Levy Economics Institute of Bard College

Policy Note

2015 / 2

THE GREEK PUBLIC DEBT PROBLEM

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Introduction

The Greek economic crisis started as a public debt crisis five years ago. However, despite austerity and a bold "haircut," public debt is now around 175 percent of Greek GDP. In this policy note, we argue that Greece's public debt is clearly unsustainable and a very significant restructuring of this debt is needed for the Greek economy to start growing again. Insistence on maintaining the current policy stance is not justifiable on either pragmatic or moral grounds.

The experience of Germany in the early post–World War II period provides some useful insights for the way forward. As we detail below, in the aftermath of the war there was a sweeping cancellation of the country's public and foreign debt, which was part of a wider plan for the economic and political reconstruction of Germany and Europe.

Seven decades later, while a solution to the unsustainability of the Greek public debt is a necessary condition for resolving the Greek and European crisis, it will not, by itself, be sufficient. As the postwar experience shows, a broader agenda that deals with Greece's domestic economic malaise as well as the structural imbalances in the eurozone is also of vital importance. In fact, solving these problems looks to be much more difficult than dealing with the issue of the debt.

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Why Is a Restructuring of Greek Debt Necessary?

The first and foremost reason for restructuring Greece's debt is the simple fact that, otherwise, it cannot be repaid under any plausible assumptions. As a result, the extension of current policies that target high fiscal surpluses in the name of debt sustainability will lead to a deepening of the recession—or a prolonged period of stagnation—with all its attendant consequences for the Greek society.

Moreover, because the unsustainability of the debt is obvious to everyone except the official sector of the eurozone, the debt overhang creates uncertainty that prohibits a recovery in private investment activity. Finally, precious resources that could be used to put an end to the recession of the last five years and lead to a recovery are sacrificed for the servicing of this clearly unsustainable stock of debt.

According to Greece's international lenders and its previous government, the stock of debt is at sustainable levels. Their projections show the debt being reduced to less than 120 percent of GDP within a seven-year period, by virtue of consecutive years of public surpluses combined with a strong positive reaction from the foreign sector and the private investment that will lead to a high growth rate.

More precisely, the last review of the Greek bailout program by the International Monetary Fund (IMF 2014) forecasts the following:

1. A primary surplus of 3 percent of GDP in 2015 and more than 4 percent between 2016 and 2022.
2. A net export surplus of 2.1 percent of GDP in 2015 that will increase over time and converge to 4.1 percent of GDP by 2022.
3. A strong rebound in investment, with real fixed capital formation growing at a rate of 9.7 percent in 2015, 13.7 percent in 2016, 11 percent in 2017, and more than 7 percent in 2018 and 2019.

As a result of (2) and (3), and despite the high fiscal surpluses, the economy will achieve a very robust growth rate: 2.9 percent in 2015 and around 3.5 percent between 2016 and 2019, converging to 2 percent by 2022. The combined effect of these processes, according to the troika, will be a decrease in the Greek debt-to-GDP ratio, since both the numerator of this fraction will decrease while the denominator increases rapidly. By 2022, the ratio will have fallen below 120 percent.

These numbers are consistent from an accounting point of view. However, it is wildly implausible that they will materialize. They can at best be characterized as wishful thinking, as most of the troika's forecasts have been so far. There is no historical precedent, save for Singapore, for such a miraculous economic expansion in the face of public surpluses of more than 4 percent of GDP. Given the recent performance of the Greek economy and the condition of the European and global economies, it is also hard to see where the rebound in investment and net exports will come from. The growth rate of gross fixed capital formation in Greece recorded double-digit *negative* numbers until recently, while the most recent data show a (negative) growth rate of -3.3 percent in the first three quarters of 2014 against the same period the previous year.

At the same time, the improvement in net exports over the last five years has been the result of the recession, mostly through a decrease in imports rather than a significant improvement in exports.[1] From this point of view, the continuation of current policies with the single goal of fiscal surpluses will lead—in the best-case scenario—to a stagnation of the Greek economy, with high unemployment rates and further increases in the debt-to-GDP ratio.

Moreover, although officials in the eurozone have studiously ignored these facts, the markets and the private sector in general are well aware of them. As a result, the debt overhang looms over the Greek economy like a modern-day sword of Damocles, creating uncertainty and preventing any serious investment activity.

Finally, as we have demonstrated in recent policy reports (e.g., Papadimitriou, Nikiforos, and Zezza 2014c), although the interest on the Greek debt has been significantly lowered in the last three years, the payments made by the Greek government to the holders of its debt absorb a significant amount of resources. These resources could produce beneficial results if they were instead channeled toward public investment programs.

Some Other Dimensions of the Problem

Restructuring the Greek debt is usually opposed on moral(istic) grounds. The argument made by austerity advocates typically goes as follows: "The accumulated debt is part of past excesses of the Greek government and the Greek people, the corruption of the Greek political system, the dysfunctional public sector,

and the high incidence of tax evasion. Thus the Greeks have to endure a prolonged period of austerity and pay for it."

Certainly, this argument has some merit. It is true that corruption and tax evasion are problems in Greece. It is also true that the public sector is dysfunctional, and that Greek governments at certain periods in the past have been imprudent and spent excessively.

However, the issue at hand is much more complicated. First, as mentioned above, insisting on full repayment of the Greek debt is not pragmatic; the debt cannot be repaid under any plausible circumstances, and the longer we ignore this reality, the worse it will be for the Greek economy and for the European economy as a whole.

Second, the Greek fiscal problem is to a large extent the result of the structural problems of the eurozone. The policies that were put into place after the signing of the Maastricht Treaty in 1992 and the adoption of the euro in 2001 exerted a large negative impact on the foreign sector of the Greek economy and led to a gradual increase in the current account deficit. The fiscal deficits of this period reflect the worsening of Greece's external position as the government attempted to stabilize the economy. In turn, these deficits could be ignored for such a long period of time—close to 15 years—only because of the euphoria in global financial markets during the same period. It is not coincidental that the debt crisis in Greece and throughout Europe erupted after the global financial crisis of 2008.[2]

Related to the structural deficiencies of the eurozone, the Greek crisis has been exacerbated because the public debt is de facto denominated in a foreign currency—that is, as a member of the monetary union, Greece no longer has a central bank that can act as lender of last resort. If this were not the case, the country would not have found itself in such a dire situation. Even now, should the European Central Bank guarantee the rollover of the existing debt, Greece would only have to worry about the sustainability of its current account.

Third, from a moral standpoint, the cost of default has to be shared between the creditor and the debtor. The existence of a positive real interest rate for borrowing—at least to a certain extent—is supposed to represent the existence of a risk of default. For that reason, because the risk of default differs among countries, the interest rate also varies. During the current crisis, in the case of Greece and elsewhere, the creditors have been exempted from any responsibility for their lending behavior before the crisis began, and after which they were generously bailed out. Instead, the burden has fallen unilaterally on the shoulders of the debtors. This is clearly a biased interpretation of morality.

Fourth, even if Greece could repay its debt and there were no structural imbalances in the eurozone, would the sacrifice be justified on purely moral grounds? The Greek economy has already experienced the largest peacetime decrease in GDP of any developed country in modern history. Is this sacrifice, and the further sacrifices that the adjustment programs require, morally justified?

John Maynard Keynes provides an interesting answer to this question in *The Economic Consequences of the Peace*. As is well known, in 1919 Keynes was a member of the British delegation at the Versailles conference, which produced the homonym treaty that officially ended the war between the Allied powers and Germany and defined the reparations that Germany had to pay.[3] Keynes attacked what he called the "Carthaginian peace" of the treaty. The main body of his argument is pragmatic in nature: he argued that the reparations numbers generally exceeded Germany's capacity to pay. As a result, and similar to the Greek situation today, the provisions of the treaty would not only lead to the destruction of the German economy, but they would also be in vain.

Keynes goes one step further and asks: even if Germany could pay the reparations, would the consequences of the peace be justifiable on moral grounds? His answer is a resounding no:

> The policy of reducing Germany to servitude for a generation, of degrading the lives of millions of human beings, and of depriving a whole nation of happiness *should be abhorrent and detestable,—abhorrent and detestable, even if it were possible, even if it enriched ourselves, even if it did not sow the decay of the whole civilized life of Europe*. Some preach it in the name of *Justice*. In the great events of man's history, in the unwinding of the complex fates of nations Justice is not so simple. And if it were, nations are not authorized, by religion or by *natural morals*, to visit on the children of their enemies the misdoings of parents or of rulers. (Keynes 1919 [2013], 142; emphasis added)

Note how Keynes turns the whole morality (or justice) argument on its head. According to the winners of the war, it was just and moral that Germany should pay reparations. This

is what the loser in a war was supposed to do. However, according to Keynes, "Justice is not so simple," and "degrading the lives of millions of human beings, and . . . depriving a whole nation of happiness" is neither moral nor just. It is also significant that he put forward this argument shortly after the most deadly war in the history of his country.

Finally, in a similar vein, Keynes warns that the stubborn insistence on demanding reparations that could never be repaid would lead to a serious economic crisis that, in turn, could have serious political repercussions for Germany and the rest of Europe:

> Men will not always die quietly. For starvation, which brings to some lethargy and a helpless despair, drives other temperaments to the nervous instability of hysteria and to a mad despair. And these in their distress may overturn the remnants of organization, and submerge civilization itself in their attempts to satisfy desperately the overwhelming needs of the individual. This is the danger against which all our resources and courage and idealism must now co-operate. (144)

Unfortunately, history confirmed Keynes's predictions. The economic strain exerted by the reparations demands—and, more generally, the Allies' treatment of Germany immediately after the war and into the next decade—was one of the main factors in the Nazi party's rise to power in the late 1920s, setting the stage for a second world war.

Keynes's arguments are of obvious relevance to the Greek problem today. The depth of the crisis that the Greek economy has been subjected to in the cause of debt repayment is not justifiable from a moral point of view, *even if* it could eventually lead to a lower debt-to-GDP ratio. Most important, the political and ideological shifts of the crisis have already been severe for Greece, with the rise to prominence of a neo-Nazi party whose influence is bound to increase if the current situation continues.

From a historical perspective, it is both interesting and ironic that Germany today finds itself on the other side of the argument. Like England, France, and the United States in 1919, it is Germany that now stands as the modern guardian of "justice" and "morality."

The Restructuring of German Public Debt Post–World War II

Another irony of history is that Germany, which staunchly opposes any effort to restructure the Greek public debt, was the beneficiary of the largest debt restructuring deal in history, in the aftermath of World War II. This debt cancellation was one of the main factors that ushered in the "German economic miracle" of the postwar period.

Germany came out of the war with a massive amount of debt, both external and domestic. The external debt can be decomposed into three main parts:

1. Prewar debt of around DM13.5 billion that was related to reparations following World War I. This debt had not been serviced since 1933, and the figure does not include the interest foregone.
2. Post–World War II debt related to reconstruction loans received mainly through the Marshall Plan, amounting to DM16.2 billion.
3. External debt accumulated during World War II, in the range of DM85 billion to DM90 billion (Ritschl 2012a).

These numbers *do not include* any reparations related to World War II, which were never calculated or paid.

To get an idea of the order of magnitude, German GDP in 1938 was around 100 billion reichsmarks,[4] while the GDP of West Germany in 1950 was at most DM100 billion. Thus, the external debt amounted to roughly 120 percent of German GDP.

The London Debt Agreement of 1953 restructured Germany's prewar and postwar debt—items (1) and (2) above.[5] As a result,

- The country's pre- and postwar debt was reduced by almost half, from DM29.7 billion to DM14.3 billion.
- No interest was charged for the period from 1933 to 1953 during which the debt had not been serviced, and the interest rate for servicing the DM14.3 billion debt that remained after the agreement was significantly reduced.
- Germany was given a five-year grace period (1953–58) during which annual payments of DM567 million were due. After 1958, its annual payment rose to DM765 million.

Finally, the external debt that was accumulated during the war was never repaid—let alone any reparations.

Unlike what is widely supported in the public discourse, the above numbers show that the provisions of the London agreement were only the tip of the iceberg in the cancellation of Germany's total external debt at that time.

These figures do not include the benefit from the interest forgone. At a rate of 3 percent, around DM3 billion in annual income transfers to foreign countries was avoided. This is a very significant amount given that West German exports totaled no more than DM8 billion in 1950. For Germany to find DM3 billion without a contraction of its GDP and imports would have required a 40 percent increase in exports.[6]

Germany also had public debt, which amounted to roughly 379 billion reichsmarks in 1944. This amount includes the 8 billion reichsmarks in external debt accumulated during World War II, included in (3) above. This public debt was restructured through a currency reform in 1948 that introduced the deutsche mark in the western occupation zones (see note 4). Germany's domestic public debt, which amounted to approximately 370 billion reichsmarks in 1944—total public debt of 379 billion minus the 8 billion included as part of the external debt—was reduced to only DM18 billion as a result of the reform (Ritschl 2012b).

The sum total of the above is staggering. DM350 billion in domestic debt (due to the currency reform of 1948), plus DM15 billion in debt reduction after the London agreement of 1953, plus DM90 billion in wartime debt that was never repaid sums to DM455 billion—more than four times German GDP in 1938 or West German GDP in 1950.[7] Again, these figures do not include interest foregone or war reparations of any kind.

This restructuring of the German debt took place as part of a wider economic plan for the reconstruction of Europe, which entailed the establishment of several institutions that promoted cooperation among European countries. The Organisation of European Economic Co-operation, or OEEC (precursor to the Organisation for Economic Co-operation and Development), is a significant example of this kind of institution. The OEEC was the venue for the European Payments Union, established in 1950, which allowed for the immediate rebooting of trade among the European economies without current account convertibility.[8]

Moreover, there was an implicit agreement that Germany would be allowed to repay its remaining debt through an expansion of its exports. It was understood that Germany could be the only economy in Europe that could be a major capital exporter to the rest of the continent. As a result, the German economy was reoriented toward export-led growth.[9] In this sense, the postwar German economic miracle and the robust development of the rest of the European economies was not the result of abstract market forces. Instead, they were based on very specific and detailed planning.

Conclusions: Lessons for Today

One has to be very careful when drawing historical analogies.[10] However, the historical experience allows us to make some brief points about the Greek public debt problem as well as the current Greek and European crisis.

First, Greece needs a bold cancellation of its public debt. The insistence on full repayment of its debt is not justified on either pragmatic or moral grounds. Moreover, as the past has shown, these situations can have dangerous political repercussions.

Second, the cancellation of the German debt following World War II provides a template for such an arrangement. As explained above, this debt cancellation was far-reaching.

And third, the post–World War II developments also show that debt restructuring is a necessary but definitely not sufficient condition for the solution of the crisis in Greece and the rest of Europe. As happened in the early postwar period, the restructuring needs to be part of a wider plan to deal with the malaise of the Greek economy and, most important, with the structural problems of the eurozone as a whole.

Notes

1. A detailed discussion of the foreign sector of the Greek economy is provided in our series of Strategic Analysis reports; see Papadimitriou, Nikiforos, and Zezza (2013; 2014a, b, c).
2. See Nikiforos, Carvalho, and Schoder (2014) and Papadimitriou, Wray, and Nersisyan (2010).
3. The exact schedule for the payment of reparations was defined in a conference in London in 1921.
4. The deutsche mark (DM) was introduced as part of a general currency reform in 1948, replacing the German reichsmark. Under the reform, all nominal assets were converted at a ratio of 10:1. For example, an asset with a nominal value of 10 reichsmarks was exchanged for a nominal asset worth one

DM. Claims against the state, completely wiped out, were an important exception to this conversion. To avoid the collapse of the banking system, banks were given claims against the state that covered the discrepancy between the assets and liabilities that resulted from the reform. Finally, recurring payments (wages, rents, pensions, etc.) were converted at a 1:1 rate. Details of the currency reform are provided in Deutsche Bundesbank (2002) and Lutz (1949).

5. For a full description of the London debt conference of 1953, see Guinnane (2004) and Kaiser (2003).
6. These calculations are provided in Ritschl (2012b).
7. Obviously, the GDP of both West and East Germany in 1950 was higher than that, and most of the debt was incurred by the unified Germany of the prewar period and during the war.
8. For details on the European Payments Union, see Eichengreen and de Macedo (2001).
9. The plan was devised mainly by the United States; see Guinnane (2004) and Berger and Ritschl (1994).
10. For example, an obvious omission in our analysis is the role of the Soviet Union in the interwar and post–World War II periods.

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