ALLIED REPARATIONS POLICY, 1918-1923: THE DISPARITY BETWEEN TRADE AND REASON

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'Economics inevitably takes place in a political context'. This observation from Nobel Laureate Paul Krugman is an apt summation of Simon Mee's account of Allied actions after the First World War. Mee analyses their reparations policy toward defeated Germany and finds that it allowed politics to trump economics. The consequences of inhibiting free trade are clearly evident in the case of 1920s Germany. This example has never been timelier than today, when the global economy is once again suffering from a great shock that is leading many to abandon economic reasoning for political reasoning.

Introduction

The Rise and Fall of the City of Mahagonny was a political-satirical musical written by Bertolt Brecht. Premiering in Germany in March 1930, German audiences were treated to a selection of rag-time, jazz and formal counterpoint, most notably in the 'Alabama Song':

> Oh, show us the way to the next little dollar,
> Oh, don't ask why, don't ask why,
> For if we do not find the next little dollar,
> I tell you we must die, I tell you we must die.[1]
>
> (Brecht 1979: 6)

After the First World War, Germany was obliged to pay 132 billion gold marks in war reparations.[2] She was to pay compensation not merely for the war damage that she herself had directly caused, but also for the costs of the war as a whole (Feldman 1993: 310). Since payments were to be made largely with foreign exchange, the only feasible means of paying was through a sustained drive of German exports in traditional and world export markets. The Allies were reluctant, however, to give such ground to German exporters after the war. It is in this sober context that the 'Alabama Song' can best be understood: it serves as an analogy for the economic struggle between the German Republic and the Allies during the early 1920s.[3]

This paper will propose the hypothesis that the economic consequences of German reparations were intricately linked to the disparity between Allied trade and reparations policy during the years 1918-23. The exogenous shock of the First World War on the European economy is central to this paper's argument. The war fundamentally changed - and constrained - the political and economic environment through which trade operated. At the same time, however, the inherited assumptions and traditions of the pre-1914 economic environment still played a key role in the formation of Allied reparations policy. These assumptions and traditions only gradually gave way to the new economic realities of the post-war period. Thus, in the immediate short run, a disparity arose in post-war Allied policy. This in turn gave rise to a key paradox; while demanding from Germany exorbitant sums of foreign exchange, the Allies actively discriminated against the only viable means through which Germany could pay: exports.

The economic legacy of the First World War

[1] Extract cited in Ferguson (1997).

[2] For the sake of clarity, all German figures in this paper are quoted in 'gold marks' (GM), the pre-war currency of Germany, i.e. 1913 marks (4.2GM=$1).

[3] Altogether some twenty-eight countries were involved with war debts and reparations during the 1920s. For most countries these amounts were relatively small, however, this paper will focus on by far the most important participants: Germany, the United States, the United Kingdom, France and Belgium. See Aldcroft (1977: 79)

The years 1890-1914 were a prosperous period as a whole for Europe, with an average annual growth rate of 2.2%. During this time, Germany had risen to the rank of an industrial power both at home and as a member of the economic world community. Indeed, in the period 1890-1914 the German Reich experienced a period of relatively good economic performance, with an average annual growth of 2.8% and an annual inflation rate of 1% (Ferguson 1997: 261). However, the First World War brought the golden years of the late nineteenth century liberal economic order to an end, 'changing the nature of domestic and international politics, as well as structures of individual economies' (Findlay and O'Rourke 2007: 435; 429). According to Aldcroft, the direct cost of the war, in constant pre-war prices, was the equivalent of five times the world-wide national debt in 1914 (1977: 30).

During the war, governments across Europe came to intervene significantly in the organisation of economic activity. In Germany, public spending had accounted for only 18% of net national income in 1914. By 1917, however, it had reached a peak of 59% of gross domestic product. This left an overhang of government interference in the economy in the 1920s, a trend that was broadly similar for all European belligerents. There occurred a momentous shift in the patterns of production and consumption across Europe, most notably in the effort made to increase the productive capacity in war-related industries, such as iron, steel and shipbuilding. Much of this capacity became 'superfluous' when the conflict ended, as peacetime production failed to swiftly change in accordance with the sudden decline in demand (Feinstein et al., 1997: 22). These concerns created an argument for trade protection after the war, and many Allied industries succeeded in securing such protection.[4]

The fact that the Treaty of Versailles added to Germany's hardship is in no doubt. The principle of national self-determination was held firmly above economic considerations throughout the Paris Peace Conference. Economic relationships established during the last half century were smashed by the creation of new nation states and the redrawing of almost all borders (Aldcroft, 1977). Each new nation created its own currency, put up tariffs to protect domestic industry, and pursued independent fiscal and monetary policies (Feinstein et al., 1997). Trading constraints were evident from the start, in particular for Germany, as new patterns of trade had to be 'created in a climate of old rivalries and resentments' (Van der See & Boyst, 1989: 241). European powers now faced new competition in traditional export markets, as Latin American and Asian markets were increasingly taken over by the United States and Japan during and after the war. All these factors contributed to poor trading conditions in the post-war period, with Germany's share in particular falling from 13.1% to 7.1% (Robinson, 1944: 620).

German reparations

Reparations were just one aspect of the international financial dislocation which followed the end of the First World War. However, they were 'arguably the most political issue of the period' (Webb, 1989: 103). According to the Treaty of Versailles, the size of the reparations bill was dependent on Germany's 'capacity to pay'. After much deliberation, in May 1921, the Allies set the reparations bill at 132 billion gold marks ($33 billion) bearing 5% interest plus 1% principal repayment per annum.[5] While recent historiography has made much of the fact that the 132 billion was divided into two tranches, this debate has missed much of the point.[6] A debtor's real burden is determined not by the overall size of his or her debt, but by the method of payment.

The London Schedule set up a payment plan in which the Germans were to pay two billion gold marks in annuities in addition to roughly another billion yearly in the form of 26% of the value of their exports (Feldman, 1993: 309-310). As German net national product was 40 to 42 billion gold marks in 1921-22

[4] For example, post-war lobbying in Britain gave rise to such legislation as the Key Industries Act of 1919 and the Safeguarding of Industries Act of 1921.

[5] As reparations payments were fixed in pre-war gold marks, any future German inflation would not reduce their value.

[6] The first 50 billion gold marks were designated 'A' and 'B' bonds, to be serviced forthwith. The remaining 82 billion gold marks, however – the 'C' bonds – carried no interest, and required no payment until the 'A' and 'B' bonds were amortised in the latter half of the century. As such, recent Francophile historiography has argued that Germany's immediate burden was substantially less than first thought. Also, see Feldman (1993: 309-314).

(Webb, 1989: 76), simple arithmetic suggests that reparations demands of 3 billion per year plus an extra 1 billion in non-reparation payments (i.e. occupation costs) to the Allies brought total demands to around 10% of national product. While this was not an impossible sum to pay, it was large enough to cause severe problems with German finances.

The question of German 'capacity to pay' dominates the historiography of reparations because it stresses the transfer problem, an issue that 'bulks large in the literature of international trade theory' (Johnson, 1956: 212).[7] The transfer approach at the conference was considered the most sophisticated method to the question of German capacity, and it held the most prestige among Allied experts (Trachtenberg, 1980: 74). However, the annuities imposed were deemed by the Germans to be completely unfeasible, requiring an external surplus equivalent to 80% of 1921-22 exports (Eichengreen, 1992: 133). Was it possible to transfer such a huge sum without disrupting trade relations and exchange rates?

Allied reparations policy

In the lead up to the war, Germany ran an average annual deficit of roughly 0.7 billion gold marks (Ferguson 1998: 429). To have turned this into an average annual surplus of 3 billion gold marks would have required either a severe reduction in German consumption - which would have threatened social upheaval - or a huge increase in German exports - which would have implied an acute international conflict on interests. In a speech before the Supreme Allied Council in 1922, the German foreign minister Walter Rathenau acknowledged this, 'One possible remedy [that could allow Germany to pay] would be a reduction in consumption. But this is hardly feasible, since the middle classes and the workers live already far below their pre-war standards' (Rathenau, 1924: 362-364). The only realistic way of paying reparations, he argued, was the 'raising of output and an increase in exports. But such an increase is difficult, because other nations are opposed to the increase of imports from Germany'. Indeed, as recent Nobel Laureate Paul Krugman (2008: 10) observes, 'Economics inevitably takes place in a political context', and buoyed by nationalist fervour - the very sentiment that led to the outbreak of war in 1914 - the defenders of the London Schedule sought to justify exorbitant amounts.[8] They rationalised their demands using classical trade theory and pre-1914 economic reasoning.

The classicists contended that, provided the German government sought to defend a fixed exchange rate (they had the gold standard in mind), the very act of getting foreign exchange to pay reparations transfers would tend to raise German interest rates, causing domestic deflation and falling German prices in relation to import prices (Balderston, 2002: 27). This would tend to deflect German demand from foreign to home goods and also reduce Germany's demand for all goods by reducing money income relative to the prices of imports. German exports would increase; goods traditionally sold abroad would sell in larger quantities, and goods previously unprofitable to export would also be sold abroad. Trachtenberg notes, however, that exactly the opposite process applies to the creation of the necessary trade deficit in the creditor nations (1980: 79). The Germans could then buy the needed foreign currencies required without a continuing fall in the mark (ibid.: 64). Assuming this process worked – and it presupposed no discrimination against German exports – it would accomplish just what the advocates of reparations intended: a partial transfer of the Germans' earned purchasing power and national income to foreigners. The defenders of the London Schedule also turned toward pre-1914 economic reasoning for their argument. Among other examples, they referred to the case of Britain, which, for reasons of profit and empire, transferred a sizable 8% of national income in capital exports in the period 1911-13. The Allies argued that the balance of payments adjustment mechanism absorbed the transfer and minimised the impact on British industry and on the balance of payments (Eichengreen, 1992: 132). As a result, there was no serious impact on British living standards.

In this light, reparations annuities constituting 10% of German national income seemed reasonable. However, as Eichengreen (1992) counters, British capital exports abroad before the war had returned to London as

[7] This paper defines the transfer problem as the maximum value of goods and services that might be transferred from Germany to other nations without upsetting trade relations and exchange rates. See Pollard (1973: 259).

[8] The British 'Khaki election' of 1918 is a just one example. Lloyd George's war-time coalition government exploited the patriotic sentiment arising in the aftermath of the First World War, and secured a large victory. Also, the French position hardened following the victory of the right-wing Bloc National in the 1919 election.

foreign deposits and some in the form of export demands. It was actually these mechanisms that minimised the impact on British living standards. Neither mechanism could operate as strongly to recycle German reparations.[9] Furthermore, the British had invested abroad voluntarily 'with the option of devoting those resources to future consumption' (ibid.: 132-133). However, the war had changed the economic landscape completely, and undermined the potential trajectory of any future German trade surplus. A young John Maynard Keynes led a heterogeneous group of economists and intellectuals opposing the London Schedule. Emphasising the intractability of the transfer problem, Keynes (1971) contended that a large trade surplus was impossible. Expanding exports by 80% required a further increase in imported inputs, which actually multiplied the gross increase in exports necessary to effect the transfer (Eichengreen, 1992: 132). Keynes noted that, due to Germany's narrow tax base, even if the Germans successfully raised the amounts to pay reparations through taxation, it was unable to purchase the gold or foreign currencies needed to pay the Allies without the collapse of the mark in the money markets. Was it sensible to cripple Germany economically when so much of Europe's pre-1914 welfare had depended on German growth?

Allied trade policy

> 'Germany can only pay such huge sums by taking an even greater share of the world market than was the case before the war. Is that in our interest? Would it not be better to earn this money ourselves on these markets, instead of encouraging Germany to take them from us?'
>
> (Trachtenberg, 1980: 75)

With these words, President Wilson spoke for many in the Paris Peace Conference on 26 March 1919. They were a far cry from his previous call in the Fourteen Points for the 'removal, as far as possible, of all economic barriers and the establishment of an equality of trade conditions among all nations consenting to the peace and associating with its maintenance'. Wilsonian idealism had come to a crashing halt at the Paris Peace Conference with the art of realpolitik rapidly taking over.

It is often overlooked that, a large element of the battle over reparations was 'a struggle to assure an advantageous starting point in the post-war economic competition' (Maier, 1979: 60). In the lead up to the war, German exports were heavily concentrated in the products of industries already characterised by intense competition. These exports included iron, steel, textiles and coal. Allied delegations at the Paris Peace Conference were certainly aware of the dangers posed by German competition. As Keynes eloquently put it, he 'did not expect to see Mr Lloyd George fighting a general election on the issue of maintaining an Army to compel Germany at the point of bayonet to undercut British manufactures' (1971: 207). He argued that trade barriers were inevitable as there was no viable way of transferring the payments demanded of Germany without permitting a level of exports that would become unbearable to the recipients.

Indeed, the Allies actively discriminated against German exports and with it her only feasible means of payment. Under Articles 265-269 of the Versailles treaty, Germany was required to grant the Allies unilateral and unconditional most-favoured-nation treatment for five years, without any reciprocation by the Allies. Special transitional arrangements were prescribed for duty-free trade between Alsace-Lorraine and the now Polish districts of eastern and the new Germany (Keynes, 1971: 93-96). Belgium put extra duties on German goods, while Britain and the United States forbade the import of German dye-stuffs. A direct connection between reparations and the rise in protection can be found in the Reparation Recovery Acts, passed by the United Kingdom and France in 1921; in conjunction with the London Schedule, the legislation levied special duties of 26% on German exports with revenues credited to the German reparation account (Webb, 1989: 113). Protectionist legislation such as the Reparation Recovery Acts meant that an extra burden of the transfer would fall on Allied consumers as well as German producers. A better option would have been a surtax of 26% on imports; however, this measure would have hurt Allied export industries. Instead of offering the invisible hand, Allied governments gave a helping hand to vested interests while 'the interest of the consumer was almost constantly sacrificed to the producer' (Smith, 1995: 196).

[9] 'The basis for conjecturing that neither mechanism would operate as powerfully in the case of German reparations is that Germany was in no position to expand her exports, in response to any increase in foreign demands, beyond the expansion required to effect the initial transfer' (Eichengreen, 1992: 132).

A disparity of consequence

The barriers against German exports increased the real value of goods that Germany had to sell to get foreign exchange and increased the likelihood that it would be impossible to make the transfer. However, even as the Allies effectively took efforts to 'shackle her industrial might', they complained that Germany's effort to meet its reparations obligation was inadequate (Eichengreen, 1992: 133; 125). Thus, a disparity arose. The exogenous shock of the war had changed economic and political conditions irrevocably, encouraging the Allies to adopt autarkic and protectionist policies for trade. But by discriminating against German goods, the Allies essentially nullified their argument of classical trade theory. Since tariffs and protection distorted prices in the international market, the theoretical question of the transfer problem - what changes in prices would be needed to clear international markets in the presence of reparations - became irrelevant (ibid.: 134). In this light, the reasoning for Allied reparations policy was glaringly out of sync.

The resulting disparity in Allied trade and reason was not without consequence. A direct link can be traced to the rise in Allied protectionism and German social tension in the immediate aftermath of the war.[10] In addition, the annuities constituted a tremendous burden for German finances. Whether to finance government deficits, to buy foreign currency, or to pay deliveries in kind, paying reparations meant printing paper marks. In this sense, Keynes was right; reparations added to the inflation already existent in the German economy. There is much evidence to suggest that German inflation would have been lower in the absence of reparations and thus revenue would have been higher in real terms (ibid.: 141). This in turn would suggest that reparations had a direct role to play in the mark's depreciation and, consequently, the disastrous hyperinflation of 1922-23.[11]

Conclusion

It is here we recall Bertolt Brecht and *The Rise and Fall of the City of Mahagonny*. Beneath the rag-time and jazz, we have seen that the desperate hunt for that 'next little dollar' was a result of the disparity in post-war Allied policy. While complaining that Germany's effort to meet its reparations obligation was inadequate, the Allies effectively took efforts to 'shackle her industrial might'. In this light, the 'Alabama Song' holds further a parallel; the contrast between the upbeat rag-time and the sober message of poverty is in some ways similar to the contradiction that lay in Allied reason and trade; optimistic calculations of Germany's 'capacity to pay' stood in sharp contrast to the harsh realpolitik of Allied trade policy.

Economics inevitably takes place in a political context, especially in a 'climate of old rivalries and resentments' such as the post-war period. When one considers the London Schedule, it is evident that political considerations were held at all times over economic reasoning. By relying on classical trade theory and pre-1914 historical examples, the defenders managed to paint a thin veneer of feasibility over the London Schedule. Yet prices were intentionally distorted in the interests of Allied trade merchants, while the interests of Allied consumers and German exporters were sacrificed. Perhaps Brecht even had Adam Smith in mind when he famously quipped, 'No one can be good for long if goodness is not in demand'. Germany could not be expected to pay in good faith while the Allies actively discriminated against her exports.

Ninety years ago, in the aftermath of a global economic shock, it was Keynes who warned against economic nationalism and protection. Yet policy makers at the Paris Peace Conference discarded his argument in favour of short-term political opportunism. The consequences were disastrous. This contingency of politics upon economics is apposite given our present financial crisis. Today, we are at another crossroads in history where policy makers around the world are struggling to cope with enormous shock to the global economy. Will they succumb to political pressure and revert back to economic protectionism? Or will they now listen to Keynes? The question remains.

[10] For example, the right-wing Kapp Putsch of 1920.

[11] However, the problem is how to quantify that role, and how to evaluate it alongside other factors such as German domestic policy (i.e. money supply) and political tensions.

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