“The Dawes Bonds: Selective Default and International Trade”

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Sovereign debts

- Motivations to repay: reputation, collaterals, supersanctions and trade retaliation
- Formalization of trade sanctions limited
- If fear of trade sanction large enough we should not observe a default in the first place
- But is the sanction credible?
- International trade and default: decline in bilateral trade following a default (Rose, 2006) BUT sanctions or economic consequences of default?

Sovereign debts

- But Martinez and Sandleris (2011): decline in bilateral trade not different for creditors and non creditors
- Evidence that the threat of trade sanctions induces sovereigns to repay their debts seems elusive at best (Panizza et al., 2009)
- What is the impact of the sanction on reimbursement likelihood after the default? (or on the loss given default). Form of sanction not neutral

Sovereign debts

- Achieving a trade surplus is a natural way for the sovereign to get foreign exchange
- Creditors have an incentive not to sanction the defaulter (or not too much)
- If no creditor coordination => all creditors should grant favourable trade conditions
- 1930s: priority to repayment of commercial debts in order not to jeopardize overall payment by aggravating the country’s current account (Eichengreen and Portes, 1989)

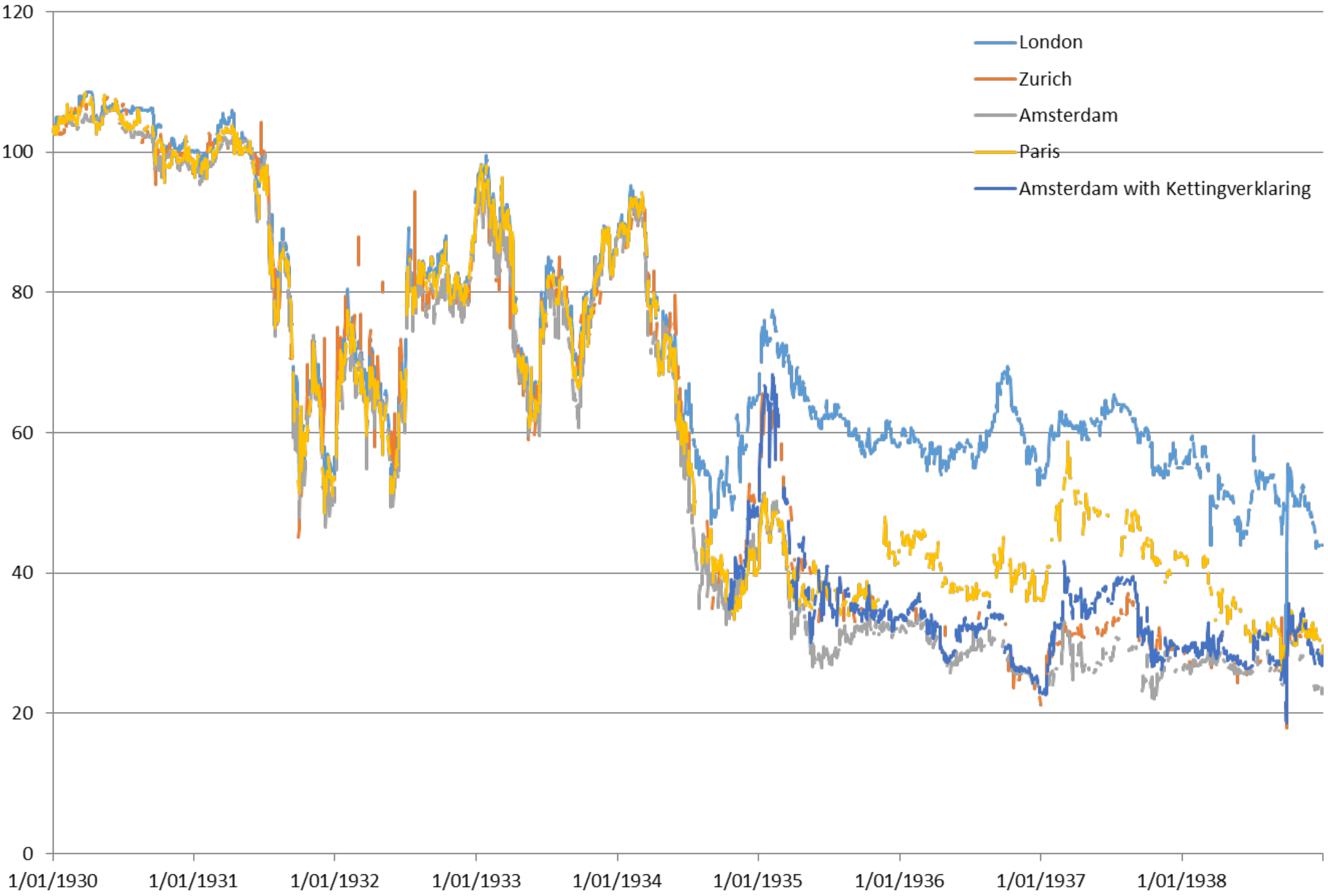
Sovereign debts

- Distributional consequences: Different creditors (not just bondholders) will attempt to reap the benefits from international trade
- Trade surplus implies exports are lower than imports with the defaulting country => may lead to conflicts between interest groups
- Possible to devise an incentive compatible mechanism? Power of the debtor?

Germany post-1934

- Unique historical case of selective default leading to reimbursement negotiations linked to trade
- Exact same bonds (cross-listed) floated and traded in different countries
- Market segmentation: measure of perceived risk of selective default and how creditors valued the different trade deals
- Better trade conditions for the debtor lead to higher bond prices

Price of Dawes loan in £



Dawes loan

- Consequence of WWI reparations, stabilization loan issued in 1924, 7%
- Dawes loans issued in sterling amounted to £22 million with the following distribution:
  - £12,000,000 in Great Britain
  - £3,000,000 in France,
  - £3,000,000 in Switzerland
  - £2,500,000 in The Netherlands
  - £1,500,000 in Belgium

Dawes loan

- May 15 1933, the Reichsbank announced: "the German foreign exchange position is so unfavourable and the question of the further transfer of funds for the debt service is *so* seriously affected thereby, that a direct discussion with the creditors is necessary"
- Main problem: foreign exchange. Reichsbank: willing to reimburse in Reichsmark instead of foreign currency
- Negotiations…

Negotiations

- For all loans: payment 50% in foreign currency, 50% in Reichsmark scrip. Gold Discount Bank: buy back scrip at 50% of its value. Dawes and Young loan, special status: Full payment promised.
- Dutch and Swiss reactions: German trade surplus with Switzerland and The Netherlands guarantees an inflow of foreign currency to be used for the bonds
- Dutch and Swiss creditor: threat to impose unilaterally a clearing system

Negotiations

- BoE archives: threat perceived as credible in Berlin
- October 1933, first breach of inter-creditor equity: for Dutch and Swiss creditors the scrip could be exchanged for 100% of its value
- Agreement renewed in February 1934.
- New German default in June 1934

=> Creditors begin to negotiate separate deals with Germany

Swiss and Dutch

- July 1934 => Switzerland agrees to cap interest rates to 4.5% and promise to increase imports from Germany. Dawes and Young loan, special status: Full payment promised.
- October 1934: Dutch agree to the same terms
- April 1935 (Dutch) and June 1935 (Swiss) agreements with Germany: end of the special status of the Dawes and Young loans with interest payments under the form of Funding Bonds carrying a 4% nominal interest rate

France

- July 1934: clearing agreement, payments made through Reichsbank and the Franco-German Office for Commercial Payments
- 15.75 per cent of the daily value of French imports from Germany to be credited to a special Reichsbank account with the Franco-German Office and used for the payment of the coupons of the Dawes and Young Loans

UK

- The British Treasury supports trying “to get an agreement for equal national treatment of all the creditors if possible; but if that is not possible, to press Germany for a special agreement in favor of the United Kingdom by which British creditors receive as good treatment as the Swiss and the Dutch and to make our acceptance of any special Swiss and Dutch agreements conditional on Germany giving us equivalent terms”

UK

- 26 June 1934, the British parliament passed the “Debts Clearing Office and Import Restrictions Reprisals Bill” authorizing the government to impose a comprehensive payments clearing system against Germany
- 4 July 1934: Germany will pay interest in full to British holders of Dawes and Young bonds until a permanent solution is found (Wendt, 1971)

UK

- Permanent solution

⇒Anglo-German Payments Agreement of 1st November 1934

⇒Comprehensive control over all payments transactions between the UK and Germany only exercised on the German side, which committed to spending specified shares of the foreign exchange revenue from German exports to Britain on individual categories of British claims

UK

- 55% were reserved for British exports and another 10% for reducing outstanding commercial debt
- Permanent transfer of the full amount of interest payments on the Dawes and Young Loan to British investors
- Treaty remains up to 1938: Agreement leaves more foreign exchange to Germany and British Empire of vital importance to the German economy as a supplier of raw material

US

- Plead against discrimination. Bank for International Settlements supports this view

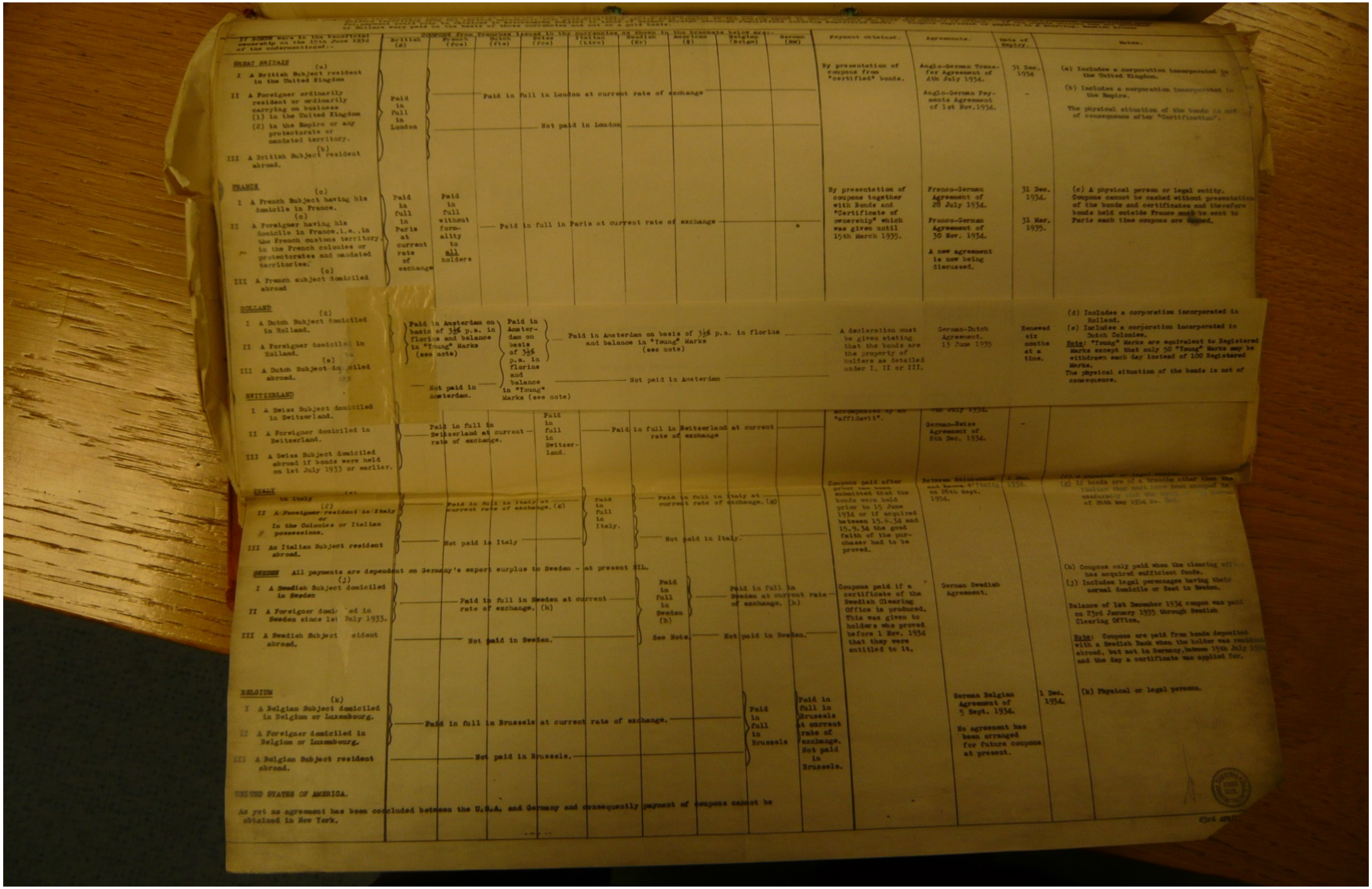
⇒By December 1934, all principal creditor countries bar the USA made special agreements with Germany

- Inter-creditor discrimination

⇒complex impact on the debt management and on eligibility

- Countries differed on eligibility criterion (nationality, domicile, creation of affidavits)

Complexity



If BONDS were in the beneficial ownership on the 15th June 1934 of the undermentioned:-	British (£)	French (fcs)	Dutch (fls)	Swiss (fcs)	Italian (Lire)	Swedish (Kr)	American ($)	Belgian (Belgas)	German (RM)	Payment obtained.	Agreements.	Date of Expiry.	Notes.
GREAT BRITAIN (a) I A British Subject resident in the United Kingdom; II A Foreigner ordinarily resident or ordinarily carrying on business (1) in the United Kingdom (2) in the Empire or any protectorate or mandated territory.	Paid in full in London	Paid in full in London at current rate of exchange								By presentation of coupons from "certified" bonds.	Anglo-German Transfer Agreement of 4th July 1934. Anglo-German Payments Agreement of 1st Nov. 1934.	31 Dec. 1934 / -	(a) Includes a corporation incorporated in the United Kingdom. (b) Includes a corporation incorporated in the Empire. The physical situation of the bonds is not of consequence after "Certification".
(b) III A British Subject resident abroad.		Not paid in London											
FRANCE (c) I A French Subject having his domicile in France. (c) II A Foreigner having his domicile in France, i.e., in the French customs territory, in the French colonies or protectorates and mandated territories. (c) III A French subject domiciled abroad	Paid in full in Paris at current rate of exchange	Paid in full without formality to all holders	Paid in full in Paris at current rate of exchange							By presentation of coupons together with Bonds and "Certificate of ownership" which was given until 15th March 1935.	Franco-German Agreement of 28 July 1934. Franco-German Agreement of 30 Nov. 1934. A new agreement is now being discussed.	31 Dec. 1934. 31 Mar. 1935.	(c) A physical person or legal entity. Coupons cannot be cashed without presentation of the bonds and certificates and therefore bonds held outside France must be sent to Paris each time coupons are cashed.
HOLLAND (d) I A Dutch Subject domiciled in Holland. II A Foreigner domiciled in Holland.	Paid in Amsterdam on basis of 3½% p.a. in florins and balance in "Young" Marks (see note)		Paid in Amsterdam on basis of 3½% p.a. in florins and balance in "Young" Marks (see note)	Paid in Amsterdam on basis of 3½% p.a. in florins and balance in "Young" Marks (see note)						A declaration must be given stating that the bonds are the property of holders as detailed under I, II or III.	German-Dutch Agreement. 13 June 1935	Renewed six months at a time.	(d) Includes a corporation incorporated in Holland. (e) Includes a corporation incorporated in Dutch Colonies. Note: "Young" Marks are equivalent to Registered Marks except that only 50 "Young" Marks may be withdrawn each day instead of 100 Registered Marks. The physical situation of the bonds is not of consequence.
(e) III A Dutch Subject domiciled abroad.	Not paid in Amsterdam.			Not paid in Amsterdam									
SWITZERLAND I A Swiss Subject domiciled in Switzerland. II A Foreigner domiciled in Switzerland. III A Swiss Subject domiciled abroad if bonds were held on 1st July 1933 or earlier.	Paid in full in Switzerland at current rate of exchange.			Paid in full in Switzerland.	Paid in full in Switzerland at current rate of exchange					... accompanied by an "affidavit".	... July 1934. German-Swiss Agreement of 8th Dec. 1934.	-	
ITALY ... in Italy (f) II A Foreigner resident in Italy or In the Colonies or Italian possessions.	Paid in full in Italy at current rate of exchange. (g)				Paid in full in Italy.	Paid in full in Italy at current rate of exchange. (g)				Coupons paid after proof has been submitted that the bonds were held prior to 15 June 1934 or if acquired between 15.6.34 and 15.9.34 the good faith of the purchaser had to be proved.	Between Reichsbank and Banca d'Italia on 26th Sept. 1934.	1 Dec. 1934.	(f) A physical or legal entity. (g) If bonds are of a tranche other than the Italian they must have been stamped in conformity with the ... of 26th May 1934 ...
III An Italian Subject resident abroad.	Not paid in Italy					Not paid in Italy.							
SWEDEN All payments are dependent on Germany's export surplus to Sweden - at present NIL. (j) I A Swedish Subject domiciled in Sweden II A Foreigner domiciled in Sweden since 1st July 1933.	Paid in full in Sweden at current rate of exchange. (h)					Paid in full in Sweden (h)	Paid in full in Sweden at current rate of exchange. (h)			Coupons paid if a certificate of the Swedish Clearing Office is produced. This was given to holders who proved before 1 Nov. 1934 that they were entitled to it.	German Swedish Agreement.		(h) Coupons only paid when the clearing office has acquired sufficient funds. (j) Includes legal personages having their normal domicile or Seat in Sweden. Balance of 1st December 1934 coupon was paid on 23rd January 1935 through Swedish Clearing Office. Note: Coupons are paid from bonds deposited with a Swedish Bank when the holder was resident abroad, but not in Germany, between 15th July 1934 and the day a certificate was applied for.
III A Swedish Subject resident abroad.	Not paid in Sweden.					See Note.	Not paid in Sweden.						
BELGIUM (k) I A Belgian Subject domiciled in Belgium or Luxembourg. II A Foreigner domiciled in Belgium or Luxembourg.	Paid in full in Brussels at current rate of exchange.							Paid in full in Brussels	Paid in full in Brussels at current rate of exchange.		German Belgian Agreement of 5 Sept. 1934. No agreement has been arranged for future coupons at present.	1 Dec. 1934.	(k) Physical or legal persons.
III A Belgian Subject resident abroad.	Not paid in Brussels.								Not paid in Brussels.				

UNITED STATES OF AMERICA.

As yet no agreement has been concluded between the U.S.A. and Germany and consequently payment of coupons cannot be obtained in New York.

23rd April

Source Bank of England Archives

Getting the best deal

- Complex scheme meant that bondholders could sometimes chose where to apply

UK British issue (gross)	9,158,600 £	
Certified amounts (£)	In 1934	In 1938
British issue	7,387,000 £	8,114,100 £
Belgian	479,500 £	574,200 £
Dutch	263,600 £	303,700 £
French	1,319,900 £	1,402,500 £
Swiss	297,900 £	316,600 £
TOTAL	**9,747,900 £**	**10,711,100 £**

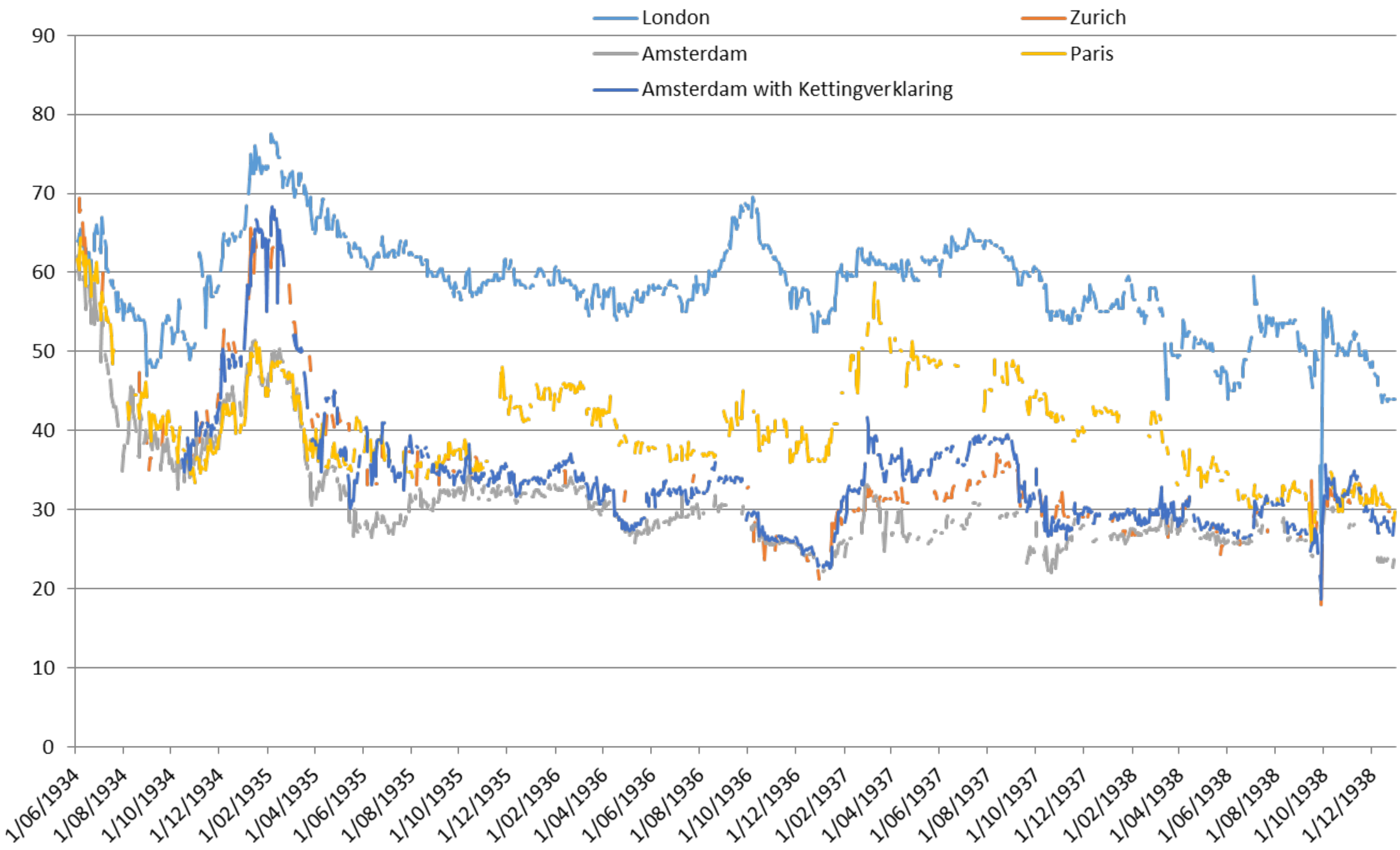
Source: BoE archives, OA26-2, for 1934; and OV34/281, for 1938

- In four years close to an additional £1,000,000 had been recognized as British

Data

- Daily price of the bonds on four different markets: Amsterdam (with and without affidavit), London, Paris, Zurich from 1930 to 1938
- In theory cross-listed bonds have a close price otherwise arbitrage takes place: valid up till the default in June 1934, not afterwards!
- In general price in the UK dominates but in some instances prices in Zurich were higher than in London

Price of Dawes loan in £



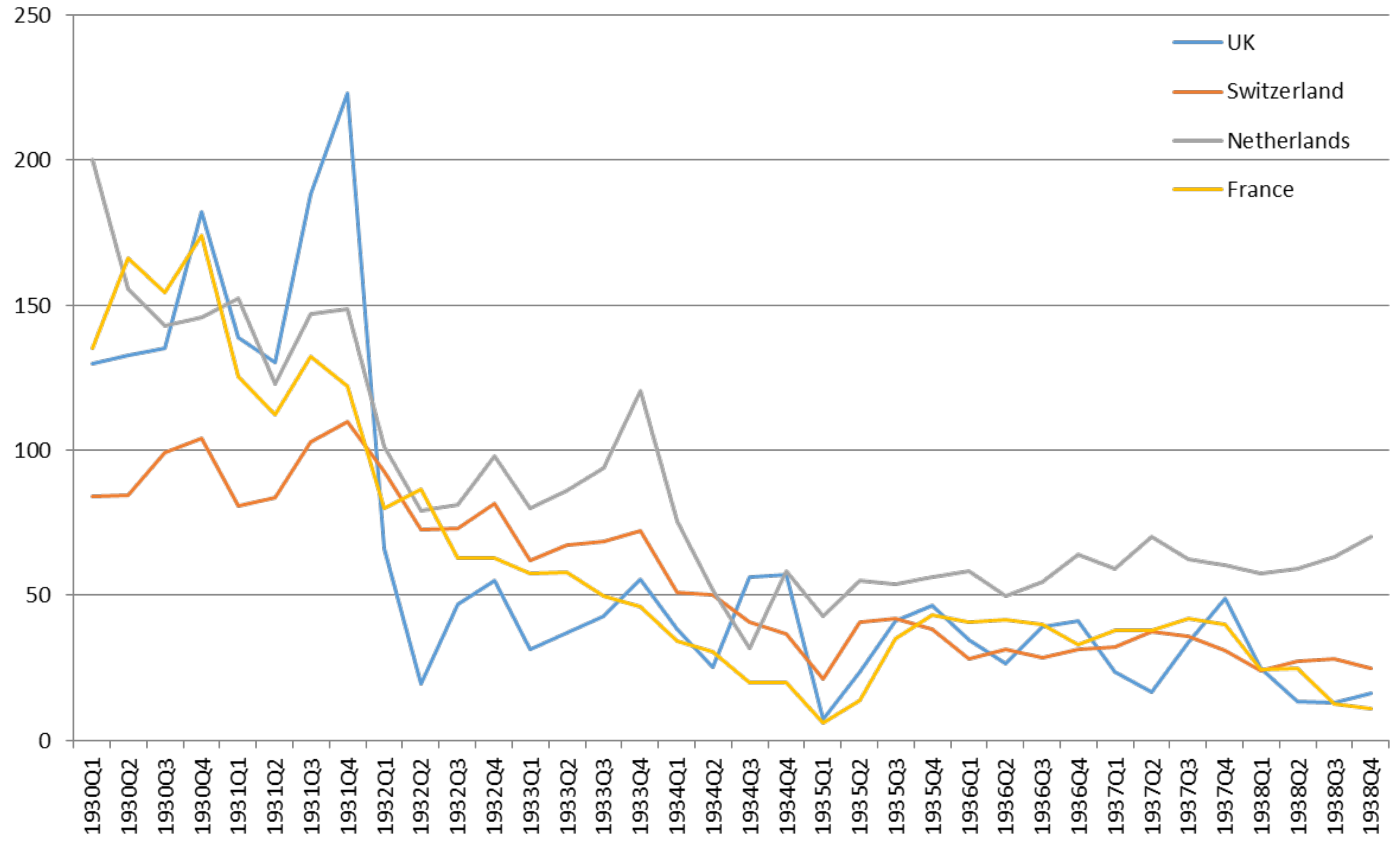
Trade and reimbursement

- Trade is central in the approach devised by the different countries
- Is the high price observed for the UK reflecting a better position in terms of trade (i. e. higher imports from Germany)?
- Or were other elements at play?
- To work, the clearing system requires:
  - a German trade surplus
  - the willingness to use this surplus for bondholders

Trade and reimbursement

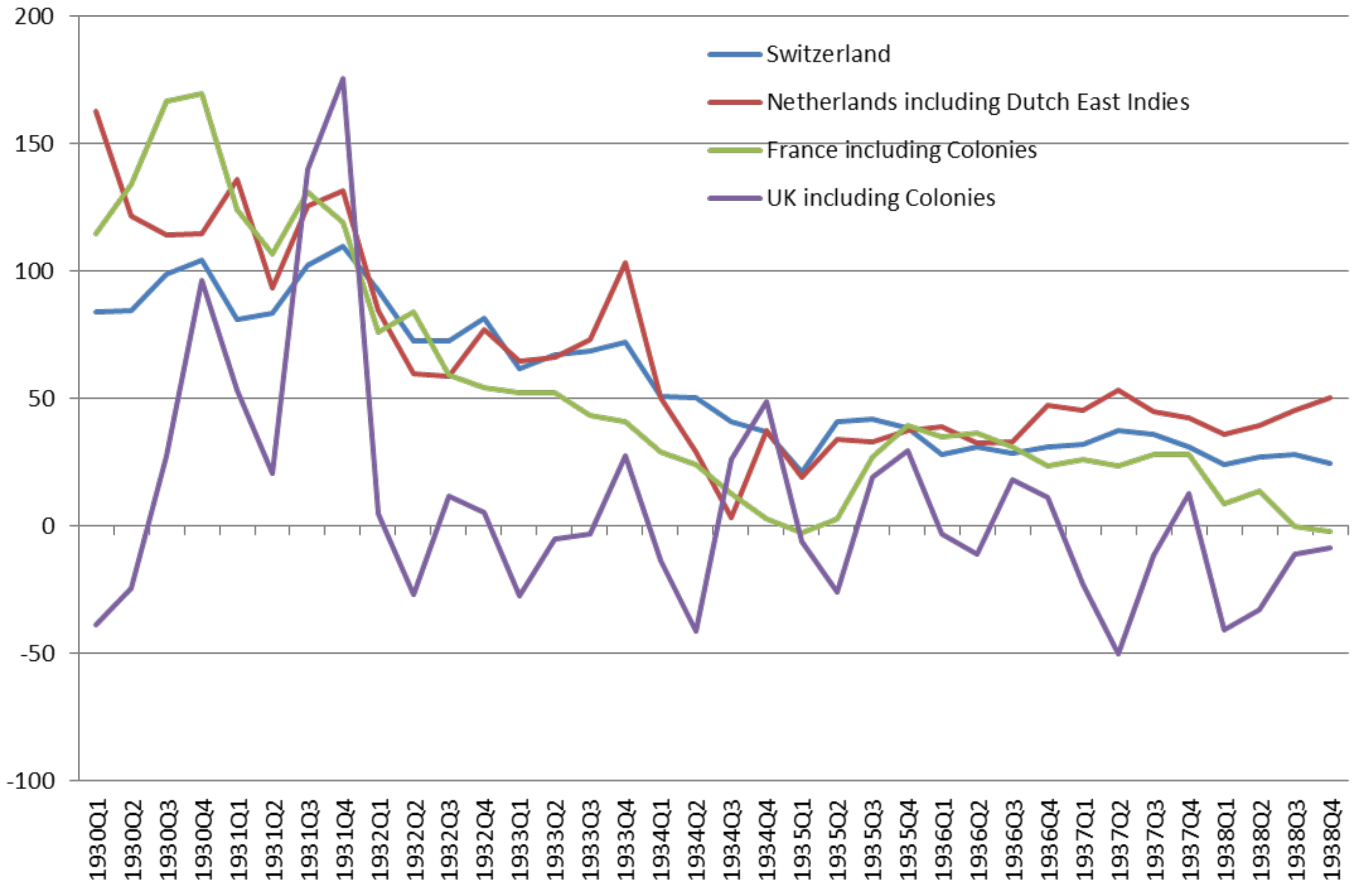
- German surplus not for granted
- Known at the time
- *The Times* 25 October 1934: Clearing could lead to a contraction of Anglo-German trade, may lead debtor to receive less than before, mostly a problem of Sterling transfer because debt per head lower than in many other countries
- Impact of clearing on trade evolution

German Trade Surplus



German Exports in Million RM, colonies not included

German Trade Surplus



German Exports in Million RM, colonies included

Trade and Price of Dawes loan

- Correlations between lagged trade surplus and bond price

	UK	Swiss	Nlds	France
Lagged trade (no colonies)	29.84%	49.41%	34.83%	48.38%
Lagged trade (with colonies)	44.00%	49.41%	-54.43%	44.29%

- Limited data so just an indication
- Quarterly data 1934 Q2 to 1938 Q4, price average per quarter

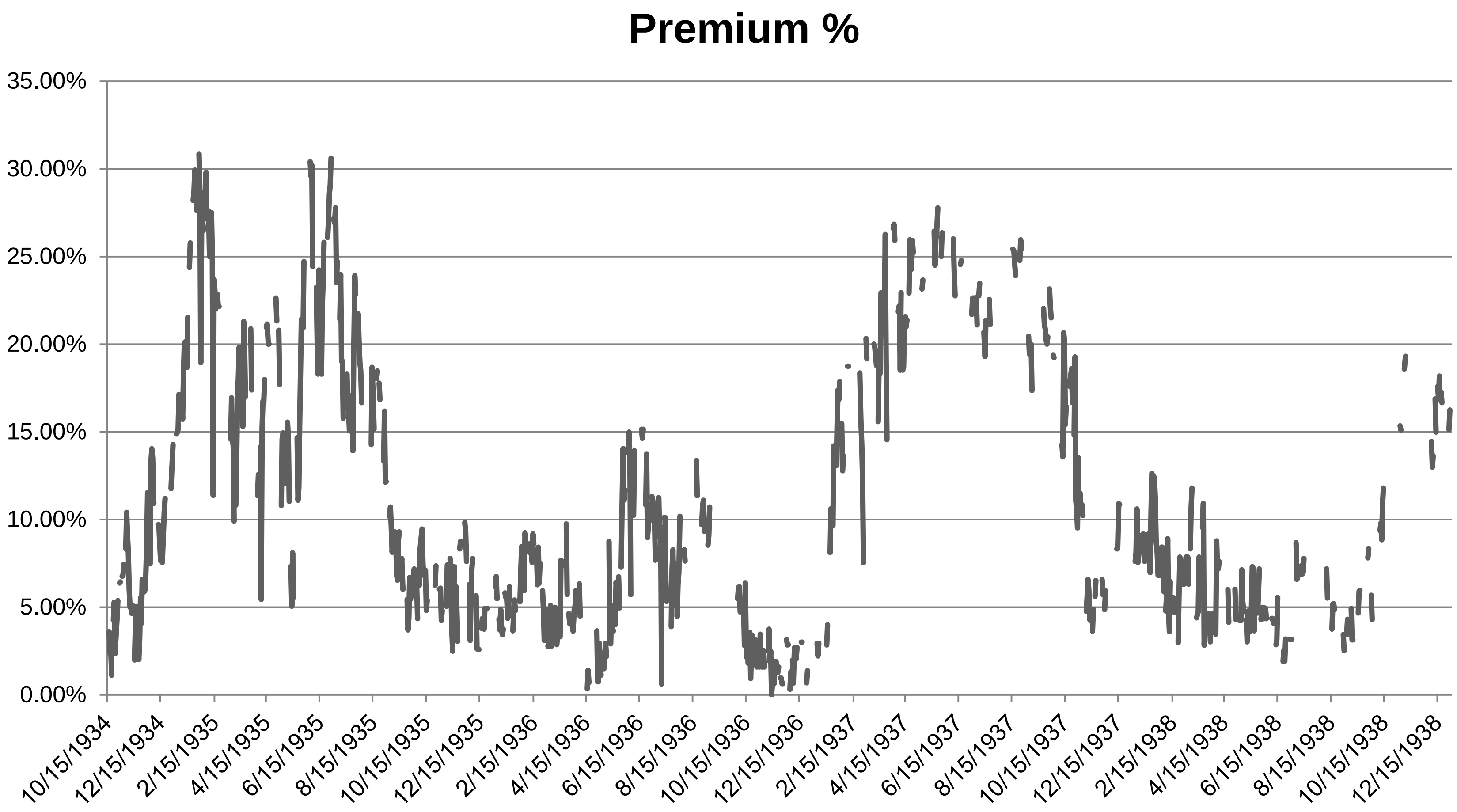
Value of the deal?

- Amsterdam prices for Dawes bonds with and without affidavit (kettingverklaring)
- Premium for the affidavit?
- Premium =

$(\text{Price}_{\text{with affidavit}} - \text{Price}_{\text{without}}) / \text{Price}_{\text{with affidavit}}$

- Large variations in the premium (high of 30.86%!)
- Correlation with lagged trade 20.18% without colonies, 26.24% with colonies

Affidavit Premium



Clearing and Trade

- System rests on the ability (and willingness) of the debtor to generate a trade surplus
- Incentives to get hard currency only to reimburse foreign debts not very high in Nazi Germany
- French case => Germany imports massively raw materials, exports not large enough to compensate trade and debt service. In August 1935 => Imbalance for France (700 million FF) => decision to reduce exports to Germany (quotas)

Political economy of the clearings

- Quotas to Germany

$\Rightarrow$ French industry and agriculture lobby

$\Rightarrow$ increase of quota

$\Rightarrow$ new increase in the clearing imbalance

$\Rightarrow$ clearing system abolished in 1937 but positive balance of foreign exchange to be used first for Dawes and Young loans

Conclusion

- Comprehensive clearing agreements: limited incentives to increase trade surplus
- Sovereign debts and trade have an impact on other parts of the economy limiting the effectiveness of potential sanctions
- Clearing agreements created distributional struggles within creditor countries

Political economy of the clearings

- Struggle for pay-outs from clearing funds between interest groups in creditor countries.
- The Netherlands: protection of the agriculture: 39,5% of the clearing account earmarked for these (Klemann, 2008)
- Switzerland: priority given to export and tourism industry
- UK: extremely large amount of German commercial debts £4.7 million by late 1934 (Forbes, 2000)

Conclusion

- Trade sanctions often presented as one reason for sovereign debt reimbursement
- Dawes case allows analyzing the effectiveness of such sanctions
- Threat to impose unilaterally a clearing led to negotiations but at the cost of inter-creditor equity
- Better trade terms led to higher bond prices