The Political Economy of the Euro Crisis: False Mental Models, Interest Groups, and Time Inconsistency Problems

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Phase I Creation of the Euro

False Mental Models (FMMs)

1. Bicycle Theory: Need continued progress to avoid falling back
   - The most important geopolitical gains already secured

2. Thought monetary integration just like trade and financial integration (didn't understand OCA theory).

3. Overoptimism about neo-functional spillovers (endogenous OCA)

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Time Inconsistency

- Front loaded benefits,
  major costs come later.

- Interest groups in deficit countries played small role.
  Euro creation was driven by elites for geopolitical objectives.

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Phase 2 The Rules for the Euro

FMM

- German objective: avoid disequilibrium from
  1. Inflation (ECB) (worked)
  2. Fiscal excesses (Growth and Stability Pact) (didn't work)
  3. Entry of Southern European countries (Entry Criteria) (didn't work)

- They overlooked other problems:

  No mechanisms established for dealing with

  - Private sector disequilibria
  - Financial crises

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Phase 3 Operation of the Euro & Development of the Crises

1. Growth and Stability Pact undercut when France and Germany ran excess deficits.

2. Private sector disequilibrium

   A. Housing Bubbles

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B. Growing loss of competitiveness in countries like Greece & Italy and Growing competitiveness in Germany

- Current Account Deficits (2006-07)
  - Spain and Portugal (9-10% of GDP)
  - Greece (11-14%)

- Fiscal Deficits
  - Ireland and Spain – surplus
  - Portugal and Spain (2-4%) and falling
  - Greece (6-7%)

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C. Financial Markets

- Provided easy financing rather than discipline until crises broke out.

  [capital flow surges and sudden stops a la emerging markets]

- Spreads on sovereign debt didn’t start to widen substantially until 2008

Phase 4 Crisis Responses

Interest groups

- Interest groups contributed to growing disequilibria
- Interest groups made reforms difficult
- Public awareness in surplus countries limited options for financing
- Collective decision making
  - Problems of the unanimity rule.

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TIs

1. Officials consistently misdiagnosed the causes and underestimated the magnitude of the problems.
   - Pure liquidity versus solvency (wishful thinking)
   - Blame on excessive pessimism of financial markets and rating agencies [speculators trying to bring down the Euro]

2. Doctrine of expansionary fiscal contraction.

Efforts to calm markets by committing to longer run costs and/or trying to hide problems

3. Guaranteeing debt (caused Ireland's huge fiscal deficit)

4. No default mantra

5. Repeated statements by leaders that they would do "Whatever it takes to save the Euro" without making sufficient actual commitments (soon undermining credibility)

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6. Crisis countries agreeing to austerity and reform plans that weren't implemented sufficiently (again undermining confidence)

7. Decisions to increase the headline size of EFSF without putting in more money

8. Announcing much too small haircuts on Greek debt (Approx. 21%)

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9. Later attempting to impose large “voluntary” haircuts on Greece without this being a credit event.

10. Not facing up to the problems of the major banks until very late (Bogus ‘rigorous’ stress tests).

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Phase 5 Resolution of Crisis

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