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**FINANCIAL *VERGANGENHEITSBEWÄLTIGUNG*:
THE 1953 LONDON DEBT AGREEMENT**

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Financial *Vergangenheitsbewältigung*: the 1953 London Debt Agreement

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Abstract

The 1953 London Debt Agreement settled Germany's debts from the period between the two world wars and allowed the country to re-establish its role in international capital markets. The Agreement wrote down the overall debt by about 50 percent, gave the debtors a much longer period to repay, and tied payments to export surpluses and Germany's ability to repay. The Agreement also allowed Germany to postpone some payments until reunification. The Agreement reflected a subtle and responsible understanding of the problems associated with the reparations and debt crises of the 1920s and 1930s, as well as fears about the moral hazard problems that would arise with making any part of the Agreement contingent on events Germany could influence. Discussions of the European debt crisis today often refer to the London Debt Agreement as a precedent for debt forgiveness; such parallels are at best inexact.

Two days after the former German Democratic Republic (East Germany) became part of the Federal Republic of Germany in October of 1990, the German Debt Administration announced that it would issue a new set of bonds. An observer might have thought, reasonably enough, that the new bonds were to pay for investments to upgrade the former East Germany's crumbling infrastructure or for some other purpose related to the integration of the two economies. But these new bonds were intended to repay obligations Germany had incurred as long ago as the 1920s. This fact should puzzle: The Nazi regime had effectively defaulted on all that debt. And in any case, why should Germany, in 1990, *start* repaying debts incurred so long ago? The simple answer is that these repayments were required under the 1953 London Debt Agreements, which marked the end of Germany's isolation from international capital markets.

A more complete explanation starts with the Versailles Treaty, and the terms that Treaty imposed on Germany, most notably the reparations. Along the way it became clear that although the Germans were supposed to pay, what they actually did was to borrow more and more. In June of 1931 U.S. President Hoover called a moratorium on international debt payments, including Germany's reparations obligations, and the 1932 Lausanne Conference resulted in the permanent suspension of war-reparations payments. The reparations bill per se played no further role in our story. After taking power in 1933 the Nazi regime extended earlier measures to block repayment of most of the outstanding debt. The matter remained moot during World War II, although creditors had not forgotten what Germany owed. After the Second World War Germany agreed at the London Debt Conference to make partial payments on the earlier debt. The German government successfully argued that it should not have to assume the obligation for the entire debt since it only represented what was then West Germany. Thus what became known as the London Debt Agreement (hereafter, LDA) of 1953 stipulated that some payments would be postponed until such time as the two Germanies were reunited. Those notices about new German bonds were announcing the financial end to Europe's second Thirty Years War.

This paper focuses on the LDA as a financial agreement that marked an important step along the road to the new Federal Republic's full sovereignty and reintegration into world financial and trading networks. The LDA also raises or illustrates some broader issues. While we focus on the way the LDA came to be, in conclusion we return to the implications of this episode for other sovereign-debt matters.¹

Reparations and debt

The London Debt Agreement did not directly concern the reparations Germany had been required to pay after World War I, but to understand both the debt the LDA did cover, and the concerns that motivated the deal crafted in 1953, we must briefly summarize the reparations history. Throughout World War I, all belligerent governments had been forced to finance massively increased spending out of increased taxes, inflation, and debt. They ended the war with tremendous debts to their coalition partners, to their citizens, and in the case of the Entente, to the United States. All governments had assured their citizens that after the war, the other side would pay the war's financial costs. Thus Article 231 of the Treaty of Versailles (1919) reflected not just the usual practice of forcing the vanquished to pay, but an attempt by the western Allies to repair their public finance at Germany's expense. Three features of the reparations demand are important to the later LDA. First, the 1919 Treaty did not name a specific sum for the reparations bill. Second, when the Allied experts responsible for naming a sum initially presented their results in 1921, the sum named was huge – 132 billion (thousand million) gold Marks. Much of the discussion at the time, as well as considerable argument since, turns on the question of whether

¹ Buchheim (1986, p.222) notes that there is little historical literature on the London Debt Agreement. This remains the case, with one welcome exception. Rombeck-Jaschinski (2005) has contributed a fine study of the LDA itself and the diplomacy that made it possible. She does not stress the LDA's financial aspects, and seems unaware of the present paper's earlier version.

Germany could pay without committing its people to poverty. The third feature directly informed the LDA: political leaders on both sides viewed that 132 billion Marks figure as fictional, and expected Germany to pay far less.

The London Schedule of Payments (1921) officially set the total reparations obligation at 132 billion (gold) Marks. The Germans would pay reparations by servicing two sets of bonds, the so-called “A” and “B” bonds, which together totaled 50 billion Marks. The Reparations Commission could issue “C” bonds for portions of the remaining 82 billion Marks, but the Germans would service these bonds only if the Commission concluded that the German economy was able to bear this further burden. The “C” bonds had some political significance, as Schuker (1988, p.17) notes, but no serious observer ever expected them to be issued or serviced. Belgium’s premier noted that such bonds could be put away “without bothering to lock up, for no thief would be tempted to steal them.” The Commission set service on the “A” and “B” bonds at 2 billion gold Marks per year plus 26 percent of the value of Germany’s exports, thus scaling the reparations payments to Germany’s ability to pay.² In the end Germany paid about 23 billion Marks in reparations, a little more than half of what Keynes thought it could pay.³

² Schuker (1988, p.17) quotes the Belgian premier. The reparations are themselves the subject of a number of large academic literatures we cannot discuss here. Just to indicate the scope of argument, some have debated the moral or political justifications for reparations in general (perhaps the most important debate is the “Fischer controversy,” concerning Germany’s war aims. See Fischer (1961) or Fischer (1967)); others (most famously, J.M. Keynes) questioned whether Germany could afford the sums proposed at the time and whether there was any legal or moral basis for some of the calculations that went into the final bill (see *The Economic Consequences of the Peace* (1919); “Cancellation (1921)” and “Cancellation (1928)” in *Essays in Persuasion and A Revision of the Treaty*); and still others have focused on the narrower question of how Germany could transfer real resources to the payees without running huge trade surpluses that would distort the terms of trade (the so-called “transfer problem;” see, for example, Keynes (1929). Throughout this paper I use the term “Mark” to denote the German currency of the day. At the pre-World War I parities, \$1

The reparation demands created political problems within Germany and for Germany's relations with the Allies. Some historians and several important political leaders at the time thought that political moral hazard was one important element behind the crisis and hyperinflation of 1922-23. The Erzberger tax reforms of 1919-1920, while fulfilling Allied demands in spirit, contained serious loopholes and did not raise German tax revenues rapidly enough to avoid a series of "fulfillment crises." Arguing that Germany had not been forthcoming with reparations, the French and Belgians, as was their right under the Treaty, occupied the Ruhr, an important mining and industrial region. The idea was to force the German government's hand in the long term, and to extract resources in the short term by trying to appropriate coal directly at the pithead. In response, the German government initiated a policy of passive resistance. The German government encouraged workers to stay home, supporting them with grants in lieu of their regular wages. The resulting strain on public finances (and the perception that the German government was not interested in, or politically able to reform those finances) led to hyperinflation.⁴

gold = 4.2 gold Marks. One Mark was worth one shilling sterling. After stabilization in 1924, the new Reichsmark once again traded at \$1 = 4.2 RM. The Deutsche Mark re-established in 1948 after another round of wartime (and post-war) inflation at first traded at 3.33 to a dollar, but then fell to the old parity of \$1=4.2 DM.

³ Keynes (1971a, p. 200) concluded that the most Germany could possibly pay was \$10 billion, or about 40 billion Marks. Mantoux (1952) is a sharp criticism of Keynes's writings on the Treaty of Versailles. Not all of Mantoux's discussion is fair, but he demonstrates convincingly that Keynes underestimated the German economy's ability to pay reparations. Schucker (1988, Table 12) estimates that Germany actually paid 22.89 billion Marks through 1932.

⁴ Bresciani-Turroni (1937) contains both a clear narrative of the relevant events in the 1920s and an analysis that, while not fully shared by modern writers, remains an excellent starting point.

Historians have interpreted these events along two lines. One stresses the impossible position of the German government, trying to secure democratic legitimacy while facing incompatible fiscal demands. The other sees in the German reaction to the Ruhr occupation an effort to show the Allies that Germany could not be forced to pay reparations against her will. Feldman (1993, Chapter 8) conveys the nuances of the bad behavior and mixed motives on both sides. Feldman alludes to a particular moral hazard problem. The London Schedule was vague in the sense that 82 billion of the notional total of 132 billion Marks would be owed only if the Reparations Commission concluded that paying the first 50 billion Marks had not been too difficult for the Germans. Some historians, like Schukert (1978, pp. 355-358) argue that Wilhelm Cuno (the Chancellor) and Walther Rathenau (then Foreign Minister) saw the situation in 1922 as offering Germany a way out of the Treaty. Whether the German governments actually tried to demonstrate an inability to pay (as their foreign critics thought) is irrelevant to the role these crises played in the lesson the participants in the London Debt Conference later drew. The possibility and perception were enough.⁵

What ensued instead during the period from 1924 through 1933 was a system whereby international lenders, mostly American, lent money to public and private entities in Germany. The Weimar (that is, federal) government used part of those loans to make reparations payments to the European Allies. The European Allies receiving the reparations payments used them, in large part, to repay their debts to the United States. External loans to German governments enabled them to function in the face of rising expenses and a weak tax base. The lending helped finance improvements in the lives of ordinary citizens by paying for public swimming pools and other

⁵ Marks (1998, p.364) offers an appealing summary: “At the peace conference and thereafter, German leaders pointed out that if Germany worked hard and cleared this first debt [the A and B Bonds –T.G.], its reward was a second heavy burden.... Germans did not point out, however, that the converse was true as well: if Germany failed to pay, its debt would be sharply reduced, as it effectively was.”

facilities. External loans to private entities, mostly German businesses, financed new production that kept people employed and provided tax revenue to governments. So long as the funds kept flowing, the system worked. The Great Depression ruined the international financial system that made these flows possible, and the Germans defaulted. At that time they owed American lenders more than they had paid on the reparations bill, which led Schuker to title his study “American Reparations to Germany.”

The road to default

By 1932 Germany owed more than 20 billion Marks to external creditors. U.S. citizens and financial institutions accounted for about 40 percent of this total, with the Netherlands, Great Britain, and Switzerland, owed another 40 percent (Klug 1993, Table 2). Default on these obligations was not a one-time event, nor was the default usually as simple as a declaration that Germany would not honor the debt. The process began in 1931, when Germany enacted exchange controls. The exchange controls covered debt service (“transfer stops”) and eased the German debt burden. The German government paid foreign creditors in Marks. Creditors could not convert all of their Marks to another currency because of the exchange controls. The foreign creditor’s only option was to use the Marks to buy German goods for export, and obtain the desired currency from these sales.

As the Great Depression worsened, many countries devalued their currency or went off the gold standard entirely. Germany could not, both because of the agreement that placed the *Reichsbank* under international supervision, and because of fears of renewed hyperinflation. Devaluations of the dollar, sterling, and (later) French franc increased the Mark’s value by over 60 percent with respect to these currencies of major trading partners, making German goods prohibitively expensive in foreign markets. By forcing foreign creditors to take their debt payments in kind, the transfer stops partially offset the disadvantage of the pricey German mark. Thus the debt service was turned into a subsidy for German exports.

Another form of partial default relied on the German government's ability to drive a wedge between groups of creditors. The short-term debt was more British and relatively more of it was owed to banks, as opposed to individual bondholders, giving the Germans two ways to split their creditors. On July 1, 1933, the *Reichsbank* announced that henceforth only 50 percent of debt service for bonds would be paid in foreign currency as legally required; the rest would be paid in special inconvertible scrip issued by the *Reichsbank*. Creditors could sell this scrip to the *Golddiskontobank* for 50 percent of its nominal value in convertible Marks (thus effectively accepting a 25 percent reduction in their payments) or hold onto it against promises of full redemption in the future.⁶ In 1934 the *Reichsbank* created another option, the so-called funding-bond scheme. Creditors could agree to exchange the payments owed to them now for funding bonds that paid a 3 percent rate of interest. As the funding bonds did not affect the principal of the underlying obligations, and the promise was to pay off these bonds eventually (the date given was January 1, 1945), this scheme was not technically a default, either. But the funding bonds effected a considerable reduction in the value of the debts to the creditors.⁷

Other divide-and-conquer strategies met with some success. In 1934 Germany defaulted entirely on the Dawes and Young loans, but after threats from the United Kingdom restarted service on the *UK* tranches of the loans (James 1986, p.407). The Swiss agreed to trade concessions in return for preferential handling of money owed them. One challenge for post-war negotiators was cutting through the fog created by the Reich's complicated efforts to reduce its debt payments.

⁶ The scrip was then made available to German exporters at face value, to subsidize exports and thus partially offset the over-valuation of the Mark. For the rest of this story, which is not central to the issue of debts per se, see Irmiler (1976) and Ebi (2003).

⁷ Klug (1993) notes that the German authorities were able to reduce the effective debt somewhat more by surreptitiously purchasing discounted German debt on financial markets.

The debts covered by the London Agreement

The LDA covered four broad classes of loans. (1) The first were not strictly speaking reparations obligations, but were two loans floated as part of efforts to stabilize the German economy and ensure smooth payment of the reparations. The first loan, the so-called Dawes loan, arose directly out of the reparations scheme. After the fulfillment crises and hyperinflation of the early 1920s, the Entente sought a new approach. In April of 1924 Charles G. Dawes, a former director of the U.S. Bureau of the Budget, led a committee that proposed a series of agreements between Germany and its creditors, and also raised an international loan of about 800 million Marks that allowed Germany to stabilize its economic situation. The Dawes plan also rescheduled reparations payments to reduce the immediate burden considerably. The plan placed the *Reichsbank* under international supervision to strengthen its independence from the government, a move intended to reassure there would not be a second period of hyperinflation.⁸

The Dawes plan at first worked even better than had been hoped. This success was the result, in part, of a flood of international lending, primarily from the U.S., following on the apparent solution of the reparations problem. By 1928 the agent supervising reparations payments on behalf of the Allies, Parker Gilbert, worried that the German government was becoming fiscally irresponsible. These concerns led to another conference in 1929 under the chairmanship of Owen Young, an American lawyer and businessman who had earlier advised the Dawes committee. The resulting Young plan involved another loan (this time of 1.2 billion Marks) and a short-term reduction in reparations payments. For the first time, the Young plan fixed a definite,

⁸ The Dawes agreement also separated payment from transfer; after its enactment, the German government had to make payments in Marks to reparations officials, who were then responsible for its conversion in the currencies desired.

unconditional sum Germany would have to pay.⁹ The Young plan lasted only a brief time, as the global depression overtook events. The Lausanne Conference effectively cancelled the reparations debt in 1932.

(2) The LDA covered two types of loans made to German businesses. The first were ordinary commercial loans. Germany in the 1920s was an attractive place for such commercial lending, especially because the war left German firms hungry for raw materials and new equipment. The U.S. for its part had gone from being a large net debtor at the start of the war to being a large net creditor at the end of the war. The LDA dealt separately with a second category of loans to business. During the 1931 banking crisis, some foreign creditors, mostly banks, agreed not to try to repatriate their money. This helped stave off default in Germany by extending loans past their original due date. The first such “*Standstill*” agreement was signed on September 19, 1931, and was intended to run for six months only. The agreement froze existing credits (with continued interest payments) in the amount of some 6 billion Marks (Forbes 1987, p.575). These agreements were renewed repeatedly through the 1930s, but with smaller and smaller credit lines, as the depreciation of both sterling and the dollar reduced the Mark value of the loans, and as some lenders were able to get part of their money back.

(3) The LDA covered a third class of loans consisting of obligations of German cities, *Länder*, and other sub-federal governmental units. Throughout the 1920s, each German state had considerable fiscal autonomy, including the right to float loans in Germany and abroad. Something similar was true for Germany’s cities. Debts from World War I and debt due to reparations obligations were clearly the duty of the federal or central government. But this entity had, at first, no direct control over borrowing by state and city governments. By the late 1920s state and local borrowing had become enormous. The public sector debt had two sources. One

⁹ This agreement also established the Bank for International Settlements in Basel, Switzerland, to act as the agent to receive and disburse the payments.

was the ballooning size of government spending overall, as the government tried to buy social peace by continuing wartime subsidies of food and transport, and later by pushing through increases in public-sector salaries that were not sustainable given the tax system. As James (1986, p.39) notes, the fraction of all income spent by the state rose from about 14.5 percent prior to the war to 24 percent in the second half of the 1920s. Almost 12 percent of all foreign loans issued in the United States between 1924 and 1929 went to German cities (James 1986, p.95).

(4) The final class of debts covered by the London Agreement arose out of assistance to Germany after World War II. Both Britain and the United States provided assistance, but the bulk of this debt was to the U.S. government. There were two main programs. The U.S. “Government and Relief in Occupied Areas” (GARIOA) program had begun shortly after the war with the intention of providing for immediate civilian needs, including food, fuel, and medical supplies. The European Recovery Program (Marshall Plan) of 1948-1951 was intended to foster long-term recovery through investment in productive facilities. The Marshall Plan operated in nearly all of western Europe and Turkey, but the terms applied to Germany were different. The Plan in general offered technical assistance, grants, and loans; for Germany the initial terms of the Plan included a higher ratio of loans to grants than elsewhere.

The London Debt Conference

In 1949, the United States, the United Kingdom, and France brought their three western occupation zones together into the Federal Republic of Germany (or “West Germany”). West Germany did not yet have full sovereignty, however, and one of the obstacles to its full independence was the outstanding issue of the defaults of the 1930s. As the legal successor state to the defunct German *Reich*, West Germany recognized its responsibility for the state debt. The Allies also wanted the Federal Republic to accept responsibility for ensuring the payment of private debts, which strictly speaking was not its responsibility as the *Reich*’s successor state. In a response to the Allied High Commissioner dated March 6th, 1951, Chancellor Adenauer accepted

responsibility for the debt and signaled Germany's intention to repay, but reiterated two points that were important bases for the conference. First, the repayment plan must have "the objective of normalizing the economic and financial relations of the Federal Republic with other countries." Second, "it will take into account the general economic position of the Federal Republic, notably the increase of its burdens and the reduction of its economic wealth."¹⁰

Today Germany is viewed as one of the safest sovereign debtors, and the German economy is the recipient of many millions of dollars of foreign investment every year. But as Buchheim (1986, p.220) notes, at the time of the London Debt Conference most observers had in mind long years of what they viewed as Germany's irresponsible treatment of foreign debts and property owned by foreigners. John J. McCloy, the American High Commissioner in Germany, had made it clear in 1949 that the Germans could expect no additional private credits until the earlier debt had been dealt with (Abs 1991, p.55).

Adenauer accepted Germany's responsibility to deal with most, but not all, of Germany's external debt. First, Germany would undertake to repay all public debt issued in Germany between the two World Wars, including the obligations of the central government, the several states, and municipalities. Second, the Federal Republic recognized debts owed by German *private* debtors, so long as they lived in the Federal Republic. With respect to these debts, the German government accepted not the obligation to repay, but to establish mechanisms to ensure repayment. These debts had to be included in the overall plan because private debt payments would affect Germany's overall transfer abilities. Third, Germany accepted responsibility for debt incurred by the Austrian government during the period of *Anschluss* with Germany. Finally, the Federal Republic acknowledged its responsibility for repayment of advances under the Marshall

¹⁰ "Agreement," Appendix A, p.112. Note that page citations are to the version of the agreement printed in the British parliamentary papers. The U.S. version was printed as a Senate document for the first session of the 83rd Congress.

Plan and other post-war recovery schemes. The agreement specifically excluded several other types of obligations, including claims for damages arising out of the Second World War.

All parties to the discussions recognized that there were issues of equity and economics that would require compromise. Would the Germany of 1951 accept responsibility for debts issued by political entities that no longer existed? Prussia, for example, had been the largest of the German states prior to 1945, but was dissolved at Allied insistence at the end of the war. Under the LDA, the Federal Republic also accepted responsibility for the debts of Prussia, which no longer existed. Would the people of the Federal Republic be expected to repay *all* German debts, or would some be assigned, in theory at least, to the people of the fourth occupation zone, to the German Democratic Republic (“East Germany”)? To the extent some debt was reserved for later, what would be the basis for the division: territory, former GDP, etc.? Most of the debt in question had not been serviced at all for many years. How much of the unpaid interest would be added on to the outstanding principal? Interest rates had been much lower through the 1930s than in the 1920s; what rate would be used to compound back interest? The debt had been issued in several different currencies, some of which had depreciated badly in the intervening years. How would the obligations be valued; that is, how many Marks would be paid to service each US dollar of debt, each French franc of debt, etc.?

The London Conference accepted as a premise that Germany would not be expected to pay the full bill that would emerge from a purely technical reckoning of the outstanding debt. One important motivation for the debt settlement was to strengthen the German economy. Demanding that the Germans service an enormous debt was incompatible with that goal. This consideration had a distinctly political edge. The Federal Republic’s birth coincided with the first stages of the Cold War, and the Korean War ran from the summer of 1950 to the summer of 1953. The Allies could hardly win the trust and loyalty of the German population if at the same time they insisted on debt payments that would further impoverish a people already suffering from the consequences of an extended and destructive war. In addition, some of the debt had been incurred

under politically sensitive conditions. The Dawes and Young Loans were not, strictly speaking, reparations debt, but they might not have been needed in the absence of reparations.

Some of the LDA's logic is only understandable in light of the way the negotiations actually took place. The only extensive, first-hand account of the process that led to the London Debt Agreement is the book ghost-written in Hermann Abs' name (Abs 1991).¹¹ Abs was the leader of the German delegation at the conferences. His report is informative, but it is probably even more self-serving than most such accounts. Abs was one of those Germans who had worked hard, and successfully, to construct the new Federal Republic, but he was never fully forgiven for his behavior under the National Socialist regime.¹²

Abs' account stresses that the negotiations were complicated and often rancorous. The different Allies had different objectives. The United States, early on, proposed simply forgiving all debt that arose out of assistance after World War II. This was not acceptable to the British, who were in much reduced financial circumstances (Abs 1991, p.102). Other disputes were not between governments, but between different classes of creditors and between these creditors and their governments. These conflicts were implicit in the basic premise of the discussions, which was that Germany would not be asked to repay any more than she could afford. Once accepted, this premise in effect created a fixed pool of possible repayment. Every Mark paid to a Dawes loan creditor would not be available to a Young loan creditor, and every Mark paid to the U.S. government in fulfillment of Marshall Plan agreements would not be available to private creditors. U.S. Senator Guy Gillette referred to this fact when he complained to the State Department that it was agreeing to a big write-down of post-war debt (owed to the U.S.

¹¹ Also of interest is Schwarz (1982), which reprints speeches by Abs and the transcript of a meeting devoted to the 1953 London Debt Agreement.

¹² See James (2001, especially pp. 99-104 and 215-217).

government, that is, the taxpayer) to make more (German) resources available to repay private creditors (Abs 1991, pp.120-121).

The discussions and negotiations proceeded in four stages. The Allies began by setting up a “Tri-Partite Commission on German External Debt.” This Commission played a leading role, as government representative and moderator, in the negotiations. The Commission then worked with the German government to establish both which debts would be covered and how much they totaled, and to establish ways to determine Germany’s ability to make payments. These first talks were completed in Bonn, in June, 1951. In the second stage, the four governments were joined by representatives of private creditors from the United States, France, and the United Kingdom, as well as several central banks. These discussions, which were completed in London in July 1951, also included representatives of German private debtors.

In the third step, the actual debts and repayment schedules were negotiated. Here the parties split the government creditors from the private creditors. Most of the debt due to governments arose out of post-war assistance to Germany, and thus was more recent and represented less difficult issues. Most pre-war debt, on the other hand, was owed to private creditors by both public and private debtors in Germany. The main conference for the negotiation of the debts owed to private parties, which took place in February, 1952, involved representatives of hundreds of private entities from dozens of countries, including the three western powers moderating the conference.¹³ The German government played a dual role in these discussions, as both a party itself (because it would repay debts that arose out of earlier public issues) and as the entity that was to protect the interests of German private debtors as well as ensure that they honored any commitments that arose out of the conference.

¹³ The agreement itself was signed by representatives of Belgium, Canada, Ceylon, Denmark, France, Greece, Iran, Ireland, Italy, Liechtenstein, Luxembourg, Norway, Pakistan, Spain, Sweden, Switzerland, South Africa, the U.K., the U.S., Yugoslavia, and the Federal Republic of Germany.

The fourth step created a parallel agreement covering inter-governmental debt, and produced the detailed technical reports and agreements that would amount to the actual London Agreement. The final agreement was signed on the 27th of February 1953 in London. The Agreement did not come into force without difficulty. The German *Bundestag* at first rejected it, taking offense at the apparent implication that repayment of France's post-war aid amounted to an agreement that France's occupation policy for its zone had been enlightened and constructive, when most Germans saw it as otherwise. Several Bundestag delegates then remembered that they had intended to vote the other way, and the Agreement passed on a second vote.¹⁴

The Agreement

The agreement embodied three general principles: the amount Germany owed was reduced considerably; she was given a long period in which to repay; and the amounts owed in any given year were tied to her ability to make transfers. The value of the debts covered and the amount by which they were written down depends on the way the various currencies are valued. Most commentators agree that pre-war debts covered by the London Agreement of 1953 involved about 13.5 billion Marks, 7.7 billion of which was public debt. Unpaid interest on those debts amounted to another 2.6 billion Marks. Post-war debts, which are conceptually easier to calculate, were about 16.2 billion Marks. The agreement reduced the total pre-war debt to about 7.5 billion DM, and the post-war debts to about 7 billion Marks. The German government agreed to repay a total of 11 billion Marks, of which 4 billion represented pre-war debts. Another 3.5 billion Marks were shared among private German debtors.

¹⁴ Buchheim (2003) notes that this view of the French was less fair than it was widespread. An amusing recounting of the ratification maneuvers in the Bundestag can be found in Abs' comments printed in Schwarz (1982, pp.35-26).

Under the calculations used in the London Agreement, the reduction in the total obligations, both public and private, was about 50 percent. A more standard commercial calculation leads to a higher write-down, however. For example, the agreement called for only 2.6 billion Marks of unpaid interest on 13.5 billion marks of pre-war debt. If the Germans had paid three percent interest on the outstanding debt from the transfer stop (1933) to 1953, they would have owed closer to 7.7 billion Marks, even without compounding. (The Dawes loan had a seven percent coupon rate, the Young loan, 5.5 percent.) Precise valuation of the pre-war debt is greatly complicated by the several stratagems used during the transfer stop, and the exact amount of the debt reduction is not our point. The London Debt Agreement required that Germany pay *at the very most* half of what she owed.

Agreements on the post-war debt were an inter-governmental matter. The United States made these inter-governmental negotiations easy by reducing its claim of \$3.2 billion to \$1.2 billion. The U.S. offer was contingent on a satisfactory settlement of the pre-war debt (Abs in Schwarz 1982, p.22). Abs interpreted the U.S. offer as a threat to encourage a settlement of the pre-war debt; in any case, given the basic understanding that Germany's ability to pay was the binding constraint, the U.S. offer freed up \$2 billion for other creditors. The United Kingdom and France also agreed to smaller reductions of much smaller post-war aid debts. The U.S. decision doubtless reflects political calculations, as detailed below, but as a practical matter the reduction treated Germany on a par with other recipients of Marshall plan aid. About 15 percent of Marshall Plan aid to the United Kingdom and France was in the form of loans, which was about the same percentage of the German's aid once the London Debt Agreement had converted some German loans to grants (Buchheim 1990, p.70).¹⁵

¹⁵ Dernburg (1953, p.301) puts the loan proportion much higher, at about 1/3. He does not provide a source and his figures do not agree with those of the official U.S. government sources. Hardarch (1994) is an account of the Marshall Plan in Germany.

The reduction for pre-war debt was more difficult. Final agreement relied on creative treatment of the gold clauses written into the original credit agreements. Gold clauses were a common feature of international loans in the nineteenth and early twentieth centuries, inserted into debt contracts as hedges against inflation and currency depreciation. A dollar-denominated loan made in 1924 with a gold clause would require that the borrower repay dollars with a gold value equivalent to a dollar in 1924. The LDA's Article 12 states that gold clauses were to be ignored for all loans issued in either U.S. dollars or Swiss francs. This innocuous language amounts to a devaluation of such debt by about 40 percent. Had the clauses been honored in 1953, every dollar owed under a Dawes loan would have cost the German government 7.11 Marks. By ignoring the gold clauses, the Germans could repay in the actual dollars of the day, each of which cost 4.2 Marks. The London Agreement essentially shifted the cost of U.S. devaluation back to the lenders, even though their debt contracts had explicitly protected them against such revaluations.¹⁶ The U.S. Congress had nullified all gold clauses in (U.S.) domestic debt with a Joint Resolution on June 5, 1933. The U.S. Supreme Court upheld Congress' right to do so, meaning that all such clauses were henceforth meaningless in U.S. credit contracts (Kroszner 1999). But U.S. law did not extend to other creditor countries, nor did it apply to debts owed by foreign creditors to U.S. residents (Dernburg 1953, p.303). The Dawes Loan had gold clauses only for its US-dollar tranches, but they were part of all Young Loan tranches. Respecting the gold clause in some cases and ignoring it in others would result in vastly different valuations of the different tranches of the Young Loan. In some cases a country's currency had depreciated so badly that ignoring the gold clause would have stripped that country's creditors of all their claims. An extreme example was Italy; the lira had depreciated 98 percent between 1930 and 1952.

¹⁶ In 1933, the U.S. devalued the dollar from 1/20th to 1/35th of an ounce of gold.

The Agreement stipulated what amounted to a *dollar* clause: all debts other than those denominated in Swiss francs were valued as if they had been issued in dollars rather than the currency printed on the security. The “dollar clause” represents a convenient compromise. The dollar’s depreciation against gold meant that this apparently technocratic decision achieved a very large reduction in German’s debt. On the other hand, by using the dollar as the valuation standard, the Agreement guaranteed that creditors in countries with badly-depreciated currencies would not bear a disproportionate burden from the gold clause decision. Abs (in Schwarz 1982, pp.29-30) presents the gold clause discussions as an especially difficult part of the negotiations.¹⁷

Once payment figures were agreed, the conference arranged a repayment schedule that took account of Germany’s situation. For the period 1953-1958, only interest payments were due. This delay gave Germany some additional breathing room, and avoided interfering with the reparations Germany had agreed to pay to the State of Israel (see below). Starting in 1958, the LDA required Germany to make annual payments for all debts of 765 million Marks. The 567 million Marks of interest payments due in 1953 were less than Germany’s 708 million Mark trade

¹⁷ Glasemann (1993b, p.29) notes that the agreement Abs describes only applied to the obligations of the *Reich*. Other *Reichsmark*-denominated obligations were valued in the same way only if they had a “specifically foreign character.” Loans were deemed to have this character if they were issued under foreign law or were payable in a foreign location. If not, they were written down, with 10 Reichsmarks being paid off with 1 D-Mark. In a private communication, Stephen Schuker emphasizes that Dawes and Young Loans were supposed to have taken priority over all other Reich obligations, and that the U.S. government had pressured J.P. Morgan and Company to float the Dawes Loan. But in the London Agreement the U.S. tacitly colluded in ignoring the terms promised to the Dawes and Young investors. The point here is not whether the Germans should have had to pay X or Y after 1953; the U.S. and other governments were in effect forcing investors to shoulder part of the cost of a change in foreign policy goals.

surplus with the rest of the world. As Germany's economic miracle took off, she exported more and more, leading to ever-larger trade surpluses. The fixed payments under the London Agreement became less and less significant. By 1968 Germany ran a total trade surplus of 18.4 billion Marks. Some loans had been entirely repaid by the 1960s, and most of the agreement was satisfied by the early 1970s. The last annual payment due under the original agreement was made, as planned, in 1983.

The Agreement treated all German creditors equally, in the sense that the payments were scaled to total German exports rather than to any particular debtor's ability to pay. This equal treatment benefited some debtors at the expense of their creditor. German firms that were either profitable in 1953 or soon would be were treated the same as the cash-strapped governments of the Federal Republic. Individual firm profitability was not the issue, however; the LDA treats the constraint as German transfer abilities, and this required debt reduction even for entirely solvent private firms.

Reparations to Israel

Concern about transfer potential shaped a second agreement undertaken by the Federal Republic at the same time. Early on Adenauer and other German leaders recognized that on both moral and practical grounds, Germany should make significant payments to the State of Israel and to Jewish groups in recognition of the horror the Nazi regime had inflicted on the Jewish people. Adenauer agreed that Germany would pay one billion dollars to the State of Israel, and another \$500 million to the Conference on Jewish Material Claims Against Germany (CJMCAG).

Abs' strategy in London had been to present Germany's ability to transfer payments as the binding constraint, effectively forcing the various creditors to compete against each other for every Mark of payment. Abs argued that all claims against Germany, including the Israeli, should be considered together and at once. Adenauer's agreement to make an additional large payment to Israel and the Jewish organizations undermined Abs' argument; the creditors in

London seized upon Adenauer's promise as evidence of German dishonesty, a greater ability to pay, or both. Abs' approach might have left Germany with a smaller combined bill, but by implicitly treating the Israeli reparations as equivalent to the purely commercial and inter-governmental debts, it would have undermined the entire political point of Adenauer's approach. Germany's discussions with Israel dealt entirely with the method of payment. The Israeli side made clear that they would not bargain over the size of the payment. Germany and Israel eventually agreed that most of the payments would be in kind, to spare pressure on Germany's trade surpluses.

Abs's role in this aspect of the London Agreement was characteristically complex, and his version of events is less than frank. In his own recollections Abs coyly notes his reservations about the simultaneous timing but separate locations of the two discussions (Abs in Schwarz 1982, pp.23-26). Adenauer (1966, p.141) notes that the German delegation in London – that is, Abs — showed little sympathy for the priority of the Israeli claims. In fact, on 19 May, 1952, Abs made an unofficial offer to the Israeli delegation that was so meager as to be completely inconsistent with fulfillment of Adenauer's earlier promise. Abs' offer so appalled the Israelis that Nahum Goldmann (President of the World Jewish Congress) wrote to the Adenauer stating that the Chancellor's honor and the trust of the Israeli government was on the line. Adenauer (1966, p.147) claims that he had no foreknowledge of Abs' offer. In his own memoir Abs does not mention the incident, although he does refer to a somewhat earlier conversation with Goldmann (16 May) in which Abs told Goldmann that either both negotiations (London and with the Israeli delegation) would succeed, or both would fail (Abs 1991, p.131).¹⁸

¹⁸ In his memoirs, Adenauer stresses that the obligation to Israel was moral, and not an attempt to curry favor with the United States, or a reaction to a so-called "Jewish Lobby" in the United States. Adenauer's biographer agrees, stressing Adenauer's long-standing ties to the Cologne Jewish community, as well as Adenauer's sincere horror at what had befallen the Jews at the Nazi's hands (Schwarz 1997). Wolffsohn

Reunification

The Agreement made Germany's repayments conditional on one event. According to Article 25, if Germany reunified, the parties to the agreement would adjust the plan in three ways. First, certain specific features of the agreement would be implemented automatically. Second, the principles embodied in the agreement would be extended to private debtors in East Germany. Finally, the specifics would be adjusted to take account of any loss of property in the east. This final rubric would allow some debtors to escape repayment on the grounds that they had lost their own property to the Soviet occupation or the East German regime.

These clauses allowed Germany to defer repayment of some of the back interest due on the Dawes and other pre-war loans until reunification. At a political or moral level, it was not seen as appropriate to make the people of West Germany repay debts on behalf of the whole country, when part of that country had evolved into a separate sovereign state. This consideration applied to the Dawes and Young loans, money borrowed by a much larger *Reich*, and applied in a different way to loans to Prussia, which no longer existed and whose former territory accounted for not much more than half of the Federal Republic as of 1953. Second, this provision provided a safe way of conditioning German payments on her ability to repay. Re-unification might have seemed remote or even impossible in 1953, but in any case few predicted that re-unification would occur as it did, with a nearly bankrupt East Germany being taken over by the West. The Agreement contemplated a situation where re-unification meant that Germany could afford to pay *more*, not less.

The complicated procedure used to defer some payments was an artful compromise. A more natural procedure might have been to calculate the fraction of Germany's potential GDP

(1988) argues that whatever Adenauer's intentions might have been, he was not reacting to pressure from the United States or other western powers.

that was lost because of the division of the country, and to delay repayment of that much of the debt until unification. The German delegation to the London conference actually produced a set of calculations intended to show the reduction in Germany's ability to pay due to loss of territory and resources. These estimates imply a debt reduction of between 40 and 50 percent, approximately the outcome of the London conference (Dernburg 1953, p.300). There were reasons to doubt such calculations, and in any case it implied a larger reduction for the Prussian loans than for the *Reich* loans, because a larger part of Prussia was gone. For obvious reasons this approach was not acceptable to the creditors who held bonds issued by the now-defunct Prussia (Abs 1991, pp.179-180).

Each bond covered by this aspect of the agreement was split into two parts by the Agreement. One part was exchanged for a regular bond issued by the Federal Republic and serviced as called for in the agreement. The other, representing the back interest payments, was exchanged for a rights certificate (*Bezugschein*) that would, in case of reunification, entitle the owner to another bond for another set of payments. The technical procedure whereby the *Schattenquote* was handled also offers an interesting lesson. As noted, the original bondholders were issued rights certificate, not bonds, for the *Schattenquote*. Abs (1991, p.183) notes the reason: the conference did not want Germany issuing tradable securities that would be a “thermometer” for the market's view of the chances of German re-unification. Such a security would not only be annoying to politicians (giving newspapers something simple and easy to quote as a way of conveying how each West German action supposedly affected the chances of reunification); it would open politicians and others to the chance of a peculiar form of “insider trading,” or at least accusations of such.¹⁹

¹⁹ Glaseman (1993a) claims that these warrants were listed on the Frankfurt exchange until the mid-1970s, usually trading at about 8 percent of their nominal value. Thus Abs' fear came true even with the warrants.

The second part of Article 25 alluded to many different types of debts, the most important being municipal obligations issued by cities that were located in the former East Germany. Again, it would have been perverse to force the citizens of West Germany to repay debts incurred by Dresden or Leipzig. On the other hand, it would have been perverse to tell a creditor they were out of luck because they bought Dresden, rather than Frankfurt, city bonds in 1928. Thus the agreement in effect promised that when the Federal Republic's jurisdiction was extended to cover the former East Germany, the principles of the debt agreement would be similarly extended.

Contingency

The reparations schemes of the 1920s had several undesirable features. Certainly one was their contingency: because the effective reparations bill depended on German ability to pay, all parties had reason to misbehave and to suspect others of misbehavior. The 1953 Agreement's contingent aspects, on the other hand, caused no trouble at all. Why? One difference lies in the small amounts at stake: the *Schattenquote* were very small, while the "C" bonds of the reparations schemes were larger than the A and B bonds combined. But another importance difference here lies in the LDA's appreciation of moral hazard. To be sure, West Germany could influence the probability of future re-unification. But from the creditors' viewpoint, all that matters is whether West Germany would seriously consider the additional debt under the London Agreement as a reason to refuse unification, or to reduce its efforts to bring this about. Abs and other German participants in these discussions recognized the danger of a provision that would allow a general re-negotiation in case of reunification. The *Industriekurier*, an influential business publication, had called for Germany to assume *all* the debt, and not to allow the fact of division to cloud the country's reputation as a responsible debtor. Similar concerns led Abs and the German delegation eventually to advocate provisions that would require definite, set actions on Germany's part, should reunification occur (Abs 1991, pp.181-182). Even after the agreement was crafted, Dernburg (1953, p.313) warned of

... the politico-psychological consideration that flexible arrangements, while suited to avoid formal defaults, might encourage a German successor government less willing to meet international obligations to create conditions that would make transfers impossible. Today when we consider the economically powerful and fiscally responsible Federal Republic, it is hard to recall the bad feeling caused by Germany's treatment of foreign debt-holders in the 1930s. For this very reason, some have interpreted the debt obligations more broadly. Buchheim (1986, pp. 219-220 and 2003) argues that the debts in question were part of the new Federal Republic's "moral burden," the same obligation to break with the past that led Adenauer to advocate reparations to the Jewish state.

The Agreement was oddly vague about what constituted reunification, as Glasemann (1990, p.352) notes. The Agreement also gave Germany the right to demand new consultations about implementing the re-unification clauses, which presumably could have been used to reduce or escape the new payments altogether. But the total cost of servicing the new bonds issued at reunification was small compared to other costs of unification, and not worth raising problems with neighbors and allies.²⁰

Broader Lessons?

Discussions of Germany's debt experience naturally raise more general questions. We conclude with some remarks on what lessons the LDA holds for other episodes. This discussion

²⁰ Glasemann (1993b, pp.53-54) estimates that the original *Schattenquote* obligations were valued at about 1 billion Marks in 1953. Through purchases of the warrants by the Debt Administration, this figure was considerably reduced by 1990. The remaining obligations issued in 1990 had a face value of 240 million Marks. Estimates of the total cost of German reunification to west German taxpayers vary widely, but even the low estimates run in the many hundreds of billions of dollars.

deals with narrow economic issues; in each case there are political (and even moral) matters that lie outside the scope of this paper.

The World Bank's Highly Indebted Poor Country (HIPC) initiative strives to reduce external debts owed by the poorest countries of the world. There are two arguments for this effort. First, "debt overhang" reduces the incentive to save and invest. Until the debts are repaid, the benefits of savings accrue to creditors, not the population of the debtor country. Second, debt forces poor countries to spend scarce resources on debt service rather than education, health care, and other goals. Activists have held up the London Agreement as an example of what should be done for countries in the developing world that have enormous debts and little capacity to repay. There is strong evidence on the effect of debt overhang, and no doubt that debt service requires taking resources from other worthy goals.²¹ However, the core comparison here is incorrect. In 1953, Germany's per-capita income amounted to about \$4900 at 1990 prices. Some of the countries that agreed to the write-down were in much worse shape than Germany in 1953.²² Most of the countries that fall under HDIC today have lower incomes, in real terms, than did Germany in 1953. One can argue for a form of international economic justice that requires the wealthy to help the poor, but that idea played little role in the London Agreement.

A second perspective sometimes appears in the German press. Some of the burdens shouldered by poor countries today are "odious debts," loans made to a repressive regime, often to pay for men and equipment to repress their own population, in the past. In some cases the victims of that treatment must, even after the regime is overthrown, service these debts. Some recent German press accounts hint that the debt written-down in 1953 was odious in this sense, implying that forcing Germany to pay any of the outstanding sum reflected a form of victor's justice. This argument relies on a contentious understanding of the debt. The Versailles

²¹ For surveys of these issues, see Bird and Milne (2003) and Arsanlap and Henry (2003).

²² Incomes figures are Maddison's 1990 Geary-Kanis dollars as updated by Bolt and van Zanden (2013).

reparations obligations themselves were *cancelled*; they were not part of the debt negotiations. One could argue that both the Dawes and Young loans reflected the unreasonable expectations imposed at Versailles, although there the disasters of German economic policy in the 1920s should share some blame as well. But none of the other debts bear any strict connection to Versailles. German cities voluntarily floated bonds to pay for civic improvements such as swimming pools. German firms borrowed to invest. GARIOA aimed to prevent civilian starvation in the years immediately following 1945. The Marshall Plan tried to restart the European economy. Accounts that confuse the LDA with the reparations demands, in effect implying that the debts in question were “odious,” verge on willful misrepresentation.

So should the wealthy countries view the London Agreement as an implicit commitment to treat all debtors in the same way? Surely the London Agreement’s relative generosity reflects not abstract notions of justice, which can be applied to any situation on the basis of some sort of “precedent,” but two concrete facts of the German case. First, increasing tension with the Soviet Union had led to a strong desire to rebuild a sound, democratic Germany. Harsh repayment terms would not serve that end. When the U.S. government decided to forgive \$2 billion in German debt, it was just recognizing that what in 1945 had been a defeated enemy was now a valued ally. In 1953 the U.S. was still involved in the Korean War. Total U.S. military spending in that year amounted to \$53 billion. The U.S. contribution to the write-down, if it helped secure German loyalty to the western alliance, was cheap at the price. Something similar applied to the U.K. and to France and to all the other creditors represented by the agreement. In addition, for the U.K. and France and even for countries that cared little about the emerging Cold War, cooperating with the U.S. on this effect could, one expect, yield financial or other dividends from the U.S. in return.

A second point was also something Keynes insisted upon as a reason to oppose reparations. Prior to World War I, the German economy was central to the European economy as a whole; a healthy Europe could not exist alongside a sick Germany. The same held true after World War II. The German economy was so important to the world economy, and to Europe in

particular, that the country was in a strong position to demand concessions that would enable her to return quickly to her traditional role. Developing-country debtors, unfortunately, rarely have such a favored political role, or play such an important part in the world economy.

The London Debt Agreement has also served as an argument in discussions of the Greek debt crisis, especially after the election of the left-wing Syriza in January of 2015. Even after a write-down of about 2 billion Euros, Greece's external debt amounted to 175 percent of its GDP. Efforts to service that debt and to meet the demands of its creditors had led Greece to increase taxes and to cut back government services, "austerity" policies which were in turn largely responsible for a contraction of Greek GDP on the order of 25 percent from 2005 to 2015. As the single largest creditor and the leading state in the European Union, Germany took a prominent role in refusing Greek requests for debt forgiveness. Part of the German argument rested on the assertion that Germany had always paid its debts, and Greece should, too.

Not surprisingly, those taking Greece's side in the argument often brought up the LDA. Germany's creditors wrote down its debt in 1953; moralizing claims to the contrary, Germany has not always repaid its debts. The LDA also offers an irony: Greece was one of the signatories. In 2015, Greece (2014 per-capita income: \$U.S. 21,653) was asking for debt relief from, among others, Germany (2014 per-capita income: \$U.S. 47,590). In 1953, Germany (1950 per-capita income: \$4,281) received debt relief from both the United States (1950 per-capita income: \$9,573) and Greece (1950 per-capita income: \$1,951). On its face, Greek request for debt relief, at least to the extent that relief came from Germany, seemed like simple justice.

We can sharpen understanding of the LDA and the Greek case by considering why the comparison is not so simple. As the LDA contemplated and events have demonstrated, the German economy could support its people without additional assistance. This was not the case with Greece in 2015; there, the government recognized that full debt remission would not be enough. Just keeping the banking system and government afloat required more help from the

people who were already its creditors. The LDA represented debt relief alone. The Germans in 1953 were not asking for additional support from their former enemies or other creditors.

A second important difference reflects the nature and position of the creditors. Large parts of the European public have been convinced, fairly or not, that debt forgiveness to Greece would constitute transfers from one set of taxpayers (German, or French or Estonian) to Greek taxpayers. Such transfers seem to many Europeans a violation of the agreements that underlie the Euro or even the European Union itself. U.S. negotiators in London 1949-53 were in a different position. The American public paid relatively little attention to the German debt question. The U.S. direct, governmental contribution (which above we reckoned at \$2 billion) was a small amount compared to U.S. military spending at the time. By 1953 Americans were accustomed to their government spending huge amounts of money to protect them from real or imagined enemies.

Perhaps the most important economic difference, however, turns on the implications of debt relief for other debtor countries. In 2015, Greece was the most heavily-indebted E.U. state, but several others, most notably Portugal and Spain, suffered under heavy debt burdens. Writing down Greek debt without doing something similar for other debtors would be politically difficult. More importantly, it would raise the question among potential lenders of whether loans to E.U. countries were loans to individual countries or loans to the Union as a whole, or, even worse, whether European states took their debt obligations seriously. Although Germany was not the only heavily indebted country in 1953, it was the only one for which an agreement like this was contemplated. Creditors did not need to worry that by writing down German debts they were endangering the possibility of lending to countries in general.

The idea that the London Debt Agreement established a precedent, or that German debt relief for Greece would represent turnabout-as-fair-play, misses the nature of the 1953 agreement. The LDA represented a pragmatic understanding of Germany's situation and its potential role in the economy and security system of Western Europe. The creditor nations did not forgive half of

Germany's debts because they represented generous people; they forgave German debt because they thought doing so was in their own country's interest.

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