before it would occur again.

What was the political aspect of this story, which seems to have been unfolding so far at the sign of profit maximization and extension of the size of the financial retail market?

It is perhaps worth noting, first of all, that the dynamic behavior of the large New York banks could have not been sustained for so long had the Federal Reserve Act not lowered substantially the reserve requirements of the U.S. banking system.

And the promotion of foreign loans would have been very difficult had the U.S. authorities not actively fostered the return, on the part of a large number of countries, to convertibility under the gold standard.

Finally, the U.S. authorities, perhaps unwillingly, helped to allay the American savers' fears of lending to unknown foreign borrowers by vetting *all* foreign bonds issues in the United States through a specially constructed section of the Department of State. The fact that this vetting *only* concerned the *political* appropriateness of the proposed loans was not widely publicized, and the State Department's approval was quite naturally seen as extending to the financial qualities of the transaction.[17]

It is easy to see how some of the reasons that help to explain the U.S. banks' astonishing success in peddling foreign loans to the American public were also the reasons for the early and disastrous demise of the experiment.

The U.S. banks were behaving as if they were concerned with purely domestic operations and were pushed to excesses by the competitive structure of the banking industry in the 1920s and the lack of alternative investments. In the frenzied atmosphere of the American 1920s, it is very easy, and very appealing, to apply George Akerlof's

[16] The competitive excesses of U.S. banks in pushing loans on to foreign governments local authorities and corporations, and the often wasteful utilization of the proceeds, are well described in the *Hearings before the Committee on Finance, Sales of Foreign Securities*, U.S. Senate, 72nd Congress, pursuant Res. no. 19, Government Printing Office, Washington, 1932.

[17] This was brought out forcefully by several of the witnesses called before the aforementioned Senate Committee. The State Department's role is also analyzed in J. MADDEN, M. NADLER, H. SAUVAIN, *America's Experience as a Creditor Nation*, New York, 1937.

theory of asymmetrical information to the foreign bonds market.[18] The banks had very imperfect knowledge of the borrowers' financial conditions. The ultimate lenders had almost no knowledge of the borrowers' financial conditions. They trusted the banks and the State Department. In such a situation it would have been essential that no defaults be allowed to occur, because the finding of one "lemon" would have caused the whole market to contract disastrously. But the competitive structure of the American banking industry in the 1920s did not make this type of cooperative behavior possible. Had the large banks colluded, they definitely would have not been able to build up such a huge operation in such a short time.

For the same reasons it would have been impossible for the large banks not to shift their competitive race to the Stock Exchange. When the Wall Street boom began, the banks started to promote the retail sales of common stock to the same people to whom they had sold foreign bonds hitherto. But the attraction of American shares was much greater, as the new middle class could see its paper profits grow at a pace which was not thinkable with foreign bonds.

The disastrous end of the great foreign bond adventure thus came when the American public changed the mix of its portfolio, away from bonds and into shares. This would have not necessarily meant trouble had the great majority of foreign borrowers not been pushed by the U.S. banks' dynamic behavior, into a state of indebtedness where new loans were needed just to service the old ones.[19] Since new money was not forthcoming, defaults were inevitable. And, inevitably they occurred. It has been maintained, with satisfactory evidence, that, since foreign loans prices and interest rates reflected some widely respected index of risk, ultimate lenders had been warned, by the customary means, that they were running higher risks than they would be if they had stuck to

[18] See, GEORGE AKERLOF, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," in *Quarterly Journal of Economics*, 1970. In their paper, "The Political Economy of International Lending," presented at the CATO Conference on "World Debt and Monetary Order," P. DE GRAUVE and M. FRATIANNI also use Akerlof's paper, but rather differently from the way I do here.

[19] However, this system had been praised as late as 1928 by George P. Auld, Accountant General of the Reparation Commission, with the following words: "The dollar exchange created by the new loans takes care of the old loans and finances new American exports... This expansion, the English tell us, is dangerous to the U.S. But I have yet to hear any sensible reason advanced why it is dangerous and why it cannot go on indefinitely to levels scarcely yet dreamed of... So long as the debtor countries have no export surplus, they will be in the market for new foreign loans, and the debts will be paid by new loans." See G.P. AULD, *The Mythical Transfer Problem*, The National Foreign Trade Council, N.Y., 1928, p. 13. Quoted by MADDEN, NADLER, SAUVAIN, *op. cit.*, p. 169.

U.S. government paper.[20] However, the spread between the riskiest and the safest loans was not very large. And it is not clear how an interest rate differential would represent a differential *default* risk. It would, if it represented anything, represent a differential *illiquidity* risk.

If the differential interest rates represent only an illiquidity risk, the borrower has insufficient information about the possibility of default. Against his natural reactions when one default occurs and he tries to protect himself by dumping all sorts of foreign bonds, banks should provide by not letting defaults occur or by providing for the security of borrowers with some mutual assistance scheme. If they did, central banks could be drafted to run such schemes.

Nothing of the sort was done in the late 1920s. The large banks did not realize what could be the reactions of a public they had initiated to foreign bonds and quoted shares when the possibility of default, with consequent write-off for the loans, or of precipitous fall, with equally ruinous losses for the shares, became realistic.

As I said above, however, the conditions which permitted the meteoric rise of foreign bond sales in America were the same which caused their sudden and precipitous fall. When the foreign bond market dried up in the U.S., as the public switched to Wall Street, U.S. large banks tried to keep their main borrowers afloat by short-term loans. This was particularly true of Germany, which was also by far the main borrower in the U.S. But very little could be done to stem the outflow. Matters were made much worse by American monetary policy. High interest rates in the U.S. for the whole of 1928 and 1929 caused the amassing of huge foreign balances in New York, mostly at short term. The fear that those balances might be withdrawn induced the authorities to push rates even higher and this finally killed the already tottering stock exchange boom and ushered in the Depression.

This is not the place to revive the old debate about who was responsible for the Depression. Some lessons however, can be drawn from the international debt experience of the inter-war years. First I would remark on the destructiveness of non-cooperative behavior among the Western countries. Once the fatal mistakes of the Peace Treaty had been made and the Wartime Alliance had been dissolved, international financial policy became indissolubly linked to foreign policy. It was then too late to promote real cooperation, and what goes

[20] See HUERTAS and CLEVELAND, *op. cit.*

under the name of "Central Bank Cooperation" in the 1920s should not delude us into believing that it was anything like what goes under the same name in the post-1945 world.[21] Central bankers met with one another in the spirit of camaraderie which is typical of people performing the same functions, but the same could be said of the officers who had been killing one another in the First, and would do the same in the Second World War. It was, after all, the Soviet Army which trained and re-equipped the German Army in the inter-war period.

A second consideration worth making is that there is a marked difference between the default of Germany and that of other peripheral borrowers, like the South American countries.

Germany's default was brought about by the drying up of American long-term lending much less than by the impossibility of maintaining the gold standard in spite of massive destabilising short-term capital movements. J.M. Keynes and H.D. White were then right when they attributed to short term capital movements the role of Chief Villain in the inter-war international monetary play, and tried to exorcise them in the post-war international monetary order they designed.[22]

The German stand-still agreements were thus the consequence of the speculative excesses of short term finance. Peripheral countries, on the contrary, defaulted when international trade contracted as ruinously as it did after 1929 and their exports accordingly precipitated to depths which could not possibly allow them to service, let alone repay, their debt.

It is equally important to note that, by its skillful manipulation of the debt problem, Germany managed, in the 1930s, to repudiate most of the debt and even to build on blocked balances a network of bilateral trade which has been the subject of concern, admiration and study ever since.[23]

The Latin American countries had much worse luck. They were the principal victims of the Johnson Act which was passed on April, 13, 1934. It prohibited loans to foreign governments in default on their debts to the U.S. Government. They ended up re-paying much more than it is generally believed.

Again we are confronted with an asymmetrical reality. The largest borrower, being one of the most industrialized and, on the whole, best run

[21] STEVEN CLARKE's, *Central Banking Cooperation, 1924-31*, New York, 1967, provides a vivid account of the limits of that exercise.

[22] See, on the subject, MARCELLO DE CECCO, "Origins of the Post-War Payments System," in *Cambridge Journal of Economics*, 1979.

[23] On the subject, see ALBERT O. HIRSCHMAN's classic work, *National Power and the Structure of Foreign Trade*, Berkeley, 1945.

countries of the period, is always in a position to control its own destiny and those of many other countries, lenders as well as borrowers. It can turn events into policies.

Peripheral countries, on the contrary, remain at the receiving end. They are flooded with money when the tide is high, and they cannot do anything when the tide ebbs. Germany could turn to autarky and Britain to imperial preference. The U.S. retreated into its huge market and Japan resorted to "co-prosperity" in Asia. But the Latin American countries could either default on their debts and embark upon some import-substitution schemes or adopt, like Argentina, savage deflation in order not to default. Their lower classes thus bore most of the brunt of both schemes, when the financial merry-go-round stopped.

Of some interest when compared with the present international debt problem, is the fact that a large part of international debt was constituted by long term bonds. This should not be exaggerated as a difference because there was a very large quantity of short-term (under five years) bank credit and an also very large quantity of inter-bank credit.

Compared to the Euro-bond market, pre-war bond issues undeniably represented a much higher ratio of total international debt. Whether the fact that the prevalence of bonds meant that there were literally millions of foreign bond holders made the international market more unstable is debatable. It should be, first of all, noted that it is impossible for lenders to do anything about default. Default is, technically, a decision of the borrower, and it has such dire consequences for lenders to sovereign debtors that the former, in the case of sovereign loans, tries everything it can to prevent it from happening. Certainly, in the case of individuals, if their foreign loans have defaulted, they just incur a loss. If the lenders are banks, however, or other corporate firms default can easily have direct multiplicative effects on the financial system. Unlike individuals, however, banks being more "discrete" entities than individuals, they can get together much more easily, and have, in principle, the powers, if they agree, to stave off default indefinitely by rescheduling. Bonds, however, much more easily than loans, can be sold on secondary markets, even if they are defaulted. Even if they are formally repudiated by the governments that have incurred them, they can be purchased, at very low prices in the expectation that governments may change and decide to honor their debts.[24]

[24] It can be gleaned from the Table "Estimates of American Holdings of Foreign Dollar Bonds," (in MADDEN, NADLER, SAUVAIN, *op. cit.*, p. 316), that by 1935, only less than 50% of foreign dollar bonds were still in American hands. There is evidence of many countries repurchasing their bonds on the American market at highly discounted prices. But they were also purchased by non-American private individuals and financial intermediaries, who had better hopes in their final redeemability than the American public.

Off-loading loans is much more difficult, because there is much less experience with secondary markets for them, and because they tend to be of much shorter life than bonds (though this may not necessarily be so, in practice it is so).

On the assumption that foreign bonds had not been used as collateral for domestic credit, the solution of the international debt problem in the inter-war period would have been easier, when the collaboration of the borrowing country or agency could be secured, in the sense that it would not repudiate its bonds. That is, however, exactly what Germany did with Hitler's accession to power.

A couple of more general considerations are also in order. On the assumption that it was the disastrous effect of the slump in raw material and primary commodities prices that induced default in primary producing countries, all those countries ought to have defaulted. As it turned out, none of the British dominions did. Nor did Argentina, where Britain had a capital stake larger than that of the U.S. and British finance was very influential on the banking system. Where dollar bonds prevailed, as in Germany and especially in South America, defaults generally occurred. This differential behavior is further evidence of the danger inherent in the vagaries of U.S. finance and also of the greater stability of British-controlled or influenced financial systems, like those of the Dominions and Argentina. Argentina was the only Latin American country which did not default.[25]

From the more political point of view, it can be said that when the disastrous fall in foreign revenues occurred because of the slump in prices, and of the withdrawal of foreign balances, the democratic governments in power in various countries reacted by deflating their economies, and by trying to re-negotiate the foreign debt. The resultant failures and unemployment, however, soon induced revolution and the revolutionary governments' first action was almost invariably a repudiation, either outright or in stages, of foreign debt.

[25] In their work on America's experience as a creditor country, Madden, Nadler and Sauvain also noted that the British foreign lending operations were in the hands of an unofficial syndicate of London issuing houses, who controlled the issues very carefully. They contrasted this with the numbers, and disorganized competition, of U.S. financial intermediaries involved in foreign lending. According to a RIIA study, (quoted below), of £ 298 million British investments in foreign government bonds £ 100 million was in default in 1933. Of $ 7,490 million foreign dollar bonds outstanding in 1935, 1,810 million were in default.

Default can be thus inversely correlated to political stability, as far as the 1930s are concerned. But, in turn, political stability was maintained where the borrowers had a well organized financial and fiscal system and faced lenders, like the British, with greater experience of foreign lending.[26] This can be seen by the analysis of successful conversion operations conducted in the 1930s. Most of them involved Dominions or European countries. Most of them took place in London. Very few conversions were possible in New York. Of course the Johnson Act made conversions difficult. It was hoped, when the Act was passed, that it would put pressure on debtors, to repay their debts, but this did not happen.

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[26] The consideration that governments which attempted deflation and re-negotiation were soon replaced by revolutionary governments which repudiated debt is made by all contemporary writers on Interior Debt Problems. See, for instance, in addition to Madden, Nadler and Sauvain, C.R.S. HARRIS, *Germany's Foreign Indebtdedness*, London, 1935, R.I.I.A., *The Problem of International Investment*, London 1937, C. LEWIS, *America's Stake in International Investment*, Washington, 1938, and H.B. LARY, *The U.S. in the World Economy*, Washington, 1943.