GERMAN DEBT ISSUES: 1970-1993

John A. Consiglio*

Abstract:

Management of its national debt was Germany's main foscal policy problem during the period over 1970 to 1993. The reunification solidarity pact, which involved plans to step up new borrowing, drew Bundesbank warnings, and many sides demanded consolidation measures in the forms of spending cuts and tax increases.

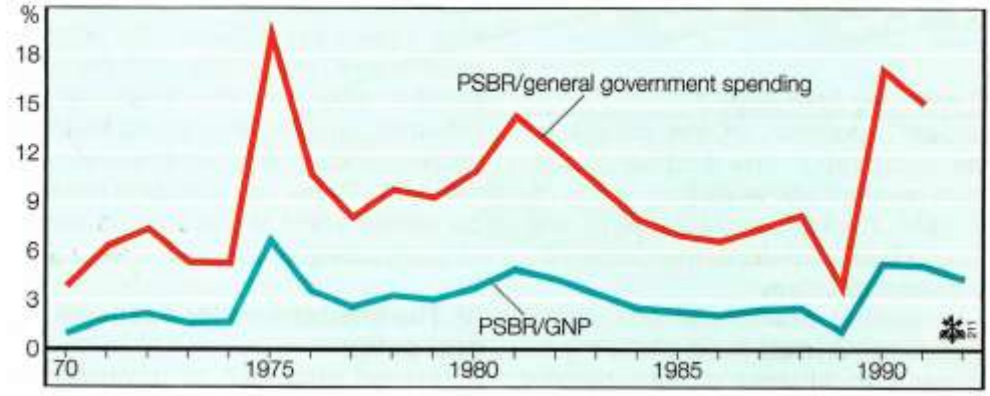
While many justifiably consider stark size, and strong inherent fundamentals, as main reasons for German economic might, others look at that country's stances in the face of specific economic issues as a reason for the country's ability to retain its European economic primacy. In this paper we look at how Germany has viewed, and acted upon, the issue of national debt and this debt's size and growth, as in fact a national fiscal-policy problem.

Waves of inflation that followed both world wars turned the German people into a permanently highly sensitised nation to the dangers of deficit spending by the state. There is a psychological mindset amongst many German citizens that equates government borrowing with inflation. Two currency reforms after World War II reduced the state's domestic indebtedness to virtually zero. After those reforms the growth of the public sector borrowing requirement (PSBR) during the era of postwar reconstruction was initally very modest. That German state was in fact more a lender than a borrower in those times.

The first severe recession of 1973-74 changed that situation. The high increase in unemployment that resulted lasted many years. Oberhauser (1993) holds that some signs of it were still evident even two decades later. From 1973 onwards German public authorities at all levels were financing big chunks of their expenditure by raising debt. In none of the years after that recession up to 1993 was there a case of net withdrawl of public debt (vide Fig 1).

**Ph.D., Senior Lecturer in the Faculty of Economics, Management & Accountancy of the University of Malta.*

Figure 1: Public sector borrowing requirement in % of GNP and general government spending



The public sector borrowing requirement also includes the following off-budget funds: "German unity" fund, loan retirement fund, "equalization of burdens fund", European Recovery Program Special Fund and the Treuhandanstalt.

Source: Bundesbank monthly reports

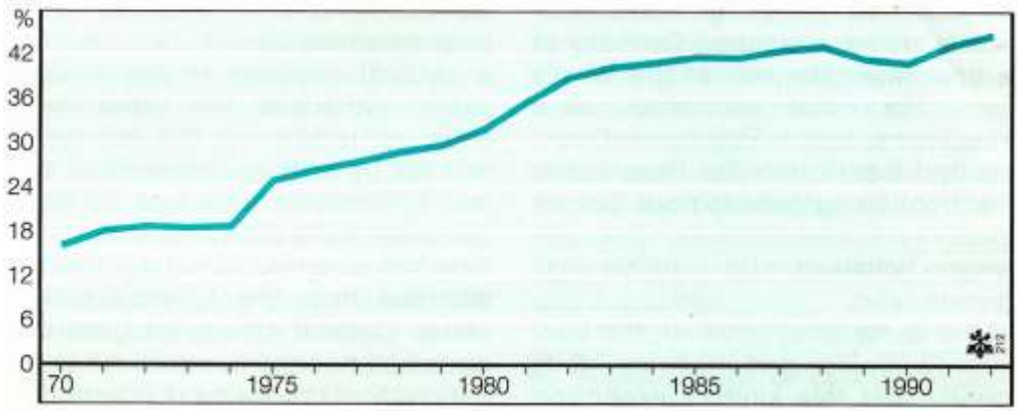
The Maastricht targets

Bouts of new borrowing occurred in Germany in clearly identifibale waves ((1975, 1982, 1989, 1990) and these were generally in response to the variations in the business cycle. During the 1980s budget consolidation efforts, combined with higher tax receipts generated by an economic upswing, led to a steep reduction in new borrowing by 1989. But then state indebtedness moved up again after Germany's unification, because a large amount of the government's injection of funds into the new *Bundeslander* (German states) was financed by taking up credit. (Vide Fig 2 for how German public sector debt evolved, inclusive of off-budget funds and the Treuhand[1]).

From a level of 16% of GNP at the beginning of the 1970s, the German debt load rose to 45% by around 1993, and the then current conjuncture was already pointing towards further increases. Growth of some 5% between 1981 and 1991 meant that one of the Maastricht fiscal virtue criteria (budget deficit at less than 3% of GDP) had been violated, even if the other Maastricht criterion of total government debt (60% of GDP) had not yet been reached.

[1] **The *Treuhandstalt* ("trust agency") was the agency that privatised the East German enterprises (VEBs) owned as public property. It was created by the Volkskammer in 1990, and oversaw the restructuring and selling of about 8500 firms with some 4 million employees.**

Figure 2: National debt in % of GNP



Source: Bundesbank monthly reports

Reunification

German reunification after 1989 necessitated scrutiny of various special arrangements (funds), and of governmental budgets that built up into overall government debt as a result precisely of that reunificfation. The federal government initially used to finance the bulk of public sector transfers to the new Eastern Germany states out of its own budget, but later started relying much more on the credit markets. Simultaneously it was a case that states and municipalities in Western Germany had also piled up new debt, even if they as such did not actively pump funds into the east: this apart from certain obligations which had been incurred under the new German Unity fund.

Reunification produced an upswing in various economic sectors (e.g. transport, retail, and manufacturing) and extra tax revenues benefitted certain *Lander* governments. This naturally helped in the financing of additional expenditures. A significant part of the transfers that were taking place to the new German states was offloaded from the central budget to credit-financed funds. The generous conversion of both the East German currency (par between the Deutsche Mark and the East German Mark), and savings assets, implied a cost that was shouldered by the *Kreditabwicklungsfonds* (loan retirement funds), and this fund alone accounted for a one-time rise of DM 190 billions in public sector debt.

The financial equalisation measures on behalf of Eastern German states and municipalities were mainly chanelled through the German Unity fund up to 1994. This was mostly financed by loans, the servicing of which was split between the federal government and the western *landers*. At that point it was estimated that the federal budget would be expected to benefit from some DM 250 billions from the privatisation of former Eastern German enterprises.

After 1995 amortisation of the burdens of the past was planned to be done via subsuming into an *Erblastentilgungsfonds* whose debt servicing obligations would be taken over by the federal government. Conspicuous here were DM 59 billions of old debts run up by the residential housing sector. In the case of the railway services sector (the West German *Bundesbahn* and the East German *Reichsbahn*) the federal government was expected to aasume existing debts, but in the case of the postal services (the *Bundespost*) its liabilities were to be taken over by its successor.

Public debt surge

Assumption of old debts was therefore part of the quantum leap in the public sector's debt load, with the major portion coming from transfers associated with the unification process. The task of allocating these liabilities to various political subdivisions remained unfinished for a long time. The PSBR went up so much that the unification boom in the west of the country around 1992 gave way to a recession. In a sense this was a case "reaching home" as such a recession had been plaguing other western industrial nations for several years.

Growth in government debt of course also implied a rise in interest obligations, and this reduced budgetary options, with no net retirement of debt being in sight. At the same time the German government was thinking about trying to reduce the PSBR over the medium term. The truth was that many German politicians and economists felt traumatised by the level of existing debt and prospects of future borrowing needs. This clouded their vision of what deficit financing really involved, and what would be the impact of stiff budget consolidation. The mere mention of "government debt" would make them reach for their amortisation tables. The nub of the question, the deciding factor, was not however the amount of debt actually already on the books, but rather whether an increase in public sector borrowing would be harmfuil or otherwise in terms of predictable consequences.

Table 1

Public sector borrowing requirement and outstanding public sector debt

Public sector borrowing requirement[1]

	1970	1975	1980	1985	1989	1990	1991	1992[2]
Federal, state and local governments	7.6	69.2	56.4	42.0	24.7	74.8	83.0	74.0
Federal government	2.0	36.4	29.7	25.1	15.4	51.6	44.3	n.a.
State governments	2.0	19.7	21.9	16.9	7.3	18.9	23.6	n.a.
Local governments	3.6	13.1	4.8	0.1	2.1	4.2	15.1	n.a.
Off-budget funds	–0.2	–0.1	–1.7	0.1	1.1	49.8	37.4	27.9
Treuhandanstalt						14.1	25.3	30.0
Total	7.4	69.1	54.7	42.1	25.8	138.7	145.7	131.9
Ratio to GDP[3]	1.0	6.7	3.7	2.3	1.2	5.3	5.2	4.4
Ratio to general government spending	3.8	19.2	10.7	7.0	3.7	16.9	15.0	n.a.
Memento: budget balance of public social insurance fund	6.3	–2.5	3.8	5.0	16.9	21.0	16.8	n.a.

Outstanding public sector debt[1]

	1970	1975	1980	1985	1989	1990	1991	1992
Federal, state and local governments	115.4	249.9	465.3	753.5	921.8	996.6	1079.5	1153.6
Federal government	47.3	108.5	232.3	392.4	490.5	542.2	586.5	n.a.
State governments	27.8	67.0	137.8	247.4	309.9	328.8	352.3	n.a.
Local governments	40.3	74.4	95.2	113.7	121.4	125.6	140.7	n.a.
Off-budget funds[4]	8.1	6.5	3.3	6.7	7.1	56.9	94.3	122.2
Treuhandanstalt						14.1	39.4	69.4
Total	123.5	256.4	468.6	760.2	928.8	1067.5	1213.3	1345.1
Ratio to GDP[3]	16.1	24.9	31.7	41.4	41.4	40.6	42.9	44.5

1) Source: German Bundesbank monthly reports (Monatsberichte); in DM billion.

2) 1992 provisional data.

3) From 1991: eastern and western Germany.

4) The Kreditabwicklungsfonds (loan retirement fund) increased after 1993 by DM 112 bn, representing the refinancing of East German liabilities.

Crowding-out

In addition to what are considered as the immediately perceivable disadvantages of government borrowing (repaying the money and meeting interest payments), there are crowding-out effects on private investment in the near term. The crowding-out process reveals what may be the most serious flaw in prevailing economic theories. The one most subscribed to is that private savings determine the total amount of net private investment, government debt, and the balance of payments on the current account.

Private saving is always identical to the sum of these three figures, but it is not the determining factor. Debateable is the contention that increasing a government's debt will inevitably restrict the scope for private investment, and lead to an increase in capital imports, both due to higher interest rates. Economic theory clings to the interest mechanism, but there are other mechanisms at work that can adjust the savings rate to the measures of investment demand cited: viz the Keynesian income mechanism (via changes in GDP), and the Kaldorian distribution mechanism (via changes in the distribution of income and therefore in savings patterns, especially in the form of an adjustment in undiastributed profits. Savings thus becomes a largely dependent variable, which adjusts itself. If variable are correclated with savings rates it emerges that interest can only play a secondary role, while saving corresponds particularly closely to undistributed earnings. (Vide in this context Scherf, 1993)

The issue of crowding-out effects in relation to German national debt problems is an important one. How did private savings adjust to investment demand? It needs emphasising that if crowding out really has the effect which is so widely feared, an economy would never be able to come back from recession, because whatever force drives the recovery (rise in foreign demand, private investment, or deficit spending), an increase in private savings is always required, (this being achieved via the income and distribution mechanisms).

The upswing in the Federal Republic of Germany in the 1980s was driven, in a first instance, by an increase in the current account surplus of some 5% of GNP. Simultaneously there was an expansion of the private investment ratio. Above all additional savings resulted from a 5% reduction in wages and salaries in relation to GNP, with a commensurate increase in profits. Cumulativekly these developments seem to provide evidence that demand management by the state, financed on the credit market, can still be very effective. The generous exchange of monetary and savings assets for those in the new German states, and the strong growth of around 4% of GNP in the government’s current borrowing after reunification, produced a high rate of economic growth in Western Germany at a time when the rest of the West’s major industrial economies were mired in recession. In just three years employment went up by 1.6 million, tax revenues totted up double-digit growth rates, and, far from being crowded out, private investment arose sharply.

But this 1989-1993 German story also shows that this kind of expansion has its limits. The positive economic growth led to wage increases that outran production. The Bundesbank’s attempt to combat the ensuring surge of price increass with a tight-money policy and rising interest rates resulted in a recession.

The debt paradox

There was another lesson to be learnt from that strong growth in the government’s income from taxes and social levies. When the multiplier and accelerator effects of an expansion-oriented demand-side policy amounted to twice the increase in PSBR, then rising government revenues – (German taxes and other levies were at 44% of GNP) – plus reduction in outlays for unemployment benefits, added up to more than the additional borrowing, what Gendenberger (1983) and Oberhauser (1985) term as a “debt paradox”. But the incremental revenues were split three ways between the federal government, the states and municipalities, and the social insurance schemes, and were used to finance additional spending rather than to retire debt. Critical voices held that there had not been a concerted effort at the various levels of government and administration.

Conclusions

So the build-up to the 1993 recession showed that a rational approach to German government borrowing could still be structured from the interrelationships which we have discussed above.

Anti-cyclical borrowing for example. Every state has to be prepared to cover the cyclical dip in tax receipts, and rise in spending on unemployment benefits, by accepting a cyclical increase in the budget deficit. Otherwise government ends up reinforcing the economic setback by putting a squeeze on demand. In our own current years it appears that Chancellor Angela Merkel only came round to accepting this thinking after much pan-European popular resisstance to tough austerity measures.

During a recession this concept also holds true if the state tries to consolidate some so-called structural deficits inherited from a full-employment phase. Cyclical deficits are generally given half-hearted approval, whereas anti-cyclical borrowing is only acceptable to a few.

At a local authority level one often finds that a bandwagon sort of mentality develops. This has to be replaced by clearly defined strategies which would be aimed at concerted efforts and systematic reduction of new borrowing as the economic situation improves.

An expansionist demand policy has to pay careful attention to the wages side. Wage increases should be related to increases in the volume of consumer goods or productivity increass. As opposed to many other countries the German philosophy often appears as if holding that additional increases to keep up with inflation have to be resisted. Especially since this is impossible anyway in real terms. The necessary behaviour on the wages side could conceivably be secured by some form of stability pact between labour and management, in which not only is it made clear what both sides would be really putting into the "agreement pot", but also setting out the economic expansion programme. For example, in Malta a stability pact of this nature never got off the ground simply because to the labour (trade unions) side it was never ever clear what in fact the employers side would be putting in.

Under these types of conditions one would normally expect that price increases would be largely contained, and if this is so then a central bank could dispense with a high interest policy. Certainly this is more desireable because of any such policy's impact on other European Union countries. Putting into place the above conditions, at least to some extent, might then yes be justified to warn against too little government borrowing. In the case of Germany this often reflected the country's overemphasis on budgetr consolidation in the middle of recession. It was either that or.....too much borrowing!

Twenty years after 1993 the German economy is now again showing signs of slowing sharply. Whilst still an island of growth in a stuttering EU, on the front of general government gross debt the record has been one of constant growth, as a percentage of GDP, from 45.8% in 1993 to 83.9% in 2010. Will it again soon be the time for reviewing its debt management policies?

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