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NOTES ON

The Roles of False Mental Models and Time Inconsistency Problems in the Generation and Prolonging of the Euro Crisis

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THEME

The central theme of this paper is the role played by false(or at least questionable) theories or mental models and time inconsistency problems in contributing to the generation of the euro crisis and the ineffective policy responses to attempt to deal with the crisis.²It is not argued that these are the only factors, only that they are important ones.

The paper also highlights the relevance of some of the biases in decision making pointed to by the recent literature on behavioral and neuro economics and finance

¹ Thomas.Willett@cgu.edu I have discussed the failure of the euro zone to generate strong endogenous effects in the areas of fiscal policy coordination and labor and product market flexibility in "The Failure of "Endogenous OCA Analysis and the Early Euro Experience," (with Orawan Permpon and Clas Wihlborg), *The World Economy*, Vol. 33, No. 7, July 2010: pp. 851-872. and analyzed the evolution of the problems leading to the Euro crisis in "The Euro Debt Crisis: It isn't just fiscal" (with Clas Wihlborg and Nan Zhang). *World Economics*, Vol. 11, No.4, October-December 2010. and "Verities of European Crises" (with Clas Wihlborg), in Gerald Caprio ed *The Encyclopedia of Financial Globalization*(forthcoming).

² Time inconsistency problems refer to situations where actions have substantial differences in the ratio of their costs to benefits over time combined with short time horizons(high time rates of discount. These differences between short term and long term effects can lead decision makers to make decisions that are inappropriate from a long run perspective.

and discusses how the euro experience fits with a number of theories from public choice and international political economy.

PRIME EXAMPLES

1. One of the most fundamental faulty mental models, was the view, held especially strongly by German officials, that excessive money creation and fiscal deficits were the only major problems to worry about in the operation of the euro. These are certainly important areas of concern but far from the only. While Greece's huge budget deficits have received most of the attention its economy would be having severe problems even without these deficits. A growing loss of competitiveness had led to a current account deficits running 7 to 10% of GDP before the global financial crisis hit. While these large current account as well as budget deficits had been funded easily by private capital flows during the heady early days of the euro, when these began to dry up huge financial problems emerges. Capital flow surges and sudden stops proved to be problems not limited to emerging market countries. Rather than having an internal adjustment mechanism that primarily promoting convergence, the euro zone found a great deal of divergence.

Portugal and Spain also developed huge current account deficits ranging up to 9% for Spain and 10% for Portugal.. Ireland and Italy ran only small current account deficits.

On the fiscal side Portugal ran substantial deficits, although not of the Greek magnitude while Ireland and Spain were running surpluses.

Easily available, cheap financing from the financial markets also helped fuel huge housing bubbles in countries like Ireland and Spain

2. The major political advocates for the creation of the euro did not understand that monetary integration is fundamentally different from trade and financial integration. A common currency takes away the ability of member countries to pursue independent monetary policies. The costs and benefits of alternative exchange rate cum monetary policy strategies are explored in the literature on the theory of optimum currency areas. While this literature has by now identified over twenty factors that may influence these cost benefit ratios most of these can be grouped under three main headings. Since the primary issue is whether domestic monetary policy should be aimed at stabilizing the exchange rate or the domestic economy, the relative sizes of the domestic and external sectors are obviously relevant. (This also affects the effectiveness of exchange rate adjustments). A second crucial factor is the degree of flexibility of the domestic economy and the third is the pattern of disturbances that hit the economy.

SOME BACKGROUND:

Policy developments both in the early stages of the European project and the creation of the eurozone were driven by political elites primarily seeking political objectives. Economic interest groups played only a fairly minor role. Interest groups, however, played a substantial role in blocking the reforms to control government budgets and make economies more flexible that were needed for the euro zone to work well.

In testing explanations that focus on the role of ideas or mental models it is important to distinguish between their roles in motivating actors versus how well they work out in practice. For example:

Beliefs in neofunctionalism played a role in policy formation but didn't work out well in reality.

OCA theory was ignored in policy decisions, but proved highly relevant in reality.

One frequent criticism of arguments that ideas are important is that they are merely a mask for interests. This certainly often occurs, but in complicated situations perceived interests are a function of agents' views of the world and thus can have an independent influence on behavior.

The interests argument is commonly applied to fairly obvious economic and/or political interests. In the case of the creation of the euro, however, it was not primarily self-interested motivations but geopolitical objectives-to tie Germany strongly to the rest of Europe so that new intra European wars would become unthinkable- that were the primary motivations of the political elites that drove the process. (Of course for the political leaders the prospective prestige of historic actions also likely played some role.) Rather than ideas or mental models being just masks for narrow interests. the major biases at work in the creation of the euro were the beliefs of the elites that involved wishful thinking about how the process would operate. It is this tendency to fit one's positive views of how the world will work to one's normative views of how one would like the world to work is a

frequent cause of the adoption of the faulty mental models discussed in this analysis.

MAIN STORY LINES OF THE CRISIS

The Four Fundamental Phases:

- 1 Creating the euro was a mistake, at least for a large zone.
- 2 The institutional mechanisms set up to govern the operation of the euro zone had several major problems.
3. The proximate causes of the crisis from the defective operation of the euro zone: Not just fiscal. Also growing lack of competitiveness in several countries financed by overly optimistic banks and financial markets and huge housing bubbles in a number of countries

Elaboration on 1

Major reasons for creation of the euro

- 1 Continuation of the geopolitically motivated European project to one area too many. (last generation of German leaders who would put such emphasis on this)
2. French wanted this since they'd already given up monetary independence to the Germans when they decided (wrongly) that exchange rate adjustments were no longer effective. Both symbolically and substantively giving up monetary sovereignty to the euro was preferable.
3. This was the price demanded by others for German reunification (They feared the increased power they thought this would give Germany so they required an

offset). In exchange Germany was given the major say in setting up the rules for the ECB and fiscal limitations.

Elaboration on 2

There was a lack of ways to enforce the institutional framework that was created and a failure to create mechanisms to deal with several major potential problems:

A. The convergence criteria weren't effective in limiting membership to the strong core countries.

B. Lack of surveillance mechanisms for non fiscal disequilibria

C. Lack of mechanisms for dealing with potential financial sector problems and with financial crises.

Note--The argument that the euro was created on "a big lie" that you could have monetary union with out fiscal union is overstated. The hope was that the fiscal restraints in the Growth and Stability Pact would be sufficient to avoid the need for further fiscal integration.

PHASE 1 THE CREATION OF THE EURO

FALSE MENTAL MODELS (FMMS)

1. Belief that it was essential to follow economic integration with monetary integration in order to maintain the geo political benefits (peace in Europe) from the European project. The additional geopolitical benefits were likely to be largely infra marginal These views were also at least partially based on the "bicycle theory" of

European integration under which if you weren't continually moving forward you would fall back.

2. Lack of understanding that monetary integration was fundamentally different from trade and financial integration, i.e., Not understanding optimum currency area (OCA) analysis and /or believing that sufficient endogenous responses would be generated to make the currency union workable (neo-functionalism spill over theory and endogenous OCA theory)

TIME INCONSISTENCY ISSUES (TIs)

Benefits of appearing statesmanlike and initial economic effects of creating and joining the currency union tend to come first while the major costs come later.

On the economic side this is an example of exchange rate based stabilization where the benefits of lower interest rates and inflation and the costs of overvaluation and crises come later. (Some ERBS programs are successful but many fail).

This economic time inconsistency problem was partially offset by the entry criteria which required some early pain for a number of countries.

PHASE 2 THE CREATION OF THE EURO ZONE INSTITUTIONS AND RULES

Many of the provisions were well considered. For example the ECB has had a very good track record on inflation.

There were some major flaws, however.

FMMs

1. The belief that the only major causes of serious disequilibrium would be from inflation and fiscal excesses, i.e., the idea that only the public and not the private sectors could be a major source of disequilibrium, hence the primary focus on the GSP and not enough on improving domestic economic flexibility, (structural reforms). (The need for such policies were of course noted but little was done to force their implementation). There was a failure to sufficiently appreciate political economy considerations, i.e. the strong interest group pressures against such reforms.

2. Excessive belief in the enforceability of

A the entry criteria (Germany and France didn't envision that the southern European countries would be able to join),

B The Growth and Stability Pact (GSP)and

C that financial markets and the no bailout clause would provide sufficient discipline.

3. The belief that it wasn't necessary to deal before hand with lender of last resort and potential bailout issues. This was presumably due to a combination of hopes that such provisions wouldn't be needed and desire to avoid complicated and potentially contentious negotiations over them. The fear that having such provisions would generate moral hazard was also relevant.

TIs

1. The costs of structural reforms tend to be front loaded relative to the benefits.

2. The political costs of enforcing the GSP tend to come first while the benefits of keeping the system working are longer term.

3, The domestic political costs of acknowledging how much non monetary co-ordination would be required would come up front while the benefits of the smoother operation of the system would be delayed.

PHASE 3 THE IMPLEMENTATION AND OPERATION OF THE EURO ZONE

Violations of the fiscal rules by Germany and France made it hard to enforce them on other countries. The institutions had insufficient independent power to force compliance and governments found it difficult to enforce measures against each other. Considerable creative accounting was allowed and in the case of Greece false statistics were not caught.

While some useful reforms to increase countries' economic flexibility took place these were far from sufficient to provide an effective adjustment mechanism. The combination of reform fatigue and political opposition to reforms undercut the arguments from neofunctionalism and endogenous OCA theory that such reforms would continue at a rapid pace.

A second version that "crisis will bring the reforms" is being tested now.

Contrary to officials' expectations considerable non fiscally generated disequilibria emerged with wages and prices in countries such as Greece diverging rather than converging to those in countries like Germany. (Ironically Germany displayed much

stronger endogenous responses to improve competitiveness than did countries like Greece.

Financial markets rather than being a strong force for providing early discipline helped the continued financing of both balance of payments disequilibria and housing market bubbles at low cost. There was widespread euphoria and interest rates in Greece dropped to barely above German levels.

The considerations now being explored in the literature on behavioral and neuro finance help explain this.

Most of the false mental models that contributed to the subprime crisis in the US were in play.

PHASE 4 INADEQUATE RESPONSES TO THE CRISIS

One rescue effort after another has failed to provide more than temporary relief. Promises by European leaders to do whatever it takes to defend the euro have steadily lost credibility as they are followed by band aids. Political squabbling among European leaders has also greatly hurt confidence.

FMMs

1. As with the US, officials initially tended to substantially underestimate the magnitudes of the problems and treated them primarily as liquidity problems when there were also solvency problems. (This is easy to explain in terms of cognitive biases that lead us to see things as we'd like them to be and liquidity problems are much easier to deal with than solvency one). This led to persistently

insufficient responses in terms of financial fire power. For the same types of reasons officials were extremely slow to face up to needed large recapitalization of the major banks and to insist that there would be no sovereign defaults. Not surprisingly these inadequate responses and the very public squabbling among political leaders hurt rather than enhanced market confidence, making the crisis worse.

2 The particularly German view that the only serious problem was due to fiscal excesses and that the answer was fiscal contraction. Politically unrealistic reforms were imposed to be implemented rapidly. The insufficient progress toward meeting these goals further undermined confidence.

3. The belief in expansionary fiscal contraction became gospel among a number of European governments. This was a convenient belief for countries like Germany since then there would be no conflict between their moral views that the Greeks should pay dearly for their past excesses and efficient responses to the crisis.

The evidence suggests that fiscal contraction will have an expansionary effects on an economy only under a very limited set of conditions that did not apply here. The severe budgetary contractions made recessions worse and therefore often led to increased budget deficits. in the short run. There is no question that budgets needed to be brought under control, but timing and political feasibility considerations were given far too little weight.

TIs

1.The moves to guarantee bank debt and insist that there would be no sovereign defaults helped reduce contagion in the short run but generated huge costs in the

longer run(which didn't take very long to start showing up) The huge Irish fiscal deficits came primary from the government's bank guarantees. Prior to the crisis Ireland had been a model of fiscal responsibility.

2. The strategy of EU leaders to announce that they were committed to doing whatever was needed to save the euro but without backing this up sufficiently with detailed plans and actions allowed agree among the leaders in the short run while papering over substantial disagreements among them. Initially such announcements had short run favorable calming effects but the continues lack of adequate follow through began to substantially undermine the credibility of the EU governments.

3. The long delays in officially recognizing the substantial need to shore up the major European banks and the weak stress tests of the banking authorities likewise initially had some confidence building effects and allowed governments to keep from making their publics aware of the potentially large fiscal costs that might be involved, but again over the longer run could not be avoided and undermined confidence. (Shortly before they failed, the major banks in Ireland had passed what officials called rigorous stress test). Such actions were likely due to a combination of both wishful thinking and time inconsistency incentives.

4. The announcement of large headline figures for increasing the size of the rescue funds without actually butting up more money had very short term favorable effects which dissipated quickly. Plans to do this via leveraging through what would be in effect Collateralized Debt Obligations(CDOs) with sales to the public and perhaps outside governments like China have ended up also undermining confidence by showing the limited willingness. or ability given strong domestic opposition. of euro

zone governments to actually back up their pledges of being willing to do whatever it takes to save the euro.

5. The plan to induce financial institutions to take 50% haircuts on their Greek debt with having this called a default again lowered the costs to governments in the short term but further undermined confidence and could end up killing the insurance market of Credit Default Swaps for sovereign debt.. What good are such contracts if you're hit with a 50% loss and they don't pay out? (Some officials would be happy with destroying this market and have argued that CDSs, along with other forms of evil speculators who want to destroy the euro and ill informed credit rating agencies that inappropriately downgrade European government debt ratings have been a major cause of the crisis but while its not possible to prove that such agents haven't been excessively at times, during the crisis their evaluations have clearly been much closer to the mark than those of official pronouncements).

NOTES ON IMPLICATIONS OF THE CRISIS FOR THEORIES OF PUBLIC CHOICE AND INTERNATIONAL POLITICAL ECONOMY

In terms of methodology many of the arguments made here are quite consistent with rational choice models and some are consistent with the emphasis of realist models international relations on geo-political concerns as major motivators of national policies. as well as their frequent assumption that domestic politics plays little role in international policy formation .

While some interest groups (primarily multinational firms and financial institutions) played a role in lobbying for monetary union, the euro's creation was pushed primarily by elites for geo-political reasons. It's clear that the German public didn't want to give up the DM so median voter theory certainly didn't apply there although it did with the limited number of referenda on the euro.

When it came to implementing the terms of the GSP, domestic political considerations did come to the fore as they did again with the domestic opposition to large commitments for financial aid during the crisis.

Likewise some important aspects of the creation and operation of the euro zone are consistent with neofunctionism particularly in terms of it having a strong influence of many promoters of the euro, but these views turned out to be wildly overoptimistic in terms of the strength of such forces to prompt sufficient reforms to avoid the crisis.

Here public choice's emphasis on the role of interest groups has considerable explanatory power. Most of the rigidities in European economies weren't there because of stupidity but because politically important interest groups benefited from them. Such interest groups also explain a good bit of the pressures for fiscal expansion and the opposition to fiscal contraction.

The evidence runs against optimistic views of how strongly multinational institutions and agreements can force changes in national behavior where this would generate considerable domestic political costs such as often occur with substantial budget cutting. This experience is partially consistent with a neorealist institutionalist perspective that where less powerful countries are the violators,

then international agreements can have some bite, but not when the major powers such as France and Germany are the violators.

It is too soon to tell whether its prediction that the crisis will lead to much stronger political and fiscal integration will prove correct. The crisis has certainly led to increased advocacy of such increased integration, but strong opposition has been voiced as well.

The consistency of my story with rational choice models is only partial. All too frequently rational choice analysis assumes that actors know the true model. If our analysis is correct, however, the strong form assumption that this is always the case is not consistent with the euro experience. Nor do the adoption of all of the ideas or mental models that we have discussed appear to be fully dependent on countries' structural positions. On the other hand such considerations were at times important. For example the abolition of capital controls made the old compromise system of Europe's Exchange Rate Mechanism highly crisis prone a la the one way speculative option and unstable middle arguments. This forced a starker choice between hard fixes and more flexible exchange rates.

Likewise the French government's questionable belief that structural change had rendered exchange rate devaluations highly inflationary and ineffective contributed importantly to the decision to in effect peg to the German mark. In turn once this structural policy change occurred the major cost of creating a common currency, the loss of independence for domestic monetary policy had already become operative so that there was little if any further cost to going to a common currency.

Furthermore the creation of a common currency would mean that monetary policy

wasn't made unilaterally by Germany with both substantive and symbolic benefits for France.

Our analysis is not consistent with the strong forms of rational choice theory that assume that agents behave as if they engage in careful analysis of the costs and benefits of investing in knowledge and analysis before making decisions. The amount of analysis leading to the adoption of a number of the ideas and policies discussed here was often quite scanty.

Likewise while the focus on short up costs and benefits is consistent with rational time inconsistency analysis, a good deal of the government behavior discussed as well as that of financial markets is consistent with a number of the behavioral biases identified in the literatures on cognitive psychology and neuroscience that have started to be emphasized in the growing literature on behavioral and neuro economics and finance.

Lastly our emphasis on the role of ideas gives much of our analysis a flavor of constructivism. While I *am* quite skeptical of many of the stronger claims made by some of its advocates our analysis does not support the view of some critics that the adoption of ideas is almost always determined by rational choices based on underlying structural conditions.

I also do not agree with the claims of some critics such as Andrew Moravcsik that to be accepted constructivism must make novel predictions that fit the data better than other theories. This implies a bias in favor of privileging other theories. Where two theories have the same predictions we cannot scientifically choose between them.

This allows advocates of different approaches to continue to espouse them, but denies them the right to claim that only their theory can explain the data.

Theory testing certainly should play an important role in professional activity and this requires the search for differences in the predictions of different approaches. However, exclusive focus on such objectives unduly narrows the scope of productive research.

For many purposes analytic narratives of important experiences are of considerable value. This indeed is the objective of this analysis.. An exclusive focus on theory testing would lead to a scholar missing many of the most important events in the search for differences in testable predictions. I hope I've made clear in this analysis that many approaches in economics and international relations and comparative politics theory can make a contribution to explaining developments and that none of them have full explanatory power.

Case studies can often provide useful data for efforts at middle level or contingent theorizing that focus on the conditions that influence the comparative explanatory power of different theories or considerations.