War reparation and its effects.

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War reparations have a long history. In fact, it predates modern societies, with older civilizations extracting resources from enemies long after defeating them.

In Europe, reparations were common in the 19\textsuperscript{th} and early 20\textsuperscript{th} centuries. There are many examples. France was obliged to pay indemnities after the Franco-Prussian War (1870-71). The amount of 5 billion gold francs was supposed to be paid in 5 years, and it was set as the exact equivalent, in per capita terms, to the indemnity imposed by Napoleon on Prussia, in 1807. After the Greco-Turkish War of 1987, Greece was forced to pay an indemnity of GPB 4 million to Turkey\textsuperscript{1}. The curious detail was that the country was already in default and had no foreign reserves. For the purpose of indemnity, the country was compelled to accept oversight of its public finances by an international organization that lasted until the country was able to achieve the necessary surplus to pay Turkey – after the Great Financial Crisis, Greece was again monitored by creditors to guarantee that it would not default.

It should be noted that in the 19th century, most countries used some form of gold standard. That could be either strict, in which gold coins circulated, or paper money, in which the money supply was set at a given rate between the currency base and gold reserves. Thus, countries’ finances were tied to the precious metal and fiscal expansion was only possible if there were capital inflows to finance them. In the case of Greece and in most countries at the time, war reparations meant a fiscal contraction to meet these new obligations. This was, of course, pro-cyclical. Defeated countries would have gone through recessions regardless of war reparations. But indemnities would make them worse, with recessions either lasting longer or being more acute.

We can model war reparations as a government outflow that has to be balanced by new taxes, less spending, inflation or the use of foreign reserves. If the latter were the case, there would be no effect in the market for goods and services, the money market, or the loanable funds market. But that was rarely the case, as indemnities were usually set up to cause social harm to the defeated countries. Henceforth, they usually required capital outflows that decreased money supply and in addition to either government expenditures through diversion of other spending to pay for the reparations or new taxes to raise the necessary funds. In these instances, aggregate demand would fall.

\textsuperscript{1} Not all reparations were paid in currency or goods. In addition to money, as a result of the Sino-Japanese War of 1895, China had to open the ports of Chongqing, Hangzhou and Suzhou to Japanese trade.
Of course, we are ignoring the effect of the war itself. There is little doubt that wars cause an enormous amount of economic damage, both on winners and losers (the possible exception is when wars are not fought on a country’s soil.) Here we concentrate solely on the effect of war reparations – these effects would come on top of the damage wrought on the defeated countries (for instance, war usually causes aggregate supply to fall, one instance being the shrinking of the labor force due to all those killed or injured.)

War reparation causes GDP to contract and a deflationary process in the short run. Eventually, lower prices would provide the necessary stimulus for exports to grow and the economy would come back to full employment, but at a huge economic and social cost.

Likely, the most famous case of war reparations is that of Germany after World War I. All countries in the Central Powers (Germany, Austria, Hungary, Bulgaria and Turkey or Austria-Hungary, the German Empire, the Ottoman Empire and the Kingdom of Bulgaria, as the countries were known at the time) faced reparation after being defeated. Nevertheless, in most cases reparations were not paid in full and were cancelled. That was not the case regarding Germany. The total amount owed by the country was set at GPB 6.6 billion (or 7 tons of gold) at the Treaty of Versailles. This figure was divided into three categories of bonds, with the first two totaling GBP 2.5 billion and to be unconditionally paid in full, while the last tranche was interest free and contingent on the country's ability to pay, to be assessed by a committee of Allied members. These reparations were to be paid in gold, cash backed by gold or tradable commodities such as steel, raw iron or coal (Alphahistory.com).

In the German case, reparation had a distinctive economic effect due to the de facto abandoning of the gold standard. Unlike the earlier example of the Franco-Prussian War, in Germany the link between paper currency and gold was abandoned. The German government continued to issue marks even as gold reserves evaporated. In some ways, the 1920s hyperinflation in Germany was
the first of its kind, following a foreign currency crisis and fiscal expansion financed by the printing of the local currency. There are striking similarities between this and the Latin American currency crises in the 1980s. In both instances, countries borrowed heavily (even before reparations, Germany issued bonds to fund its part in the first World War, instead of raising taxes) and capital outflows severely weakened their currencies. All the while, they maintained hefty public deficits. We can describe capital outflows to indemnities in the foreign currency market (assuming, for convenience, that Germany paid reparation in GPB) as:

Exchange Rate (DM per GPB)

With capital outflows, the demand for foreign currency increases and the mark devalues, contributing to inflation. Instead of raising taxes, the government chooses to print money to finance the deficit, further stoking inflation. This increase in money supply did not generate economic activity, and only inflation. Throughout the 1920s Germans found it difficult to pay reparation in full – France occupied part of the country in 1923 to extract payments, for instance. By 1931, the German economy collapsed and the debt was mostly cancelled.

So far, we have assumed that war reparations are paid or cancelled relatively quickly (in the short-run) and that most of the harm comes from recession (the Franco-Prussian War) or inflation (in the Weimar Republic – Germany - in the 1920s). Nevertheless, we have a case of reparation that continue to produce capital outflows for decades – Haiti.

Haiti has a unique history. It gained its independence by a revolt of slaves against slaveholders, the only country in the Americas ever to do so. Philippe Girard (2011) describes in detail the historical context and the struggles of Haitians in gaining independence, but the title of his book says it all: The Slaves Who Defeated Napoleon: Toussaint Louverture and the Haitian War of Independence. The French colony of Saint-Domingue (how Haiti was then called) was responsible, in the late 1700s, for 60% of the world’s coffee and most of the sugar imported by
Britain and France. The first slave revolt happened in 1791. During part of its revolutionary period, France abolished slavery. The British and the Spanish also had interests in the island. By 1802, the French sent a sizable force to reclaim the island and were able to do so, planning on reestablishing slavery. But revolts resumed and the Haitians were able to defeat the French. On January 1st, 1804, Jean-Jacques Dessalines, one of the leaders of the Haitian Revolution, declared independence and became the country’s first ruler. As Matthewson (1996, p. 22) points out: “The Haitian Revolution marked a critical juncture in attitudes and policies toward slavery and race relations. It involved the establishment of a Republic of Blacks in the midst of the slaveholding Caribbean and the collapse of French power in the hemisphere.”

In 1825, however, France sent a significant military force to Haiti, demanding reparation. The demand was of 150 million franc and, maybe worse, a forced discount of 50% of sugar prices on its exports to France. The first payment in gold left Haiti in the ships that sailed back to France – the gold was paraded in Paris as it went into the public coffers. In 1838, the total indemnity was reduced to 90 million francs, to be paid in 30 years. As Sperling (2017) observed: “France’s demand for reparations from Haiti seems (...) the equivalent to a kidnapper suing his escaped hostage for the cost of fixing a window that had been broken during the escape.” The country could not afford to pay it all in this 30 years window, and the principal of the debt was paid only by 1893. It took Haiti until 1947 to pay all accrued interest.

Unlike the short run effects of the previous cases, the outflows to service the Haitian debt put constant pressure on the country’s current account. Regardless of the position of the economy in the business cycle, constant capital outflows create a pressure for the currency to devalue or for the monetary base to contract, under the gold standard. This created a continuous need for trade surpluses. But unlike trade surpluses that generate higher aggregate demand or balance borrowing to finance public or private investments, the surplus necessary for reparation created no economic benefit to Haitians. It was simply a continuous income transfer from a poor to a richer country. It was certainly an obstacle for the country to develop. The capital outflows can be described as a barrier to the accumulation of factors of production, since much of the natural resources that would increase potential output were used for reparation through exports that brought in the currency to balance the capital outflows. There is little doubt that the war reparations kept the rate of growth in aggregate supply lower than it would be in its absence.

Of course, not a single factor can explain the fact that Haiti is still extremely poor today, with GDP per capita of approximately USD 760 per year. There are many internal factors, as well as other barriers – it took a long time for the United States to recognize Haiti as an independent country, for instance. After all, an independent country in which all people of color were free

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2 Many people believe that it is better for a country to be a net exporter than a net importer. That is true of American president Donald Trump, who had always claimed that trade deficits are bad and that trade wars can be won as exports surpass imports. As we have seen on Chapter 10, imbalances happen only when there is a constant pressure on the overall Balance of Payments, and not solely on a single subaccount, such as the trade of goods. In many emerging markets, a history of currency crises creates the impression that trade surpluses are good for a country. That is not so. For countries with constant capital outflows, trade surpluses may be necessary, but that does not mean that they are good for a country. In fact, the US can easily finance its trade deficit with surpluses in the Balance of Services and the capital accounts.
went directly against the interest of slaveholders in the country, at the time. The American
government, under Thomas Jefferson, did not recognize Haiti’s independence, and embargoed
trade with the country (Matthewson, 1996). No country can claim that its development was
completely opposed by the rest of the world, but if there is one country for which freedom was a
hefty price to pay, it was Haiti.

Questions for discussion.

1) War reparations after World War II were much smaller than in previous wars. For
instance, Italy agreed to pay reparations of about US$125 million to Yugoslavia, US$105
million to Greece, US$100 million to the Soviet Union, US$25 million to Ethiopia, and
US$5 million to Albania. Discuss the implications, for the long run welfare of the global
society, of not forcing the defeated countries to pay significant war reparations.

2) For countries on the receiving end of war reparations, what would be the impact on the
exchange rate in the short-run? Show this graphically, through a representation of the
foreign currency market. Would exporting companies in the receiving country benefit or
lose from capital inflows from war reparations?

3) A World Bank report summarizes some of the economic damage of the civil war in Syria
that started in 2011 (World Bank, 2017). The study assessed “the economic and social
consequences of the Syrian conflict as of early 2017. The conflict has inflicted significant
damage to the Syrian Arab Republic’s physical capital stock (7 percent housing stock
destroyed and 20 percent partially damaged), led to large numbers of casualties and
forced displacement (between 400,000 and 470,000 estimated deaths and more than half
of Syria’s 2010 population forcibly displaced), while depressing and disrupting economic
activity. From 2011 until the end of 2016, the cumulative losses in gross domestic
product (GDP) have been estimated at $226 billion, about four times the Syrian GDP in
2010.” Discuss the conditions for the country to recover after the war finally ends. Do
you think that international aid would be helpful in alleviating the damage suffered by the
people in the country?

References:


Philosophical Society, 140(1), 22-48.

Sperling, D. (2017). In 1825, Haiti Gained Independence From France For $21 Billion -- It's
Time For France To Pay It Back, Forbes.com, December 6, available at: