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Market Comment

CLARMOND

## An Unreliable Creditor

**In the 1930's the United States was the world's 'Unreliable Creditor'. Its actions directly contributed to the political and economic problems of that time. In today's Europe in an ironic twist of history, Germany along with the ECB and Brussels have this unenviable mantle.**

AS WAR IN EUROPE ERUPTED IN 1914 American businesses were in debt to British investors for \$3bn; they also owed the French \$1.5bn. After four years of war and 2.3m lives sacrificed the financial tables had turned completely; the Anglo-French allies had borrowed from the Americans to wage war. Britain owed the US \$4.4bn, the French \$3.5bn. These 'inter-allied' debts were wildly unpopular in Britain and France who, having paid so heavily for the cause of freedom, expected some degree of forgiveness. Andrew Bonar-Law, Conservative Prime Minister, who lost two sons in the war, called this American debt payment "Blood Money" and offered his resignation.

With the end of the war the German economy struggled to recover; it strained under the burden of paying war reparations to the Anglo-French. How then to restart German growth? More debt of course. High yielding German bonds were promoted by Wall Street to private American savers who hungered for income. This established a bizarre chain of debt in which private American savings were lent to Germany, Germany then paid war reparations to Britain and France and who, in turn, paid the US government the inter-allied debt.

### The chain snaps

By 1927 interest rates in America had begun to rise and American savers no longer looked overseas for yield. By 1931 the problem that

private American creditors faced was their position in the German debt repayment queue, it was behind the inter-allied debt. President Herbert Hoover finally agreed to forgive the "Blood Money" debt of the Allies, if the Allies forgave German war reparations; this action moved private American capital to the front of the repayment line.

The Allies promptly forgave Germany but then were astounded to see the US Congress overrule the President and insist on full inter-allied debt repayment. The Anglo-French still owed the "Blood Money," but now Germany was off their reparation hook. The French lashed out and labelled the Americans 'an unreliable creditor.'

### The modern parallel

At the birth of the Euro, savers from northern Europe purchased the high yielding debt of their new European compatriots; the 'convergence trade' was all the rage. While the capital from the north continued to flow, the southern Europeans could make good on their payments. By 2007 capital flow had become a trickle, yields rose, debt prices collapsed and debt servicing fell under a cloud of doubt. The private savings of northern Europe were bailed out by the ECB, who stepped in and paid full value for the dubious debts, yet still kept the southern debtors firmly on the repayment hook. Institutional interests of the northern European creditors were placed above the



### Junck Debt

community interest of a united Europe; just as previously narrow American interests were placed ahead of a functioning global system. Southern Europe now faced its own 'unreliable creditor'. In 1931, facing such fickle American conduct, the British retreated from the global monetary and trade system into a one of Imperial Preference. Other countries followed suit, prioritising their parochial rather than their common interests.

This leadership vacuum of the 1930's allowed noxious actors to gain legitimacy and power in Europe and Asia, ultimately leading to WWII. At the end of which the Americans did not repeat their earlier error of demanding repayment by those that could not manage their debt burden; Japan and Germany had near debt-free starts for their remarkable recoveries.

Debts that cannot be repaid should either be written down with losses being taken for poor judgement, or even completely forgiven. In today's Europe, either action will suffice, as the alternative will deliver a reliably precarious outcome. ■