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The political economy of the Euro crisis: Cognitive biases, faulty mental models, and time inconsistency☆

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ABSTRACT

This paper discusses a number of major factors that led to the euro crisis and the failure of officials to deal with it effectively. It is argued that a good deal of these deficiencies in policy can be explained by a combination of faulty mental models, time-inconsistency problems, and cognitive biases such as wishful thinking. The project of European integration has brought great economic benefits and fulfilled the founders' hopes that the European economies would become so tied together that war would be unthinkable. In creating the euro, however, they failed to recognize that monetary integration is fundamentally different from trade integration and that the group of euro countries as a whole did not come close to meeting the criteria for an optimum currency area. Furthermore the institutional infrastructure created for the euro was far too weak to head off emerging problems and to deal effectively with the crisis once it broke out.

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1. Introduction and overview

This paper seeks to develop a better understanding of the major causes of the euro crisis and the reasons why the European policy responses have so often been inept. While concerns about the huge Greek deficits were the spark that provided a wakeup call to the financial markets a much broader set of problems had emerged. The euphoria surrounding the creation of the euro contributed to spending booms in a number of countries, especially on real estate, financed by easy credit generated by banks in the surplus as well as deficit countries. Rather than providing discipline over wage and price behavior the fixed exchange rates implied by the common currency were accompanied by substantial wage and price increases in a number of countries. This in turn led to large current account deficits. These were easily financed in the early days but as doubts emerged about real estate bubbles and the soundness of many private financial institutions as well as concerns about public debt the easy financing dried up and balance of payments crises were added to the picture. Wages and prices in the crisis countries have proven to be much less flexible that would be necessary for needed domestic economic adjustments to work efficiently and the result has been recessions and high unemployment in the crisis hit countries. While as of this writing in fall 2013 the turmoil in financial markets has calmed a good deal and concerns about threats to the continued existence of the euro area have eased the costs of the crisis on domestic economies remains high. While several of the crisis countries have returned to modest economic growth unemployment remains at record levels and real incomes and output are still well below pre crisis levels. This in turn has generated social and political crises in a number of countries.

While many factors interacted to generate this fiasco we focus on three types of considerations that we believe have been of particular importance. One is the well-known concept of time inconsistency, but applied to a broader range of issues than the inflation–unemployment dynamics to which it is typically used in macroeconomics. The other two types of considerations require going beyond the traditional economic assumption of well-informed rational actors. We emphasize both the influence of cognitive biases and the sometimes-devastating consequences of placing excessive faith in particular views of the world (mental models).[3]

In the view of many economists the project of creating a common European currency was doomed from the start. It failed by a substantial margin to meet the criteria developed in the literature on optimum currency areas (OCAs) for a currency area to generate net economic benefits and could impose enormous costs as we have now seen.[4] But while economic arguments were made that a common currency was needed to complete European economic integration this was more of a selling strategy to the public than the real reason which was the geopolitical[5] goals of elites – to continue

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[3] The precise meaning of mental models will be discussed in Section 2. We use faulty mental models as a short hand to include views or beliefs about positive analysis that prove to be wrong or at least questionable. We grant that not all experts will necessarily agree with all of our characterizations of the mental models that we consider faulty.

[4] It should be noted that OCA theory does not argue that common currencies are always a bad idea, only that a number of criteria such as having highly flexible economies should be met for the currency area to work well.

[5] Geopolitical refers to foreign policy considerations including national security as opposed to domestic politics. On the history of the European project and the creation of the euro see the analysis and references in McNamara (1998) Marsh (2009) and Marsh (2013) and Van Meddelmaar (2013).