WHY INNOVATE?
Founding the Bank for International Settlements

By BETH A. SIMMONS*

THEORIES of the development, maintenance, and adaptation of international institutions have been at the center of scholarship in international political economy in the past decade. Functionalist logic, often based on game-theoretic representations of strategic state behavior, has been especially influential in explaining the demand for international institutions. These theories point to the role of international institutions in infusing international relations with a greater degree of certainty, to the general longer-term benefit of cooperating nations.[1] This article draws on a distinct but parallel development in the economic literature on international finance: dynamic contracting and rational expectations approaches to capital market suboptimality.[2] Like functional theories of international cooperation, this approach focuses on the dynamics that lead to inefficient outcomes and provides a theoretical rationale for the

* Thanks to the following individuals for their helpful comments: James Alt, Mark Brawley, Barry Eichengreen, Jeff Frieden, Craufurd Goodwin, Joseph Grieco, Stephan Haggard, Miles Kahler, Ethan Kapstein, Robert Keohane, Stephen Krasner, Peter Lange, Lisa Martin, Kalypso Nicolaïdis, and Louis Pauly. Encouragement for research into this subject was given by Professor Robert Boyce, London School of Economics. All errors and fallacies remain my own. I thank the Fulbright Foundation for generous financial support for my European research. I am indebted to the following individuals and institutions for their kind assistance in my research: J. M. Keyworth, archivist of the Bank of England; John Orbell, archivist of Baring Brothers, London; the British Public Records Office; the family of Sir Josiah Stamp, collection of papers relating to Sir Josiah Stamp, London; School for Oriental and African Studies (diary of Sir Charles Addis), London; Carl Backlund and Rosemary Lazenby, archivists at the Federal Reserve Bank of New York; Historical Collections Department, Baker Library, Harvard Business School, Boston; National Archives, Washington D.C.; and the archives of the Ministère des Finances, Paris. Thanks to Lyle Scruggs and Adam Krob for research assistance. An earlier version of this paper was presented at the annual meeting of the American Political Science Association, Chicago, September 1992.

[1] Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984); idem, "The Demand for International Regimes," in Stephen Krasner, ed., *International Regimes* (Ithaca, N.Y.: Cornell University Press, 1983).

[2] For an excellent review of this literature, see Vincent Crawford, "International Lending, Long-term Credit Relationships, and Dynamic Contracting Theory," Princeton Studies in International Finance, no. 59 (Princeton: International Finance Section, Princeton University, 1987). For a review of functional theories of international regimes, see Stephan Haggard and Beth A. Simmons, "Theories of International Regimes," *International Organization* 41 (Summer 1987), 506–9.

development of international institutions to overcome these inefficiencies. When applied in the context of the policy preferences of the key actors (the governments of the major powers, their central bankers, and the dominant international bankers of the day), this approach makes it possible to explain not only the impetus for international financial cooperation, but also why this effort converged on an international financial institution such as the Bank for International Settlements.

This article applies some of the insights of the dynamic contracting literature to a historical case of institutional innovation in the area of international debt and finance: how it was that the BIS, the world's first multilateral banking institution, could be established during one of the most nationalistic periods in diplomatic history. The major insight of that literature is that international institutions may be explained as a function of the benefits that both lenders and borrowers expect to gain from smoother and more efficient capital market operation. By contrast, the creation of the first "world bank" (as some referred to the BIS) is not easily understood in terms of the traditional theories of international relations. Realist theories, with their emphasis on state competition, do not easily explain why the major powers agreed to a cooperative intergovernmental banking institution that was proposed, designed, and backed by financiers and central bankers and *not* by statesmen. Realists would find it especially difficult to explain why states would involve private actors in negotiations as fundamental to power relations as the reparations issue. They would also likely predict a solution much more like France's Ruhr policy than the multilateral banking institution that actually emerged.[3]

Theories of hegemonic stability that link the provision of international public goods (for example, policies or organizational structures that contribute to a stable international economic environment) with the interests of a major power might make either of two predictions, neither of which would be correct. On the one hand, if the analyst were to judge the United States to be the dominant power (not unreasonable, since that country emerged from World War I as the major international creditor country), one would expect the American government to have championed the new bank, as it did the International Monetary Fund in the 1940s. Yet the United States retreated into isolation and refused to endorse or allow American officials to participate in the BIS. On the other hand, if the analyst views the interwar years as an interregnum marked by British decline and nascent (but incomplete) American ascendance, then hegemonic stability theory could barely account for the establish-

[3] This was a coercive strategy to force German debt repayment through military occupation of the Ruhr valley in the early 1920s.

ment of the bank at all. Finally, functional theories of international regimes, which stress the creation of cooperative arrangements as the result of their anticipated benefits, point in a fruitful direction but might lead one to expect much more innovation than in fact occurred.[4] Theories of dynamic contracting, given the array of actors' interests prevailing at the time, not only explain the impulse to innovate in 1929 but also illuminate why the BIS assumed an unusual Janus-faced character: statutes that comprised both banking functions and reparations functions; central bank membership with private management; a nonpolitical facade with an explicit trust agreement to act as agent for the creditor governments.

The interwar years lend themselves to a study of how international institutions get started. These years saw important market disturbances that lead one to expect a heightened demand for new international institutions. But unlike the period immediately following the Second World War, the interwar years are the more general case of a fairly pluralistic international system. Hence, some of the conclusions drawn from the interwar years may be more generalizable for institutional formation than those drawn from the special post-1945 case. Furthermore, the problems and solutions encountered in trying to fashion a viable international economic modus vivendi in the 1920s and 1930s informed the architects of the Bretton Woods system. To understand the impetus for the International Monetary Fund and the World Bank, it is useful to understand their political and institutional lineage.[5]

[4] Despite several instances of a "perceived need" to cooperate in international economic affairs, the interwar years generally offered few innovations in international economic organization. See S. V. O. Clarke, "The Reconstruction of the International Monetary System: The Attempts of 1922 and 1933," Princeton Studies in International Finance, no. 33 (Princeton: International Finance Section, Princeton University, 1973), 3; and idem, *Central Bank Cooperation, 1924–31* (New York: Federal Reserve Bank of New York, 1967).

[5] See Jeffry Frieden, *Banking on the World: The Politics of American International Finance* (New York: Harper and Row, 1987), 63–64. For the IMF comparison, see Richard Gardner, *Sterling-Dollar Diplomacy in Current Perspective* (New York: Columbia University Press, 1980), 110–44. One of the few international organizations to survive the Second World War, the bank is now estimated to hold between 10 and 15 percent of global monetary reserves on behalf of its member central banks, from which it provides short-term bridge loans to a member whose currency is under severe pressure. It has cooperated closely with the International Monetary Fund since 1978 by accepting special drawing rights deposits, and twice in the 1980s it granted credit facilities to the IMF. The BIS has also been instrumental in coordinating financial regulations, particularly capital adequacy requirements, within the markets of its members. See Ethan B. Kapstein, "Resolving the Regulators' Dilemma: International Coordination of Banking Regulations," *International Organization* 43 (Spring 1989); Dale D. Murphy, "Regulatory Convergence in International Banking: Capital Adequacy Standards" (Manuscript, MIT Department of Political Science, 1991). Its membership has always encompassed all the central banks of Europe, except those of Albania and the USSR, and for this reason it is viewed by some as well positioned to facilitate the integration of Eastern Europe into the international monetary system. See Mario Giovanoli, "The Role of the Bank for International Settlements in International Monetary Cooperation and Its Tasks Relating to the European Currency Unit," *International Lawyer* 23 (Winter 1989). Information on the bank's activities can be found in its *Annual Report*.

Little has been written about the *origins* of the BIS, however, and the work that has been done is largely historical rather than theoretical.[6] One reason may be that the bank failed in its original mission: in the face of the Great Depression it was unable to calm the currency and capital markets and ensure the collection of debts and reparations from Germany. Nevertheless, the neglect of one of the most innovative efforts in financial cooperation up to that time is unfortunate, since the bank's founding provides interesting theoretical insights into why and when international institutions are created. The argument of this paper is that the BIS was designed to avert capital market breakdown by enhancing Germany's perceived commitment to meet its international debt obligations. It was part of a bargained arrangement whereby reparations demands were reduced and a new institution created to increase the likelihood that Germany would in fact honor its commitments. The new institution was conceived and designed by private financiers and central bankers: both had a strong interest in capital and currency market stability and fully expected the new international bank to contribute to this end. Despite the animosities and suspicions among the major powers and despite the void in international leadership, these actors persuaded their governments to accept the BIS in hopes of minimizing their financial losses and stabilizing the fragile international monetary system.

The article proceeds as follows. First, I present a dynamic contracting framework for understanding capital market inefficiency and multilateral debt bargaining. Second, I present the evidence that capital markets were nearing collapse in the late 1920s, thus establishing a rationale for institutional innovation. Third, I discuss the reparations problem of the 1920s and show that the BIS was designed to secure German debt payments and thus to help address the problem of extreme market inefficiency. Fourth, I discuss the interests of the major governments and their central bankers and show how these interests informed and constrained the negotiations that led to the formation of the bank. Fifth, I describe the critical role of private financiers in proposing and designing the bank. Finally, I conclude that dynamic contracting theory sheds more light on the formation of the BIS than do traditional, state-centric approaches. It is only by understanding the *array* of interests (of governments, central bankers, and private financiers) in the dynamic bargaining setting that one can understand international financial innovation in a period otherwise marked by diplomatic conflict.

[6] Frank Costigliola, "The Other Side of Isolation: Establishment of the First World Bank, 1929–30," *Journal of American History* 61 (December 1972); Eleanor Lansing Dulles, *The Bank for International Settlements at Work* (New York: MacMillan, 1932).

I. Capital Market Failure, Sovereign Borrowing, and Institutional Innovation

Sovereign international borrowing is potentially problematic for capital market efficiency. The problems of enforcing contracts under anarchy make such loans uniquely difficult to arrange, while information asymmetries between sovereign borrowers and lenders exacerbate the problem of making credible long-term commitments to fulfill obligations. Furthermore, credit markets for sovereign states are usually noncompetitive, so both lenders and borrowers can act strategically. These characteristics of international lending pose potential difficulties for the smooth operation of capital markets.

Dynamic Contracting Approach

These problems have been analyzed extensively in the literature on dynamic contracting. One finds that sovereign borrowers frequently have preferences which are time inconsistent: an agreement that is rational when a loan is being negotiated may not be rational to fulfill after the loan has been extended. For instance, it is rational for borrowers *ex ante* to pledge to use the money to make profitable investments, to follow "responsible" macroeconomic policies, and to repay the loan on time. Once the money has been disbursed, however, these may no longer be optimal policies from the point of view of the borrower.[7] Since creditors anticipate the risk of defection, they may charge higher interest rates, but they are also likely to ration credit by quantity rather than by price.[8] Borrowers will then pay higher rates for a smaller supply of credit than they would have had they been able to make an enforceable, or at least a credible, commitment. Lenders, for their part, will have forgone some profitable investment opportunities. Both parties would have been better off had the borrower been able to guarantee a responsible course of action.

In these models suboptimal lending results from the inability to enforce sovereign debt agreements. Some models have also considered the

[7] Less often discussed is the problem of lenders' time-inconsistent preferences. For lenders, under some assumptions, it may be rational *ex ante* to commit oneself to a credit ceiling so as to impose a limit on the borrower's consumption and reduce the chances of default. *Ex post*, however, a lender may be unwilling (for fear of losing the entire investment) to enforce the limit that would have been optimal were it credible in the first place. See Martin Hellwig, "A Model of Borrowing and Lending with Bankruptcy," *Econometrica* 45 (November 1977).

[8] Note that raising their interest rates to compensate for the heightened risk would actually raise the probability of default. See Richard Cooper and Jeffrey Sachs, "Borrowing Abroad: The Debtor's Perspective," in Gorden W. Smith and John T. Cuddington, eds., *International Debt and the Developing Countries* (Washington D.C.: World Bank, 1985). Credit rationing is often the result in models that incorporate imperfect information and information asymmetries, a problem treated below.

effects of asymmetrical information in which the lender cannot be certain of the true intentions of the borrower. Unenforceability and information asymmetry are considered in turn.

THE DIFFICULTY OF ENFORCING CONTRACTS

The bane of international lending to sovereign states is that these loans are extended under anarchy: authoritative enforcement of obligations or collective decisions is weak or lacking.[9] Even if a state agrees to submit to international arbitration concerning the fulfillment of its contractual obligations, such submission is necessarily voluntary and enforcement of any judgment notoriously problematic. In contrast to the case of a private borrower, there is no generally recognized formal procedure for handling a state's default on international debt.[10] Lenders know that sovereign borrowers have incentives to make promises at the contracting stage that may be rational to break once financing is secured. This makes it difficult to design mutually beneficial contracts.

Lack of external enforcement, though a universal condition, is not a sufficient explanation of market failure. Many loan agreements never

[9] For an excellent review of these difficulties, see Jeffrey Sachs and Daniel Cohen, "LDC Borrowing with Default Risk" (Cambridge: National Bureau of Economic Research Working Paper, no. 925, July 1982).

[10] According to the most generally accepted theories of international law, sovereign external debts are like any other form of international agreement; no special rules or methods of redress apply to state defaults. See J. G. Starke, *Introduction to International Law*, 10th ed. (London: Butterworths, 1989), 304 and passim. Nineteenth-century conceptions condoned the use of force to enforce financial obligations. The Palmerston Circular (1848) argued that a state could intervene and even resort to military force on behalf of private bondholders while the Drago Doctrine limited such interventions to cases in which states refused to accept arbitration or submit to an arbitral award. Both of these modes of enforcement are unavailable in a world in which the peaceful resolution of disputes is the prevailing norm. On the other hand, foreign debts of *private borrowers* can be enforced in the courts of the nationality of the borrower, making the problems of contract enforceability much less serious than is the case of sovereign borrowers. The problem goes back at least to the early nineteenth century, when creditor groups tried to organize to improve their chances of collecting sovereign foreign debts. On the Organization of Foreign Bondholders, see Max Winkler, *Foreign Bonds: An Autopsy* (Philadelphia: Rowland and Swain, 1933), 153–57; Murray Edelstein, *Overseas Investment in the Age of High Imperialism: The United Kingdom, 1850–1914* (New York: Columbia University Press, 1982), 129; Leland Hamilton Jenks, *The Migration of British Capital to 1875* (New York: Alfred Knopf, 1938), 290. The best overview is given by Herbert Feis, *Europe the World's Banker, 1870–1914* (New Haven: Yale University Press, 1930). The IMF has played a similar role in the postwar world. See Charles Lipson, "The International Organization of Third World Debt," *International Organization* 34 (Autumn 1981); and Sebastian Edwards, "The International Monetary Fund and the Developing Countries: A Critical Evaluation," *Carnegie-Rochester Conference Series on Public Policy* 31 (Autumn 1989). For explicit comparisons of interwar debt and default with the 1980s, see Barry Eichengreen, "Resolving Debt Crises: An Historical Perspective," in Sebastian Edwards and Felipe Lorraine, eds., *Debt, Adjustment, and Recovery: Latin America's Prospects for Growth and Development* (Oxford and Cambridge: Blackwell, 1989); and Barry Eichengreen and Richard Portes, "Dealing with Debt: The 1930s and 1980s," in *Dealing with Debt: A World Bank Symposium* (Washington D.C.: World Bank, 1989).

require enforcement because neither party has a better alternative. In that case the mere threat that a default would end the relationship is sufficient to assure compliance. Vincent Crawford has labeled such agreements "internal implicit contracts" and cites the well-known repeated-play Prisoners' Dilemma literature as the theoretical underpinning for this result.[11] The fact that most states honor their borrowing commitments suggests that such contracts are often sufficient.

There are, however, a number of factors that can raise the risk of default and render self-enforcing agreements problematic. Since the immediate benefits of borrowing are typically concentrated in the present while repayment is a lien on the future, nonperformance may be exacerbated by highly polarized or unstable domestic political conditions.[12] Highly polarized political systems may foster inflationary macroeconomic policies, since contending factions may refuse to shoulder increased fiscal burdens and may thereby render the government unable to balance its budget.[13] Under these conditions, internal implicit agreements are not likely to be sufficient to assure compliance.

Theoretically, international institutions could ameliorate the enforcement problem in several ways. They might be given explicit authority to punish, although it is difficult to imagine an international financial institution with this degree of supranational authority. An international institution could hold some form of collateral that the borrower would forfeit in the event of default.[14] Just what might constitute meaningful collateral for a sovereign loan, however, remains problematic.

International institutions are much more likely to have an indirect impact on enforcement. They are useful in designing "external implicit

[11] Crawford (fn. 2), 5–6. Another form of implicit contract is that of "pure reputation" modeled by Jeremy Bulow and Kenneth Rogoff, "Sovereign Debt: Is to Forgive to Forget?" *American Economic Review* 79 (March 1989), 43–50.

[12] For an example of the theoretical work linking the default decision to political instability, see Joshua Aizenman, "External Debt, Planning Horizon, and Distorted Credit Markets," *Journal of International Money and Finance* 9 (June 1990). Default and political polarization are explored in Alberto Alesina and Guido Tabellini, "External Debt, Capital Flight, and Political Risk," *Journal of International Economics* 27 (November 1989).

[13] Sebastian Edwards and Guido Tabellini, "Political Instability, Political Weakness and Inflation: An Empirical Analysis," *Journal of International Money and Finance* 10, Supplement (March 1991). An institutionally underdeveloped tax system may be another condition associated with debt default. See Homi J. Kharas, "Constrained Optimal Borrowing by LDCs," *Domestic Finance Study*, no. 75 (Washington D.C.: World Bank, 1981); and Menachem Katz, "Government Policy, External Public Indebtedness, and Debt Service" (Washington D.C.: International Monetary Fund, 1982).

[14] The most reasonable forms of collateral to hold—foreign exchange reserves, government or railway bonds, title to property, title to import duties—are usually worth only a fraction of what an indebted government might owe. They are moreover worthless if the defaulting government does not wish to honor them and if there is no ultimate enforcer of these claims.

contracts," to continue with Crawford's terminology, which rely on actions by third parties to make the penalty for noncompliance more severe. International institutions can, for example, link contract fulfillment with future streams of credit by providing creditors with incentives to participate in a coordinated moratorium in case of repudiation.[15] Then the potential defaulter would have to compare the costs of defaulting with the costs of capital market autarky. International institutions could even be used to coordinate far-reaching economic sanctions, such as seizure of overseas assets, loss of trade credits, or even a trade embargo. Such sanctions would support a larger set of mutually beneficial agreements than would be the case in the absence of the institution.[16]

INFORMATION ASYMMETRY

While all models of dynamic contracting in international capital markets assume the lack of authoritative enforcement, some also incorporate assumptions of imperfect information. Often this assumption takes the form of information asymmetry in which the borrower is assumed to know more than the lender does about his ability and intention to live up to the terms of the loan agreement.

Although one might think that having private information would advantage a borrower in a loan negotiation, the situation is the opposite: in dynamic, forward-looking models, the asymmetry actually makes it harder for a borrower to establish its credibility. Lenders know that in

[15] In the absence of institutional arrangements among themselves, creditors can find it difficult to coordinate their reactions to default. While it may be preferable for all to attempt to punish a borrower's defection by withholding future credit, individual firms may find it profitable to make separate deals to defect from the group effort to impose sanctions. But most importantly, under conditions of anarchy, creditors face tremendous uncertainty regarding the resolution of a sovereign state's payment moratorium. To the extent that creditors anticipate collective action problems among themselves, this may contribute further to suboptimal market behavior. See Charles Lipson, "Bankers Dilemmas: Private Cooperation in Rescheduling Sovereign Debts," *World Politics* 38 (October 1985). However, recent theoretical work by Jeremy Bulow and Kenneth Rogoff (fn. 11) suggests that "punishing" by a generalized credit moratorium is not sufficient to ensure compliance. In their model, "small" countries (defined as those that cannot affect world prices and interest rates) are simply not able to establish their reputations, because they will be better off if they default and use the savings to conduct future business by paying cash in advance. They conclude that a "pure reputational model," in which the only punishment is an end to foreign borrowing, provides insufficient incentives for compliance.

[16] There is disagreement in the empirical literature concerning LDCs as to whether or not a country's "reputation" actually lessens its future access to credit. See Bulow and Rogoff (fn. 11). Empirical work by Peter Lindert appears to confirm the weak role that reputation has played in international finance in the twentieth century. See Lindert, "Response to Debt Crisis: What Is Different about the 1980s?" in Barry Eichengreen and Peter Lindert, eds., *The International Debt Crisis in Historical Perspective* (Cambridge: MIT Press, 1989); Peter H. Lindert and Peter J. Morton, "How Sovereign Debt Has Worked," in Jeffrey D. Sachs, ed., *Developing Country Debt and Country Performance* (Chicago: National Bureau of Economic Research, 1989).

order to secure the best possible terms, sovereign borrowers have strong incentives to misrepresent their intended behavior regarding future borrowing, investment versus consumption, and macroeconomic policies (once again, the problem of time inconsistency). Therefore sophisticated lenders build into their loan offers protection against the possibility that the borrower is abusing his privileged informational position. They try to protect their interests in the face of imperfect information by rationing credit[17] and by shortening loan maturities so as to gather better information on the borrower's true intentions and abilities.[18] But shorter maturities are more costly to both lenders and borrowers because of the high transaction costs of frequent rollover negotiations and the element of uncertainty they inject into financial planning. Once again, both parties would be better off with access to unbiased information.

Both lenders and borrowers have excellent theoretical reasons to try to overcome informational asymmetries through institutional innovation. International institutions may provide credible information on political and economic conditions within the borrowing country that no individual lender, given its limited resources, could afford to gather. This information can be used to establish the appropriateness of the volume of investment given its contemplated uses and the macroeconomic setting into which it will be injected. Quality information is a collective good, and to the extent that it is perceived as accurate, it will assist borrowers to make believable promises.[19]

There is a second reason both lenders and borrowers should have an interest in institutions that provide high-quality information: to establish the nature of any impending default, whether due to outright repudiation, temporary illiquidity, or genuine insolvency. As Jeffrey Sachs has pointed out, it might be appropriate to punish repudiation, but it makes much more sense to finance a temporary period of illiquidity and to forgive a portion of the debt in cases of insolvency. The problem for creditors is to recognize the difference. Unbiased information on economic conditions makes repudiation more costly than it might be, were it able

[17] See D. Jaffee and T. Russell, "Imperfect Information, Uncertainty, and Credit Rationing," *Quarterly Journal of Economics* 90 (November 1976); J. Stiglitz and A. Weiss, "Credit Rationing in Markets with Imperfect Information," *American Economic Review* 71 (June 1981); D. Gale and M. Hellwig, "Incentive-Compatible Debt Contracts I: The One-Period Problem" (Bonn: DP, 1983); and Jonathan Eaton and Mark Gersovitz, "Debt with Potential Repudiation: Theoretical and Empirical Analysis," *Review of Economic Studies* 48 (April 1981).

[18] Kenneth M. Kletzer, "Asymmetries of Information and LDC Borrowing with Sovereign Risk," *Economic Journal* 94 (June 1984).

[19] At any rate, it can be thought of as a collective good for lenders and for all but the *highest risk* borrowers, who may fare better in a low-information environment. The fact that Germany was reasonably cooperative in agreeing to international supervision indicates that they were probably not in the highest risk category at this time.

to masquerade as a genuine inability to pay. Hence, better information feeds back into the ability to enforce. Without it, creditors will find it difficult to establish debtor culpability and to agree among themselves to sanction. But if a respected and well-informed international institution avers outright repudiation, creditors can more swiftly coordinate their punitive response.

Multilateral Negotiations, Debt Rescheduling, and Institutionalization

So far, we have considered the case in which a debtor is faced with a unified rational creditor and have explored the incentives for each to form an international institution. But the case of the Bank for International Settlements was inextricably tied to the problem of German reparations in the context of Germany's overall debt burden during the 1920s. Since Germany had huge debts to both private lenders and government creditors, and since decisions made to reduce reparations affected the value of outstanding private loans, it is necessary to analyze the debt rescheduling in a multilateral setting that takes into account the interests of the debtor (Germany), officials creditors (France, the United Kingdom, and—indirectly via interallied war debts—the United States), and private lenders (holders and marketers of German bonds). In other words, bargaining can take place between debtor and creditors, *and* between private lenders and creditor governments, constrained by their taxpayers.

A dynamic bargaining-theoretic model developed by Bulow and Rogoff roughly resembles this situation, although it is designed to analyze the renegotiation of a sovereign's private debt with the possibility of the creditor's government making side payments to facilitate agreement.[20] The basic problem of the model is for creditors and debtors to agree on a new debt schedule. The debtor can threaten default, while the private creditor can threaten punishment by using its domestic legal system to interfere with the debtor's trade, assets, and access to further investment. This model assumes that punishing debtors can be costly to the citizens (taxpayers) of the private lenders' country. Hence, the state can be motivated to make side payments to either the debtor or private creditor, rather than allowing costly sanctions to be implemented.[21]

[20] Jeremy Bulow and Kenneth Rogoff, "Multilateral Negotiations for Rescheduling Developing Country Debt," *International Monetary Fund Staff Papers* 35 (December 1988).

[21] The model is based on symmetrical information, but the effect of relaxing this assumption is that agreement is delayed. Bulow and Rogoff (fn. 20) assume that the creditors' states will not interfere with the domestic legal system to prevent private creditors from sanctioning. Several other assumptions of the model should be pointed out: the debtor is assumed to be a small country in the sense that it cannot influence world interest rates but is sufficiently

In this three-way rescheduling negotiation, each party takes turns making offers on how to divide the benefits of reaching an agreement; in this model, such benefits are equal to the total gains from trade. Two key parameters heavily influence the eventual division. The first is each party's rate of discount, since the more patient player has a greater capacity to threaten credibly to wait and therefore can demand a better offer. The second parameter influences both creditor and debtor governments' willingness to make side payments: the magnitude of the two countries' gains from trade. The higher these gains, the more likely the creditor government will be to make concessions. A final interesting result that flows from the model's rational forward-looking assumptions is that the benefits from unanticipated creditor-country side payments accrue to both lenders and borrowers, while anticipated side payments will accrue to the debtor exclusively. If side payments are anticipated, that is, a competitive financial market will use the side payment to make more loans.[22] Creditors' governments, therefore, have an incentive to try to make a credible commitment *not* to make side payments, but this is difficult to do if their trading relationship with the debtor is extensive.

This model suggests that governments that are most sensitive to the costs of enforcement and whose rate of time discount is the highest are most likely to make side payments to a sovereign debtor during a rescheduling agreement. While the model was created to explain creditor government side payments during private debt negotiations, it can easily be generalized to any case in which governments and private lenders are creditors and in which punishment for default of a sovereign borrower is costly.[23] The model points out that governments are constrained in their ability to threaten punishment because to do so can end up hurting their own citizens who benefit from the trading relationship with the debtor.[24] As sovereign debtors and private creditors contemplate rescheduling, creditor governments with the higher rate of time discount and

large to have some impact on welfare in the creditor country if trade is cut off. The debtor borrows, not to smooth consumption, but because its rate of discount exceeds that of world interest rates. Debtors cannot provide collateral. Both states' utility depends on the consumption of imports, which in turn depends on their ability to export. In case of default creditors can cut off trade until the debt is rescheduled by agreement. A debtor can store its exports, but they tend to depreciate over time. All private creditors are assumed to be a unified entity.

[22] Note that this conclusion depends on the assumption of competitive capital markets, which differs from most of the literature cited above in which capital markets were characterized as oligopolistic.

[23] This is just the special case in which private creditors will not move from their original offer (their debt is not presently being rescheduled) and governments are willing to cut their own demands for repayment as part of a side payment to the debtor to facilitate agreement.

[24] Bulow and Rogoff's model (fn. 20) assumes that side payments can be made up to the value of total trade with the debtor country. This assumption would need to be relaxed to reflect accurately the political pressure the creditor governments felt to press for their full reparations during the 1920s. This problem is discussed below.

the more extensive trading links with the debtor should be most amenable to making side payments.

Finally, we must consider the form these side payments or concessions might take. Most obvious is monetary: governments may agree to reduce their own claims on a country (or agree to pay off a portion of the borrower's debt) in order to reach agreement on a reasonable *overall* debt burden. This would cut the burden of debt service (a benefit to the debtor) and enhance the value of the outstanding debt (a benefit to private lenders). But governments could also choose to make *organizational* side payments: they could pay the start-up and ongoing costs for the development of an international institution that would help overcome capital market suboptimalities and better secure their own outstanding loans. Since organization can be costly to provide and is unlikely to be provided by more numerous and decentralized market actors facing difficulties of collective action,[25] creditor governments were in a position to agree (hesitantly, to be sure) to support the collectively beneficial BIS.[26] As I argue below, no single banking institution or consortium was willing to assume such costs in 1929. This conception of the problem helps to explain why reparations negotiations during 1929 involved not only talk of financial concessions on the part of governments but also the proposal (initiated by independent financial experts but eventually accepted by the creditor governments) to establish and fund the Bank for International Settlements.

Summary: Dynamic Contracting Theory as a Framework for Interpreting the Formation of the BIS

The dynamic contracting literature provides a coherent framework for understanding the incentives of Germany and its creditors to create an innovative international financial institution in 1929. The impulse to innovate, these theories suggest, flows from the structural inability of states to make credible commitments under anarchy. Because international institutions can ameliorate (though not solve) enforcement and informational problems, incentives to innovate are greatest when a major debtor's credibility is ebbing and capital markets are beginning to break down. We would therefore expect institutional innovation when there is

[25] Mancur Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1965).

[26] Norman Frohlich, Joe Oppenheimer, and Oran Young term the willingness of any individual to supply a collective good without providing all of the resources himself an exercise of "political leadership" or "political entrepreneurialism." See Frohlich, Oppenheimer, and Young, *Political Leadership and Collective Goods* (Princeton: Princeton University Press, 1971), 6. I avoid this terminology, however, because it connotes a much more active and positive role than the bargained concession suggested here.

evidence of potentially disruptive credit rationing. Dynamic contracting theory suggests that international institutions that coordinate punishment and provide unbiased information can make it more costly for the parties to defect from the loan agreement.

A multilateral bargaining model can also help account for the pattern of concessions or side payments made during debt-rescheduling talks. Because both enforcement and default are costly to the citizens of creditor states, their governments will be willing to make side payments to assure a rescheduling agreement, especially if the benefits from trade with the debtor are significant and the creditor government's rate of time discount is high. I have argued that side payments may include not only debt concessions but also organizational and financial support for international institutions, which can be expected to improve capital market efficiency in the future. This bargaining perspective—incorporating the interests of debtor, private creditors, and creditor governments—addresses the anomaly of international financial institutionalization in the late 1920s, a time of both rampant nationalism throughout Europe and the virtual isolation of the United States government.

II. The Environment for Innovation: Political and Financial Conditions in the Late 1920s

How can we understand the intensified search for improved international financial cooperation in the late 1920s? An international economic and political environment that posed increasingly intolerable risks for both the German government and its major creditors, official and private, provides the answer.[27] The source of the threat was a slowdown in international lending to Germany that began in 1928. For much of the decade Germany had imported massive amounts of capital to finance domestic investment and consumption, but by 1928 liquid capital was subject to the "push" of Germany's domestic political instability *and* the competing "pull" of the booming American stock market and high American interest rates. The result was a severe curtailment of new capital imports to Germany by 1928, which worsened after the Wall Street crash

[27] This was not the first time an international bank had been discussed at high levels. In 1920 the League of Nations Committee on International Credits entertained the idea of an international bank of issue, which eventually evolved into a proposal for a League commission that would supervise and guarantee international loans for countries otherwise unable to obtain them. The former was proposed by Sir George Paish, the British economist, and submitted to the League by Léon Delacroix, the Belgian prime minister. The latter plan was developed by the Dutch banker Ter Muelen. See Barry Eichengreen, *Golden Fetters* (London: Oxford University Press, 1992).

TABLE 1
CAPITAL IMPORTS OF THE THREE MAIN DEBTOR COUNTRIES
(IN MILLIONS OF CURRENT U.S. DOLLARS)

	1924	*1925*	*1926*	*1927*	*1928*	*1929*	*1930*
Germany	421	857	151	1,072	1,007	553	148
Australia	220	110	170	257	193	166	187
Argentina	—	—	226	122	181	4	243

SOURCE: League of Nations, Economic Intelligence Unit, *World Economic Survey, 1931–32* (Geneva, 1933), 39–49.

of October 1929.[28] (See Table 1.) Foreign bond flotations in America were halved from their 1927 levels by 1928–29. Nineteen twenty-eight was the first year in which long-term investment in Germany began to level off, accompanied by a downturn in short-term lending (see Figure 1).

From 1927 on investors became increasingly skeptical of making additional loans to Germany. Few were impressed with the purposes to which much of the capital Germany had borrowed had been put, a perception reinforced by Reichsbank president Hjalmar Schacht's 1927 critique of the German "recovery."[29] Nor were investors impressed with Germany's commitment to service its public debt out of taxation. Only 2 percent of public spending was involved in debt service (the figure for Britain was nearer one-quarter). Public funds were largely used to enhance the stability of the political system: nearly 60 percent of government spending went to social services, as compared with 37 percent before the war. The poststabilization budget surpluses of 1924–25 had eroded and become serious deficits in 1928.[30] In the face of continuing conflict over taxation, investors were reluctant to make further loans to the Reich.

Markets were increasingly pessimistic about the political stability of the Weimar Republic. Nineteen twenty-eight marked the breakup of a center coalition and an increase in support for the Social Democrats, who still needed coalitional support from an array of increasingly right-wing parties. Government stability was threatened whenever budget debates

[28] Derek H. Aldcroft, *From Versailles to Wall Street, 1919–1929* (London: Allen Lane, 1977), 261–67; James W. Angell, *The Recovery of Germany* (New Haven: Yale University Press, 1929), 190–94.

[29] Schacht, *The Stabilization of the Mark* (London: Allen and Unwin, 1927). See also idem, *The End of Reparations* (New York: Jonathan Cape and Harrison Smith, 1931), 33, where he makes his famous critique of German public spending on "stadiums, swimming pools, public squares," and so forth.

[30] S. Andic and J. Veverka, "The Growth of Government Expenditure in Germany since the Unification," *Finanzarchiv* 23 (1964), 258; A. T. Peacock and J. Wiseman, *The Growth of Expenditures in the United Kingdom* (London: Princeton University Press, 1967), 184. See also Helmut Böhme, *An Introduction to the Social and Economic History of Germany* (Oxford: Basil Blackwell, 1978), 102–13.

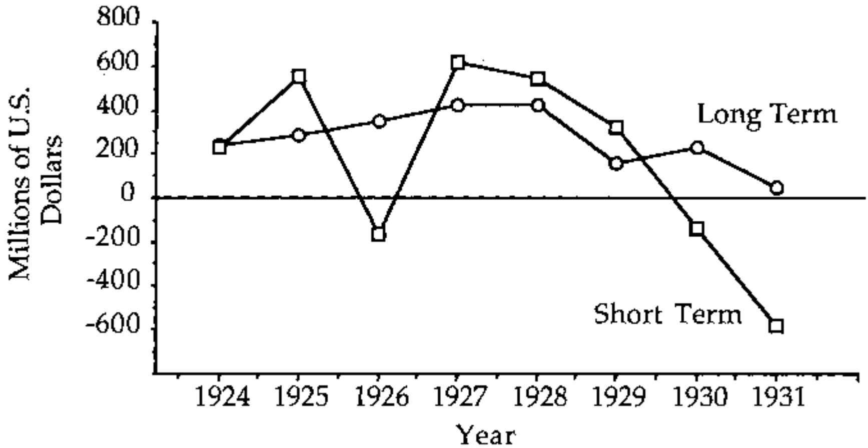


FIGURE 1
GERMANY'S NET CAPITAL MOVEMENTS

exposed the basic social divide of unemployment insurance and increased industrial taxation on the one hand versus spending austerity and tax cuts on the other. In addition, labor disputes took a growing toll on productivity: 20 million working days were lost in 1928 as compared with 6 million in 1927 and 1.3 million in 1926.[31] In short, political conditions in Germany in the late 1920s were far from reassuring for investors: by 1928 deteriorating political conditions were contributing to the perceived risk of default. The market reacted by investing elsewhere, primarily in booming American stocks.[32]

Germany's creditors had high stakes in German solvency. Though estimates for 1929 are not available, some £70 million of British assets were frozen in Germany's general financial collapse two years later.[33] American investors also had a significant stake in Germany. More than 55 percent of all foreign long-term loans to Germany between 1924 and 1931 were extended by U.S. investors, and even as late as 1931—after

[31] For a good account of the complicated coalitional politics involved, see Henry Ashby Turner, *Stresemann and the Politics of the Weimar Republic* (Princeton: Princeton University Press, 1963), 220–62. Industrial and unemployment statistics are from Harold James, *The German Slump: Politics and Economics, 1924–1936* (Oxford: Clarendon Press, 1986), 218. See also Erich Eyck, *A History of the Weimar Republic* (Cambridge: Harvard University Press, 1962), 2:192–95.

[32] The October 1929 crash itself certainly contributed to the desiccation of international capital flows, but as can be seen in the cases of Argentina and Australia, capital imports rebounded in 1930, while for Germany they did not. Note also that short-term capital flows began to drop off in 1928, prior to the crash itself.

[33] This estimate is given by Phillip Snowden, chancellor of the exchequer, cited by W. A. Morton, *British Finance, 1930–1940* (Madison: University of Wisconsin Press, 1943), 31.

American lending had been cut back drastically—fully one-quarter of Germany's short-term debt was owed to Americans.[34]

Theories of capital market failure explain the timing of experts' concerns for a new bargain regarding Germany's external debts, which are described in the following section. The bank's initiation in early 1929 coincided with the curtailment of lending to Germany, and while it is true that much of the reversal in capital flows was undeniably due to relatively more attractive investment options in American stocks (and later, by the stock market crash and depression), Germany's inability to make credible commitments must not be underestimated. These concerns were at the fore as the reparations question was reopened in 1929.

III. Reparations Negotiations: From the Dawes Plan to the Young Plan

Reparations poisoned Germany's political and financial environment for the greater part of the decade. The Reparations Commission determined German reparations in April 1921 to total $33 billion—a figure roughly twice the size of Germany's total economy in 1925.[35] The weight of the reparations burden on its economy had contributed to the German financial disaster in the first half of the 1920s. By September 1923 the inflationary crisis required rethinking the reparations issue, which resulted in the Dawes Plan of 1924. This plan, designed by financial experts and private businesspersons, improved Germany's immediate financial position by scaling back the annual payments, but it did not establish a total figure for Germany's war indemnity. The Dawes Plan included a RM 800 (U.S. $190.5) million bond flotation. As this was much in excess of scheduled German annuities, it encouraged further private lending. As long as foreign capital flowed into Germany, the Dawes Plan worked satisfactorily, and eventually some RM 7.6 (U.S. $1.81) billion were paid out to Germany's creditors under the scheme.

With the gathering depression and the cessation of new lending to Germany in 1928, it was clear that the early postwar reparations figures were ludicrously out of all proportion to Germany's ability to pay. Politically, it was becoming untenable for Germany to be under the direct

[34] *The Problem of International Investment* (London: Royal Institute of International Affairs, 1937), 237–38. For a discussion of the causes of such high American investment levels, see J. Madden, M. Nadler, and H. Sauvain, *America's Experience as a Creditor Nation* (New York: Prentice-Hall, 1937); and the Hearings before the Committee on Finance, *Sales of Foreign Securities*, United States Senate, 72d Cong. (Washington, D.C.: GPO, 1932). By 1935 Germany had defaulted on nearly $887 million of dollar bonds, of which about $532 million was held in the United States.

[35] B. R. Mitchell, *European Historical Statistics, 1750–1975*, 2d rev. ed. (New York: Facts on File, 1981), 819, Table K1.

supervision of the Reparations Commission—the foreign supervisory board that had been set up under the Dawes Plan. Financially, the burden of the yearly payment and the uncertainty of the total claim degraded the value of Germany's private outstanding debts and discouraged further investment.

Between February 1929 and January 1930 a series of expert and diplomatic negotiations were held to reschedule Germany's reparations debt. These negotiations were initiated by central bankers and private actors, who were the first to link problems in the capital market with the need to reorganize Germany's financial obligations. Governor Strong of the New York Fed explicitly mentioned the reversal in capital flows to the American Agent General for Reparations, S. Parker Gilbert,[36] as a hazard to the smooth functioning of the Dawes Plan in the summer of 1928.[37] Montagu Norman, governor of the Bank of England, agreed and wrote in his diary that "*only a crisis*" would encourage international cooperation regarding Germany's debt.[38] After consulting with the major central banks and financial houses, Gilbert urged the creditor governments to convene a committee of experts to reorganize and finalize Germany's reparations debt. The Young Committee[39] (so called after the American chairman, Owen D. Young) met in Paris in February 1929 to hammer out a solution. This was the first of two negotiations among independent financial experts[40] to reschedule Germany's debt, the results of which were submitted for governmental approval at the Hague Conferences in August 1929 and January 1930 (see Table 2).

It was the Young Committee that proposed the creation of a bank to handle Germany's debt. This innovation was meant to help break the

[36] A Treasury officer until 1923, Gilbert quit that post and as a private citizen assumed the job of foreign supervision of the German economy in 1924. He later went on to become a partner in J. P. Morgan and Company, a job he held for most of the 1930s.

[37] Strong wrote to Gilbert that high American interest rates and the reversal in capital flows could "ultimately present a real hazard to Europe and especially to the smooth operation of the Dawes Plan." Benjamin Strong to S. Parker Gilbert, July 14, 1928, quoted in Lester V. Chandler, *Benjamin Strong, Central Banker* (Washington D.C.: Brookings Institution, 1958), 459.

[38] Norman diary, May 14, 1928, Bank of England Archives, London (henceforth BEA/L).

[39] Formally, the Committee of Experts on Reparations.

[40] The second meeting of "experts" took place in Baden-Baden, Germany, in the autumn of 1929 and was known as the Organization Comittee because it hammered out the bank's formal statutes. The degree of actual independence varied from country to country. The stature of the British and the American delegates and the fact that they were indeed private businesspersons assured their independence. There is little doubt, however, that delegates took their country's national interests into consideration. Thomas Lamont described his responsibilities as follows: "In assisting to draft the report, we should naturally have in mind the best interests of the United States, and we will do everything within our power to guide it into channels and into terminology that will be cooperative with American interests. But we must face the fact that when the report is finished, we must sign it if we are satisfied with it as independent experts." Undated [April ? 1929], file 179-6, Lamont Papers, Baker Business Library, Harvard Business School (henceforth LP/HBS).

TABLE 2

NEGOTIATIONS AND PARTICIPANTS IN THE FORMATION OF THE BIS

	Dawes Plan Negotiations	*Initiation to Reopen Reparations*	*Young Committee Negotiations, Paris*	*First Hague Conference*	*Organization Committee, Baden-Baden*	*Second Hague Conference*
Date	Jan.–Apr. 1924	Autumn 1928	Feb.–May 1929	Aug. 1929	Sept.–Dec. 1929	Jan. 1930
Purpose	scale back and finance Germany's annual reparations payments; stabilize German currency; balance German budget	settle reparations total and design a final schedule; improve chances of collecting German debts and conditions for further lending	propose reparations total and final schedule; improve chances of collecting German debts and conditions for further lending	approve the Young Plan; discuss other territorial issues in Europe	draft the statutes of the BIS	approve the statutes of the BIS
Participants[a]	Charles Dawes[b] (U.S., comm. chair) O. D. Young[g] (U.S.) Sir J. Stamp[l] (U.K.) J. Parmentier[p] (France) Sir R. Kindersley[u] (U.K.)	S. P. Gilbert[c] (in consultation with central banks and major American financial houses)	O. D. Young (U.S., comm. chair) J. P. Morgan[h] (U.S.) T. W. Lamont[m] (U.S. alt.) Sir J. Stamp (U.K.) Lord Revelstoke[v] (U.K.) E. Moreau[x] (France) J. Parmentier (France) H. Schacht[y] (Germany)	P. Snowden[d] (U.K.) Henderson[f] (U.K.) H. Chéron[i] (France) A. Briand[n] (France) Hilferding[q] (Germany) Stresemann[s] (Germany)	J. E. Reynolds[e] (U.S., comm. chair) Traylor[j] (U.S.) W. T. Layton[o] (U.K.) Sir C. Addis[r] (U.K.) P. Quesnay[t] (France) C. Moret[w] (France) H. Schacht (Germany)	P. Snowden H. Chéron J. Curtius[k] (Germany)
Participants selected by:	governments concerned with reparations	—	governments concerned with reparations[z]	—	governors of central banks	—

Government official(s)?	no	no	no	yes (finance and foreign ministers)	no	yes (treasuries or economics ministries)
Action taken	Dawes Plan U.S. $190.5 m. bond flotation; more feasible payments schedule; transfer protection under the direction of the Reparations Commission	creditor governments persuaded to renegotiate German reparations	presented plan to cut back further yearly reparations annuities; to found the BIS; and to commercialize the remaining German debt	adopted Young Plan, with slight upward revisions made to the British share; authorized negotiations on BIS statutes	drew up the statutes of the BIS; placed banking functions prior to reparations functions but limited the credit resources available for BIS lending	adopted the statutes of the BIS

[a] For simplicity, only participants from the United States, Britain, France, and Germany are listed. Other participating countries included Italy, Belgium, and Japan.

[b] President (1902–21) and chairman (1921–25), Central Trust Company of Illinois; United States vice president, 1925–29; ambassador to Britain, 1929–30.

[c] Assistant secretary to the Treasury of the U.S., 1920–21; under secretary of the Treasury, 1921–23; agent general for reparations, on location in Germany, 1924–30; partner, J. P. Morgan and Company, 1931–38.

[d] Chancellor of the Exchequer.

[e] President, First National Bank of the City of New York.

[f] Foreign minister.

[g] Businessman and chairman of General Electric.

[h] President of J. P. Morgan, the premier American financial house.

[i] Minister of finance.

[j] President, First National Bank, Chicago.

[k] Minister of economics.

[l] Industrialist (especially railroads) and economic adviser (specialist in taxes and accounting) to the British government.

[m] Partner of J. P. Morgan and Company, 1911–43; reparations expert on the American Commission to Negotiate Peace, 1919.

[n] Foreign minister.

[o] Editor, *Economist*; scholar, director of the National Federation of Iron and Steel Manufacturers.

[p] Director, Mouvement Général des Fonds (Ministry of Finance); resigned in 1923; universally held in high regard for financial technical excellence.

[q] Finance minister.

[r] Private banker, as well as central banking experience at the Bank of England and as a member of the board of the Reichsbank.

[s] Foreign minister.

[t] Ministry of Finance, 1908–28; Banque de France, deputy governor, 1928–30; governor, 1930–35.

[u] Director, Bank of England, 1914–46; governor, Hudson's Bay Company, 1916–25; chairman and managing director, Lazard Brothers and Company.

[v] Senior partner of Baring Brothers (a major British financial house); died halfway through the negotiations and was replaced by Sir Charles Addis.

[w] Banque de France.

[x] Governor of the Banque de France, 1926–30.

[y] Governor of the Reichsbank.

[z] All members had been officially selected, and the Americans acting as private citizens had been cleared by the White House, but only the French delegates seem to have been closely controlled by their governments.

deadlock over reparations, which involved not only *how much* Germany would pay but also the *institutional arrangement* by which payments would be overseen and transferred to Germany's creditors. According to Young, "Not until some cooperative machinery such as the International Bank was set up could there be fair and intelligent talk about [reparations] amounts."[41] These experts were constrained by market reactions to the progress of their negotiations. In early March 1929 J. P. Morgan cabled the New York firm that he was "truly apprehensive" that a breakdown in negotiations could imperil the whole gold standard, a fear expressed by the British experts as well.[42] Even as these experts deliberated, deteriorating capital and currency markets painfully prodded them toward innovation.

The idea of establishing a bank emerged early in the negotiations in a proposal by Hjalmar Schacht. His plan called for pledging German obligations to an international bank and using these obligations as reserves for an international expansion of credit. Schacht's proposal focused squarely on an institution that would bankroll international trade and investment and thereby improve Germany's capacity to pay reparations.[43] It was unanimously opposed by all other participants on the grounds that it was likely to be inflationary.[44]

The experts from the creditor nations were more concerned to develop an international institutional structure to facilitate, rather than finance, payments. One early version called for a commission to be composed of central bank governors, chaired by an impartial expert, to oversee the problem of transferring reparations to creditor govern-

[41] Young, memo to the Committee of Experts, March 27, 1929, 179-8, LP/HBS.

[42] Stamp to Hopkins, April 15, 1929, DPP2.4 Baring Brothers, London (henceforth BB/L); cable, J. P. Morgan to Leffingwell (New York), March 11, 1929, 178-17, LP/HBS. Lamont also expressed concern about the effects of a break in the negotiations on the market. Lamont to New York office, April 19, 1929, 178-20, LP/HBS. So did Governor Harrison of the Federal Reserve Bank of New York, Harrison to Mellon, April 26, 1929, Harrison Papers, Federal Reserve Bank of New York (henceforth FRBNY). From the British side, see Charles Addis (member of the British delegation to the Paris conference), meeting of the General Council of the Reichsbank, March 23, 1929, BB/L; Ray Atherton, chargé d'affaires, American embassy, London, to the secretary of state, April 23, 1929, File 462.00 R 296 2837, State Department Records, National Archives, Washington, D.C. (henceforth NA/W); minutes of the meeting of the British delegation, February 16, 1929, DPP2.4, BB/L.

[43] For Schacht's position on exports, see his speech before the Expert's Committee, June 28, 1929, 180-20, LP/HBS; and Schacht (fn. 29, 1931), 208. Gilbert warned the American delegation that Schacht's strategy was to push the trade functions of the bank in the Organization Committee. July 4, 1929, 180-21, LP/HBS.

[44] See Burgess to Harrison, report of his trip to Europe, 797.3A, BIS, 1929-70, FRBNY. Comments on Schacht's bank plan can be found in a memo: "The BIS," for D. W. Morrow by de Sanchez, [June?] 1929, 180-11, LP/HBS. Memo, Pinsent to Hopkins, March 12, 1929, British Treasury Documents, 1393 F11282/1, Public Records Office, London (henceforth PRO/L).

ments.[45] Envisioning a broader mechanism for monetary cooperation, the British expert Josiah Stamp proposed a compulsory clearing house for central banks, with the power (he did not specify how) "to find some rational means of counteracting the present scramble for gold."[46] These formulations signaled the negotiators' concern with the impact of reparations on exchange rates and the international monetary system, though they also raised questions of the bank's interference with existing central bank operations.[47]

The American bankers were originally thinking along somewhat different lines. They were contemplating the familiar model of a profit-making institution, the proceeds of which would be shared with Germany as an incentive to make payments. A profit-making BIS would guarantee unimpeded American participation.[48] It ran counter to the idea of a nonprofit "bank of central banks," however, and was opposed by both the British, who thought it would compete with London banking interests, and the Federal Reserve Bank of New York.[49]

Young took these ideas as points of departure and assigned a working group composed primarily of persons with extensive central banking experience to draft a proposal during the first week in March.[50] By March 6 a "brand new idea [had] burst upon the horizon":[51] a nonpolitical institution that would liquidate the foreign-controlled reparations machinery, receive and distribute reparations, serve as a trustee for Germany's official creditors, and oversee the problem of commercializing German obligations by selling bonds to private investors. As it emerged in June

[45] Cable, De Sanchez to Morgan and Company, New York, February 25, 1929, 178-17, LP/HBS.

[46] Minutes, meeting of British delegates, March 4, 1929, DPP2.4, BB/L; see also Stamp's address before the Society of Incorporated Auditors and Accountants, July 1929, private papers of Josiah Stamp, London.

[47] Cable, J. P. Morgan and Company [Leffingwell?] to Morgan and Lamont, March 12, 1929, 178-17, LP/HBS.

[48] See Pinsent's diary of Addis's report of the Heads of Delegations Meeting, October 25, 1929, T160 386, F11282/03/1; Treasury Documents, PRO/L.

[49] "Notes on the Capital of the Bank," memo, March 13, 1929, 797.3, FRBNY. The New York bankers were constantly criticized for their profit motive. Memo of an interview between Snowden and Francqui, written by Leith-Ross, November 14, 1929, T160 386 F11282/03/1, Treasury Documents, PRO/L. In any case, Lamont expressed a good deal of skepticism that bank profits could be counted on for much. Lamont to Hamilton, May 23, 1929, 179-23, LP/HBS.

[50] The group included Walter Stewart (U.K.), economist with the Bank of England; Shepard Morgan (U.S.), who had been working with the agent general's [for reparations] office in Berlin; Burgess, Federal Reserve Bank of New York; Pierre Quesnay, and Hjalmar Schacht (see Table 1). According to Josiah Stamp, the idea of an external bank emerged from various subcommittees as a way first of handling the trustee function (take over the role of the Reparations Commission) and then of developing wider credit functions. Stamp to Hopkins, March 13, 1929, DPP2.4, BB/L.

[51] Burgess to Harrison, March 6, 1929, 797.3, FRBNY.

1929, the Young Plan[52] contained the broad outlines of the proposed BIS, with the suggestion that it expand credit, enhance central bank cooperation in monetary affairs, and facilitate payment of Germany's reparations debt in a way compatible with the servicing of its massive debts to private lenders.[53] The BIS, holding German railway paper as collateral, was to receive and disburse payments on the earlier Dawes loan.[54] The bank was also to decide the timing and volume of German reparations bonds to be released on to the market.[55] If Germany maintained it was necessary to postpone payment, the BIS would form an impartial advisory committee to investigate Germany's economic position and recommend appropriate measures.[56]

The bank itself had no power of enforcement, but the Young Plan envisioned raising Germany's cost of defection by reorganizing its creditors.[57] Until the bonds could be sold to investors, the BIS was to be the legal trustee of the creditor governments.[58] Part of its role would be to enforce agreements *among* creditors to overcome distributional disputes

[52] Formally, the Report of the Committee of Experts on Reparations, June 1929, Cmd. 3343.

[53] Report of the Committee of Experts on Reparations, June 1929, Cmd. 3343, Part 6(C) stated that the bank offered advantages over the current reparations setup, "which offers advantages to both Germany and the Creditor countries, because the Bank in putting the payments on a business basis makes their receipts more certain and facilitates their movement."

[54] The collateralized portion of the debt recognized a thirty-seven-year nonpostponable RM 660 (U.S. $157) million annuity. The German government deposited certificates attached to yearly coupons representing this unconditional obligation, plus an additional amount that increased yearly and could be postponed in an emergency, for a total yearly average payment of about RM 2 billion (U.S. $476 million). It was the responsibility of the BIS to collect these coupons as they matured. For the distribution among creditors, see Annex VII of the Young Plan (Cmd. 3343), and Articles III, IV, V, and VI of the Trust Agreement. Had the plan not been interrupted, Germany would have made its final World War I reparations payment in March 1987. The exchange rate of 4.2 marks to the dollar (the rate at which Germany stabilized in 1925) is used throughout. This rate was generally in effect from 1925 through 1930. League of Nations, *Monthly Bulletin of Statistics* (1931), Table XV.

[55] Shepard Morgan, "Conditions Precedent to the Settlement," *Proceedings of the American Academy of Political Science* 14 (January 1931).

[56] Members of the advisory committee would be nominated by the government of the central banks of each of the founding countries: France, Germany, Britain, Belgium, Italy, and Japan, and with one representative of American finance. (American policy prevented Federal Reserve participation.) Four additional members representing various areas of expertise could be added to the advisory committee if desired. If transfer was postponed, Germany was still obliged to deposit the amount due in reichsmarks with the bank.

[57] Memo, "The Young Plan and Sanctions," December 10, 1929, 667/6, BEA/L.

[58] Cmd. 3484, Misc. no. 4 (1930); Agreements Concluded at the Hague Conference, January 1930, Annex VIII, "Form of the Trust Agreement between the Creditor Governments and the Bank for International Settlements," Article II, (a)(b) and (c). The allies failed, however, to make the BIS responsible for debt payments to the United States, a provision that would have made Morgan's cooperation impossible. The French, Belgians, and Italians were in favor of making the BIS the agent for paying off debts to America in full. Memo, to Snowden from Leith-Ross, [late Sept.?] 1929; minutes from the Subcommittee on the Trust Agreements, October 23, 1929; T160 386 F11282/03/1, PRO/L.

and free ridership in case of default.[59] The BIS was to enforce nondiscrimination among creditors in case Germany suspended payments.[60] If Germany did not resume payments within two years, the BIS would propose revisions *collectively* for the creditor governments (which would only go into effect with their approval).[61] This agreement reduced the uncertainty of how to proceed in case of default. Meanwhile, the bank was responsible for surveillance and informing the creditor countries about economic and financial conditions in Germany (a clear effort to establish Germany's credibility and economic capacity and to lessen the likelihood that Germany might disingenuously claim it could not make a payment on time).[62]

The BIS would also be crucial in overcoming problems of collective action among *private* lenders. No single firm or consortium was willing to step in and perform the informational role that the Reparations Commission had under the Dawes Plan. In the absence of such information, it would be very difficult for Germany to make credible commitments about investment and macroeconomic policies and repayment intentions. Moreover, as the central agent for bondholders, the BIS would be in a better position than were individual investors to link repayment to future lending through a coordinated moratorium. Finally, though never mentioned explicitly in its statutes, the BIS was in a better position to reward German compliance with favorable access to international trade and to punish defection by coordinating economic sanctions. In all of these ways, this multilateral banking institution had the potential to influence the costs and benefits of cooperation. This innovation, and a recommen-

[59] One example is a sort of escrow account deposited by France with the BIS; the account would compensate Britain and other allies who had accepted smaller shares of the nonpostponable annuity. France had been given a larger share of the nonpostponable portion, in exchange for more moderate overall reparations demands. France then deposited 500 million gold marks ($120 million), to be held in trust by the bank and then split among the creditors to help equalize short-term payments.

[60] Young Plan, Annex III, Art. VII(a). The principle of nondiscrimination among creditors was of primary importance to the British Treasury. Trust Agreement, Revised Draft, July 25, 1929 (Leith-Ross's handwritten note in the margin); Leith-Ross to Waley, October 21, 1929, T160 386 F11282/03/1, PRO/L. The concern about distribution in case of postponement was largely motivated by the need to continue to cover debts to the United States. Memo of a conversation between Addis [?] and Quesnay, October 25, 1929; letter from Leith-Ross to Pinsent, November 1, 1929; note of an interview between Snowden and Francqui, by Leith-Ross, November 14, 1929, T160 386 F11282/03/1; Stamp to Leith-Ross, July 4, 1929, 1393 F11282/1, Treasury Documents, PRO/L.

[61] The French wanted to bar the BIS from making revisions in the payment schedule. The Germans naturally wanted a committee of revision and particularly a committee that would rule that their failures were not due to bad faith. The middle ground (BIS proposals, government ratification) was proposed by the British. Leith-Ross to Pinsent, October 23, 1929.

[62] Article 7 of the Draft Trust Agreement between Britain and the BIS; July 11 and July 25, 1929, T160 386 F11282/03/1; PRO/L.

dation that Germany's yearly reparations payments be slashed by more than one-quarter, was submitted to the creditor governments for their approval at the Hague.

IV. Interests in Innovation: The Position of the Major Powers

What interest did Germany's official creditors have in reducing reparations and accepting the proposed BIS? Publicly, the various governments were most concerned with securing the maximum feasible reparations income, since they counted heavily on German payments to balance their own budgets and repay the United States.[63] Moderating their reparations demands was politically and fiscally costly for Germany's official creditors, and each had made efforts to resist significant concessions prior to the opening of the Paris Conference in February 1929. The French prime minister Raymond Poincaré promised his people that reparations would cover France's debts to England and the United States, as well as a net indemnity for war damages, and he pushed for annuities twice as high as those that Schacht claimed Germany was able to pay.[64] Britain, the most reluctant of the creditor governments to reopen the reparations issue, had announced that it would press for reparations payments to cover its liability to the United States.[65] Both the Coolidge administration and the incoming Hoover administration, which assumed office in March 1929, steadfastly refused to discuss allied war debts or to express any opinion on Germany's total indebtedness.[66]

Once the reparations issue was reopened, however, governments had to make a new set of calculations based on the speculative pressures ignited

[63] Interallied debts totaled a staggering $26 billion, mostly owed to the United States and the United Kingdom, and involved some twenty-eight countries. The director of the Economic and Financial Organization of the League of Nations, Sir Arthur Salter, wrote in his memoirs that "the history of the years between the wars could be largely written in terms of the problems of reparations." Salter, *Memoirs of a Public Servant* (London: Faber and Faber, 1961), 154.

[64] Poincaré's speech at Caen, reported in *Le Temps*, October 28, 1928; *Le Matin*, November 6, 1928; and *Journal Officiel*, November 16, 1928, p. 2549. See also Paris embassy to Kellogg, November 13, 1928, 462 R 296: 2465. Poole to Kellogg, November 16, 1928, 462 R 296: 2473; November 20, 1928, and November 22, 1928, 462 R 296: 2483; State Department Documents, NA/W. Committee of Experts on Reparations, February 12, 1929, BB. 2, February 16, 1929, BB.4; BB/L. See also Martin Wolfe, *The French Franc between the Wars, 1919–1939* (New York: Columbia University Press, 1951), 29–32.

[65] Frederick Leith-Ross, *Money Talks: The Autobiography of Sir Frederick Leith-Ross* (London: Hutchinson, 1968), 102–6; Arthur Salter, *Recovery* (London: G. Bell and Sons, 1933), 144–47. The British had resisted reopening the reparations issue, as the Treasury was fairly satisfied with the income from German reparations under the Dawes Plan.

[66] Kellogg to Armour, December 7 and 21, 1928, 462 R 296: 2521, 2558b; Schurmann to Kellogg, December 15, 1928; 462 R 296:2538; Armour to Kellogg, December 20, 1928; 462 R 296: 2556, State Department, NA/W.

in foreign exchange markets. The German mark and the British pound were especially vulnerable to destabilizing speculation; they suffered sharp selling pressures whenever it looked as if the Paris conference might fail.[67] These currencies were backed by relatively slim gold reserves. Moreover, in the first half of 1929, while the Paris meeting was in progress, the United States gained $210 million worth of gold and France gained $182 million at the expense of Britain and Germany.[68] (See Table 3.) These gold losses made Britain and Germany anxious to reach an agreement. Using Bulow and Rogoff's language, these countries had the highest future discount rate; because of their currency vulnerability, they put a premium on settling the reparations question sooner rather than later.

Despite its golden fortress, France's growing trade interdependence with Germany gave the French government an incentive to reach an agreement on German debts. France's trade with Germany went from a low of 2 percent of net national product in 1923 to more than 6 percent by 1930. Britain's two-way trade with Germany was equal to about 4.5 to 5 percent of NNP. By contrast, two-way trade between Germany and the United States was small relative to the size of the American economy (see Figure 2).[69] Germany was France's primary trade partner by 1930, while Britain and the United States traded primarily with each other

TABLE 3
SHARE OF THE WORLD SUPPLY OF MONETARY GOLD
(PERCENTAGE)

	U.S.	*U.K.*	*France*	*Germany*
1928	37.2	7.4	12.5	6.5
1929	37.7	6.9	15.8	5.3

SOURCE: Federal Reserve System, *Banking and Monetary Statistics* (Washington, D.C.: Federal Reserve, 1943).

[67] *London Sunday Times*, April 21, 1929; Keynes's article in the *Daily Express*, April 22, 1929. See also Jon Jacobson, *Locarno Diplomacy, Germany and the West, 1925–1929* (Princeton: Princeton University Press, 1972), 218.

[68] Charles P. Kindleberger, *The World in Depression, 1929–1939* (Berkeley: University of California Press, 1973), 112–16. On French gold imports, see Paul Einzig, *The Fight for Financial Supremacy* (London: MacMillan, 1931); and R. G. Hawtrey, *The Art of Central Banking*, 2d ed. (London: Frank Cass, 1932), 1–40. On the general decrease in British liquidity, see D. E. Moggridge, *British Monetary Policy, 1924–1931: The Norman Conquest of $4.86* (Cambridge: Cambridge University Press, 1972), 127.

[69] The logic of the bargaining model derived from Bulow and Rogoff (fn. 20) would place more emphasis on absolute levels of trade than on the trend itself, since the pressure to make concessions flows from the present, or possibly anticipated, costs of enforcement via sanctions. The trend would be important only if it were used to project future costs of enforcement, in which case much more weight should be placed on France's *growing* trade dependence on Germany.

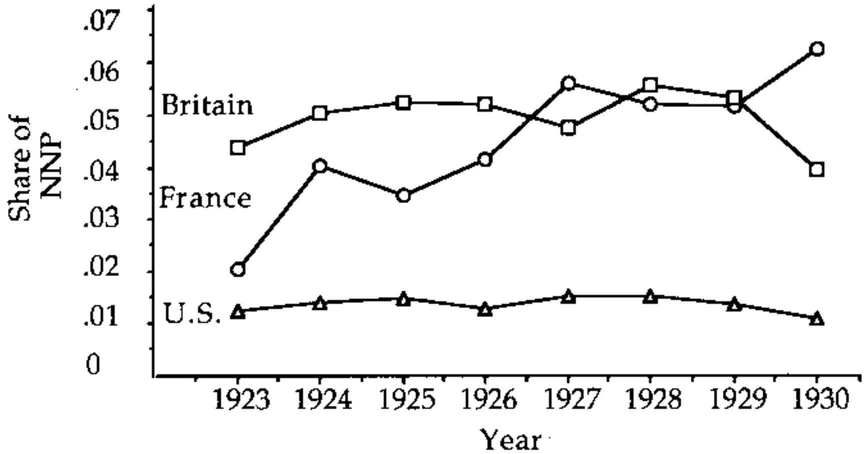


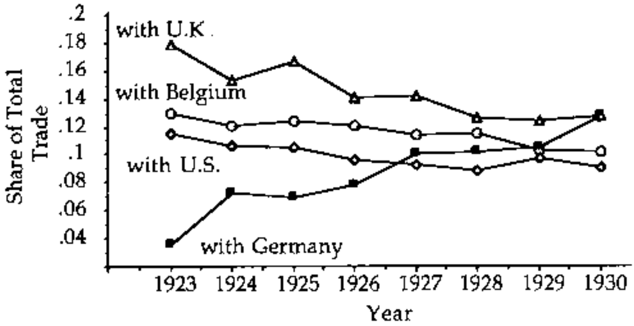
FIGURE 2
TRADE WITH GERMANY AS A SHARE OF NNP

(Figure 3). Bulow and Rogoff's bargaining model suggests that French (and to a lesser degree, British) dependence on German trade provided an incentive for these governments to make concessions to reschedule Germany's debt, since attempts to enforce their payment unilaterally through trade sanctions would prove costly to the citizens of these creditor countries.

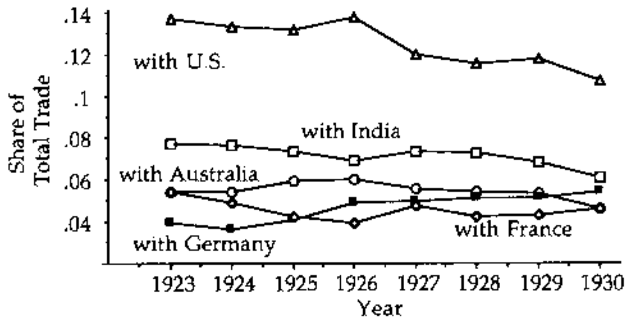
The creditor governments made two concessions to Germany and to Germany's private creditors to secure their cooperation in commercializing Germany's reparation debt. The first was a scaling back of reparations by roughly one-fourth of the annuity under the Dawes Plan. The second was the decision to back the Bank for International Settlements, which had been designed and proposed by bankers. This section reviews in greater detail both the interests of the governments of the major powers and the views of their central bankers, and it sets the stage for understanding the multilateral bargaining that took place over the course of 1929.

GREAT BRITAIN

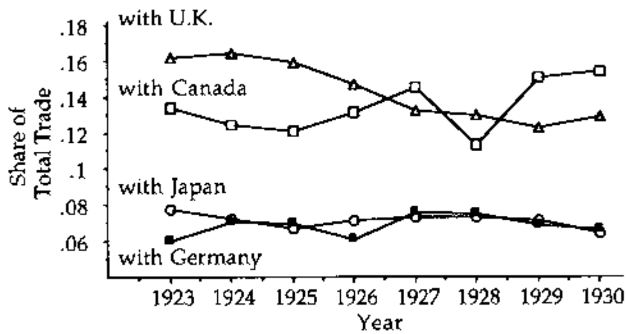
The British government was pulled in two directions during the Paris negotiations and the summer of 1929. On the one hand, domestic political pressure discouraged a disproportionate reduction in British reparations demands. On the other hand, intransigence contributed to monetary instability and downward pressure on the pound. Treasury and



(a) % of France's Total Trade



(b) % of United Kingdom's Total Trade



(c) % of United States Total Trade

FIGURE 3

THE IMPORTANCE OF TRADE WITH GERMANY FOR FRANCE, THE UNITED KINGDOM, AND THE UNITED STATES elected officials championed the fiscal concerns. The Bank of England warned of the monetary consequences.

Although British Treasury officials were not unconcerned with the pound, they were much more likely to view the reparations issue through fiscal lenses. When the plan first surfaced, Treasury officials expressed concern that the inflationary consequences of an international bank would erode the value of German payments to Britain.[70] Over the summer of 1929 Treasury dealt not so much with the new institution's banking functions, which they left to the staff of the Bank of England, as with the Trust Agreement, which defined the relationship between the bank and the Treasury with respect to reparations payments. Treasury officials resisted giving the BIS discretion should Germany be unable to transfer the annuity. They wanted the BIS to assume the responsibility for collecting full reparations from Germany under the plan.[71] British Treasury officials saw the BIS as a way to ensure that Germany would repay on schedule and as promised.

The change in government in the early summer of 1929 threatened British acceptance of the Young Plan's reparations agreement (though the BIS itself did not become a major electoral issue). The electoral campaign in the spring had aroused widespread discontent over taxation, and Labour's candidate for Exchequer, Phillip Snowden, had taken the popular position that the Treasury should collect as much as possible from foreign governments.[72] In the general elections of May 30, 1929, Conservatives lost 159 seats and Labour gained 157 in the House of Commons. Early in July, Snowden informed Parliament that he was not willing to accept the Young Plan, and a week later he announced his intention to

[70] Memo, Leith-Ross [?] to Hopkins, March 12, 1929, 1393 F11282/1, Treasury Documents, PRO/L.

[71] Leith-Ross to Pinsent, October 23, 1929; Leith-Ross to Pinsent, November 1, 1929; British Treasury Documents, T160 386, F11282/03/1, PRO/L. They also would have liked the BIS to assume responsibility for funneling reparations directly to the United States to pay off Britain's war debt, but they were sensitive to the difficulty this would cause with American public opinion. Hopkins memo, November 4, 1929; Pinsent to Leith-Ross, November 6, 1929, T160 386 F11282/03/1, PRO/L; Leith-Ross to Addis, April 3, 1930, 667/9, BEA/L. Moreover, the British realized that no matter what they agreed to separately with the bank, the American government would hold Britain responsible for the full payment. Memo, to Snowden from Leith-Ross, [late September?] 1929, T160 386 F11282/03/1. They realized that Morgan could not issue the bonds if the BIS were to get involved in debt payments to the U.S. British Delegation, Financial note no. 3, January 1930, T160 386 F11282/03/2, PRO/L. See also Addis to Norman, November 10, 1929, 630, BEA/L.

[72] Treasury told the British delegates upon their return to London that they were not "well disposed" to their reparations settlements. Sir Charles Addis, private diary, June 21 and 25, 1929, SOAS, London. On the domestic reaction to the reductions, see *Daily Mail*, April 19, 1929; "Mr. Snowden and the Balfour Note," *Nation and Athenæum* 45 (April 20, 1929), 67–68; *Manchester Guardian*, April 20, 1929; "Mr. Snowden's Victory—And After," *Nation and Athenæum* 45 (August 31, 1929), 698–99.

seek a redivision of creditor receipts from Germany. He carried out his threat on the first day of the Hague conference, despite efforts to convince him that the breakup of the Hague conference would be dangerous for the British economy.[73] Most of the conference was stalemated over this issue. The logjam was eventually broken by French concessions on evacuation of the Rhineland, which resulted in an increase in Germany's commitment to the reparations settlement. Snowden ended up receiving about 75 percent of his original demand (a sum that totaled about .5 percent of the British budget), at the expense of the Germans, French, and Italians.

Treasury also harbored vague fears of the newly proposed bank. Influential officials were skeptical of putting German payments on a commercial basis; they sensed an emerging alliance between central banks and investors in German securities that would press for future reductions in German payments. They were also skeptical of the Bank of England's claim that the BIS would be useful in securing central bank cooperation[74] (discussed below). The new Labour appointees to Treasury were disposed to curtail the bank's more expansive functions and bring the BIS under greater government control.[75]

The Bank of England was much more supportive of the Bank for International Settlements because of its potential role in stabilizing the position of the pound in the international monetary system. Britain's relatively small gold reserves made it difficult to defend the pound without international monetary cooperation and the willingness of smaller powers to hold foreign exchange as reserves instead of gold.[76] Neither France nor the United States had supported these efforts during the 1920s; indeed, they had conducted their foreign exchange operations rather unsympathetically. As a result, Britain could not defend its prewar parity

[73] On behind-the-scenes efforts to secure Snowden's cooperation, see the following cables: Lamont to Young, July 31, 1929; Morgan to Young, July 31, 1929, 180-26; Lamont to Morgan, August 1, 1929; Young to Lamont, August 2, 1929, 180-27; Morgan to Lamont, August 6, 1929, 180-29; Morgan to Lamont, August 9, 1929, 180-30. Lamont concluded that "if the Conference breaks, it will be due to the Chancellor's unbridled belligerency and unforeseen complexities in British internal politics which none of us has the power to remedy. The Prime Minister apparently has no firm control over his ministers." Lamont to Young, August 11, 1929, 180-31, LP/HBS.

[74] Memo, "The B.I.S.: Criticisms by R. G. Hawtrey," July 27, 1929, BIS 667/2, BEA/L; memo, "International Clearing House," R. G. Hawtrey (undated), BIS 667/2, BEA/L.

[75] Leith-Ross to Hopkins, July 15, 1929, T160 1393 F11282/2, Treasury Documents, PRO/L.

[76] This is the "gold exchange standard" with which Britain had tried to achieve international cooperation through the Genoa Resolutions of 1922. Cmd. 1667/1922: "Papers Relating to the International Economic Conference," Genoa, April–May 1922, especially pt. III, Report of the Second Commission (Finance), pp. 59–67; Cmd. 1650/1922: "Resolutions Adopted by the Financial Commission of the 20th and 29th of April 1922." See especially resolutions 1, 2, 9, 10, and 12.

without deflation, which exacerbated unemployment and caused a loss of lending business from London to New York, where interest rates were generally lower. The Bank of England, and especially Governor Norman, thought that the BIS might be useful as a forum for coordinating the policies of the leading central banks of Europe and America. Norman was interested not merely in a stable resolution to the reparations problem but also in broader institutionalized monetary cooperation between the major central banks—a consistent theme of British international monetary policy since 1922.[77] However, in contrast to the American bankers who had initiated the idea of an international bank, private British financiers were not enamored of the plan. While they agreed that it would improve Germany's commitment to pay, they feared the BIS would embark on credit and discount operations and compete with London's private commercial and investment banks.[78] These objections—and most importantly the British banks' fear of competition—served to curtail the Bank for International Settlements' more expansive credit functions proposed by the experts the previous spring.

In sum, the Young Plan was accepted by the British government because it had received satisfaction on reparations and because the governor of the Bank of England was fully supportive of the BIS, which he constantly referred to as a "club for central bankers." The Bank of England's international monetary concerns were clearly reflected in the bank's eventual membership (it was to be a "bank of central banks"), as well as in its stated purpose of fostering international monetary cooperation. At the same time, the reservations of private British financial houses were reflected in its significantly curtailed banking functions. Britain's reparations interests were protected in the Bank's Trust Agreement, in its limits on private banking, and in its potential for improving central bank cooperation.

[77] There was also the fear that the BIS itself could become another *hoarder* of gold. Bank of England, memo, "BIS, Precis of the Expert's Scheme," July 8, 1929; "Answers to OEN's [Otto Niemeyer, Treasury] Questions," Governor Norman, July 8, 1929, 667/6, BEA/L. Despite opposition to the gold exchange standard, Fed officials supported the BIS as a forum for Central Bank cooperation. See memo, "The BIS," for D. W. Morrow by de Sanchez [June?] 1929, 180-11, LP/HBS; [Lamont?] "America and the International Bank," *Foreign Policy Association News Bulletin* 8 (July 5, 1929); and Leon Fraser, "The International Bank and Its Future," *Foreign Affairs* 14 (April 1936).

[78] Leith-Ross to Hopkins, July 15, 1929, T160 1393 F11282/2, Treasury Documents, PRO/L. This concern was also voiced in the financial press. See *Financial News*, March 11, 1929; *Journal of Commerce*, July 18, 1929. These concerns resurfaced in the 1944 debates surrounding establishment of Bretton Woods institutions, where financial interests of the City of London feared that "if the plan is adopted financial control will leave London and sterling exchange will be replaced by dollar exchange." See Gardner (fn. 5), 123.

France

The French government was less willing than were the British to make compromises with respect to reparations. They did agree, however, that there was no sense in killing the goose that laid the golden eggs. In France's case, there was little difference between the Treasury and the central bank with respect to reparations. Unlike the pound, the franc Poincaré was strong, and the Banque de France had ample gold reserves for its defense. Fewer French funds were invested in Germany. For a number of reasons, Paris did not have the stake in international financial or monetary leadership that Britain did.[79] As a result, the French did not feel as vulnerable as did the British to German financial difficulties.

In 1929 France's monetary and financial policies were markedly inward looking. The French had learned earlier in the decade that financial security was necessary to the independent conduct of foreign policy. Financial instability in 1924–26 had made France vulnerable to pressures to withdraw from the Ruhr, to accept the Dawes Plan, and to reach a debt accord with the United States.[80] Now in a position of relative strength, French officials wanted to shore up a balanced budget and to further France's security objectives in Europe.[81]

France's greatest concern was enforcement of Germany's commitment to pay. The preferred solution was to put German obligations on a commercial basis. French treasury officials wanted to sell German obligations to private investors as soon as possible, which would immediately shift the onus of creditor status from the Trésor to individual (mostly American) bondholders.[82] This sale of bonds to the public was referred to as "mobilization," and the effect would have been to pay off Germany's *official* creditors at once. Indeed, in July 1929 Poincaré made the receipt of advance payment through mobilization a condition for French evac-

[79] French investors had traditionally favored domestic to foreign investment, and the franc never became a significant store for international value. See Margaret G. Myers, *Paris as a Financial Center* (New York: Columbia University Press, 1936); Einzig (fn. 68), 58–70.

[80] Eleanor Dulles, *The French Franc, 1914–1928: The Facts and Their Interpretation* (New York: MacMillan, 1929); idem, *The Dollar, the Franc, and Inflation* (New York: Macmillan, 1933); and Stephen A. Schuker, *The End of French Predominance in Europe: The Financial Crisis of 1924 and the Adoption of the Dawes Plan* (Chapel Hill: University of North Carolina Press, 1976).

[81] Memo, "The BIS," for D. W. Morrow by De Sanchez, June 1929[?], 180-11, LP/HBS.

[82] Commercialization was not new, since Germany had in fact been fulfilling its obligations under the Dawes Plan by borrowing anew on a commercialized basis to pay off its official creditors. Mobilization, however, would mean that the remainder of the German annuity would be a direct obligation of the German Reich to individual bondholders with no guarantee by the creditor powers or the BIS.

uation of the Rhineland.[83] France would then get paid as soon as the German obligations could be sold, rather than receiving installments into the distant—and uncertain—future. The goal of commercialization was shared by Emile Moreau, governor of the Banque de France, who reasoned that while Germany might renege on political debts, the risk of being cut off from international sources of capital would discourage default on commercial loans.[84] The French were especially concerned that they not be discriminated against if Germany did default. As the official creditor with whom Germany had the worst bilateral relations, France feared that unless creditors could agree to some equitable procedure in case of default, the British, who had taken a much softer line on the reparations issue, would continue to be repaid while payments to France would be allowed to fall into arrears.[85]

Overall, there was little difference in perspective between French central bankers and their government, and ratification of the Young Plan went relatively smoothly. As became clear in debates in the Chambre in mid-July, the overwhelming appeal of the plan, and hence of the bank, was that it commercialized and mobilized the German debt. Both the Trésor and the Banque de France were influential in securing the bank's enforcement of the principle of nondiscrimination among Germany's creditors in case of default—a critical point for Germany's least-loved creditor. Resistance to the plan tended to come from the far Left, which

[83] Note from Moreau and Parmentier to Poincaré, June 13, 1929; quoted in Etienne Weill-Raynal, *Les Reparations Allemandes et La France*, vol. 3, *L'Application du Plan Dawes, le Plan Young, et la Liquidation des Réparations (Avril 1924–1936)* (Paris: Nouvelles Editions Latines, 1947), 457. See also Poincaré's speech in *Journal Officiel, Chambre, Débats Parlementaires*, July 16, 1929, p. 2544. See also the Report of M. Gignoux on the Hague Accords, *Commission des Finances de la Chambre*, March 24, 1930; *Journal Officiel Documents Parlementaires, Chambre, Session Ordinaire*, 1930, Annex no. 3.070, 318. On the link to France's Rhineland policy, see Jacobson (fn. 67), 300.

[84] U.S. Embassy, Paris, to State Department, November 1, 1928, 462 R 296 2470; Shurmann to Kellogg, December 15, 1928, 462 R 296, NA/W. France's input reflected this obsession with the defection problem. In alliance with the Belgians they concocted unorthodox means to ensure that Germany would be subject to the discipline of the capital market. The French suggested that bonds be created for the whole of the German reparations debt and then that the numbers of the bonds be mixed up, so that the Germans could not tell whether they would be defaulting on a political or a commercial obligation. The point, of course, was to subject the Germans to market discipline, even if governments were the primary holders of German bonds. Although this idea was nixed by the Americans and the British, it highlights France's extreme concern with potential German defection. The French proposal is recorded in a conversation between Stamp and Parmentier, February 15, 1929, BB.42; for the Belgian suggestion, see the minutes of the meeting of the British delegation, February 1929, DPP2.4, BB/L. For the American reaction, see Young to President Hoover and secretary of state, March 2, 1929, 179-25, LP/HBS.

[85] This fear was expressed by Emile Moreau, governor of the Banque de France, the first week of the Paris Conference. Memo, "Commercialization and Mobilization," February 21, 1929 [unattributed; likely written by a member of the American delegation], 179-7, LP/HBS.

wielded little or no influence in France at this time.[86] Despite their objections, there seemed to be general recognition that the Young Plan was an acceptable means of achieving France's goals.[87]

THE UNITED STATES

The U.S. government officially absented itself from the Paris conference, as it had done with every other important economic conference of the decade. Its overriding concern was to maintain the strict separation of allied war debts and German reparations. On the latter the U.S. government refused to take any position whatsoever.[88] U.S. officials opposed any link between the Bank for International Settlements and debts owed the U.S. When it appeared such a link might take shape, Stimson cabled Young in Paris that he was "very disturbed" that "practically, Germany will be paying her obligations to an international bank. . . . [W]e will be collecting reparations from Germany in satisfaction of the Allied war debt to us through the means of an international bank which we have created and in the management of which we participate." If the settlement were to go through as planned, Stimson complained, for all practical purposes the U.S. would be "the one creditor nation."[89] The United States government opposed any bank that would simply be a funnel for German reparations to pay off American war loans.

Through a series of acerbic exchanges, the American experts tried to convince the administration that the BIS would benefit the United States without involving their country in reparations. The primary benefit of the BIS, Young told the Hoover administration, would be to deflect Eu-

[86] The Socialists objected to the bank on the grounds that they preferred international financial cooperation to be under state control in collaboration with the League of Nations, rather than under control of a "financial oligarchy." They also noted that while the plan protected Germany in case of a payment moratorium, it did not protect those of her creditors who were in debt to the United States. Léon Blum, *Populaire* (March 11, 1929); Vincent Auriol, *Journal Officiel, Chambre, Débats Parlementaires* (July 18, 1929), 2632.

[87] This generally favorable impression is conveyed in the French press. *Journal des Débats* (March 7, 1929) referred to the proposal as an "international clearing house" and a "superbank" and was generally favorable to the idea but warned of the political power it might give the United States. *Le Temps* (March 7, 1929) was generally favorable, as was *L'Agence Economique et Finance* (March 7 and 12, 1929). *Echo de Paris* (March 8, 1929) noted apprehensions in some circles regarding the "supranational" authority of "Young's" bank. On March 13, 1929, it carried an article that supported the trustee aspect of the plan but noted that the "Americans' superbank" was a "dangerous distraction from the real issue" of how much Germany should pay.

[88] This was virtually the only point on which American negotiators had strict orders from their government. Stimson to Young, April 15, 1929, 2787a; conversation between Stimson and the German ambassador, April 24, 1929, 2824; Stimson to Young, May 2, 1929, 2852, vol. 43, State Department Documents, NA/W.

[89] Stimson to Young, April 8, 1929, 462 R296, vol. 42, Doc. 2773b, State Department Documents, NA/W.

rope's ire *away* from its principal creditor. Young argued that the bank would provide the "color of commercialization"; it would shift Germany's debts from political to market machinery, "diminishing the consequent irritation toward us." Stockholders in the bank, he predicted, would be private individuals or central banks and would provide a "buffer against political influence." The BIS would "organize the credit forces of the world" for collection of debts from Germany.[90] This collective effort was expected to remove the threat of political disruption from U.S./European economic relations. Young, Lamont, and Harrison (governor of the Federal Reserve Bank of New York) tried to convince the administration that the BIS would perform a very specific function that no individual financial firm wanted to take on in 1929: it would manage the rocky transition to normalcy.

Nonetheless, by late spring the U.S. government had begun openly to distance itself from the work of the Young Committee. In May, Stimson announced publicly that no official of the Federal Reserve System would be permitted to participate in the BIS. This announcement drew an acrimonious response from the American delegation:

> If Washington had made the most diligent study to find a way of bringing the [Paris] Conference to failure, it could not have used a method more effective than that adopted by Secretary Stimson. The officials in Washington seem to have not the remotest conception that they are blithely playing with dynamite. . . . Even though Washington itself may not wish to cooperate at least it can refrain from torpedoing before it gets started the machinery from which it is to benefit.[91]

To a great extent, the administration's proscription was intended for domestic political consumption. In Stimson's words, only by maintaining its official detachment could the administration preserve American participation in the bank while preventing its "friends on the Hill from running amuck."[92] Over the summer of 1929, Young, Lamont, and Gov-

[90] Cable, Young to Hoover, Mellon, and Stimson, March 2 and 19, 1929, 179-25, LP/HBS. For an extremely generous interpretation of the American experts' motives, see Ida Tarbell, *Owen Young: A New Type of Industrial Leader* (New York: MacMillan, 1932).

[91] Memo, Lamont [?] to Schneider, May 17, 1929, 179-22, LP/HBS. As early as May 1929, Secretary of State Stimson had made it clear to the New York banking crowd that the U.S. government would not permit any official of the Federal Reserve System to serve or select representatives or members for the proposed international bank. Cable, J. P. Morgan Inc. New York to Lamont in Paris, May 17, 1929, 178-26. Lamont blamed the American administration for making the collapse of the negotiations more likely. Lamont to Elihu Root, April 19, 1929, 179-27, LP/HBS.

[92] Stimson to Hoover, June 8, 1929, quoted by Frank Costigliola, "The Politics of Financial Stabilization" (Ph.D. diss., Cornell University, 1973), 478; more generally, idem, *Awkward Dominion: American Political, Economic, and Cultural Relations with Europe, 1919–1933* (Ithaca, N.Y.: Cornell University Press, 1984). Mill intimated to Harrison upon receipt of the Young Plan that "after a more careful study of the Plan I have reached the conclusion that

ernor Harrison convinced the Hoover administration to take a less obstructive stance vis-à-vis the BIS. They argued that maintenance of the gold standard depended on the American willingness to cooperate and that cooperation would greatly benefit the United States by bolstering confidence and stimulating trade.[93] Finally, Secretaries Cotton and Mills agreed to send an inconspicuous low-level representative from the Federal Reserve System to protect American interests at the upcoming bank organization committee meeting in Baden-Baden, although no officials of the Federal Reserve were ultimately allowed to work for the BIS.[94] While the Hoover administration generally supported the goals of the American bankers in 1929, the position it took for domestic political reasons was a source of tension between the American negotiators and their government, not to mention of confusion for the Europeans.

American interests placed severe constraints on the institutional solution to Germany's debt repayment. It is likely due to American participation that the BIS statutes contained any reference to "banking functions" at all, for the more dominant the reparations functions, the less sympathetic was the U.S. administration. The United States government simply would not yield on the question of delinking the bank from the payments of interallied war debts and obstinately refused to participate officially. As the government with ostensibly the least to lose (much less trade with Germany, a stable currency, and the only government not

if neither reparations nor inter-allied war debts existed it would probably be advisable for the Federal Reserve System to participate in the organization and management of the international bank" (emphasis added); Mill to Harrison, June 19, 1929; Harrison Papers, 2013.1, FRBNY. This ambivalence reflected that of American opinion more generally. A sampling of American reactions include "The United States and the Bank for International Settlements," *Commercial and Financial Chronicle* (June 29, 1929), 4211-13, which opposed Federal Reserve involvement in European politics. Other press reports noted that American aloofness might be dangerous. *Chicago News*, July 6, 1929. See also *New York World*, July 5, 1929; *New York Herald Tribune*, July 5, 1929; *Commercial and Financial Chronicle*, July 6, 1929.

[93] Memo on the Young Plan for the secretary of state, June 25, 1929, 180-18, LP/HBS.

[94] Harrison, memo of conversations with Cotton and Mills, September 6, 1929, 2013.1 Harrison Papers, FRBNY. A series of letters between Harrison and the administration shows that the Fed was to be allowed to carry on a low-key relationship with the BIS. See Burgess to McGarrah, July 13, 1929; Harrison to Burgess, July 17 and 18, 1929, FRBNY; Harrison to Moreau and Schacht, August 13, 1929, FRBNY; see also Harrison's memo, "Views and Comments Relative to Provisions of the Experts' Report Concerning the Bank for International Settlements and Its Possible Relations with the Federal Reserve Bank of New York," August 19, 1929, FRBNY; Young to Moreau, July 22, 1929; Harrison to Schacht, July 22, 1929, all in FRBNY file 797.3. See also Harrison, memo of a conversation with Cotton, December 18, 1929, Harrison Papers, Correspondence File, 2011.1, FRBNY. It was agreed that no American who was not satisfactory to the New York Federal Reserve would serve on the board of the BIS. Morgan to Lamont, memo regarding an interview between Young, Harrison, Cotton, and Mills, July 13, 1929, 180-22, LP/HBS. The reasons behind the American government's ambivalence were summarized from the British point of view in a letter from the British embassy in Washington to Treasury, Howard to Henderson, July 12, 1929, T160, 1393 F11282/2, PRO/L.

owed reparations), the Hoover administration thought it could afford to be intransigent on these issues. In two short years they would be proved wrong.

Germany

The German government had clear reasons for cooperating with efforts to revise reparations and reorganize its debt. Improvements in the German standard of living over the past decade had largely been financed by foreign capital and were threatened by the reversal in capital flows that had become evident by 1928. The capital drought sparked a budget conflict, which in turn precipitated a cabinet crisis in the first four months of 1929.[95] But German leaders were maneuvering between narrow options: on the one hand, the growing appeal of nationalist slogans limited the domestic political feasibility of cooperation with the Allies; on the other, German intransigence elicited the immediate negative reaction of the money market, causing the mark to plunge.

Moderate German leaders believed the nation's interests would be served by reduced reparations and a credible program of payments that would inspire the confidence of foreign capital. German officials also wanted the benefits of external supervision of their economy without politically repugnant Allied control. The direct foreign control of the economy which had been in place since the war—the Reparations Commission, foreign supervision of the domestic economy, foreign representation on the Board of the Reichsbank—was increasingly politically unacceptable and fed the fires of German nationalists.[96] The German government also wanted to settle several outstanding territorial issues with France and an agreement on reparations was viewed as the price for French cooperation.[97] Stresemann, the foreign minister, wanted to conclude a reparations agreement that would secure a promise from France for an early evacuation of the Rhine.

The Young Plan provided Germany immediate financial relief: it scaled back yearly reparations payments by 28 percent, without which an immediate tax increase would have been needed to meet the obligations of the Dawes loan. Higher taxes and the restriction of foreign credit

[95] Turner (fn. 31), 246–52.

[96] On the importance of eliminating international control, see Schacht's letter to Stresemann, September 20, 1928, cited in Eyck (fn. 31), 175.

[97] Jacobson (fn. 67), 239–349. The British Labour Party also supported evacuation, and from May 1929 this was government policy. Henry R. Winkler, "The Emergence of a Labor Foreign Policy in Great Britain, 1918–1929," *Journal of Modern History* 28 (September 1956). British public opinion also favored French evacuation of the Rhineland. See "The Importance of the Rhineland," *Nation and Athenæum* 44 (December 15, 1928), 402–3.

would have aggravated the economic depression already under way. Stresemann defended the plan, not as an ideal settlement, but as a superior alternative to financial crisis such as had occurred in 1923.

There were major differences between the German government and the Reichsbank president over subordination of the reparations question to Germany's larger political and diplomatic goals in Europe.[98] Schacht was strident in his rejection of any agreement that would exceed Germany's capacity to pay. He opposed his government's position that Germany could agree to higher reparations payments in exchange for territorial concessions. The effect on the German economy of "paying" for such concessions would be devastating and would dash investor confidence. Schacht originated the idea of an international bank, which he hoped would improve Germany's access to foreign credit. Without that, he argued, it would be impossible to pay reparations.[99]

Predictably, the Young Plan came under nationalist attack in Germany. The German National People's Party announced it would place the plan on a referendum before the German electorate. The Association of German Industry refused to endorse it until the political benefits could be guaranteed. Only after surviving a series of motions of no confidence proposed over the summer by the extreme Right and extreme Left did the government achieve a majority of support in the Reichstag.[100] This support was slim and insecure, however, and was vulnerable in the months to come to the open opposition from the president of the Reichsbank.[101] A strong current of German opinion supported Schacht's intransigence, especially on the grounds that the bank was not empowered to finance German trade and long-term investment.[102] By September na-

[98] From the British perspective, see the diaries of Lord Revelstoke (member of the British delegation to the Paris Conference), February 27–March 2, 1929, DPP2.4, BB/L.

[99] Addis wrote to Leith-Ross of the Paris negotiations: "[The BIS] held out to Germany the prospect of increased foreign trade and the promise of material assistance out of the profits of the BIS. It was by this means and only by this means that the Experts succeeded in persuading Germany to agree to the annuities of the last 22 years." Addis to Leith-Ross, July 28, 1929, Governor's File 263, BEA/L.

[100] Jacobson (fn.67), 290–91.

[101] Throughout the experts' conference, Schacht had insisted that Germany could not be forced to pay ridiculous amounts. Lord Revelstoke's private diary, February 19, 1929, DPP2.4, BB/L; Schacht's memo of April 17, 1929, reprinted in Schacht (fn. 29), 63–71. When it became apparent in the autumn of 1929 that the BIS would not be able to extend much credit, Schacht threatened to walk out, to the thrill of an increasingly nationalistic German public. Federal Reserve Bank of New York, Foreign Information Division, memo, "Germany and the Bank for International Settlements," February 1930, File 797.3, FRBNY. By January 1930 Schacht was demanding that the German government repudiate the Hague Protocol of the previous August. This put the German government in a very difficult position, since it could ill afford to appear less energetic than the Reichsbank in the defense of German interests. Gilbert to McGarrah et al., January 12, 1930, file 797.3, FRBNY.

[102] See, e.g., L. Albert Hahn, "Die Internationale Bank und Krediterleichterung," Hans

tionalist extremists, spearheaded by Hitler, were sponsoring a special plebiscite against the plan, though it was obvious that they lacked the twenty-one million signatures needed to bury it.[103] The Müller government managed to hang on until the Young Plan was finally ratified in March 1930. Germany's interests in the Young Plan were reflected in the drastic reduction in reparations, as well as the creation of a neutral, nonpolitical machinery to enhance their credibility. Schacht's hope for expansive BIS financial functions was largely checked by general concerns about inflation and the specific concerns of British bankers cited above.

In short, the creditor governments, and especially their treasuries, primarily wanted to do as well as possible on the collection of reparations (the United States government, of course, wanted to avoid any official involvement with reparations whatsoever). Simply put, governments faced immediate political and fiscal pressures to maximize their expected financial payoffs. *Not a single government actively supported the establishment of an international bank; they had to be convinced by central and private bankers that their reparations interests would actually be furthered if such a bank were established.* Central bankers in Britain, Germany, and the United States were much more sensitive than were their treasuries to the implications for the international monetary system if reparations were unresolved and confidence dashed, and they were correspondingly more enthusiastic about the bank's potential role. The BIS was a concession to Germany and to American financiers to secure their cooperation in commercializing the reparations. The initiative for innovation came from the private sector, to whose interests we now turn.

V. The Role of the Private Sector

The key to settling and reorganizing the German debt was in the hands of a relatively small group of private actors who had an overwhelming stake in avoiding the collapse of international lending: highly internationalized American and to a lesser extent British financiers.[104] This group was crucial to the successful commercialization and sale of the German debt to an investing public. They were indispensable in achieving the French desire to shift German obligations to private investors

Niesser, "Der 'Kreditfonds' der Internationalen Bank," and Melchior Palyi, "Die Reparationsbank als Quelle für Kreditschopfung," all in *Die Reparationen Bank* (Frankfurt am Main: Kritische Betrachtungen, Frankfurter Societäts-Druckerei, 1929).

[103] Turner (fn. 31), 258–59.

[104] Morgan in particular was seen as the key to the New York bond market and the ticket to a successful mobilization. Third meeting of the British delegates, Paris, February 10, 1929, DPP 2.5, BB/L.

and collect the proceeds immediately and the Germans' desire to be rid of the Reparations Commission. Bankers' cooperation was therefore essential in resolving Germany's debt.

The private financiers who had been involved in formulating the Dawes Plan in 1924 and the Young Plan in 1929 were very much in favor of putting Germany's debt on a commercial basis and liquidating the political machinery from the war.[105] The problem was, however, that the whole of German obligations could not simply be absorbed by the market under the conditions prevailing in 1929; and partial mobilization might create problems of equity among Germany's official creditors.[106]

There were only two conditions under which private financiers were willing to undertake commercialization. The first was a significant reduction in reparations, which made them Germany's influential ally. Lord Revelstoke of Baring Brothers, for instance, and also Sir Josiah Stamp tried to convince the British Treasury to reduce its demands on the Germans.[107] Internationalist American bankers, too, thought that their own government's policy on interallied war debts was seriously misguided and believed that normal business relations could not be restored until a portion of these debts was written off, in turn triggering a cancellation of a portion of the reparations demands on Germany.[108] Private lenders complained that official debts were crowding out private investment and sapping confidence. They knew that the value of private loans would be greatly enhanced—indeed, further private lending (from which these financiers could expect to gain as intermediaries) might be stimulated—if taxpayers simply swallowed the loss through cancellation.[109] This was precisely the outcome the American Congress wished to avoid. In short, private capital wanted significant cancellations of pub-

[105] J. P. Morgan described the rescheduling and commercialization of German reparations as "this great work, which if successful, seems to me to mark the end of the war period as it settles the last outstanding questions between the belligerents." Telegram, Morgan to Revelstoke, January 18, 1929, DPP2.4, BB/L.

[106] This problem was recognized prior to the Paris negotiations. The British feared that the French and Belgians would use partial mobilization to claim priority for their reparations, leaving the British with the risk of collecting political debts from Germany. Memo, Pinsent, "Provisional Conclusions of the 1st meeting of British members of the Committee of Experts on Reparations," January 25, 1929; Goodchild to Pinsent, February 6, 1929, DPP2.4, BB/L.

[107] Revelstoke evidently did not succeed, however. To Montagu Norman, he described Treasury as "hide-bound" in their ideas and in possession of "impossibly inelastic ideas." Revelstoke Diary, February 24 and 25, 1929, DPP2.4, BB/L.

[108] Joan Hoff Wilson, *American Business and Foreign Policy, 1920–1933* (Boston: Beacon Press, 1971), 123–56; Melvin Leffler, "The Origins of Republican War Debt Diplomacy," *Journal of American History* 59 (December 1972), 590.

[109] Cancellation was advocated by J. P. Morgan as early as 1922. See John Douglas Forbes, *J. P. Morgan, Jr.* (Charlottesville: University Press of Virginia, 1981), 145.

lic debts, whereas governments sought their commercialization. Neither wanted to be caught holding massive amounts of German bonds if Germany unilaterally declared itself unable to pay.[110]

The second condition was the creation of a new collective structure for marketing German bonds. No single firm was willing to take on this responsibility under the grim market conditions of the late 1920s. Early in the negotiations at Paris, J. P. Morgan evidently intimated to Lord Revelstoke that his firm would take responsibility for marketing some $500 million of German bonds, but similar commitments were not forthcoming from financial houses in Europe.[111] Three months later a Morgan associate did not mince words regarding his hesitation about marketing German bonds: "I think the things most in our minds as concerning ourselves are the protection of the lien and security of the Dawes bonds which we issued and the desire to avoid responsibility for commercialization or for the International Bank."[112] The price of private cooperation was reparations reductions and the establishment of the BIS with official support.

The value of a multilateral banking institution became clear in an exchange between the American and French experts over how to accomplish commercialization. The French wanted an immediate sale of a "considerable block" of the German annuity in the markets of all the allied governments and proposed that the bonds be internationalized and made interchangeable into any currency in the world. The Americans realized that this would translate into a vast wave of German bonds washing up in New York.[113] France's Trésor would collect, leaving American financiers to manage an oversaturated market for German bonds. The Americans preferred that successive tranches be managed by an international bank. That bank, for which they would bear no direct responsibility, would in effect determine when and how to place the loan.

In its crudest form, then, the deal between financiers and creditor governments was reduced reparations for commercialization. But the only way in which the American bankers were willing to hold up their end

[110] Lord Revelstoke wrote of J. P. Morgan at the beginning of the Paris Conference that "he is intently desirous, for his own credit's sake, to be the leader of a satisfactory settlement." Clearly, a settlement that involved reduced reparations would enhance not only Morgan's personal credit but also the value of foreign bonds his firm would sell to investors. Lord Revelstoke diary, February 14, 1929, DPP2.4, BB/L.

[111] Lord Revelstoke diary, February 14, 1929, DPP2.4, BB/L.

[112] There was much concern at the time that the market for German bonds was dangerously oversaturated. Cable from New York Office to Lamont, May 16, 1929, 178-26, LP/HBS.

[113] Memo, written by a member of the American delegation, "Commercialization/ Mobilization," February 21, 1929, 179-7, LP/HBS.

of the bargain was through international cooperation, which would improve the chances of collecting reparations and protect individual firms from the risky business of managing the German debt. In Thomas Lamont's words, "The magnet which has held the [Paris] Conference together from the beginning has been the International Bank. That piece of machinery is . . . essential to the Plan. . . . It would have been laughed out of existence had it not been for the prestige of Mr. J. P. Morgan and Lord Revelstoke, and their wise and broadminded advice which dominated the bank plan."[114] The price of private cooperation was the Bank for International Settlements. It was a price the creditor governments were not averse to paying, since it also improved the expected value of reparations.

VI. Conclusion: Dynamic Contracting, Multilateral Bargaining, and the Establishment of the bis

The Bank for International Settlements was designed to address the problem of capital market failure, a storm that was gathering as the 1920s came to a close. It is a historical fact that it was not successful in this respect. It is easy to enumerate the bank's early limitations: the bis was ultimately unable to extend important credits to finance international trade; it had limited financial resources; it got the cold shoulder from the United States government. However, innovation *did* take place, and its timing fits with expectations that are generated by theories of dynamic contracting in capital markets under conditions of anarchy. This literature points to the difficulty of making credible commitments, to information asymmetries, and to collective-action problems among creditors as sources of severe market malfunction when contracts cannot be enforced. It also points to the role of international institutions in bolstering a borrower's credibility and addressing creditors' collective actions, to the mutual benefit of both.

Dynamic contracting theory provides a rich and parsimonious approach to understanding the puzzle of the founding of the Bank for International Settlements during the late 1920s—a time of heightened international tensions, British financial weakness, and official American isolation. Traditional theories of international relations that focus on relations between governments would tend to miss (or misinterpret) the crucial role of public/private bargaining that went on in this case. Theories that focus on high politics might view the bis as a solution "im-

[114] Lamont to Morgan and Company, New York, June 1, 1929, 178-27, lp/hbs.

posed" on Germany by her creditors. Hegemonic theories would puzzle over why both the British and the American governments avoided leadership in the formation of this new institution. Dynamic contracting theory provides a perspective that helps several pieces of the puzzle fall into place.

First, it sheds light on why capital inefficiencies arise. The central difficulty of a sovereign borrower is that it cannot readily be forced to repay, and due to time-inconsistent preferences, such a borrower may find it difficult to make a credible commitment *ex ante*. Political instability and polarization can contribute to the temptation to defect *ex post*, as the market judged to be the case with Germany from 1928. While it is hardly the whole story (the booming American stock market was surely critical), assessments of Germany's credibility contributed to the slowdown of capital inflows in 1928 and their reversal a year later. In this model, market inefficiencies arise because of anarchy and information asymmetries, which are exacerbated by domestic political instability in the borrowing country.

Dynamic contracting theories also point to the mutual interests of debtors and creditors in overcoming capital market suboptimality. Because of credibility problems, debtors pay too much and receive too little capital. If the borrower cannot establish its credibility, lenders forgo loans that would have been profitable. This perspective highlights a *common interest* in addressing the market failure. It throws into question any interpretation that views the Young Plan and the Bank for International Settlements as a solution imposed on a Germany under the thumb of her creditors.

Finally, dynamic contracting theory provides a rationale for institutionalization. Forward-looking actors should be willing to negotiate arrangements that help establish the borrower's credibility: the rewards are better access to capital for the debtor and further profitable lending, on a more secure basis, for the lender. We should therefore expect a new institution to address the problems of enforcement and asymmetrical information. The BIS did this by holding German railway bonds as collateral; by providing neutral information on Germany's economic conditions and repayment intentions; and by coordinating the actions of Germany's creditors in case of default, in this way potentially enforcing an "external implicit contract" to limit Germany's future access to capital in case of repudiation.

A dynamic contracting approach also has interesting implications in a multilateral bargaining setting that involves a sovereign debtor, private lenders, and creditor governments. In this setting, negotiations between private creditors and their governments may be as crucial as those between creditors and debtors. When debts are rescheduled in such a setting, private creditors and their governments can bargain over the total volume of debt and the institutional setting in which it will be handled. This perspective allows that private and public creditors often have distinct interests. In Bulow and Rogoff's model, governments are sensitive to the costs of enforcement (which can include economic sanctions) if their citizens carry on significant trade with the debtor country. In our case, France was increasingly dependent on German trade and correspondingly less willing to exercise unilateral trade sanctions over the course of the 1920s. Another critical parameter is the creditor government's time horizon. In discussing the rescheduling of reparations, a convenient proxy for the rate of future discount is gold reserves and vulnerability of the currency to bear speculation. Britain and Germany were most subject to this pressure and made concessions accordingly.

Finally, this framework helps to order an inquiry into the interests of an array of actors who were instrumental in international institutional innovation. Such an inquiry is essential in understanding the *form* that the institution eventually takes. I have argued that because of their much greater sensitivity to the international monetary and financial implications of noncooperation, private financiers with their reputations and continued business at stake and central bankers who were charged with maintaining monetary stability were the initiators and designers of the BIS. Private American financiers pressed for a bank that would manage the liquidation of the last financial vestiges of the Great War, and, drawing from a model familiar to them, they hoped to expand the functions of the BIS to include a number of normal banking activities. British financiers, fearful of competition, opposed expansive banking functions and eventually prevailed on this point. Central bankers in the United States and Britain wanted to use the BIS as a forum for central bank cooperation, the function that has most recognizably survived to the present day. Treasury and elected officials viewed the BIS through fiscal lenses with an eye on domestic politics. But because the BIS was expected to improve the chances that they would actually collect reparations, they agreed to its establishment, cut their reparations demands, and held the BIS responsible for selling the German debt to investors as soon as possible.

The best reason for analyzing the BIS in the dynamic bargaining framework proposed here is that it is provides a better explanation than rival approaches available in the traditional international relations literature. Any approach that focuses primarily on state-to-state bargaining would have difficulty explaining how the BIS got on the international agenda at all. During the 1920s politicians of the creditor powers would have encountered major domestic obstacles and reaped few immediate political rewards for initiating a more cooperative and innovative stance on the problem of Germany's debt. They faced overwhelming domestic incentives to take a tough stand on reparations. Private investors and central bankers, however, understood and had a stake in smooth-functioning capital and currency markets. They initiated the bank and held out the promise of commercialization in exchange for reduced reparations demands and official acceptance of the Bank for International Settlements. Were private actors excluded from the analysis, it would be difficult to understand such innovation in the context of the 1920s.

Systemic analyses would misunderstand and mispredict the creation of the Bank for International Settlements. Realists would not diagnose the common interest Germany and its creditors had in a new institutional setting for handling the reparations issue. To the extent that they could explain the institution at all, it would be interpreted in coercive terms, in which case it would be difficult to account for the significant reparations reduction and for the substitution of the bank for the Reparations Commission. Hegemonic stability theory does no better, regardless of whether one interprets the interwar years as a period of hegemony. The core of the theory is leadership of the dominant economic power, and there is simply no way to account convincingly for the creation of a relatively ambitious international organization that no government—and emphatically, *not* the United States—initiated or gave much support. Neither of these approaches could begin to understand why the new institution took the form it did, straddling reparations and banking functions and promising central bank cooperation.

Because of the traditional focus on the divisive nationalism of the interwar years, few theories of international relations have integrated private economic agents into a political analysis of this period. This study suggests that transnationalism, discovered by political scientists only in the 1970s, affected international financial cooperation in the years between the two world wars. Transnationalism was most strongly expressed in the concerns of private financiers and central bankers. Important differences existed between these groups: American bankers would have liked to put the bank on a commercial basis and give it expanded lending functions, while the central bankers were primarily interested in the role the bank could play in international monetary cooperation. This minor division never jeopardized the founding of the bank, but it did result in a curious ambiguity in the bank's primary mission. The dynamic multilateral bargaining approach described here is explicit about the interests of private creditors and those of their government. It is useful in framing a rigorous study of debt rescheduling and international institutionalization.