

American Money and the Weimar Republic

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American Money and the Weimar Republic

ECONOMICS
AND POLITICS
ON THE EVE
OF THE GREAT
DEPRESSION

William C. McNeil

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This book is Smyth-sewn.

to Vicki, Emily, and Nathan

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American Money and the Weimar Republic

Introduction

On the 10th of October 1924 the New York money market bid so enthusiastically for the American share of the Dawes Loan that the bonds were nearly sold out by the end of the day. They were soon ten times over subscribed, and a new era in international finance had begun.¹ The United States had emerged from the First World War as the major source of investment capital in the world and European states that had once made loans to America were now reduced to supplicants for that American money. But Europe's political and economic instability kept prudent American investors from lending their money abroad until 1924. With the Dawes Plan's promise of an end to Europe's problems, Americans rushed to gain the big profits offered by overseas investments. Outside of Canada, Germany became the greatest single recipient of American money. This is a study of how Germans and Americans attempted to use this money between 1925 and 1929.

By 1924, a decade of war, revolution, and hyper-inflation had destroyed Germany's once strong capital market.² What little money was available commanded real interest rates in the range of 50 percent per year. Germans looked to New York to relieve this financial pressure. Between 1925 and 1930,

American private bankers lent nearly three billion dollars to German borrowers—over twice the \$1.3 billion Germany received from the United States under the Marshall Plan after World War II. In both Germany and the United States, the loans became critical tools in efforts to define a broad range of international and domestic policy options.

Within Germany the channels cut by the new capital imports reveal the lines of political power in the “Golden Years” of the Weimar Republic. Since Germany had little experience in borrowing abroad, the anticipation of capital imports at rates cheap by German standards set in motion a flurry of political jockeying to determine which groups would have access to the money. Conservatives, industrialists, and agrarians insisted that the foreign manna must be used to increase the nation’s productive capacity. In other words, it must be reserved for their own use. Social reformers in municipal governments, labor unions, and left-liberal political parties countered with the argument that investments in public works such as housing, roads, utilities, and an expansion of the nation’s welfare system were more pressing needs of a German society suffering from ten years of social, economic, and political upheaval. Since the foreign loans were vital to financing these alternate visions of Germany’s future, an examination of how they were used helps us understand the complex politics of Weimar’s middle years.

The American loans to Germany not only raised fundamental domestic issues for Germany, they also became entangled in German foreign policy planning. The loans created strong ties between the United States and Germany. German policymakers understood that these ties might be exploited to create a kind of financial partnership between the United States and Germany or they might become a dangerous international liability that could reduce Germany to financial subordination to American bankers.

As German government spending increased in the late twenties, and as the spending became more dependent on the capital imports, German foreign and domestic policies came into conflict. Attempts to stabilize the internal economy made Germany more dependent on foreign loans, and this restricted

the policy options open to the German Foreign Office. At the same time, attempts to use the loans to achieve foreign policy goals restricted the options available to stabilize the domestic economy. The policy choices made between 1925 and 1929 shaped Germany's response to the Great Depression. Examination of these links between foreign and domestic implications of the American loans and their impact on German policies form the core of this study.

For the United States, the foreign lending that emerged in the 1920s represented America's first use of the financial power it had won in the First World War. But how would the new world power use its wealth? Revisionist historians writing in the 1950s and 60s concluded that America used its power to dominate the world economy in the service of narrow business self-interests.³ More recently, a more sympathetic consensus has formed among American historians who agree that the United States was indeed active in European affairs but argue that American policy was formulated to help stabilize European economies, not exploit them.⁴

American economic power in the 1920s was a product of its rich capital markets. Examination of how the United States controlled and used its capital exports gets to the core of American foreign economic policy. How did the United States determine where its money would be used and how consciously did the American government or banks regulate the loans with a view toward specific long-range goals? What do the loans tell us about the reality of American isolationism or interventionism in the 1920s? How much influence did the American lender have over the economic and social policies of the German borrower? The answers to these questions have broad implications for understanding one of the fundamental international phenomena of the modern world. The relationship between borrowers and lenders and the obligations assumed by each will either help stabilize the world economy, or, as the reality of the 1920s demonstrated, will make a major contribution toward destabilizing the world economy. In examining how the United States set its international financial policy in the twenties and how those policies influenced German

options, we can construct a picture of the traditions which set the framework for future American policy.

Efforts to control the foreign loans and direct them toward either privately or publicly owned enterprise also became part of a broader effort to define the role of the state in modern, capitalist societies. Would state spending help stabilize the national economy and promote public welfare, or would it actually lead to greater instability? The social and economic dislocations suffered by Germany during and after the First World War brought these issues into focus sooner and more violently than in other industrialized countries. Yet the efforts to find an acceptable level and range of government influence in the national economy had to be faced by all capitalist states, and echoes of the debates aired in Germany in the nineteen twenties can still be heard in industrial countries in the nineteen eighties.

Chapter 1

Power and Politics in the Weimar Republic

The First World War and the crisis following German defeat in 1918 altered many of the basic structures of the German economy and German society. When revolution broke out in November 1918, it appeared that capitalism would be destroyed and a socialist society erected in its place. But the socialists proved too timid to consolidate their gains, and the capitalists proved more resilient than they had initially appeared. By 1924, conservative industrial-agrarian elites regained a degree of power which in 1918–19 had seemed to be forever lost.

In late 1923 and early 1924, businessmen won major concessions as Germany ended nearly a decade of inflation and struggled to stabilize its currency and economy. Industries that had feared nationalization in 1918 now were being courted and protected by a state that was more concerned with increasing productivity than income redistribution. Important social reforms which had been antithetic to industry, especially the government guaranteed eight-hour day, were suspended and owners were given greater discretion over factory operations. The industrialist could once again begin to feel master of his own house.

The combination of this rollback of social reform on the one side and emphasis on industrial production on the other demonstrates the degree to which “bourgeois” society was saved and reformed in Weimar Germany.¹ Yet the demonstration of this “conservative” victory in 1923–25 is far from the end of the story for the Weimar Republic. Excessive fascination with this victory can obscure the drama of later years. The captains of industry might appear to have been safe and secure in the view of modern historians, but in their own view they remained locked in mortal combat with the forces of the Left which so recently had appeared ready to destroy them. If they had briefly gained from the flood tide of political fortunes, they were soon to feel the ebb as well.

To understand the forces that shaped German policy in the second half of the 1920s, we need to bring together three divergent strands in German political evolution. In looking at German political institutions in the first section of this chapter, it becomes apparent that German capital shortages played a central role in setting the stage for the social conflicts that dominated the Weimar Republic. The second section examines the origins and impact of this capital shortage. The final section explores the role of the Dawes Plan in resolving the conflicts between German foreign and domestic policies.

Institutions in Stalemate: Germany Between Inflation and Depression, 1924–1929

In Germany, as in the United States, government is divided into three tiers: federal, state, and local. Under the Bismarckian empire, state governments had retained near sovereignty in almost all areas except foreign policy. The Reich government was even dependent on the states for income, since the states retained control over most direct taxes. At the same time, municipal governments enjoyed a great deal of independence from state control since they collected a large share of their own tax revenues.

Under the Weimar constitution the federal government assumed far more power and responsibility than it had under the Empire. These gains were made largely at the expense of the state governments. The financial reforms introduced in 1919 by Matthias Erzberger granted the major taxing authority to the federal government and effectively destroyed local financial autonomy. Under the new arrangements, the Reich collected most taxes, including the income tax. It then granted the state governments a certain percentage of the tax revenues—a sum that varied from year to year. The states, in turn, passed on a specified share of the centrally collected taxes to the city governments.

Despite the decline in state power, the states retained enough influence to exercise a veto over some federal policies inimical to their interests. The state of Prussia, with over half the German population within its borders, was by far the most powerful of the state governments. Its ruling coalition remained oriented toward the left even after the Great Coalition collapsed at the Reich level in the fall of 1923. This had been an uncomfortable ruling block stretching from the conservative, industrial oriented German People's Party on the right to the Social Democratic Party on the left. From 1924 to 1928, the Social Democrats were excluded from participation in the national government, and Germany was ruled by shifting coalitions of the right. In Prussia, however, the Social Democrats continued to play a vital and even dominant role in the state government. From this vantage point, moderating pressure was persistently applied to Reich policies—as often as not through offers of cooperation in return for reformist modifications of federal laws. Beyond Prussia, Bavaria led the smaller states in a losing battle to impede the centralization of power in Berlin. Often attacking Prussia along with the Reich, the Bavarians offered enough resistance to Reich policies to delay important decisions or postpone reforms.

In contrast to the declining power of the states, the prerogatives of the city governments actually increased as they were charged with greater responsibility for unemployment compensation, welfare relief, and social overhead investment.

Their political influence also increased as they strengthened their national organization to lobby for their special interests. The *deutsche Städtetag* and the city governments it represented played a central part in determining Germany's social policies in the years between the inflation and the great depression.

Traditionally dominated by local business leaders, city governments in the 1920s tended to respond sympathetically to the welfare needs of their citizens. In the larger cities, coalitions of small businessmen, civic leaders, and Social Democrats formed alliances striving to promote municipal enterprise and civic improvement. Under the leadership of strong mayors such as Konrad Adenauer in Cologne, Gustav Böss in Berlin, and Ludwig Landmann in Frankfurt a.M., the *Städtetag* and the cities became a major force for a more generous social policy.²

In the process of reforming the relationships between the various levels of government, an unfortunate paradox emerged. Local governments were not responsible for collecting taxes, but they were responsible for an expanded range of welfare programs. In meeting their responsibilities, city governments may have been overly generous in their spending decisions because they no longer had to raise the taxes themselves to cover their expenses. Instead, they could demand that the Reich transfer a larger share of the national tax receipts to them to cover the mounting municipal spending.³ The potential for trouble in the financial relations between municipalities and the Reich was made even greater by the disastrous state of municipal finance in the wake of the inflation. High rates of urban unemployment and a massive immigration from rural areas (Berlin's population grew by 100,000 persons per year throughout the twenties) created ever mounting pressures on an already inadequate housing supply and outdated city services.⁴

In one way, the inflation itself had actually been beneficial to public finances. Public debts, both national and municipal, had been nearly wiped out as old bonds became all but worthless. The cities were particularly helped by this, since as "debt free" public administrations, they became a very

attractive investment for foreign money lenders. They were also desperately eager for foreign capital, since years of neglect in public investment and increased population created a backlog of demands for improvements in electric, water, and gas supplies, roads, street cars, public housing, and less essential projects such as theaters, museums, and sports facilities. The financial needs of municipal governments were made all the worse by the fact that during the final phase of the inflation municipal income had fallen to almost nothing, nearly bankrupting many city governments. After the stabilization, their position was further hurt when the municipal share of the income tax was reduced.⁵ When state incomes were also cut by the central government, they could respond, as Prussia did, by taking the receipts from the sales tax away from the cities and adding it to state income.⁶ Thus city governments had growing responsibilities thrust on them throughout the twenties, while their capacity to pay for their spending was steadily eroded.

The combination of municipal financial need and the fact that the inflation had eliminated their debts made cities a natural recipient of loans once the German market was reopened to foreign capital in 1925. The resultant borrowing of German cities on the foreign and especially the American market soon became the center of bitter political controversy. German industrialists resented the use of scarce and cheap foreign capital for what they regarded as socialist purposes. In the fight to regulate public borrowing abroad, the bitter social struggles which in other areas remained quiet during the mid-twenties raged on without interruption. But this time the issue also took on important international repercussions. By increasing its foreign debt, some international financial experts feared that Germany was also reducing its ability to meet its reparations payments. Thus, the domestic social struggle surrounding the public loans soon became embroiled in the complex reparations debates which often dominated international relations in the 1920s.

In the same way that German decision making was complicated by disagreements and competition among the Reich, the states, and the cities, so too was it made more difficult by

the division of authority within the Reich government itself. These divisions became glaringly apparent as Germany attempted to adjust its foreign and domestic policies to the political realities of the mid-twenties. With the German defeat in 1918 and the reparations obligations imposed upon her by the Versailles Treaty, revision of the treaty and elimination of reparations payments became the central focus of German foreign policy. When Germans finally learned that inflation and passive resistance were more costly to themselves than to their enemies, the government was forced to accept the (at least temporary) need to pay large-scale reparations. In agreeing to the Dawes Plan and accepting responsibility to help transfer reparations from Germany to the Allies, the dominant issue in foreign policy became inseparably linked to the social and economic settlements made within Germany itself. This critically important link between foreign and domestic policies was made explicit by the experts on the Dawes Committee when they said that for Germany to fulfill its reparations obligations, it had to ensure that government budgets were held in balance. Blaming the inflation on huge government deficits, the Dawes Committee argued that the German economy and German trade balances could only be put in order if the government pursued a conservative fiscal policy. Maintenance of a balanced budget in turn meant that a crucial element of foreign policy was dependent upon government agencies concerned with domestic finance and the internal economy. In this way, three departments not normally associated with foreign policy became rivals with the Foreign Ministry in the formulation of German reparations policies.

The Reich Finance Ministry exercised direct responsibility for development of the federal budget and held a much stronger position in the 1920s than it had under the prewar empire. Under the leadership of Finance Ministers Matthias Erzberger and Rudolf Hilferding, the ministry had been sympathetic to demands for social reform. But, with the removal of Hilferding, himself a fiscal conservative, immediately prior to the stabilization in 1923, control of the Finance Ministry passed to men unconcerned with any social reform. Although most senior bureaucrats may have been sympathetic to industry

and agriculture and politically close to the DVP and the DNVP, they did not determine Reich policy and, by and large, loyally served their political superiors.⁷ Perhaps more important in setting policy than the political leanings of the Finance Ministry officials was the fact that the ministry bureaucrats looked at the world through bankers' eyes. It was their responsibility to find ways to finance government spending, and they had to deal with Germany's capital shortages. This meant that as the organization primarily responsible for Reich fiscal policy, the Finance Ministry begrudged lavish spending and worked to follow the "correct" policy of preserving a balanced budget. The leading permanent official from 1925 to 1929, State Secretary Johannes Popitz, led this fight to uphold fiscal orthodoxy.

In spite of the obvious conservative orientation of the Finance Ministry, maintenance of a balanced budget proved exceedingly difficult. In the pre-Dawes Plan years, German officials had claimed that reparation payments undermined their ability to balance the budget. But the final agony of the hyperinflation and the exhaustion of all Germans led to a consensus in late 1923 that spending had to be curtailed, taxes raised, and the budget balanced. Finance Minister Hans Luther used this momentary national consensus to impose the needed medicine, and in 1924–25 Germany pursued the policies required by the Dawes Plan. But as the inflation gave way to depression in 1925, calls for state aid to special groups replaced the demands for a balanced budget which had been heard with such force only two years before.

Within the Cabinet, the Economics and Labor Ministries exerted the most pressure against a strictly conservative fiscal policy. The Economics Ministry's responsibility for preserving balanced growth in the German economy quite naturally led it to fear fiscal policies which might weaken the economy or increase business bankruptcies. The Economics Ministry's emphasis on promoting greater productivity led it to sympathize with industry when it had real economic problems but to resist industrial attempts to use those problems as a lever to win political battles. The leaders of the Economics Ministry were anxious to cut taxes in order to reduce the financial burden on industry but in a depression were also willing to see gov-

ernment spending increase in order to stimulate the economy and save industry from the full effects of the business cycle.

The Economics Ministry was led by men who tended to be less conservative than those in the Finance Ministry. The extremely influential ministerial director, Hans Schäffer, even expressed Socialist sympathies while working for the capitalist order. Julius Curtius, who served as Economics Minister from 1925 to 1929 maintained close ties to leaders in all branches of industry, but tended to identify ideologically with the pragmatists in the finishing and electrical industries.⁸ From this position he struggled to moderate the demands of heavy industry while promoting industrial growth and profits. Furthermore, Curtius persistently fought to avoid any threat of a new economic crisis in Germany, and this stand forced him steadily to extend the range of government policy in the areas of economic stimulation and stabilization. More than any other agency, the Economics Ministry under Curtius saw and understood the links between foreign and domestic policies. This placed the ministry in the middle of the social conflict between right and left and led it to resolutely urge moderation, caution, and patience in formulating German reparations policies in order to avoid any disruption of the internal economic order.

The Labor Ministry provided the most active demand within the Cabinet for expanded government aid to the economy, and it acted as the left-wing balance to the Finance Ministry's inherent conservatism. Even under the "bourgeois" governments after the stabilization, the Labor Ministry remained a strong advocate of union rights and social welfare legislation. During the long tenure of Heinrich Brauns as Labor Minister, the Reich government consistently cast its weight in support of wage settlements and state support for the economy, which enraged German industrialists.

Brauns' power was based on the bizarre position and constituency of his Catholic Center Party. A confessional party containing representatives of all social groups, the Center Party was steadily strained to hold its diverse elements together. It had to find policies that could satisfy its business supporters without alienating Catholic workers. Throughout the middle twenties, Brauns was able to win concessions for the left,

because without those concessions the party would lose its large labor vote and break apart. At the same time, Brauns was able to use this leverage within the Center Party to move even conservative governments toward the left because the Center Party was vital to every government in the Weimar era. It could and did form alliances with parties either to the left or right, and its basic needs had to be met by every government that wished to preserve a parliamentary majority. Even under the bourgeois governments, conservatives had to bite their tongues and permit the Labor Ministry its concessions to the left.

In formulating and advocating certain domestic, social, and economic policies, each of these three ministries—Finance, Economics, and Labor—took positions that directly influenced German foreign policy. Time after time, German reparations policy was confounded or promoted by domestic social and economic decisions. Time after time, these three ministries and the Foreign Office engaged in disputes that inexorably tied foreign to domestic policy.

It soon became clear that the critical element linking reparations policy and domestic policy was the flow of foreign capital into the German economy. By stimulating the economy, the foreign capital promised to ease the strains that agitated the Economics and Labor Ministries. At the same time, the inflow of capital gave Germany the foreign currency it needed to fulfill the Dawes Plan without putting excessive pressure on the Finance Ministry to balance the budget. But the loans carried dangers with them as well. By permitting deficit spending, the loans frustrated allied demands that Germany balance its budget as proof of its commitment to a fulfillment policy. They also created the fear that if taken in excessive measure they might destroy Germany's ability to formulate an independent foreign policy by making it dependent on foreign bankers. Finally, in the aftermath of the inflation, Germans worried that the loans might so expand the money supply that a new inflation would result. This fear of inflation and the antagonism felt by the international banking community to government deficits drew a final actor into the formation of German foreign and domestic policymaking.

During the inflation period, the German central bank, the Reichsbank, received most of the blame for the destruction of the German currency. By running the printing presses non-stop, the Reichsbank made the inflation possible by supplying unlimited credit to the government and to private industry. With stabilization came the conviction that the Reichsbank had to be completely freed from government control so that it could never again be forced to condone such an irresponsible credit expansion. The obvious fact that monetary policy is an essential part of economic and social policy meant that the new and independent central bank would become a major political force. When longtime Reichsbank president Rudolf Havenstein suddenly died just as the mark was being stabilized in November 1923, it was clear that his successor would have important political influence in determining how the burdens of stabilization would be distributed.

The directors of the Reichsbank immediately seized the initiative and urged the appointment of Karl Helfferich, former Secretary of the Treasury in the old imperial government, to the post of Reichsbank president. A brilliant economist and financier, Helfferich was also one of the most outspoken nationalists in Germany. His violent and vicious denunciation of Walter Rathenau came only days before Rathenau's assassination and is considered by many to have been an important factor leading to his murder. In spite of Helfferich's politics, or more probably because of them, the Reichsbank directors wrote Reich president Ebert that Helfferich was "the only man" who was qualified to become Reichsbank president. They were so confident that he would be selected that they had already talked to Helfferich about taking the job and were pleased to report that he had agreed to do it.⁹

The only serious alternative to Helfferich was the recently appointed currency commissioner Hjalmar Schacht, who was being vigorously promoted by Foreign Minister Gustav Stresemann. British leaders aided Schacht's candidacy when they warned German officials that selection of Helfferich would be suicidal for Germany. If appointed, Helfferich's reputation as an Anglophobic reactionary would ensure that no Briton would loan so much as a penny to Germany. As for Schacht, the

British were not thrilled but felt that at least it would be possible for him to work with the Bank of England. Schacht, the British felt, "even if not a Social Democrat, is at least known to have good banking experience and a pleasant personality."¹⁰ The Social Democrats themselves jumped on the Schacht bandwagon in the assumption that anyone would be better than Helfferich.¹¹ The state governments, represented in the Council of States (Reichsrat), also supported Schacht and in fact even approved his appointment before the Cabinet could reach a decision. Under this pressure, when the Cabinet could find no majority for Helfferich, it felt compelled to accept Prussia's proposal that Schacht be named the new Reichsbank president.¹²

Even as the Cabinet prepared to accept Schacht as Reichsbank president, the Reichsbank directors wrote Chancellor Marx insisting that Schacht was completely unqualified to hold the office. His theoretical understanding, they argued, was non-existent; he was unreliable, and he was so vain that he took credit for the successful stabilization policies which he had in reality opposed when they were being considered. To top off their opposition, the bank directors accused Schacht of dishonesty. They charged that while working for the government in occupied Belgium during the war, Schacht had used his official position to help the Dresdener Bank in currency speculation.¹³ The charges were repeated by the newspaper *Kreuz-Zeitung*, the mouthpiece of the conservative German Nationalist Party, indicating that at least at this time Schacht was no friend of German conservatives.¹⁴ The moving force behind the attack on Schacht was none other than Karl Helfferich himself.¹⁵ The government investigated the currency manipulation charges against Schacht and reported that it found nothing to impeach his honor.¹⁶ With little apparent alternative, the government stuck to its decision to name Schacht Reichsbank president. In time it was to learn that if the charge of his illegal activities was unfounded, the charges that he was pathologically ambitious and vain were all too true.

As Reichsbank president, Hjalmar Schacht soon became one of the most powerful political figures in Germany. When initially appointed, Schacht was closer to the left than to the

right. While acting as Currency Commissioner, prior to his appointment to the Reichsbank, he had thoroughly alienated German businessmen. His first official act had been to order the Reichsbank not to accept the emergency paper currency issued by many large industries and cities during the inflation. As he later wrote, "This first measure was quite sufficient to make me very unpopular both with the municipalities and with the large scale industrial undertakings. For the latter, the fact that the blow was delivered by a man whom they regarded as one of themselves, the director of a big bank, added insult to injury."¹⁷ As Reichsbank president, his tight money policies after April 1924 further contributed to his difficulties with conservatives and industry. But, in time, Schacht not only became closer to German industrialists and conservatives, he became a leader of their cause. This transformation was only a gradual process and Schacht always maintained some distance between himself and business leaders. In 1924 and 1925 he was still resented for his tight money policies, but by 1926 his policies, including the credit stop, were being defended by industrialists such as Paul Silverberg, who insisted that the "oppressive" unemployment caused by Reichsbank policy had been necessary to rationalize the economy.¹⁸

Schacht's drift to the right became official when he resigned from the Democratic Party in 1926 over its stand on the property settlement with the German princes.¹⁹ Schacht refused to join those who wanted to confiscate property held by the princes, and declared that even though the party urged compensation for the confiscated estates, its stand was insufficiently supportive of private property. His increasingly vicious attacks on public spending and foreign borrowing cemented Schacht's alliance with the right. A complex man whose motives and policies are taken up in some detail in following chapters, Schacht was driven by determination to preserve the value of the currency, enhance his own reputation and power, and strengthen Germany's economy and international position. That his vision of what these goals should be was often eclectic and fluctuated widely from moment to moment makes any simple classification of Schacht on the political spectrum exceedingly

difficult. During the mid-twenties, Schacht tied his policies and demands to the vision of orthodox fiscal policies supported by the international banking community. His power in German politics was greatly strengthened by these international connections and especially by his close personal friendship with Bank of England governor Montagu Norman. Yet his increasingly nationalistic and even unbalanced behavior in the late twenties and his economic manipulations for the Nazi regime in the thirties demonstrate that he was not bound by the rules of gold standard orthodoxy and instead employed economic doctrine as a tool of his political demands.

Although Schacht's policies were often helpful to private business, he never really became fully tied to the industrial elites. As late as October 1928, directors of the Reich Association of Industrialists needed reassurance that Schacht was sympathetic to their needs. Association Director Ludwig Kastl felt compelled, after a conversation with Schacht, to assure the other directors that there was a wide range of agreement between industry and Schacht. In particular, Kastl was pleased to report that the Reichsbank president recognized that the primary goal of economic and financial policy was the rebuilding of industrial capital within Germany.²⁰ Yet, in 1930 when Schacht was removed as Reichsbank president, few business leaders mourned his loss.

In the mid twenties, the emerging power of the Reichsbank over German monetary policy, added a new element to Germany's political process. Whereas the various government ministries and their social constituents fought for control over the national product, the monetary authority began to set limits on the size of that product. Germany's capital weakness restricted the policy options open to the government and increased the influence of the Central bank and the foreign lenders who could provide the funds needed to fuel the economy. From 1924 to 1929, German leaders would learn that international and monetary restraints provided a final and vital influence over Germany's domestic political struggles.²¹

German Capital and the Economy after the Inflation

By late 1923, nearly a decade of war, revolution, and inflation had virtually destroyed Germany's reserves of liquid capital. One historian has estimated that a century of savings had been wiped out and that Germany's capital reserves in 1923 had been reduced to the level found at the beginning of the nineteenth century.²² The vast majority of what little money remained was loaned out for seven days or less at annual interest rates running from 45 percent to 87 percent.²³ Unable and unwilling to commit funds to long-term investment, Germans found themselves looking longingly to foreign sources of capital. Exactly how much Germany borrowed abroad in the next five years will never be known. Some loans were issued publicly and many banks were forced to reveal their private loans. But large volumes were also lent between strictly private parties, and no small amount of German capital was sent abroad against the grain of the predominant capital inflow.

By the middle of 1930, Germans had floated long-term bond issues abroad worth about 10.8 billion RM, or \$2.6 billion at the exchange rate of 4.2 RM to the dollar. Of this amount, \$1.25 billion or nearly 50 percent came from the United States, while British and Dutch markets each took about 12 percent of the German bonds.²⁴

German short-term borrowing abroad is much more difficult to calculate since money was moved among businesses and banks with no public accountability. The best current guess is that by mid-1930, Germans had taken short-term loans abroad of 15.5–16 billion RM. America's share of these loans is open to speculation, but the international committee of experts called to assess German banking conditions after the financial collapse in the summer of 1931 estimated that Americans held 37 percent of the short-term loans the committee was able to uncover.²⁵ If this share held true for the funds they could not identify, it would mean that Americans held nearly 6 billion RM (\$1.4 billion) in German paper.

The importance of this capital movement may be lost on modern readers used to international debts ranging into

the hundreds of billions of dollars. But when we consider that Germany had accumulated a foreign debt by 1930 of 26 billion RM at a time when Germany's net national income was 75 billion RM per year, the importance of the foreign loans becomes more clear. Between 1925 and 1928 as much as one third of Germany's total investment may have been financed by capital imports, of which by far the largest share came from the United States.²⁶ At the same time, the German loans were an important share of the American capital market where they represented 20 percent of the foreign bonds sold in the United States in the five years following the Dawes Plan.²⁷ Clearly Germany's capital weakness had wide-ranging consequences.

The process by which Germany fell from one of the world's great capital markets in 1913 to a virtual financial pauper by 1924 is part of a complex web involving war, inflation, monetary stabilization, and reparations. The very process of wartime consumption and finance from 1914 to 1918 set the stage for Germany's future financial weakness. Determined to pay for the war without inordinate tax increases, the Reich government began a systematic monetary expansion which quickly undercut the value of the mark. At the same time, huge investments in war industries diverted resources from more "normal" investment. Over the course of the war, this led to deterioration in agricultural productivity, a backlog in demand for public utilities and housing, and a paucity of investment in nonwar related industries. By 1918, German investment needs far exceeded prewar levels just to make up for the lack of investment during the war. Losing the war compounded these weaknesses, since Germany had hoped to base its postwar economic recovery on profitable economic treaties which would exploit the resources of conquered countries. Instead, Germany lost its foreign investments, most of its revenue-earning merchant marine, and had to begin paying reparations for damage done to the Allies. All these factors created an overstrained capital market which was totally destroyed by the postwar inflation.

The German inflation was inaugurated by the financial and fiscal policies pursued during the war, but did not reach its dramatic conclusion until 1922-23. By the time the mark

was stabilized in October 1923, it took 4.2 trillion marks to buy one dollar. In more normal cases, economists would argue that the process of inflation alone cannot harm the total supply of capital available to an economy. For every middle-class investor whose savings were wiped out by the inflation, there had to be a borrower whose debts were reduced by the same amount. Thus, if one man lost because the money he lent to a home buyer was repaid at a tiny fraction of its original value, the man whose debt was so dramatically reduced gained and presumably now had fewer debts and more savings. At exactly what point this simple equilibrium breaks down is not obvious, but that it failed in the German inflation cannot be doubted.

The explanation for the capital shortage may lie in two sectors of the economy, which suffered the most severe losses in the course of the inflation, and which were crucial to the maintenance of Germany's monetary liquidity. On the one hand, German banks were dealt a smashing blow by the inflation, and on the other, the rentier class of moderately wealthy savers saw its paper assets virtually wiped out.²⁸

German banks, in a process that became familiar in the 1970s, were slow to adjust to the reality of a long and erratic inflation. With surprising uniformity, German private banks lost nearly two thirds of their reserves and 70 percent of their joint stock values between 1913 and 1924.²⁹ Of particular interest, a study of one South German bank reveals just when these losses were suffered. The bank in question had, like other German banks, lost 70 percent of its stock capital by 1925. Given the total loss as 100 percent, it lost 27.5 percent by the end of 1917. During 1918, the last year of the war and the time of the early revolution, it lost 16.5 percent more. In 1919, the period of instability after the revolution, it suffered the most severe losses—39.9 percent of its total loss. And finally, from 1920 to 1923, which includes the period of the hyperinflation, it lost 16.1 percent more. Thus, the most severe banking losses came, not in the hyperinflation, but during the earlier period of inflation combined with violent social upheaval and revolution.³⁰

Although all banks suffered during the inflation, the greatest losses were in savings deposited with the publicly

owned savings banks. The savings banks played a central role in providing credit for home construction and small industry, so when their deposits collapsed from 18,970 million RM in 1913 to only 25 million in 1923, it meant that credit was simply unavailable to these important sectors of the German economy.³¹

The loss of reserves suffered by German banks eliminated the most readily available source of liquid capital. In addition, after the stabilization, the bankers compounded the illiquidity as they attempted to rebuild their lost reserves. By artificially holding interest rates high and extracting large profits from a small volume of loans, the private bankers rebuilt their reserves but did further harm to the economy. In pursuing these policies, the banks were aided by the Reichsbank's refusal to expand the money supply.³²

When we add to this loss of bank reserves, the losses suffered by the traditional German class of savers, the rentier, the picture of the capital scarcity begins to be completed. With liquid assets gone and German savers wary of committing themselves to long-term investments for fear of a renewed inflation, Germany was slow to rebuild the assets lost during the inflation.³³

Beyond the loss of monetary assets, real capital was also lost in the so-called "flight into real values." As the inflation picked up momentum, and as Germans began to realize that it would not be reversed, they searched for material goods to hold which would retain some value. Savers rushed to buy material goods that had no appeal except as a hedge against inflation. Perhaps an even more insidious result was the inflation's influence on the investment decisions of businessmen. Under normal conditions, a rational businessman will base his rate and area of investment primarily on his anticipation of future sales and profits. Under a rapid inflation, the rational businessman is likely to find that other considerations are more important. Long-range planning becomes impossible and greater emphasis must be placed on immediate purchases of goods which will hold their values better than currency (almost anything). The result, as often discussed by historians of the period, will be massive "misinvestment." Investment which makes

perfect sense when one is trying to cope with the inflation might well be perfectly useless once the inflation ends.³⁴ Thus a great deal of Germany's productive potential may have been squandered on investment in areas that had little long-run benefit.

Another aspect of the misinvestment problem was the fact that in Germany, perhaps more than in most countries, large volumes of capital were employed by politically powerful industries without regard to their economic efficiency. This was particularly true of the iron and steel industry, which achieved unheard of influence during the war years and was able to exploit a postwar raw materials shortage to attain even greater power.³⁵ During the inflation and on into the post-stabilization era, heavy industry manipulated its connections to foreign and domestic financiers to funnel large sums of capital into rationalization of an industry which was already capable of producing more than the economy could absorb. In a similar fashion, agriculture, which was apparently structurally incapable of profitable production in the twenties, absorbed huge volumes of the scarce capital available to the German economy between 1925 and 1929. The largely stagnant textile industry, another "old industry" with good connections, was also able to borrow far more than its profit record would have justified.³⁶ The result was that both during and after the inflation, large sums of money were invested in firms with political influence but dim economic prospects. This kind of "misinvestment" contributed to the shortage of capital after the inflation, but had a political rather than an economic explanation.

Despite the misallocation of capital as a result of the inflation and the use of political power to determine investment choices, Germany had in fact enjoyed extensive investment in productive enterprise during the inflation. German industrial output grew rapidly after the initial decline following the wartime defeat and postwar revolution. As early as 1921-22, Germany experienced a remarkable recovery in productive capacity while the rest of the industrial world suffered through a postwar depression. In spite of Germany's loss of the war, and the dislocations caused by the inflation and French occupation of the Ruhr, German production reached 1913 levels

by 1927.³⁷ This element of real and productive investment led some analysts to argue that Germany did not really have a shortage of investment capital. The problem, it was argued, was a shortage of readily available, liquid working capital.³⁸ Although this emphasis may be accurate, there were obvious areas of the German economy where severe shortages in real investment were apparent. This was particularly true in the public service sector where social overhead investment had been seriously crippled by the war and inflation. Heavy demand in the public sector after stabilization helped put a greater strain on Germany's already weak supply of investment funds.

The weakness in Germany's liquid capital supply was in part a result of the destruction of paper assets and the loss of bank reserves. But it has also traditionally been blamed on the flight of German capital out of Germany. To escape the destruction of savings by the inflation, this argument runs, Germans exported large volumes of capital which made a major contribution to the post-inflation capital shortage. In effect, the inflation was assumed to have created a massive outflow of capital from Germany which would continue to hurt the economy until confidence in the stability of the mark induced a reverse flow.³⁹ Recently Karl Holtfrerich has demonstrated that the real flow of capital was in exactly the opposite direction.⁴⁰ Americans expected that a conscientious Germany would never permit its currency to be destroyed. In anticipation of spectacular profits when the value of the mark once again began to rise, Americans invested over a billion dollars in Germany between 1920 and 1924. Holtfrerich assumes that this money was entirely lost and that it was, in effect, an American subsidy of the German economy. Although American losses were substantial, German bankers estimated that nearly half the American money had gone toward the purchase of real goods and property which survived the inflation.⁴¹ Holtfrerich is careful to note that although the American money might have helped build up Germany's supply of industrial equipment, it did little to help Germany's long run financial position, since the American money, too, may have been swallowed up by the inflation as more misinvested capital.⁴² In any event, Holtfrerich's analysis does severe damage to the argument that a net flight of

capital out of Germany was a major cause of Germany's financial weakness.

One certain drain on German capital supplies, both during and after the inflation, was the necessity to transfer reparations payments to the Allied powers. Although huge foreign capital imports, both during and after the inflation, more than offset the outflow forced by reparations, the fact remains that reparations payments greatly reduced the net capital accumulation of the Germany economy.

In summing up the various explanations of Germany's capital shortage, the following factors seem to have been most important:

1. Destruction of liquid assets both in terms of reserves and savings. This led to severe shortages immediately after the stabilization, and fears of future inflation which induced a lower savings rate than otherwise might have been expected.

2. Misinvestment during the inflation—this is a long-range problem and one made all the worse by the inclination to continue to invest in areas that were not particularly productive. This was especially true of heavy industry, textiles, and certain sectors of agriculture.

3. Pent-up demand for social overhead spending, particularly in public utilities, housing, and city services, put extra pressure on the capital that was available.

4. Reparations payments which continued throughout the twenties to withdraw funds which might have been invested.⁴³

The Dawes Plan

On December 29, 1922, United States Secretary of State Charles Evans Hughes attempted to break the reparations deadlock between France and Germany by issuing a public call for an apolitical committee of experts to determine Germany's capacity to pay. Two weeks later, French Premier Raymond Poincaré decided on another method of solving the issue and sent French troops into Germany's industrial Ruhr River Basin to force

Germany to meet its obligations under the treaty of Versailles. For the next nine months, Germany and France fought a brutal economic war as France made its last attempt to preserve the victory of 1918 and Germany strove to reverse it. By late September 1923, hyper-inflation and near civil war seemed to be tearing Germany apart. On September 27, the new German Chancellor, Gustav Stresemann, was forced to end the passive resistance and admit that Germany could no longer carry on the struggle. Even as Stresemann was admitting defeat, France's own domestic economic and political situation had deteriorated to the point where it did not have the strength to follow up its advantage.⁴⁴

The parallel exhaustion of both France and Germany following the Ruhr occupation set the stage for the most active participation in European affairs on the part of the United States during the entire interwar period. Appealing to President Coolidge, Stresemann urged America to send a representative to a new reparations conference along the lines set out by Secretary of State Hughes a year earlier.⁴⁵ American leaders in the State Department, Commerce Department, and banking circles as well as the new President hoped that the United States would now be able to exert its influence to stabilize European economies and, through economic stabilization, promote social order. Yet they were reluctant to allow the government to become actively involved in European affairs or to use American power openly to impose a new reparations settlement. Thus, the European governments, which were unanimously anxious to have America participate in any new financial settlement, were forced to go through a charade of inviting American citizens who were not official representatives of the government to sit on the new committee.⁴⁶

Despite American willingness to send unofficial representatives to a new inquiry on German capacity to pay reparations, the European allies were almost unable to agree on what the committee should really investigate. The French government insisted that the real problem was to find German capital which had been exported and hidden abroad during the inflation. The assumption was that once this money was uncovered, German capacity to pay would be revealed to be very