With Greek debt negotiations at a critical phase it is time for Germany to end its policy of ‘muddling through’

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The Greek government is currently attempting to negotiate a deal with other Eurozone states over the country’s debt. **Joshua Aizenman** *writes on the approach of Germany throughout the crisis. He argues that the German government’s perspective is best characterised as a form of ‘muddling through’, whereby stronger action to solve the Eurozone’s instability is only advocated when Germany’s domestic priorities become threatened. He states that greater willingness for debt concessions tied to deeper structural reforms, as well as more aggressive policies aimed at hitting the ECB’s declared two per cent inflation target, would offer the best route out of the crisis.*

From the get-go, the formation of the Eurozone was driven more by the political vision of its founding fathers than by an economic cost-benefit analysis. The economic gains from ‘maturing’ the EU into a monetary union were overhyped, ignoring the questionable assessment of these gains by prominent non-European economists.

Yet, not all problematic marriages should be terminated – while the formation of the Eurozone was probably a mistake, dissolving the Eurozone now may be another, possibly even costlier mistake. Putting the Eurozone crisis in its proper historical context, the euro area is a ‘baby union’ facing its first maturing crisis. This process is painful, as has been the learning process for other unions.

The Eurozone: time for Germany to lead?

The presumption in the 1990s was that adopting the euro would provide a more symmetric structure to Europe and contain the fear of German hegemony. The 2006 speech by Otmar Issing, former Chief Economist and Member of the Executive Board of the European Central Bank, entitled “The euro as a currency without a state”, exemplified the buoyant assessment of Eurozone achievements at that time, while ignoring the gathering risks

These risks materialised shortly after the ten-year anniversary of the Eurozone, which was marked by a celebration of the single currency’s ‘achievements’. Today, the euro remains a currency without a state, under the growing dominance of Germany: a country that might stabilise the Eurozone if it avoids shirking its growing responsibility for the euro’s future. This would require Germany to invest more in upgrading Eurozone institutions and balancing its substantial gains with the economic and political responsibilities that come with them.

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Indeed, the challenges associated with managing the growing fragility of the euro may induce a reluctant Germany to face a stark trade-off: the vibrant growth of Germany, while running large current account surpluses under a pegged exchange rate with the other Eurozone countries, may come to an abrupt end if the Eurozone unravels. Germany has not yet been exposed to the full costs of the macro straightjacket associated with the euro.

The economic benefits of the Eurozone to Germany, as well as to Greece, Italy, Ireland, Portugal and Spain (GIIPS) were frontloaded. The boom experienced in GIIPS countries in the first decade of the Eurozone was magnified by the economic strength of the Eurozone core, the under regulation of borrowing by private banks and states, and by the so called issue of 'moral hazard' – the conjecture that the growing costs of unwinding the euro will induce bailouts further down the road.

The Eurozone crisis forced the GIIPS countries to confront the costs of their earlier, excessive borrowing. In contrast, beyond the growing balance-sheet exposure of its financial system, Germany has not yet been fully exposed to the downside risk of higher unemployment and lower growth that has already hit most of the Eurozone countries. While there is no doubt about the relative efficiency of the German labour market, it has also benefited from the advantage of running a sizable current account surplus under a fixed exchange rate with its Eurozone counterparts. Germany's resilience and dominant size within the EU may explain its 'muddling-through' approach towards the Eurozone crisis – doing enough to prevent the unravelling of the Eurozone, while resisting policies that may mitigate the depth of the crisis if they involve short-run costs to Germany.

A manifestation of this approach is the asymmetric deflationary bias of the ECB's inflation targeting, a policy akin to targeting Germany's inflation rather than targeting inflation for the whole of the Eurozone. This deflationary bias induced debt deflation, pushing the Eurozone toward a Japanese style 'lost decade'.Another manifestation of Germany's muddling-through approach is the prevalent German view that its persistent current account surplus is a reflection of the country's efficiency and is independent of the adjustment challenges facing the global economy, the Eurozone, and the countries in the Eurozone periphery.

Yet, at times of global deflationary pressure, global employment is not a zero sum game — higher investment and lower saving in any large surplus country would help in mitigating global protectionist threats and underemployment pressures. Ironically, Germany's attitude toward the Eurozone resembles the attitude of the United States toward the Bretton Woods system in the 1960s – benign neglect of the growing tensions, which led to the ultimate demise of the system, while the new (i.e. Richard Nixon's) U.S. government "took no initiative to do anything about the monetary turmoil as long as it did not see its domestic priorities endangered by the market". The chances are that unravelling the Eurozone would be much more costly than the end of the Bretton Woods regime.

The growing clout of Germany in the Eurozone put the country in the role of agenda setter, having the capacity to facilitate the convergence towards a deeper financial union. Yet, such a convergence requires paying greater attention to the growing cost of debt overhang. This concern applies well beyond the GIIPS countries' external borrowing: by now most Eurozone countries are burdened by the total debt overhang (private and public) approaching or exceeding twice their GDPs, increasing the drag on economic growth at times of deflationary and austerity policies.

European history during the 20th Century has vividly illustrated the economic and political risks of debt overhang – the post WWI *Treaty of Versailles* imposed a large debt overhang on Germany, ignoring Keynes' concerns in his *The Economic Consequences of the Peace* manifesto, destroying down the road Germany's middle class, at Europe's peril. In contrast, the post WWII policies allowed Germany and Western Europe faster recovery by avoiding trapping Europe into another debt overhang cycle.

Looking forward, the risk of pushing Eurozone countries further on the wrong side of the debt ' Laffer curve' would be mitigated by a greater willingness for debt concessions tied to deeper structural reforms, as well as more aggressive policies aimed at hitting the ECB's declared two per cent inflation target. Such a big push is needed in order to terminate the risky and aimless muddling through, on the way towards a more stable Euro-Union. It is better for Germany to assert leadership than for the country to be forced to act.

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