

Lessons of German history:

Trading austerity for debt relief is savage, stupid and futile

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Prime

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In this latest PRIME publication, Geoff Tily argues that parallels between events in Greece today and Germany in the 1920s go much further than commonly understood, and the policy implications are more far-reaching. Economic crisis in both countries originated in financial liberalizations, involving the gold standard in the 1920s and the euro in the 2000s. Austerity was imposed by external authority. In Germany, after immense suffering but in fact before (if only briefly before) Hitler came to power, austerity was eventually rejected.

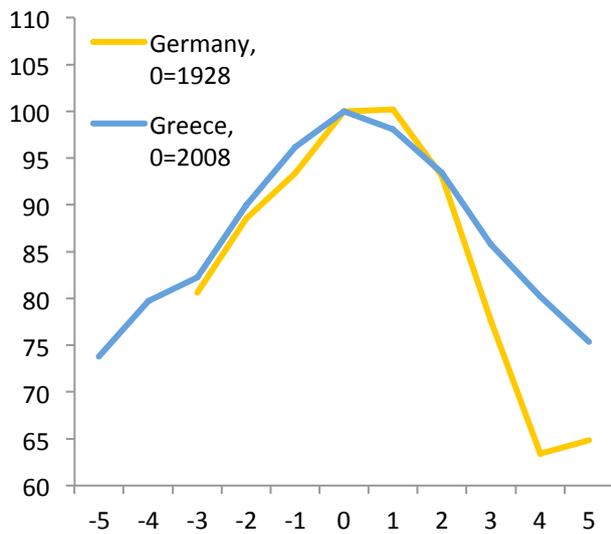
The growing emphasis on the *apparent* generosity shown by creditors to Germany in the first half of the twentieth century is welcome. But the parallels between events in Germany in the 1920s and events in Greece today go so much further than commonly understood, and the policy implications so much more far-reaching. Fundamentally, the eventual fiscal difficulties faced by both arose from dysfunctional monetary arrangements that were imposed by global financial interests.

- Both episodes were part of a process of financial liberalisation, the first beginning after the First World War, the second over the 1970s/80s
- This involved Germany and Greece respectively newly joining a deeply flawed currency union at an overvalued exchange rate, permitting very relaxed monetary conditions
- Under the new regime, excessive expansion was unleashed, including debt inflation, a sharply widening current account deficit and counter-parting capital account inflows
- Boom gave way to bust, and debt deflation
- International creditors demanded austerity in exchange for financial support
- Unemployment rose to over 25 per cent

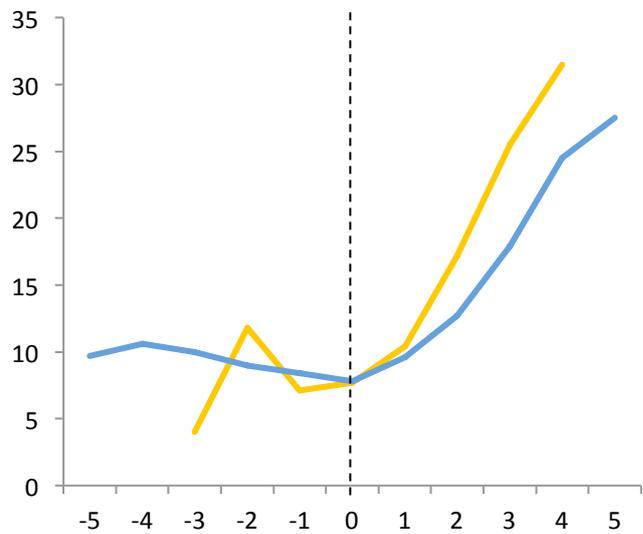
The sufferings of the peoples on both occasions were and remain immense. But the details of the events in Germany are overlooked, seemingly as a result of emphasis on reparations. The crises of the 1920s and 1930s were not the result of reparations, but instead of the highly orthodox economic and financial policies of the 1920s that were the *quid pro quo* for support with reparations from the financial sector.

The parallels between the two episodes are illustrated in charts (i) to (iv). These annual figures are aligned at the respective peaks of expansion, some 80 years apart, 1928 in Weimar Germany, and 2008 in modern Greece. The scale of expansion, and scale and pace of contraction, are very similar, as too is the absence of any serious inflationary pressure ahead of the crisis. The German deflation came relatively sooner. The detail will be discussed at relevant points of the narrative. (The major advances in the production of official economic statistics started in the 1930s, so the quality of the potentially rudimentary German figures is not known. The assumption is that they are at least broadly comparable with the statistics for Greece. The similar scale of certain features suggests this may be reasonable.)

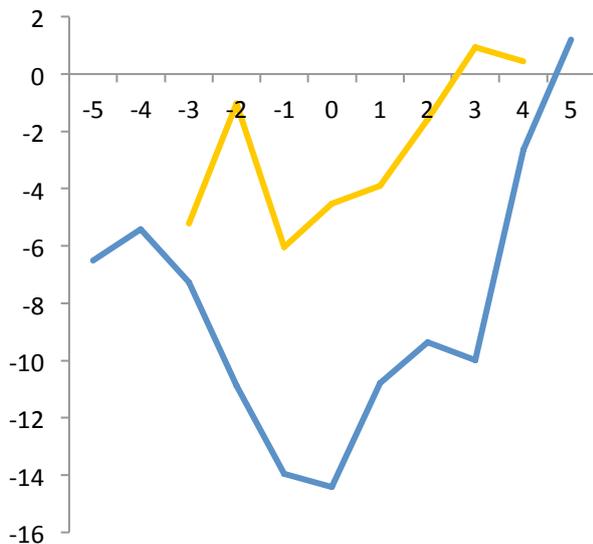
i. Nominal GDP, indices '0'=100



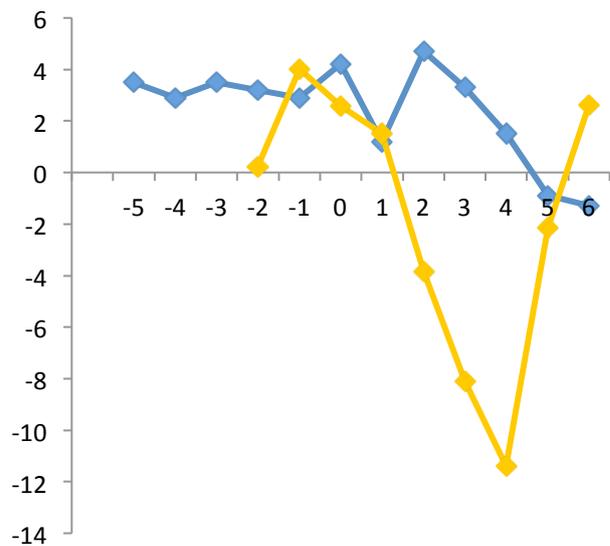
ii. Unemployment rate, per cent



iii. Current account, %GDP



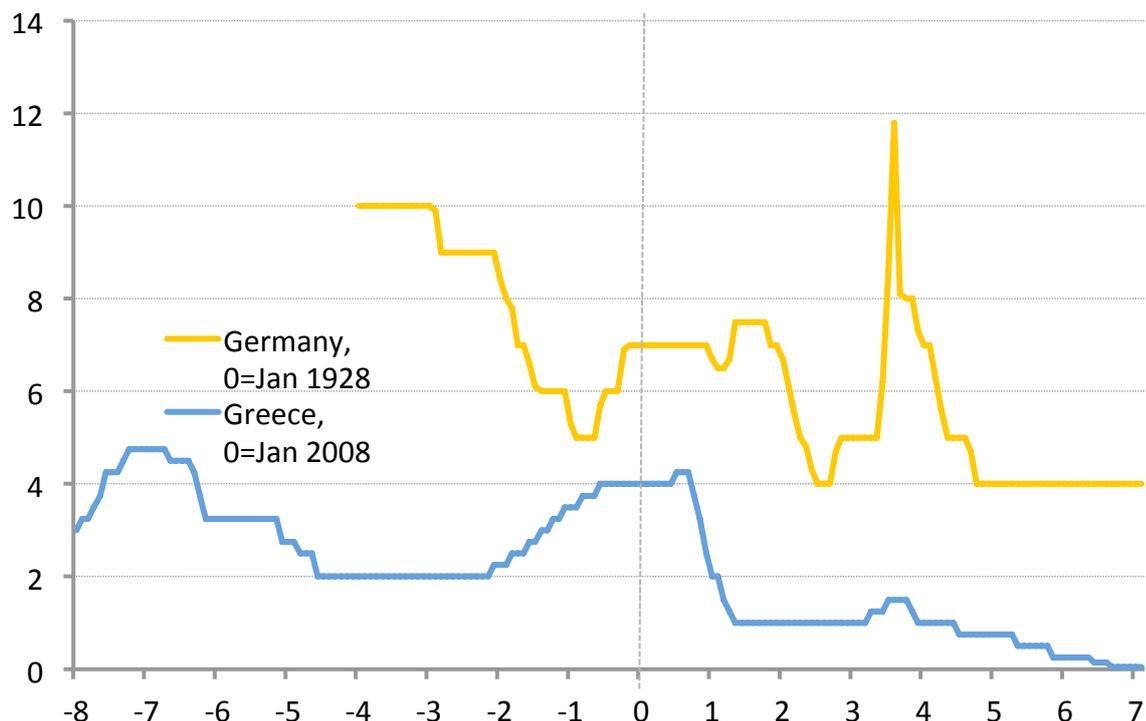
iv. Consumer inflation, annual change



Source: Ritschl (2012); Eurostat

Chart v. shows monthly interest rate changes (for Greece, the ECB rate) centred on January 2008 and January 1928, corresponding to the peaks of the two cycles. The shifts in direction are remarkably similar, though ahead of the crisis, the expansion was more prolonged under the ECB; in both episodes the authorities were slow to react to the emerging crisis; the ECB however was eventually willing to go further with cuts.

v. Discount rates, Reichsbank and ECB



In the first section events through the 1920s in Germany are briefly discussed, in particular from the perspective of indebtedness, through to the decisive default in July 1931. In the second, the events in Greece since joining the euro are traced, and the parallels emphasised. In the third section, the role of financial interests in both episodes is examined. In the last section, the end game in Germany is compared to present events in Greece. Even given the role of financial interests, (ironically) the Germans appear in a position to permit Greece the opportunity to move forwards. And this can be achieved only by massive fiscal stimulus. Finally, if this is not permitted, the history shows that exiting a deeply flawed currency union might not be the end of the world.

Germany, 1922-31

Hyperinflation

After the hyperinflation of 1922-3, the German monetary system was stabilised in November 1923 with the introduction of a new currency. A little remarked (a. understood, or b. acknowledged?) consequence of these events was that the vast corporate and government debts of the war were effectively written off. On the receiving end were the German middle classes: “The inflationary situation hit them especially hard: they lost their savings and loans which had financed the lost war. On the other hand, the state was freed of practically all its obligations”, reports a catalogue of a historical exhibition at the Berlin Reichstag (1989,274). Guinnane (2004, p.9 n.9) offers a contemporaneous interpretation: “Wilhelm Cuno (Chancellor) and Walther Rathenau (Foreign Minister) at least saw the situation in 1922 as offering Germany a way out of the Treaty”.

As Liaquat Ahamed observed in his *Lords of Finance* (2009) “Britain and France had to tap their tax revenues to pay interest on their own internal debts. Germany had inflated away its internal public debt – the Germans, therefore, had a natural surplus from which they could afford to pay reparations” (201). The economic historian Albrecht Ritschl (2012), who has taken great pains compiling German economic statistics from this era, shows a central government surplus of Rm770mn in 1924.

Dawes

In 1924 the Dawes committee put in place the arrangements for Germany to re-engage with the global financial system.¹ Their scheme, implemented in September 1924, led to:

- rescheduled reparations
- the return to the gold standard at the pre-war parity of \$1=RM 4.2
- a loan to Germany of \$200 million issued at high interest (7 per cent) to support reparations payments, recapitalise the Reichsbank and build up enough gold reserves to jump start the economy
- the imposition on Germany of an ‘agent general’, or economic proconsul/viceroy, responsible for monitoring the economy on the behalf of financial interests; the post was given to S. Parker Gilbert, later a partner of J. P. Morgan
- the reconstitution of the Reichsbank as independent of government, but under a general council, one half German, one half foreign

¹ General Charles Gates Dawes was a US banker and Vice President of the United States from 1925-29. In the period from the end of the First World War a number of individuals from the financial sector dominated the of setting the global economic policy agenda. Ron Chernow’s *House of Morgan* has J. P. Morgan as the most powerful figure.

Managed by Morgans in the US and Morgan Grenfell in the UK,

[The loan] electrified Wall Street. ... For Weimar Germany, it was a turning point. It became the decade's largest sovereign borrower. American capital poured in: Ford, General Motors, E. I. Du Pont, General Electric, Standard Oil of New Jersey, and Dow Chemical. Unemployment plunged and Germany's economic slide was reversed into a five-year upturn. This revival would provide Adolph Hitler with a splendid industrial machine and the money to finance massive rearmament. In the meantime, the world was trapped in a circular charade in which American money paid to Germany was handed over as reparation payments to the Allies, who sent it back to the United States as War debt. (Chernow, 250)

As always, orthodox financial arrangements implemented purportedly for stability, led to the wildest excesses. Initially this illusory veneer of stability must have supported the currency, and permitted cuts in interest rates from ten per cent to five per cent in two years (chart v). Within a year the German economy was expanding vigorously (chart i); nominal GDP grew by 9.9 per cent in 1926; unemployment fell to a low point of 7.1 per cent in 1927 (Chart ii). In terms of debt, Richard Roberts (Schróders' historian, 1992) observes

[I]nternational lending resumed on a large scale. Weimar Germany was much the biggest borrower and by the summer of 1930 had accumulated long-term debts of some £590 million and short-term debts of £787 million. (174)
[equivalent to \$7bn or RM27bn, or a third of 1930 GDP]

Then, with a rapidity that is astonishing, boom turned to bust.

A debt inflation gave way to debt deflation; output collapsed; unemployment soared; and prices fell (Chart iv). Inherent to the gold standard, rates had to be held up to protect the currency even in the face of the collapse of the economy. As early as 1929, the international authorities were back on the scene.

Young

The Young Plan emerged from a gathering of financiers and businessmen that began in February 1929.² Again reparations were rescheduled; the 'Young loan' of \$300 million issued (again at interest of 7 per cent). As Ritschl puts it "the price to be paid for that was a rigid deflationary programme imposed and monitored by the [central] bank" (17).

The figures below show just how rigid: German austerity was more than twice as severe as the contemporaneous cuts in the US and UK.

² Owen Young was Chairman of General Electric.

Table 1: Government final consumption expenditures, national currencies

	Germany RM bn	UK £ m	US \$bn
1930	7.9	569	10
1931	6.5	575	9.9
1932	5.8	528	8.7
1933	6.5	514	8.7
Peak to trough, %	-26.6	-10.6	-13.0

Sources: UK: Feinstein (1976); Germany: Ritschl (2012); US: Bureau of Economic Analysis

In the Spring of 1931, the one major country most weighed down by a sense of collective despair and individual hopelessness was Germany. The official figures indicated that 4.7 million people, close to 25 per cent of the workforce, double that in the United States, were without jobs. And this did not include another 2 million forced into part-time work. (Ahamed, 393)

From the Hoover moratorium to 'standstill'

The Young Plan was hopelessly inadequate. Germany was in the throes of what Irving Fisher (1933) would describe as a debt deflation, with the burden on the economy of very high internal and external private debts rising as wages, and retail and asset prices, fell. In May 1931 the failure of the Credit Anstalt bank in Austria set in motion the most critical period of the international financial crisis. On June 20th President Hoover announced a moratorium of international debts.

The United States would forgo one year's principal and interest of \$245 million on the war debts due from Britain, France, Italy, and some of the smaller European powers, provided, and only provided, that the Allies themselves suspend \$385 million in reparations due from Germany. (Ahamed, 2009, p.410)

Again, the price appears to have been further austerity.

On the very day that Hoover was proposing a moratorium to his cabinet colleagues, Chancellor Brüning launched his own initiative. On June 5, he unveiled a new package of austerity measures that included a further lowering of civil servants' salaries, a cut in unemployment assistance, and new taxes. (Ahamed, 408)

But still the crisis continued; the temporary suspension of international payments was

... far outweighed by the economic havoc that deflation was now wreaking. As consumer prices plummeted – the rate of annual inflation reached minus 12 per cent in the summer of 1932 – so too did output and employment. (Ferguson, 66)

The endgame began with what Keynes called the “shattering German crisis of July 1931”. Large-scale corporate (‘Nordwolle’, a large German wool combine, revealing losses of \$50 million) and financial (the Darmstadter Bank) failures followed. But even then the insanity of the gold standard meant that rates were hiked to 12 per cent in spite of more than a quarter of the population having no work (chart ii).

Finally, under the first ‘standstill agreement’, all payments on Germany’s short-term debt were suspended. Capital controls were imposed, *effectively ending gold standard membership*. Skidelsky (1992, p. 393) argues: “Germany defaulted on 15 July [1931]”. But, finally, Germany was free to reflate.

Greece, 2000-2015

It is doubtful whether any country should ever be described as ‘ready’ or otherwise to join a flawed currency union. Membership at an overvalued exchange rate might be welcomed by financial markets, but such conditions are also associated with excess. With Greek bank accounts (not least corporate ones) swelled with euros and monetary conditions more appropriate to the sluggish ‘core’ countries (chart v), the result was rapid expansion, followed by severe collapse.

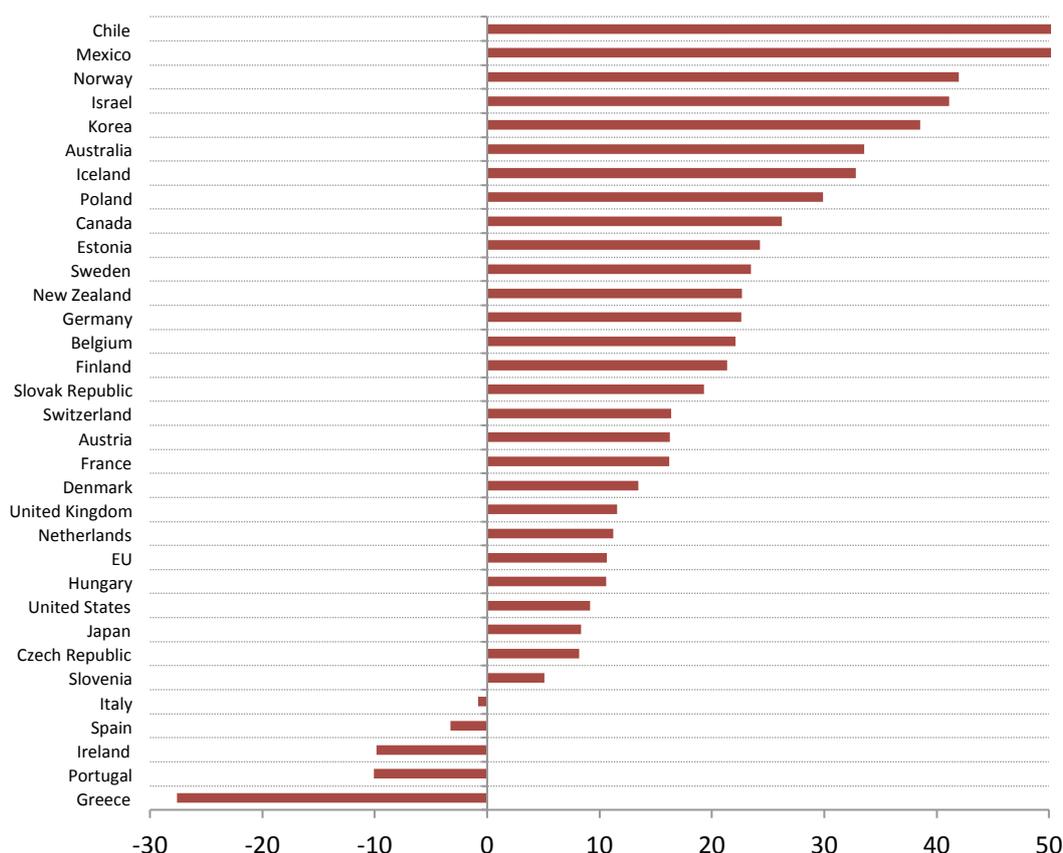
The main difference between the two episodes was that the German events happened roughly twice as quickly. Germany joined the gold standard in 1925, so expanding for only three years; Greece fully joined the euro in 2002, expanding for six years.

- GDP growth for both was rapid, averaging 7 per cent a year in nominal terms; the decline was similarly severe, but faster in Germany (3 years at -10 per cent a year) than Greece (so far, 6 years at -5 per cent a year)(chart i).
- In the expansionary phase labour market gains were relatively modest, with unemployment only edging down in both cases to 7-8 per cent; both, however, saw almost equally severe collapses, with Greece peaking at 27.5 per cent and Germany at 31.5 (chart ii).
- If the figures for Germany are correct, Greece had by far the more excessive current account deficit, reaching a peak of -14 per cent of GDP and Germany only -6 per cent; the deficit was closed at a similar pace, however (chart iii). Germany was the primary beneficiary of Greek spending over the 2000s, just as American producers benefited from Germany in the 1920s.
- While Greek household debt at 62 per cent of GDP and corporate debt at 65 per cent for Q2 2011 is some way below core countries (McKinsey, 2011, p. 14), Buttiglione *et al* (2014) report external debts very high at 238 per cent of GDP, the fifth highest of developed countries.
- Strikingly too, inflation was similarly subdued ahead of the crisis in both episodes, but deflation came far sooner and proceeded far further in Germany than in Greece so far (chart iv).

The scale of the deflation in Germany must have been a consequence of the severely restrictive monetary policy. Even after cuts at the start of the crisis, interest rates in Germany were never cut lower than 4 per cent, and by the end of 1930 were being raised again. Within full currency union, Greece avoided such conditions, but, as widely recognised, the ECB were hardly quick off the mark in releasing monetary restraint (chart v); moreover, with monetary autonomy abandoned, financial interventions in individual member countries on the scale of those outside the Eurozone were impossible.

But fiscal savagery was more formalised than in the 1920s/30s, with austerity inherent to eurozone rules under the growth and stability pact. (And later reinforced by the European Fiscal Compact - http://en.wikipedia.org/wiki/European_Fiscal_Compact) In cash terms government current spending was cut by 27.6 per cent between 2008 and 2014, by a very large margin the most severe cuts of all OECD countries (chart vi).³

Chart vi: Growth in government final consumption expenditures, 2008 to 2014, per cent, national currencies.



³ In TUC (2015) I estimated the multiplier in OECD countries over this period at around three.

The match with the extent of German austerity in the 1930s (table I, page 8) is astonishing.

With loans and support to periphery countries contingent on austerity measures, the disastrous errors of the past have been repeated and are ongoing (spending cuts continued in 2014 for Greece, Spain, Portugal, Ireland and Italy). Whilst under the ‘securities market programme’ the ECB bought government bonds from Greece and other bail-out countries (and sold assets of the same value to avoid any hint of stimulus prior to QE), it has also been involved in the tough enforcement of the harsh domestic “conditionality” measures imposed by the Troika – with the European Commission as the legal lead, but in “liaison” with the ECB and involving the IMF.

The ECB has thus been involved in fiscal enforcement measures that arguably go well beyond its monetary mandate, a point recently made by the Advocate General of the European Court of Justice in assessing the legality of the ECB’s (in the event unused) OMT programme. Strikingly, however, certain German officials have even found this limited degree of support (via bond purchases) intolerable, even though it is *exactly* the same kind of deal to which Germany was party. The degree of austerity imposed on Greece, with its broken economy and while other states continue to spend, is quite extraordinary.

Caveat emptor

According to conventional wisdom, the German psyche was shocked into permanent conservatism by the hyperinflation. This ignores the possibility that hyperinflation was deliberate. It also overlooks the wild excesses of the 1920s (and later the 1980s). As we now all know, avoiding inflation does not amount to avoiding excess (chart iv); indeed an absence of price inflation may be characteristic of debt inflation. As Albrecht Ritschl stated, “Germany is king when it comes to debt”.⁴

But Germany is no different to all those countries that have fallen victim to the excesses that appear endemic under liberalised financial arrangements. A sample: Japan, Scandinavia, South East Asia, Spain, Ireland, the United States, the United Kingdom, the Netherlands, and, undoubtedly, China. Greece is in good company. Economists, other commentators and the press may bemoan shortcomings and corruption in the Greek character and work ethic, but, as Michael Pettis has argued, there is no reason to think that these are any different or more prevalent to anywhere else on the planet. “Put differently, there is no national virtue or national vice here, and there is no reason for the European crisis to devolve into right-wing, nationalist extremism. The financial crisis in Europe, like all financial crises, is ultimately a struggle about how the costs of the adjustment will be allocated, either to workers and middle class savers or to bankers, owners of real and financial assets, and the business elite.”⁵

⁴ *Der Spiegel*, 21 June 2011. <http://www.spiegel.de/international/germany/economic-historian-germany-was-biggest-debt-transgressor-of-20th-century-a-769703.html>

⁵ <http://blog.mpettis.com/2015/02/syryza-and-the-french-indemnity-of-1871-73/>

But ‘trading’ debt support for severe austerity is less commonplace, undoubtedly because it is insane and deeply pernicious. Those imposing the ‘trade’ are, however, not concerned about the effects of economic depression on individuals, only of the value of their economic stake, their direct investments, shares and corporate and government debt. McKinsey (2012, 24) reported on the banks from the largest EU economies with a very high stake indeed:

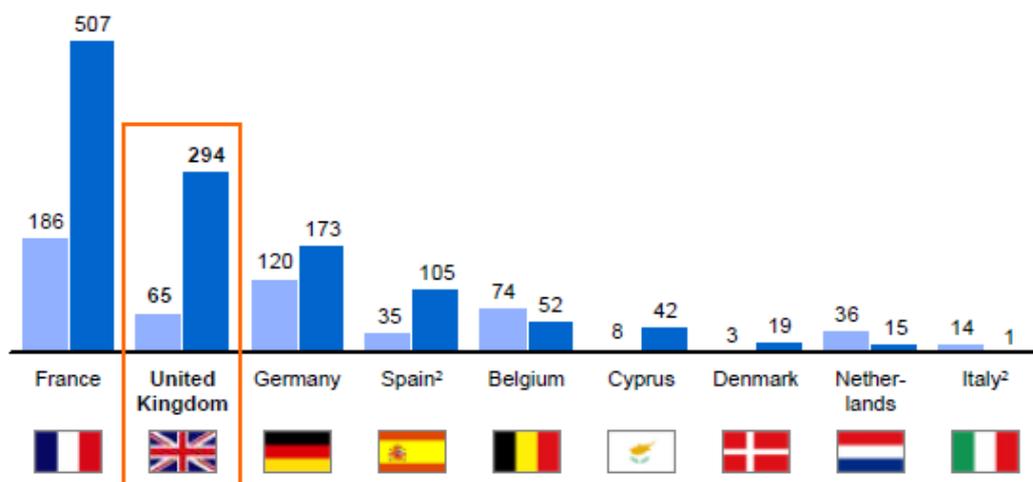
Exhibit 11

UK banks are highly exposed to the private debt of eurozone-crisis economies



Net direct exposure¹ to debt of Greece, Italy, Ireland, Portugal, and Spain
Banks participating in ECB stress test
\$ billion

■ Sovereign
■ Private sector



¹ Net direct exposure defined as gross cash long minus gross cash short.

² Excludes exposure to domestic debt.

SOURCE: European Banking Authority; McKinsey Global Institute

So French banks were more exposed to both periphery sovereign and private debt; UK banks second most exposed to private debt; German banks second most exposed to sovereign debt. Financial institutions from these richer countries may have been seriously vulnerable to periphery economies (and NB the McKinsey chart was from 2012), but they are plainly too powerful to be resisted. As a result, these exposures are now greatly reduced through the various ECB programmes⁶, but the pressures on Greece have not abated.

Today the boot may appear to be on a German foot, but it is ultimately the foot of international financiers (US stakes are not known). The holders of German assets in the 1930s may have been mainly American bankers, and today Europeans are the majority holders of Greek assets.

⁶ According to the Financial Times (30 March 2015), "European bank exposure to Greece has fallen from E175bn in 2008 to E42bn. The bulk of the country's debt is now in the hands of the EU, the ECB and IMF, instead of the private sector."

But, nationality aside, those holding the assets and calling the shots are still financiers and banks. This role was as plain as day in the inter-war period, with J. P. Morgan marauding all over the world. But the apparently technocratic and neutral arrangements under the euro remain wholly in accord with the (perceived) interests of finance, as this brief history indicates.

The financiers impose a flawed arrangement (the currency union and liberalised finance) and then drive forward excess. The borrower is then hounded for repayment nearly to death. But the lesson of German history – let alone of contemporaneous events in the US and UK in the great depression, and countless other episodes – is that the ‘trade’ is doomed to failure. The two important questions are:

- a) how quickly this truth is recognised; and
- b) which forces take forward the obvious necessity of reflation?

Endgames

In July 1931 Germany realised enough was enough. With capital control in place, monetary policy was finally relaxed. The discount rate was cut steadily to 4 per cent between the end of 1931 and the end of 1932 (chart v). But Germany continued notionally to adhere to the \$/RM 4.2 parity for the purposes of trade.

The precise changes and associated timings in fiscal policy are difficult to unravel. Keynes visited Germany in January 1931, meeting Chancellor Brüning on 11th, seemingly finding him unresponsive to fuller reflation.⁷ But some time in 1932, fiscal policy was relaxed. Ousting von Papen, General von Schleicher appears to have taken the boldest initiative. On Christmas Eve 1932, *The Economist* published an extract from a broadcast speech by the new Chancellor:

Their programme contained only one point, the provision of work, and all the Government’s measures would more or less serve this end. Recent travels throughout the country had convinced him that Germans of all classes were dominated by that single idea. Nothing else interested them – least of all constitutional changes and such petty things, which filled no stomachs. (*The Economist*, 24/12/32)

His employment plan primarily involved public works, “adding Rm. 600 millions to the Rm. 700 millions which the Brüning and Papen Cabinets had already sanctioned”, the issue of taxation vouchers to employers of new workers, and the writing off of private debt through two new financial organisations. Furthermore the policies involved an expansion of new credit, which began to exert downward pressure on the rate of interest (*Economist* 31/12/32). *The Economist* of 10 December 1932 had previously

⁷ Donald Moggridge’s commentary in the *Collected Writings* (volume XVIII) cites Brüning’s own report from his memoirs of a “long conversation ... tried to persuade him [Keynes] that an inflationary programme would shake foundations”; Moggridge also notes that “Keynes diary has no record”.

reported that this expansion of credit associated with the employment plan would be obtained with the “co-operation of Dr. Luther” (the head of the Reichsbank). Von Schleicher also refused “point-blank to introduce import quotas or similar measures”. In the same Christmas Eve article, *The Economist* argued that “the impression made by Germany, revisited this month, is decidedly of a country which is once more travelling on the up-grade”.

Ritschl’s quarterly economic statistics for Germany show the trough of national income at RM 10,351m in the third quarter of 1932 and an increase to RM 10,593m the fourth quarter. Over the same period the decline in private investment was finally arrested. On annual figures, 1932 saw peak unemployment of 31.5 per cent, followed by a fall to 27.2 per cent in 1933.

In July 1932, at the Lausanne conference, reparations were finally cancelled.⁸ All this came before Hitler’s seizure of power.

Hitler may have exploited the carnage inflicted on Germany as well as making political capital from lambasting the financiers dictating events,⁹ but it is, I think, wrong to say that democratic politicians were standing idly by. Democracy had profound difficulties handling the crisis and the machinations of international financial interests, but

- a. this was hardly the first or the last time that financiers would have the upper hand; and
- b. the politicians got there in the end, albeit very briefly.

With the election of Syriza, once more democracy has profoundly and significantly rejected established financial interests. But these interests continue to dictate terms from Brussels, Frankfurt and Washington. Greece needs decisively to be liberated from the trade of debt relief for austerity. And be granted the facilities for a massive fiscal stimulus.

While financial interests may be attempting to dictate the action, politically the ball seems very much in Germany’s court. The victim 80 years ago appears in the role of persecutor today. The German people need to understand that the situation in Greece is not caused by the people’s moral failures, but is rather due to the first inept and later cruel machinations of financiers. The hardships endured in the 1920s originated in exactly the same way, the people of Germany subject to the same passions and exuberance in the expansionary phase of a liberalised system, as those in Greece today.

But finally, if this release is not granted, the Greek people should recognise the eurozone is no more an ideal monetary system than the gold standard was in the 1920s. Effectively monetarist in its ideological foundations and practical operation,

⁸ Though while Germany was off the hook, it was only under Roosevelt that all war debts were finally cancelled in 1933.

⁹ Although, as the catalogue of the historical exhibition twice observes, Hitler had the “support of sections of heavy industry and of the financial world” (304; see also 297 and panel 213 ‘millions stand behind me’).

the euro has conformed to the global agenda of financial liberalisation, and has proved ultimately at odds with stability and prosperity. From the start of the financial crisis in 2007, the system has served even worse the interests of the citizens of Europe.

While less prominent than in the early years of the crisis, the agenda for global financial reform (e.g. 'Bretton Woods 2') remains paramount to the possibility of progressive reform across the world. For Greece to take early leave from the present dysfunctional arrangement would not be the end of the world. The Greek people might be re-assured by Keynes's words (under the heading 'The Future of the World'), as Britain became the first country to leave the gold standard in September 1931:

There are few Englishmen who do not rejoice at the breaking of our gold fetters. We feel that we have at last a free hand to do what is sensible. ... It may seem surprising that a move which has been represented as a disastrous catastrophe should have been received with so much enthusiasm. ... I believe that the great events of last week may open a new chapter in the world's monetary history. (1987, 245-9)

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*Cover Image: *Political parties in the Reichstag election*, 31 July 1932, Berlin, Propaganda zur Reichstagswahl

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