

Looking Back at Debt Relief for the Germans*

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In the ongoing Eurozone drama, the sovereign debt held by Greece is the crux of the issue. That hapless economy has seen its debt to GDP ratio increase from around 120 per cent in 2010 to nearly 180 per cent today. This is the result of a toxic combination of austerity policies that have caused its GDP to fall by more than a quarter and continuous increases in debt. These do not reflect new resources coming into the economy, but loans extended to enable Greece pay on the interest on previously incurred debt, which then get piled on to the earlier principal amount and further compounded.

Almost everyone but the Germans now recognises that this level of debt is unsustainable and some of it must be written off. But the German leadership and most of the people protest that this is unacceptable use of taxpayers' money (ignoring the fact most of the debt has gone to repay banks in their own and other "core" European countries) and will create moral hazard problems, leading other debtor countries in Europe to try and do the same.

So it's time for a little economic history. Specifically, consider two 20th century episodes: one in the 1930s in which Germany unilaterally defaulted on its external debt; and another in the 1950s when it was granted substantial debt relief on very generous terms that enabled it to recover and grow into the powerful economy that it now is.

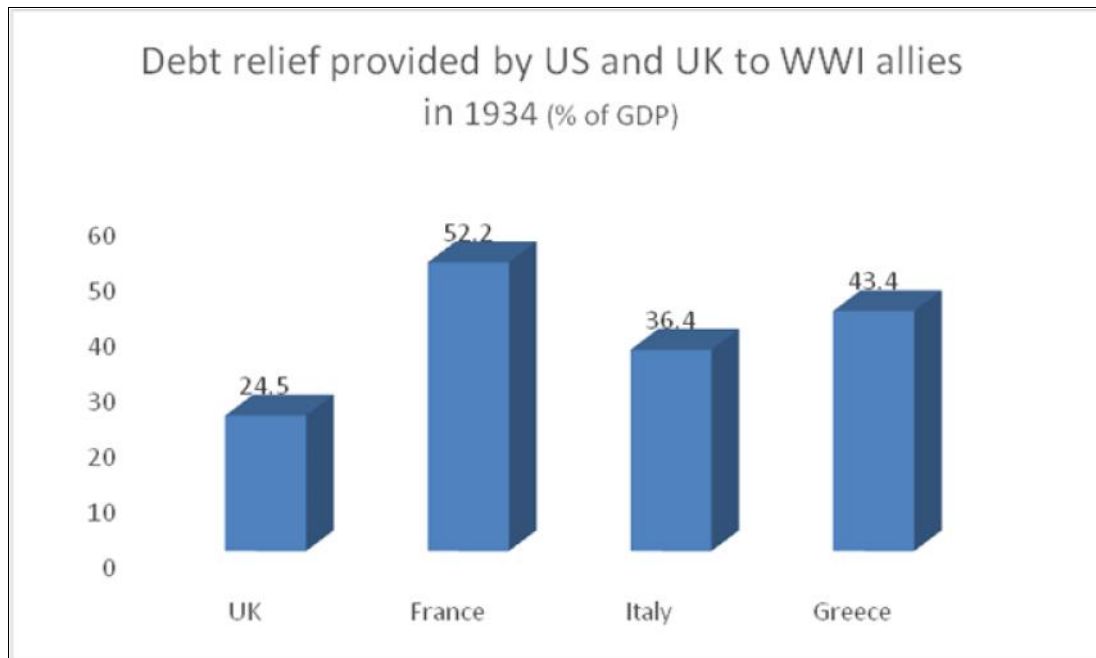
The first story has its origins in the peace conference after the First World War, leading to the Treaty of Versailles, which imposed 132 billion gold marks (\$33 billion), of reparation payments on Germany. This was the "transfer system" famously excoriated by Keynes in his "Economic Consequences of the Peace", who presciently warned that this would create economic and social devastation in Germany and fuel the rise of a dictatorship bent on revenge.

The US provided credit to Germany and also reduced the amount of these debts through the [Dawes Plan](#) over 1924-29, which enabled Germany to make these reparation payments by borrowing from abroad. However, when Wall Street crashed in 1929, the US demanded full repayment of its loans, which rapidly became impossible and generated the forces leading to the fall of the Weimar Republic. In 1931, as the external public debt to GDP ratio reached 100 per cent, fiscal austerity to make transfer payments and service the debt pushed the country into Depression. Reparation payments were cancelled in August 1932, but the creditor payments remained in the form of short term debt that was continuously rolled over.

In 1933 the Nazi government in Germany declared unilateral default on all its sovereign debts and instituted capital controls. Interestingly, this default paved the way for a major debt write-off by the US and UK, cancelling a significant proportion of debts of 19 of their World War I allies in 1934 (Chart 1). Indeed, of these countries only Finland repaid its debts in full. A recent [study](#) by Reinhart and Trebesch ("Sovereign debt reduction and its aftermath", Harvard Kennedy School Working Paper June 2015) has shown that this led to significant improvement in the economic landscape of these countries. They also note that debt write-offs are much more

effective in generating economic growth and higher credit ratings than softer options like maturity extensions and interest rate reductions.

Chart 1



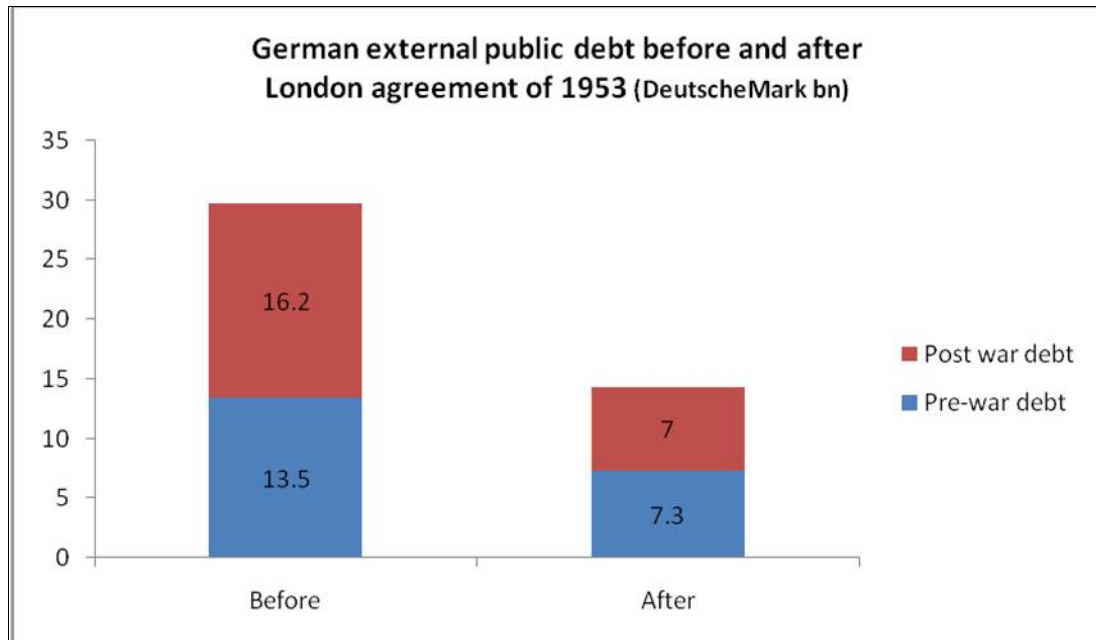
Source: Reinhart and Trebesch, 2015, page 8.

The second episode is even more relevant to the present times: the [London Debt Agreement](#) of 1953 that saw the abolition of all of Germany's sovereign external debt. This was the outcome of negotiations of Germany with 20 of its creditors (including, be it noted, Greece and Italy, and even Pakistan) The conference was the outcome of lessons learned by the US and other creditors in the interwar period, particularly the economic and political dangers of forcing countries into depression through austerity generated by the need to repay debts.

Germany at that time held a significant amount of pre-war debt (mostly incurred for reparation payments and taken on by the Nazi government) as well as slightly more than half of the total debt that was the result of US Marshall Plan soft loans to revive the economy, which had already contributed to infrastructure reconstruction.

As Chart 2 indicates, there was significant write-off of both kinds of debt: the pre-war debt was reduced by 46 per cent and the post war debt by 52 per cent. The remaining debt was converted into very easy terms: DM 2.5 billion carrying no interest; DM 5.5 billion at 2.5 per cent annual interest; and DM 6.3 billion at 4.5-5 per cent annual interest. No compound interest was charged for the long period when debt had not been serviced (since the default of 1933), and a five year grace period was provided until 1957, during which only DM 567.2 million would have to be paid each year.

Chart 2



Source: Jurgen Kaiser (2013. Page 4)

A number of features of that conference and its outcome are worth remembering today. First, it was apparently conducted in “an atmosphere of equals”, very different from the aggressive and bullying tone adopted today by Germany as creditor. The threat of any sanctions and imposition of undemocratic policies were completely off the table.

Second, the debt cancellation occurred quickly, before an actual crisis of repayment had occurred. This is important, because delays in debt reduction do not simply kick the can down the road, they make the “can” bigger, and increase the amount required of the eventual debt write-off.

Third, the debt deal was comprehensive, considering the total of all debts (public, corporate and other private). The idea was to give a fresh start to the German economy.

Fourth, the amount of total debt reduction was huge. It amounted to around half of West Germany’s existing debt. 80 per cent of Germany’s exports in 1953. Economic historian Albrecht Ritschl of the London School of Economics has estimated that the total debt forgiveness amounted to around 280 per cent of GDP over 1947-53.

Fifth, it covered all creditors, with no possibility of “holdouts” seeking to extract greater returns than other creditors.

Sixth, a really significant feature was the clause that specified that Germany would have to pay its debt only if it ran a trade surplus, and furthermore all repayments were

limited to 3 per cent of export earnings in a year. This obviously made the repayments much more feasible and less onerous for Germany, and ensured that it would not have to borrow afresh to repay old loans. But they also created incentives for Germany's creditors to buy German goods and ensure trade surpluses for that country. As one German economist has [noted](#), "The result of this debt-trade-link was a substantial contribution to Germany reaching full employment very quickly, thanks to a strong export performance". (Jurgen Kaiser, "One made it out of the debt trap: Lessons from the London Debt Agreement of 1953 for the current debt crisis", FES International Policy Analysis Paper June 2013)

Greeks looking at this history must be both jealous of that experience and shocked that the country that they had treated so generously when they were its creditors is now choosing to take such a hard and punishing line with them.

It is true that the London Agreement took place in a Cold War context in which it was politically important to strengthen West Germany as an alternative to the Communist East. Nevertheless, the recognition of shared responsibility that was the underlying philosophy of the agreement was crucial in making it so effective and its outcomes so satisfactory. It is surprising to see that such a spirit of shared responsibility apparently does not exist in a group that calls itself not just a community but a union. Perhaps, that, even more than German selective forgetfulness, is the problem in Europe today.

*** This article was originally published in the Business Line on July 20, 2015.**