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Does Germany Owe Greece a Debt? A Historical Perspective on the European Debt Crisis

1 Introduction

Ladies and Gentlemen,

Many thanks for the kind invitation to speak to you, at a time when the European debt crisis is taking another, dramatic turn. The images from Greece we have seen on TV and on the internet in the past days bring back the memory of a similar event in the past. A foreign debt crisis had been lingering. Blind to the warning signs, the creditors refused to accept talk of debt forgiveness or currency devaluation, and insisted on appointing a government of technocrats that pursued a policy of steep deflation. To postpone the hour of reckoning, good money was thrown after bad. Finally, the technocrat government lost its support in parliament over the austerity budget, and national elections were called. When the votes were counted, the shock was profound: almost 40% had gone to extremists from the right and the left. That country was Germany, September of 1930. Nine months later, the German debt default began, eventually resulting in losses equivalent to 15% of US GDP at the time. Another fifteen months later, German fascism acceded to power.

This contribution is about historical perspectives on the European debt crisis. It will focus on the issue of path dependence, or plainly speaking, deep fundamentals that change only slowly over time, or not at all. Do we find deep fundamental factors that were perhaps overlooked in the setup of the euro area, and that could help to explain the fault lines that have suddenly appeared? I concentrate on two such fundamentals. One pertains indeed to Germany. The other is more generally about Europe's Mediterranean rim and its monetary history, going back by a hundred years or more.

Germans prefer to let their history start with the zero hour of 1945. From being one of the more volatile economies of Europe, West Germany went to being an anchor of fiscal and monetary stability. Importantly, German post-war growth was export-led. Seemingly without much effort, Germany now started to transfer resources to the rest of Europe in almost every year, something that the post-World War I order had spectacularly failed to accomplish. I shall briefly revisit this story. But I will also look at the deeper roots in World War II, all with links to Europe's present debt problem.

The second line of continuity extends far back into the 19th century. Europe's present currency union is not

the first attempt to adopt a unified monetary standard. The mixed record of these previous monetary standards holds lessons in store as well. Between the two lines of continuity, little is left that seems surprising about Europe's current debt crisis – except maybe that no one took a closer look in time.

The next section deals with the financial legacy of World War II, the reinsertion of West Germany into the European economy, and the economics of the Marshall Plan. Section 3 goes further back and highlights the lessons from monetary integration in 29th century Europe. The final section concludes.

2 "Germany is Our Problem" The Legacy of World War II and Europe's Postwar Economic Order

Europe's economic reconstruction from World War II faced three major tasks: to repair what could be repaired, to es-

tablish a favourable economic environment that also included Germany, and to deal with the war's financial legacy without choking off recovery. The solution that was found rested on three pillars. The first was economic cooperation in a payments and customs union sheltered from the outside world. The second was sweeping debt forgiveness, combined with an effective aid programme and a ban on future lending to Germany. The third principle was the reorientation of West Germany towards export-led growth.

The successful implementation of these policies (more on this in a moment) turned West Germany into a net exporter, mainly of the capital goods that were urgently needed for Europe's post-war reconstruction. Since 1951, West Germany's current account has perennially been in surplus at 1% to 3% of GDP, at times and again today going up to 5%. My working hypothesis is that Germany's export orientation is in large part the result of deep institutional parameters set in the post-war period. Much of the crisis we are currently witnessing is indeed the consequence of this post-war order falling apart.

To understand what motivated the architects of the post-war European order and how it guided their actions, it is worthwhile keeping in mind the financial fallout from World War II. Germany's economic obligations included reparations of undetermined size, as well as large wartime debts and substantial amounts of foreign debts defaulted on in 1933.

German wartime debt was an institutional reflection of bilateralism in trade and foreign exchange. Beginning in 1940, Germany's central bank had started to operate a multilateral clearing system. Soon these clearing accounts were used as an accounting device for the resources that wartime Germany was vacuuming from all over occupied Europe. Official statistics valuing these resource transfers at heavily manipulated exchange rates showed these debts to amount to 30 billion RM (Reichsmark) at the end of 1944. An internal document from 1944, found in the 1980s, valued the same debts at 85 to 90 billion RM. To have a standard of comparison, calculate this into German GDP on the eve of World War II. GDP in 1938 was close to 100 billion RM. Germany's clearing debt from World War II would thus be in the range of 85% to 90% of German GDP. This is similar to Germany's debt burden today – except that it was foreign debt entirely. To get an idea of how much this debt would be worth today, multiply this debt/income ratio with German GDP of 2011. The resulting figure is a whooping EUR 2.2 to EUR 2.3 trillion.

This debt burden presented the Western allies with a delicate problem after 1945. To re-launch trade, some debt settlement had to be found. However, West Germany after World War II did not seem to be in a position to export her way out of this debt without initial credit inflows to restart her economy. The experience with World War I reparations underlined the seriousness of this problem: in the 1920s, German reparations had been recycled through international, mostly US credit. These debts were at the core of Germany's debt default of 1933. A similar pattern began to appear in the early post-war years: Germany was making deliveries in kind to Western Europe on reparation account, but at the same time received substantial transfers through US aid programmes. Not keen to repeat the interwar experience, US post-war planners insisted that restarting European trade and settlement of Germany's existing debt would need to be separated.

The solution to this debt problem was the inner core of the Marshall Plan. Every country receiving Marshall Aid had to meet political and financial conditions. This included making Marshall Aid a first claim on Germany. In this way, Germany was protected from sanctions unless Marshall Aid had been repaid. To restart European trade while the old clearing system was blocked, a new European payments and clearing system was created, carrying a guarantee based on funds provided by the Marshall Plan. This system, the European Payments Union of 1950, enabled its member countries' system to trade with each other and with Germany, without risking debt default. The system functioned seamlessly, except for a crisis in 1951, when one member country first exhausted its credit line and then teetered on the brink of default. This country was West Germany. A team of experts sent in by the Marshall Plan administration soon convinced the Germans that this was a bad idea that deflationary measures had to be taken immediately and that the independence of its new central bank was sacrosanct. Some angry phone calls from the US military government in Germany certainly helped. Interest rates were increased, the budget was stabilized, an outcry in the public was ignored, unemployment increased, and within months, the current account went into surplus. The EPU crisis of 1951 is the true birth date of Germany's combination of export orientation and orthodoxy in fiscal and monetary policy.

The last element of Germany's post-war stabilization was the London debt agreement of 1953. Under this accord, Germany resumed servicing most of her pre-1933 debt, albeit at much reduced rates and on favourable terms. However, settlement of Germany's wartime debt, and of reparations on top of deliveries made up until then and certain individual compensation packages, was postponed until future unification.

In this way, Germany entered the post-war period with a clean slate in terms of money and debt. Her new currency was safeguarded by a ferociously independent central bank, which itself was under the protection of the Allies. Her foreign debt had been reduced to minimal amounts and the rest of it blocked. And her domestic public debt had been all but wiped out in the currency reform of 1948, which replaced the debt with immobilized balance sheet assets in the banking system. This system forced rather strict austerity on the Germans: little if any credit was coming forth from abroad, and the government stayed away from the domestic bond market until the 1970s. The upside, however, was a minimal interest burden on the public budget.

This system combined with substantial taxation and public sector transfers abroad to depress private consumption and channel private savings into capital exports. Why did it remain so stable, why has this never changed?

There are several elements to an answer. Fiscal policy could afford to be conservative and remained moderately conservative given the exceptionally low interest burdens it faced. High immigration kept wages moderate during extended periods of time, a mechanism that gained renewed importance in the 1980s and again after the fall of the Iron Curtain. Popular support for strictly anti-inflationary monetary policy contributed to currency undervaluation, as probably did comparatively low productivity in non-tradables.

As a consequence of Germany's export orientation, her international asset position grew. In simple accounting terms, this asset growth is the flipside of Europe's debt crisis. If during 60 consecutive years, I sell you more than you sell me, my assets will either have to devalue at some point, or our trade flows will have to be reversed.

Up until the 1990s, this mechanism was apparently effective. Germany's foreign asset growth was lower than the cumulative current account surpluses would suggest, even under the extreme assumption of no interest. In other words, Germany kept losing money on her net foreign investments. This tendency was reversed as soon as European exchange rates were frozen in anticipation of the currency union. From now on, Germany's foreign assets and her current account moved as if in lockstep.

The growth of Germany's net foreign asset position has intensified since 2008 to reach a level of EUR 800 billion, or roughly one third of Germany GDP. This seems paradox at the time of a major international debt crisis. The theory of imperfect capital markets and sovereign debts provides the insight that absent fully enforceable claims, the volume of credit given to a country will grow until a credit ceiling is reached – usually, a glass ceiling, that is. Afterwards, lending by capital markets will come to a sudden stop, forcing a current account reversal in the debtor country. The fact that German lending to Southern Europe has continued to grow after 2008 seems to defy this logic. How can there be a credit stop if there is continued lending and actually at increasing rates?

The nature of German lending to Europe since the 2008 crisis actually proves the point: almost all of the addition to Germany's foreign wealth since that year has gone through non-market channels, mostly the now notorious TARGET2 system of the ECB. This clearing account system, originally designed to clear short-term debt, has been employed to provide German credit to Southern Europe the members of the ECB at high rates. Essentially, TARGET2 in its current form constitutes German central bank credit to the Southern European member institutions of the ECB. Pointedly but quite literally speaking, it is a license to print money.

TARGET2 is until now perhaps the major mechanism that prevents markets from adapting to Southern Europe's credit problem. Absent political intervention, markets would force both borrowers' and lenders' current accounts back into equilibrium. For Germany, this would imply that either its export industries declined relative to other sectors of the German economy (fewer luxury cars, more pizza home deliveries), or Germans resorted to higher imports of goods that do not directly compete with their export goods (more Germans vacationing in Greece). Additional adjustment would come through migration (more Germans relocating to the Mediterranean for retirement or more Southern Europeans migrating to Germany for work).

That some such an adjustment will occur in the long run seems inevitable. The European post-war order was in large part based on Germany transferring resources to Western Europe. Although this generated property rights – Germany's foreign assets –, payment was actually never effected. In other words, Europe has been in an unofficial transfer union since its very post-war beginnings. But now, the stock of these asserts, combined with other Southern European debts, has reached a critical level in which Southern European willingness and ability to repay is in doubt.

Europe is thus mired in a stock/flow problem. The European post-war arrangement depended for its viability on the flow of resources out of Germany, resulting in the growth of the stock of debt in the recipient countries. But with the latter hitting a glass ceiling, the former is affected, too. It would be difficult to prevent the stocks of debt from growing further, without bringing to a halt the flows of goods that caused debt to grow in the first place. The adjustment will be painful, it will be politically difficult, but it is essentially inescapable. The European post-war arrangement, in large part based on the smooth and seamless transfer of private capital from Germany to the periphery, is coming to an end in front of our eyes.

One may speculate about the sustainability of the frantic attempts we witness to avoid these conclusions, and to somehow get the transfer machinery started again. These range from out-

right denial of the problem to the idea of an official transfer union, the political surrogate of the market process that has now come to a halt. I view this with scepticism. Germany may have been under a property rights illusion, the now failed notion that it could always repatriate her foreign assets whenever it wished to. But it seems to me equally illusionary to assume that Germany would commit to large political transfers in a steady state, without demanding very substantial changes in the political architecture of Europe.

There is an exception to this. Again, it is TARGET2. Economically, this system is the regionally selective creation of money. It has come under heated criticism for the default risk it carries in the case of a Euro breakup. But it is only part of a wider phenomenon, the default risk on Germany's European assets that inevitably appeared once fluctuating exchange rates as a means of restoring balance were abolished. But while the Eurosystem lasts, TARGET2 is doubtless a politically expedient tool.

Being created by an independent system of central banks, it is a means of creating credit outside of parliamentary control. For a while, TARGET2 like all other means of creating money will continue to have real effects. While it does, it operates like a monetarist expansionary programme, giving Europe a ride on some dynamic Phillips curve. In an ironic twist on textbook economics, it appears to sustain and create jobs in Germany, not in the recipient countries. But eventually, monetary neutrality will restore itself. In the long run, the only thing TARGET2 or any other such scheme will do is to generate inflation. Once all the means of manipulating markets are exhausted, balance between stocks and flows of debt will inevitable restore itself, with far-reaching effects on the economies of both

Southern Europe and Germany. While initially, we may expect this adjustment to follow the Keynesian income/expenditure logic, in the medium term relative price adjustments will kick in and become dominant in the long run.

3 Not Touched by Midas: Southern Europe's Failed Monetary Integration in Longer Term Perspective

In the interest of time, I keep this short. Euro accession is not the first attempt in modern history to link Southern Europe to a wider monetary standard. Two initiatives stand out, the Latin Monetary Union of the mid-19th century and the classical gold standard. These systems blended into each other, essentially because of Germany's decision to join the British gold standard, not France's more traditional bimetallic gold/silver standard, after 1871. Germany's economic ascendancy combined with the effects of demonetizing silver to make France's position untenable, and forced her to follow suit. The details need not concern us here. What matters for our deliberations is the system that followed, and a post-mortem analysis of its failures.

The astonishing stability of the Gold Standard before World War I is well known. Our modern understanding of its workings is that it was a fiscal commitment technology: Whoever wanted to be on gold and enjoy the benefits of that had to rein in public sector deficits. This strategy was universally successful, with a few exceptions. The most notorious of these are all household brand names in the history of debt crises. In South America, these were Argentina, Brasil, and Chile, breaking away from the gold standard at various points before 1900, all mired in unsustainable fiscal policy. In Europe, these were Portugal, Spain, Italy, and Greece, again all mired in unsustainable fiscal policy.

Again, the historical details need not concern us here. But a few observations come to mind. The most striking one is probably the path dependence visible in the South American country list of offenders. All of these countries again became notorious for their debt problems after World War II and up until quite recently – with a new debt problem brewing as we speak. The European evidence needs only little further comment. Italy broke off the gold standard relatively early. Italy's position was probably doomed right from the completion of her national unification, as markets placed a heavy risk premium on the bond yields of all participating territories. Still, Italy eventually managed to stabilize its financial system outside of the gold standard and shadowed it rather successfully on the eve of World War I, without formally returning. Spain's problem finds its ready explanation in the political instability visiting the country in the last third of the 19th century. The Greek case stands out. Between its independence in the 1820s and the end of the 19th century, Greece had gone through no less than three debt defaults, the most important one being that of 1893. As a consequence, Greece was placed under international financial control, with officials from the creditor countries occupying leading positions in the central bank and the finance ministry. This regime extended far into the interwar period, and only came to an end in 1932 – when Greece defaulted again.

No direct chain of causality leads from this evidence to the crisis these countries are experiencing today. But is seems difficult to avoid the conclusion that in these cases, deeply rooted country specific characteristics are in operation, which make membership in a currency union difficult if not outright impossible. Changing these fundamentals is the true challenge facing anyone who wants to go ahead with Europe's economic and monetary unification, then and now.

4 Does Germany Owe Greece a Debt? Conclusions and Implications

A historical perspective on the European sovereign debt crisis reveals lines of continuity extending back to World War II and even into the 19th century. Two such lines were identified here. One leads to Germany and the historical origins of her export orientation, which are rooted in the deliberate, successful attempt by the occupying powers after World War II to turn Germany from a net importer and debt defaulter to a net provider of resources for European reconstruction. During World War II, the German war economy had siphoned off resources from all over occupied Europe, leaving behind plundered and partly depopulated countries. One of these countries was Greece. The internal German statistics mentioned earlier put the direct financial liabilities to Greece at 500 million RM, not counting the wider issue of reparations.

All of these debts were blocked in the London agreement of 1953. At the same time, West Germany accepted responsibility for compensating a small number of countries through indemnity packages. One such package, amounting to roughly 160 million DM, was negotiated with and given to Greece in 1960. In an exchange of notes, the Greek side reserved its position that this compensation was only provisional, and that a final settlement would be due after future reunification of Germany. No such settlement has taken place; the Two-Plus-Four treaty defining the terms of Germany's unification of 1990 makes no mention of World War II debts. With this, the case seems formally closed; a recent attempt to sue Germany for war damage in Strasbourg has been rejected. But these are legal matters of only limited concern to the economist who is not a legal expert.

So how about the economics of the issue? Has Germany paid reparations? Does it still owe Greece (and many others) a debt? From the vantage point of economic history, the current sovereign debt crisis hints to an answer to this question. The post-war European order was based on an implicit contract, a tacit understanding according to which Germany's former victims would accept a reinvented, democratic Germany in their midst without sanctions and further punishment, but would receive resource transfers from Germany. As long as Germany's foreign wealth accumulating in the process did not constitute an obstacle to further transfers, this system worked smoothly. Europe's financial crisis testifies to a breakdown of this system. What used to be capital exports is increasingly seen as transfers without compensation. The assumption of further and further credit guarantees by Germany makes this transformation more and more explicit, as does the TARGET2 system. It is an irony of history that in the process, a short-term central bank clearing system should have played a role, given that short-term central bank clearing balances played a prominent role in Europe's resource transfers to Germany in the early 1940s. History does not repeat itself, but apparently it has its habits.

The same reasoning also provides a tentative answer to the question of German debt to Greece. Germany's rather liberal assumption of credit guarantees for Greece as well as the acceptance of its part of Greece's haircut have turned the tables in favour of Greece. On the assumption that rather limited repayments will be forthcoming from Greece in the near future, it may well be concluded that now, finally, Germany has paid whatever debt it had to Greece, and the chapter of financial compensation for World War II is concluded at last.