How Germany financed its postwar reconstruction

by Lothar Komp

The war damage in Kosovo and the rest of Yugoslavia totals several hundred billions of dollars. Immense investments in housing, infrastructure, and industry are now required, simply to enable the return of over a million refugees to their homes. And all of this must be integrated into a reconstruction program for the entire region of southeastern Europe, now on the brink of economic chaos.

This poses the obvious question: Who will pay? Those economies which are most in need of productive investments, are the ones least capable of coming up with the needed financial resources domestically or abroad. So, if the course of economic development here were left to the logic of the free market, there would be no hope of repairing or improving anything. Fortunately, we know from the German "economic miracle" after World War II, that there is another way to approach such a problem—a way that has been demonstrated to work.

The German economy was in catastrophic condition in the immediate postwar years. Industrial production had dropped to one-third of 1936 levels. Transport infrastructure had been decimated. More than one-fourth of existing housing had been made unlivable by the bombing attacks, which included about 50% of all homes in the urban centers. This is a rough description of conditions just at the time that 7.9 million refugees from the former German eastern provinces, and another 1.5 million refugees out of the Soviet-occupied eastern zones, flooded into the western part of Germany.

Supplies of electricity and heating for both industry and the population had largely collapsed. Food rations in the especially cold winter of 1946-47 dropped at times below 1,000 calories per capita per day. The undernourishment of miners contributed further to bottlenecks in coal supplies, from which Germany had to derive 80% of its export earnings.

But by the end of the 1950s, this picture changed completely. Germany had risen into the ranks of the leading industrial nations. The mass unemployment of the immediate postwar years had disappeared. German businesses were active throughout the world's export markets. Foreign debts were being paid off, ahead of schedule.

The key to this success lay in the special method for financing the reconstruction.

The Marshall Plan

After the war, there was an acute scarcity of dollars in all European countries, so that Europe's most important export market, the United States, was in danger of evaporating. In June 1947, the U.S. Secretary of State George C. Marshall announced that the United States was ready to establish a European Recovery Program, in order to re-establish "the confidence of Europeans in the economic future of their countries and all of Europe." In a time-span of four years, from 1948-52, infrastructure and productive capacities in western Europe were to be brought up to at least the levels which existed before the war.

To that end, the United States provided commodity credits of $17 billion, with which European firms could buy urgently needed raw materials, fertilizers, vehicles, and machines from the United States. That meant that every dollar had at least a twofold effect: With the exception of Germany, the United States did not insist on the illusory repayment of the dollar credits; instead, the businesses involved in the program were to pay the value of the received supplies, in their own national currency, into an account of their own central bank. The respective governments could then dispose of this as they chose, in agreement with the United States. In some cases, as in England and Norway, these counter-value sums were used to reduce state debts. In Germany, they were employed completely for reconstruction, as if in a revolving door.

Immense investments were necessary if Germany was ever again to get back on its feet economically, and these investments would necessarily involve amounts of financing far beyond the aid received through the Marshall Plan. The first plans for the establishment of a Reconstruction Loan Corporation (RLC) were laid out in 1947. This was to function as the central institution for provision of investment credits. There were two crucial factors to consider. First, there was the initiative of German banker Hermann J. Abs, who informed Truman's emissary, Richard Whitehead, in September 1947, of his own ideas for the envisioned credit agency. Then there was the positive U.S. experience with its Reconstruction Finance Corporation, a Hoover-era institution revamped in 1933 by Franklin D. Roosevelt, during the Great Depression.

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In November 1948, the RLC became known as the Kreditanstalt für Wiederaufbau (KfW, Credit Institution for Reconstruction), in order to provide medium- to long-term loans "to enable the completion of reconstruction projects, insofar as other credit institutions are not able to provide the required financing." Hermann J. Abs and Otto Schniewind were entrusted with the leadership of the KfW. (Both had just previously refused to take over the leadership of the Bank deutscher Länder, the predecessor of the present German central bank, the Bundesbank.)

The loans issued by the KfW were to run primarily on a separate track from the normal banking system. If other banks shied away from the risks of a project, the KfW was empowered to provide direct credit to the businesses involved. This turned out to be the case for coal, gas, water, electricity, and transportation projects. The KfW was expressly excluded from other normal bank services, such as taking deposits, managing customers' bank accounts, or brokering stocks. The KfW was permitted to extend short-term credit in exceptional cases, but only following consultation with the central bank.

The big question initially was: Just where was the Kreditanstalt supposed to get the capital for the credits it would issue? The monetary reform of June 1948 had wiped out masses of capital. That meant that nothing could be taken, for the moment, from the domestic capital market. In the fall of 1948, the KfW tried to entice German savers with a bond, and promptly fell flat on its face. German debtors were forbidden from going to foreign capital markets, and there was nothing to be had from the public budgets.

Also, in contrast to its European neighbors, Germany never received a credit from the World Bank. There were, to be sure, negotiations between the German government and the World Bank over the course of 1953. But, because the World Bank would come up only with a paltry $20 million, and linked this pittance to unacceptable conditions, no agreement could be reached.

Finally, after persistent pressure from Germany, the United States relented and allowed the accumulated German mark—"Countervalue Funds" of the Marshall Plan—collected in the so-called ERP Special Fund, to be used to refinance the KfW. Between 1949 and 1953, the KfW obtained a total of DM 3.7 billion from this source. Principal and interest payments on KfW credits were always paid back into the ERP Special Fund.

The London Debt Agreement of 1953 stipulated that the German government would pay back $1 billion of the Marshall Plan aid it had received. But the German government paid this sum out of its tax income, so that the ERP Special Fund was left intact as the fund for the "revolving" issuance of investment credits.

Dirigistic credit policy

The mere existence of this fund by no means guaranteed success. As West German Chancellor Ludwig Erhard later remarked, everything depended on the "economically right use" of the fund. Because of the huge demand for investments in infrastructure, housing, and industry, there was an understanding between the German and American authorities, that the limited resources of the Marshall Plan, and later of the KfW, could not be surrendered to the free play of market forces. Hermann Abs always underscored the "targetted planning" in the KfW's credit issuance. Abs observed: "The activity of the KfW was not exactly oriented to the ideal model of a free market economy. Taken in the precise sense, what it did was to steer investment."

Immediately after its establishment, the KfW, in collaboration with the Economics Administration, the predecessor of the Economics Ministry, proposed a "list of priorities" for the German economy's reconstruction. These included the basic materials industries (especially coal and steel), housing, agriculture (machines, fertilizers, reconstruction of farms), local infrastructure (roads, water supplies, and so on), an autarkic energy supply for encircled West Berlin, promotion of export business, and, finally, job creation and integration of

German women in Berlin in 1946, known as the Trümmerfrauen, *or "rubble-women," struggle to rebuild the city from total ruin. By the end of the 1950s, the picture of devastation had changed completely: West Germany had risen into the ranks of the leading industrial nations, thanks to the policies of the Kreditanstalt für Wiederaufbau (KfW, Credit Institution for Reconstruction), and other agencies and individuals.*

many millions of refugees. From the outset, the aim was not merely to re-establish conditions as they had been before the war, but, rather, to promote all of those investments necessary for a productive economy that would be capable of sustaining itself in the worldwide arena.

In 1949, the KfW set the highest priority on gearing up production of coal, iron, steel, gas, water, and electricity. Because these were all areas of urgently needed and scarce products, they were subjected to strict price controls. For example, the price stipulated by the German government for coal, covered only one-sixth of the costs of production. The costs of production were, however, covered by subsidies, but not above the sales price. In the case of exported coal, Germany was forced to sell far below the cost of production. Many firms in the raw materials sector would have been unable to present any balance sheet at all, in order to obtain credits at banks. The mining firms, for example, did not even know whether the mines, which had been confiscated by the Allies, would belong to them again some day.

In similar situations today, it is the practice of the World Bank and the International Monetary Fund to advise—for example, in the case of eastern European countries—either that such firms be closed, or that they be broken up and the "competitive components" sold off to foreign investors. To be sure, there were people in the German administrative apparatus in the postwar period, who, under the circumstances, where issues of ownership had not been previously resolved, advised *against* giving credit to mining firms. But it was typical for the political and economic elite of that time, that such advice was not heeded.

Hermann Abs, at the KfW, pronounced boldly that it was irrelevant to whom the mines belonged, and that it was also irrelevant whether their production yielded a profit or a loss under those conditions. The only thing of any importance, he insisted, was that production of coal be cranked up as quickly as possible.

In the years 1949 and 1950, forty percent of all West German plant investment in the areas of energy, coal, and steel, was financed by direct credits from the KfW.

The crash program of 1949

Events in early 1949 illustrate the KfW's working methods in the decisive years at the beginning of reconstruction. The KfW opened in Frankfurt on Jan. 2, and the U.S. authorities promised to put DM 265 million of "counter-value funds" at its disposal as a first tranche. Ten energy firms received credits under Energy Program I for 20 projects, running for 10 years. As a consequence of the Soviet blockade of West Berlin, a considerable portion of this went into the construction of a new power plant there. A total of 55 mining firms obtained long-term credits for capital investments in their mines, for the payment of urgently needed imports, and for paying off bills that were due. The KfW was the direct investor in the energy and coal sectors, because the risk was too great for the private banks. In other cases, part of the financing came from private banks.

These other cases included the KfW's tractor program, under which 40,000 tractors were produced—25,000 for Ger-

TABLE 1

Distribution of Marshall Plan aid through the end of 1952

(millions $)

Great Britain	$3,165.8
France	2,806.3
Benelux countries	1,532.8
Netherlands	1,080.0
Italy	1,515.0
West Germany	1,412.8
Austria	711.8
Greece	693.9
Denmark	275.9
Sweden	107.1

TABLE 2

Investment credits of the KfW, 1949-53

(in millions of DM)

Coal mining	531.0
Electricity	835.3
Gas and water	86.0
Iron and steel	67.7
Other industries	495.2
Agriculture	466.3
Refugee housing	20.0
Fishing vessels	5.0
Housing	328.2
Mining	145.0
Oceangoing shipping	169.3
Canal shipping	9.4
Maritime and canal ports	14.6
Urban surface trains	24.7
Tourism	22.5
Small credits	0.2
Research	30.9
German Railway (Bundesbahn)	45.0
German Post Office (Bundespost)	20.0
Refugee firms	95.0
Export promotion	2.3

man farms and 15,000 for export. The producing firms, MAN, Hormag, Hanomag, and Lanz, received long-term credits for this purpose. The production of phosphates, which had been shut down throughout Europe, was also geared up under this crash program. The KfW started a program to build fishing boats, in order to secure a high-protein diet for the German population. The KfW also hand-picked some 70 firms in industrial sectors, especially in machinery and electro-technology, which had special know-how and capacities relevant to projects the KfW wanted to accomplish. These firms were then told to apply for credits for investments to get the job done.

Step by step, the KfW was allocated additional sums from the "counter-value fund," until 1953, and these funds were immediately used as the base upon which to issue new credits, and initiate new credit programs. Beginning in 1950, housing construction was one of the KfW's areas of special focus. Initial demand was estimated at some 5 million housing units. Because there was no free market for housing, refugees were assigned to the homes of other families, and the rents were fixed by the authorities.

Housing construction would not have moved ahead without state intervention. In 1950 alone, 350,000 homes were completed, every eighth one financed by the KfW. By 1956, some 3 million housing units had been completed, and government-subsidized public housing projects became an important pillar of the construction sector. In the 1960s, when more than 6 million new housing units had been completed, market conditions began to settle into the construction sector.

A 'financial multi-purpose weapon'

The West German government and the KfW were compelled, time and again during the reconstruction phase, to react to disruptions in economic development, and, thus also to improvise financing when necessary. For example, at Hermann Abs's initiative, the lower house of Germany's parliament, the Bundestag, decided in December 1951 to initiate a new special investment aid program for the basic-materials sector. Developments in this sector still lagged behind the rest of the economy, because profits were insufficient to cover the necessary investments. And if the production of coal and steel did not keep in step, this threatened to bring to a standstill production in the other industrial sectors.

According to the "Abs Plan," the booming consumer-goods industry was put under gentle pressure, to "persuade" it to invest a portion of its write-offs into bonds of a fund, administered by the KfW, from which the KfW then generated the credits for the raw materials industry. In addition, the Bank deutscher Länder agreed to issue short-term central bank credit as pre-financing for the program, so that the KfW was in position to issue the first investment credits, even before the Bundestag had formally passed the "Abs Plan" as law.

The KfW also played a crucial role in developing export markets for German industrial goods. It was not sufficient to raise the German level of production in order to re-establish a strong German position in foreign trade. Export business for German producers of investment goods became a calculable risk, only when accompanied by export credits and state credit guarantees. In March 1950, the KfW announced that the

"opening of financing opportunities for medium- and long-term export business is extremely urgent and of special importance for the economic reconstruction."

Therefore, new investment techniques for foreign trade had to be created, in addition to investment credits. The KfW granted exporters bills of exchange, so-called "Sola bills," for financing deliveries abroad, when the firm's own private bank liaisons were not able to do so. The Sola bill was, however, redeemable at the respective firm's house-bank (i.e., its private commercial or savings bank). In addition, the government guaranteed payment of the contract in the framework of the Hermes export credit insurance, in cases where the foreign customer did not pay.

Here again, the central bank played a crucial role. The Sola bill was provided with a rediscount promise from the Bank deutscher Länder, which expanded its rediscount volume for export bills, step by step, until it reached DM 1 billion in 1952. After that, the Ausfuhrkredit-AG (Export Credit Stock Company, AKA) was created to take this business off the hands of the KfW and the Bank deutscher Länder.

The German government sought to secure additional foreign contracts for German firms with bilateral trade agreements and the financing of large foreign industrial and infrastructure projects. An agreement with Yugoslavia, concluded in October 1950, was the beginning of this process. Germany agreed to deliver plant, equipment, machines, and apparatus for the mining, chemicals, electrical, petroleum, and wood industry to Yugoslavia, by the end of 1952. In return, during 1954-55, Yugoslavia delivered grain, ores, wood, and petroleum. The participating German firms received export credits from the KfW running for five years, with an additional federal government guarantee.

In 1958, for the first time, the KfW provided credits to foreign nations, with India among its first partners. Because the Indian government was unable to keep to the timing of the agreed-upon payments, which were for building the Rourkela steelworks, the KfW bought Indian Sola notes and pre-financed the Indian payments. In the 1960s, the KfW then emerged as a major credit-issuing partner for numerous large construction projects around the world, which naturally produced several thousands of high-skilled jobs in German firms in Germany itself. These included dam projects in Africa and the Mideast, railway construction in Indonesia, construction of nuclear power plants in Argentina and Brazil. Word had already spread far and wide that development aid projects in which the KfW participated, had a surprisingly high success rate—more than 75%.

Promotion of medium-sized industry

Once Germany's reconstruction was successfully completed, international capital markets opened once again for German firms and banks. The KfW has used this source of funds, from the beginning of the 1970s, in order to provide small and medium-sized businesses in Germany with long-term credit, under conditions that were otherwise the privileged preserve of large firms.

The declared aim of the "KfW Medium-Sized Industry Program" was to secure the medium-sized businesses' long-term investment capacity. Such firms would apply to their house-bank for long-term credit, and this bank would pass the application on to the KfW, unless the house-bank wanted to take full responsibility itself for issuing the credit. With this system, the KfW would be called upon only for financing those projects that the house-banks did not want to finance.

At the same time, this mechanism encouraged the private banks to provide most attractive conditions for their credits, in order to be able to keep the contracts they wanted. The interest rates stipulated by the KfW remained constant for the entire term of the credit, even if market interest rates rose drastically. And if interest rates dropped, the firm had the option of paying off the principle ahead of time. KfW credits usually ran for 10 to 30 years, with principal-free grace period of one to three years. To date, a quarter-million individual credits have been issued in the framework of the "KfW Medium-Sized Industry Program."

Post-unification reconstruction

In 1989, Germany was finally reunified with the collapse of the communist East German regime and the incorporation of its territory into the Federal Republic of Germany. Between 1990 and 1997, the KfW issued 722,000 private investment credits (chiefly to private households) in the new eastern states, with a total volume of DM 121 billion. This credit volume was seed-financing for DM 210 billions of investments, securing or creating 2.5 million jobs. In the framework of the KfW housing modernization program, 3.3 million housing units were modernized, which accounts for 40% of the total housing in the new states, of these 832,000 pre-fab units. The KfW participated in financing 4,200 infrastructure projects in the east of Germany.

Today, 50 years after its founding, the KfW is one of the largest banks in Germany, with a balance of DM 315 billion. In 1998, the KfW promoted the German economy with credits amounting to DM 65 billion. Of this sum, DM 48.4 billion went toward financing investments directly in the German economy, including DM 20.4 billion of small- and medium-sized firms; DM 15.2 billion was for housing construction; and DM 6.5 billion was for communal infrastructure. An additional DM 13.1 billion was allocated for export and project financing in other countries, and DM 2.7 billion for support of developing countries.

The investment credits for firms generated some 1 million jobs and created 60,000 new jobs. In addition, 240,000 jobs in the construction sector and related firms were secured by KfW activities in infrastructure projects and housing construction.