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# On Lying, Risk Taking and the Implosion of the Euro

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ΑΠΟΥΕ ΠΕΘΑΙΝΕΙ  
Ο ΦΑΣΙΣΜΟΣ



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“THE launch of euro notes and coins at midnight tonight will create a new era of peace and prosperity for Europe and change forever the way its citizens relate to each other”  
- Wim Duisenberg, 31 December 2001

"The new money is evidence that the hundreds-of-years-old dream of a united, unified Europe has become more real" –  
Gerhard Schröder, 31 December 2001

“The central problem of depression prevention has been solved, for all practical purposes” – Robert Lucas,  
Presidential address to the American Economic Association,  
2003

# 18<sup>th</sup> April 2012...

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- “The marriage will be far too miserable. But it can endure”  
– Martin Wolf, “Why the Eurozone May Yet Survive”, op-  
ed *Financial Times*.

# Some strange features of a family drama:

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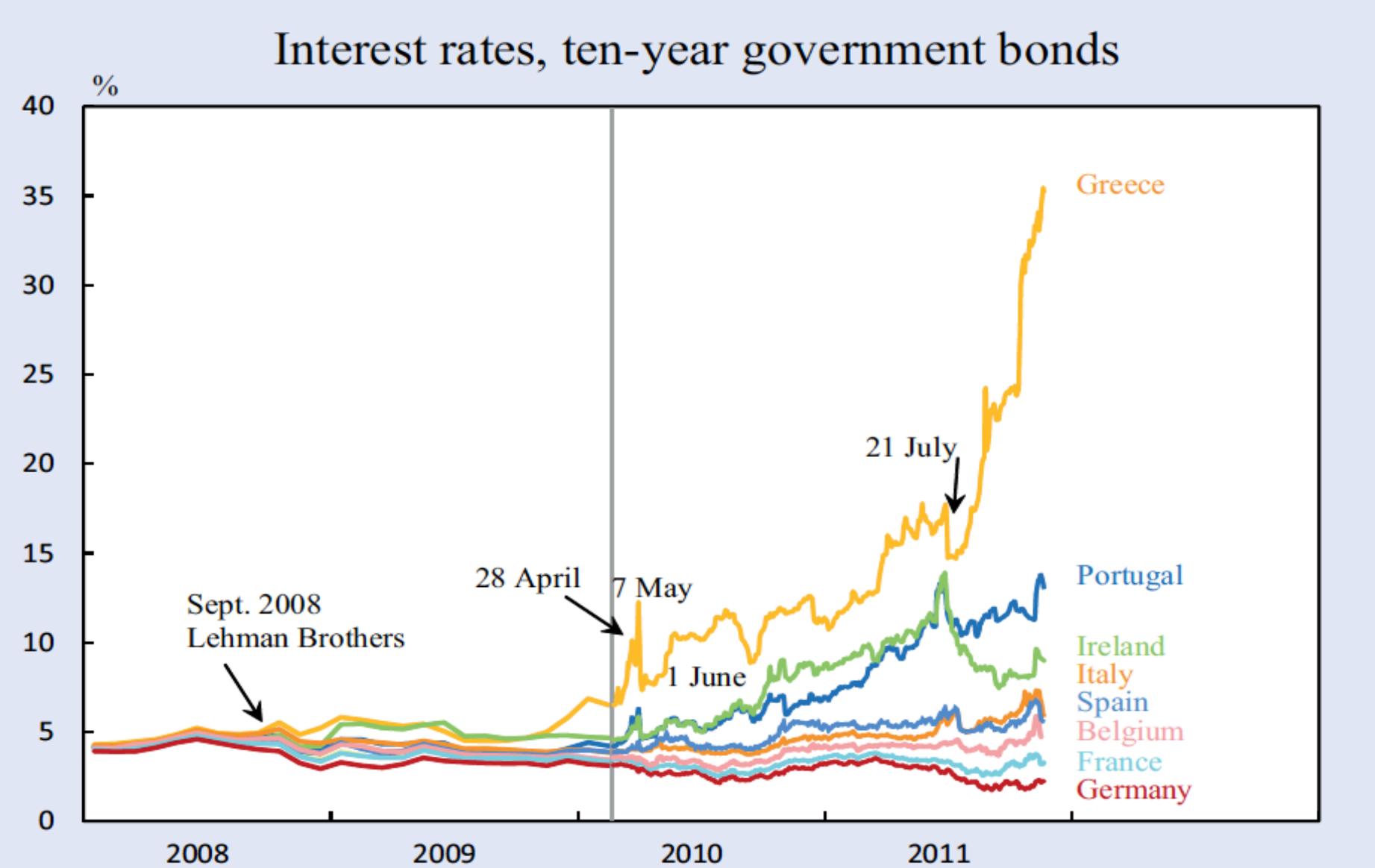
- A US state default (California?) would not threaten the dollar – why should the bankruptcy of a Eurozone country threaten the Euro?
- The eurozone (like the EU in general) is in external balance, is collectively entirely solvent, and should need no help from the IMF, China, Japan or anyone else
- There must therefore exist some internal settling of accounts that would resolve the Eurozone's problems without any largesse from the rest of the world – why can it not be found?
- The Greek economy produces < 3% of EU GDP (a fifth of California) – how has it come to pose an existential threat to the euro/EU?

# A moralizing storyline

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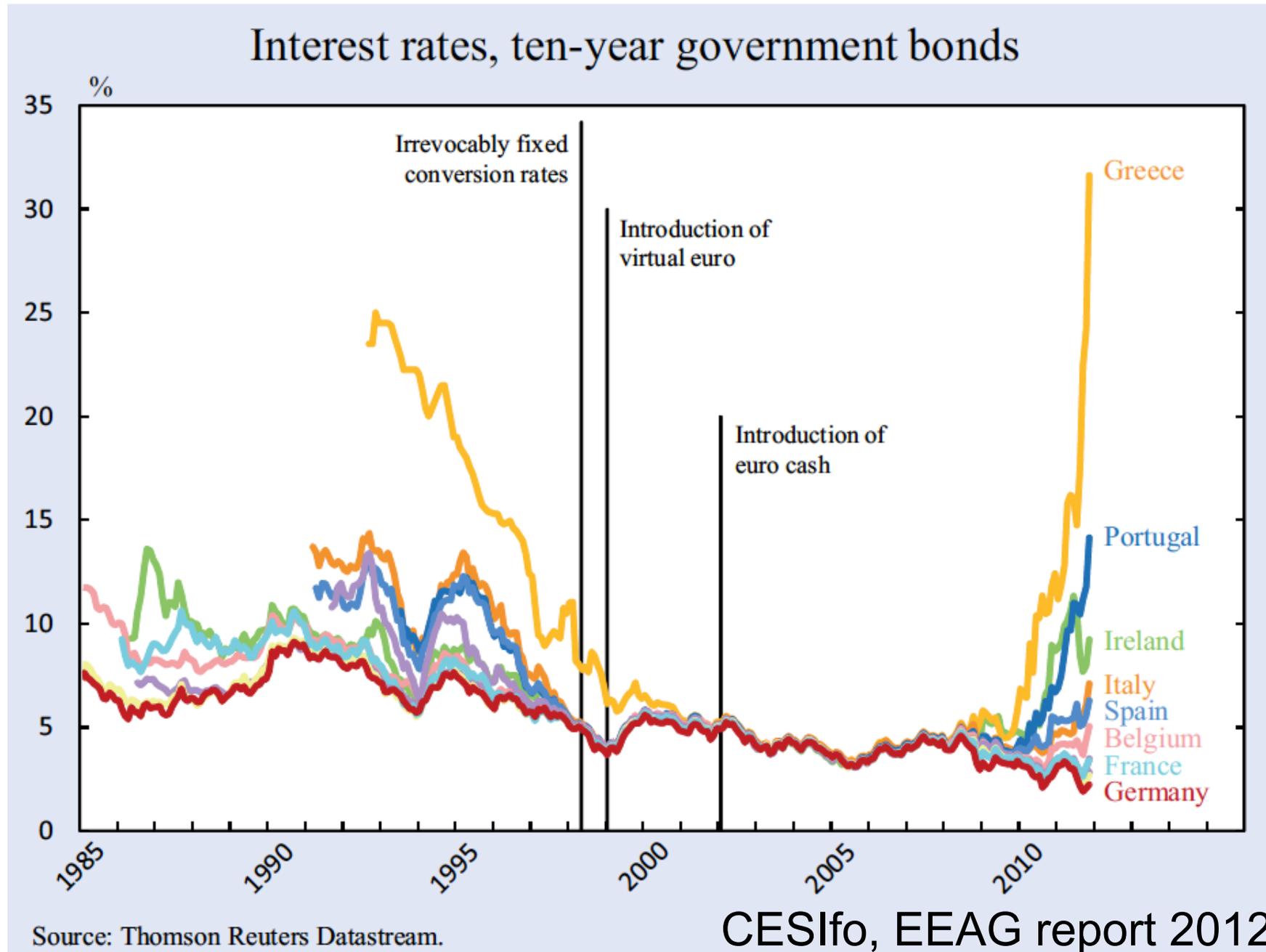
- “When we are in a crisis situation and others want to help you it is insulting to try to save one’s skin rather than to face one’s responsibilities,” Christian Estrosi (UMP), 1 November 2011
- "There are no words for how irresponsible this behaviour is towards their own people and also their partners in the Union". *Suddeutsche Zeitung*, 9 February 2012

# Fear and loathing in the bond markets:



Note: Monthly figures before, and daily figures after March 2010.  
Source: Thomson Reuters Datastream.

# Fear and loathing in the bond markets:



# Betting on an exit from the Euro: prices on Intrade

Closing prices chart

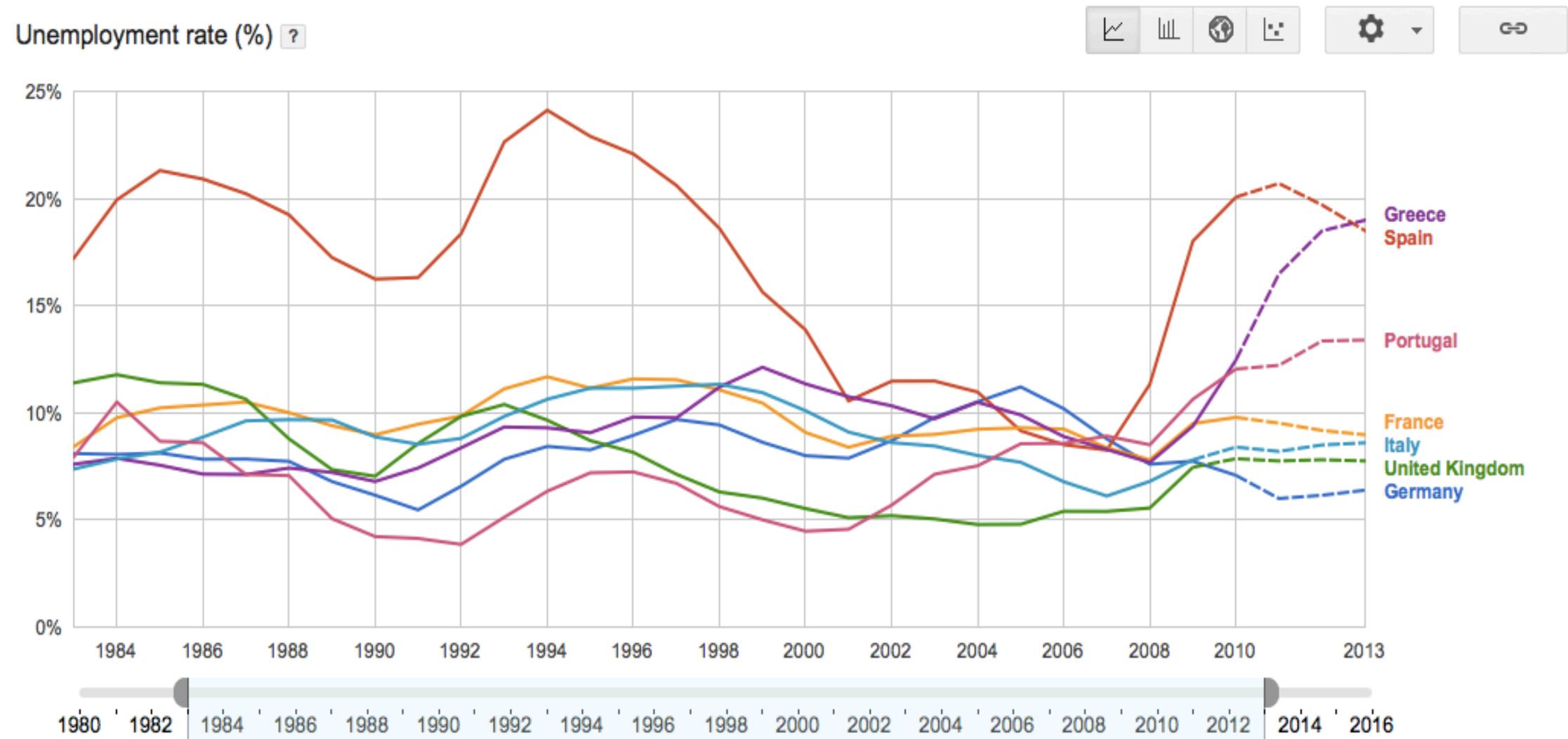
EURO.DROPPED.2014

Apr 10, 2010 - Apr 16, 2012



Source: [www.intrade.com](http://www.intrade.com) ©

# The return of mass unemployment in the Eurozone periphery



Data from IMF, September 2011 WEO Last updated: Nov 30, 2011

# Three sessions of family therapy:

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- Why didn't we see it coming? A first narrative
- Was anyone lying? And does it matter?
- Why didn't we see it coming? The illusion of panoramic vision

# (I) Why didn't we see it coming? A first narrative

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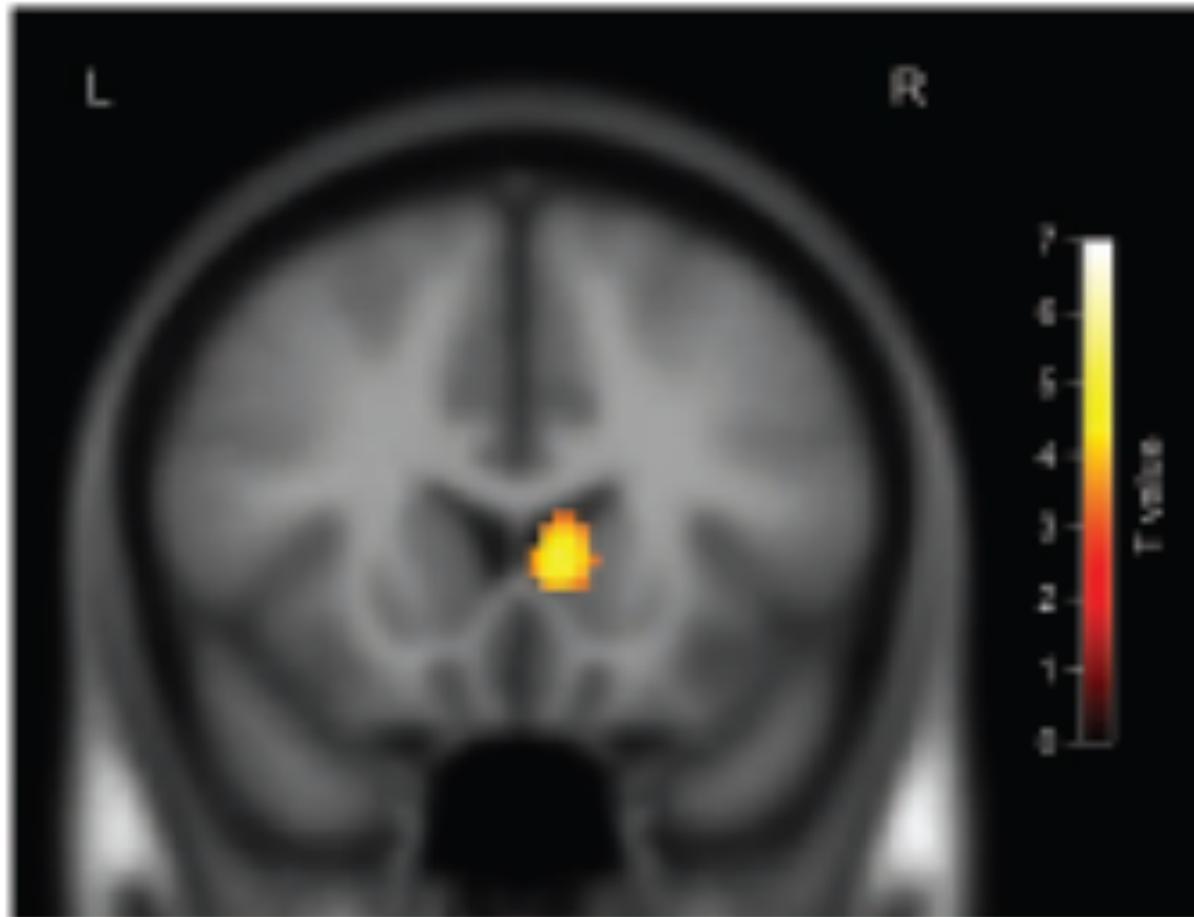
- Sincere promises, cynical lies
- Risky choices, safe harbors
- Commitment versus vigilance
- No single breach of trust
- The sleeping watchmen?

# The neural basis of altruistic punishment

(Source: de Quervain et.al., *Science*, August 27 2004)

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Activation in the caudate nucleus when subjects feel a strong desire to punish others for unfair behavior (compared to control when no such unfair behavior has taken place):



# (I) Why didn't we see it coming? A first narrative

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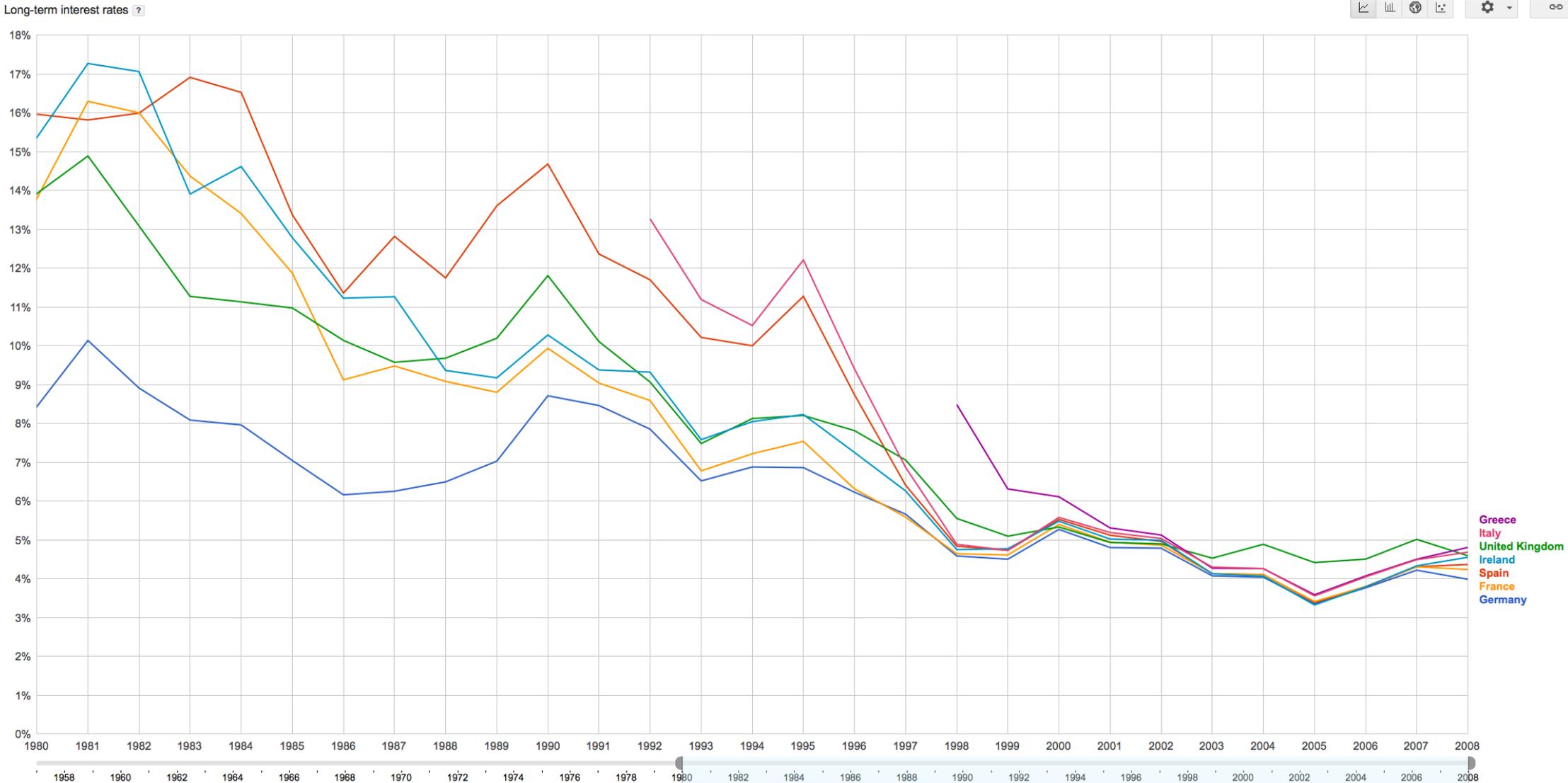
- Sincere promises, cynical lies
- Risky choices, safe harbors
- Commitment versus vigilance
- No single breach of trust
- The sleeping watchmen?

## (II) Was anyone lying? The promise...and the performance:

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- What exactly did the Euro promise?

# Long-term interest rates before and after the launch of the Euro



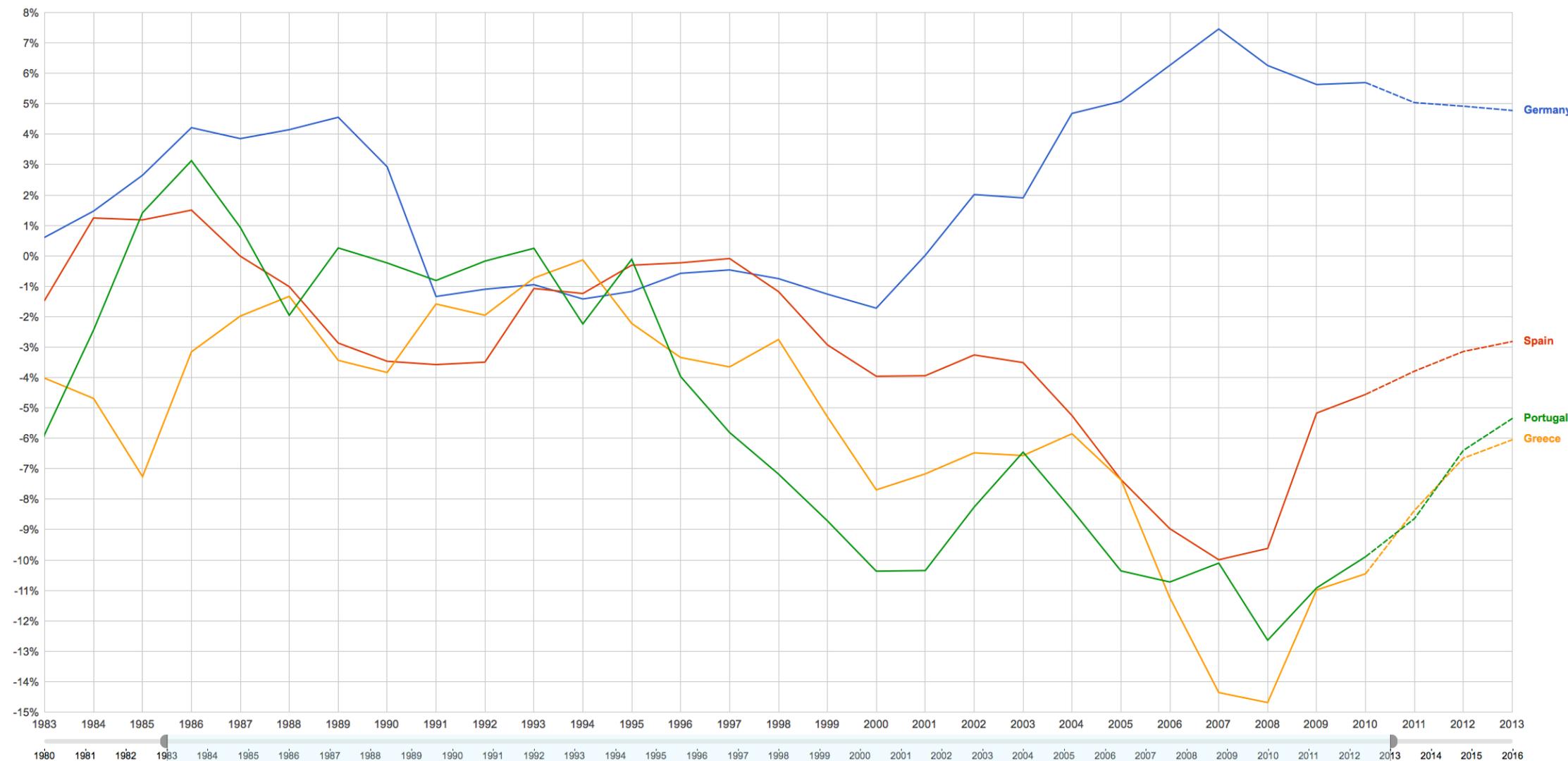
# The promise...and the performance:

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- And what did the Eurozone deliver?

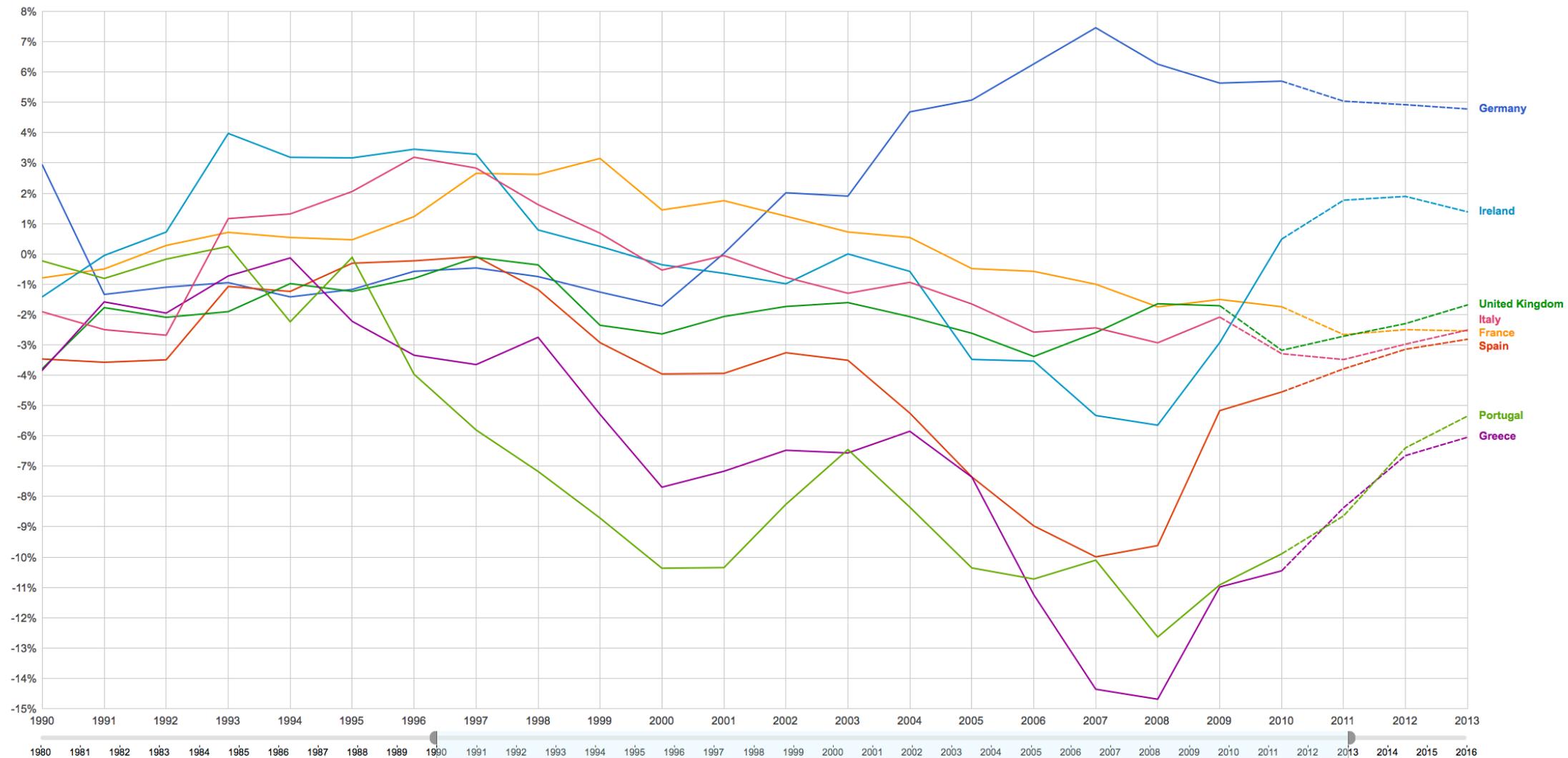
# Balance of payments as % of GDP, selected countries

Current account balance (%) ?

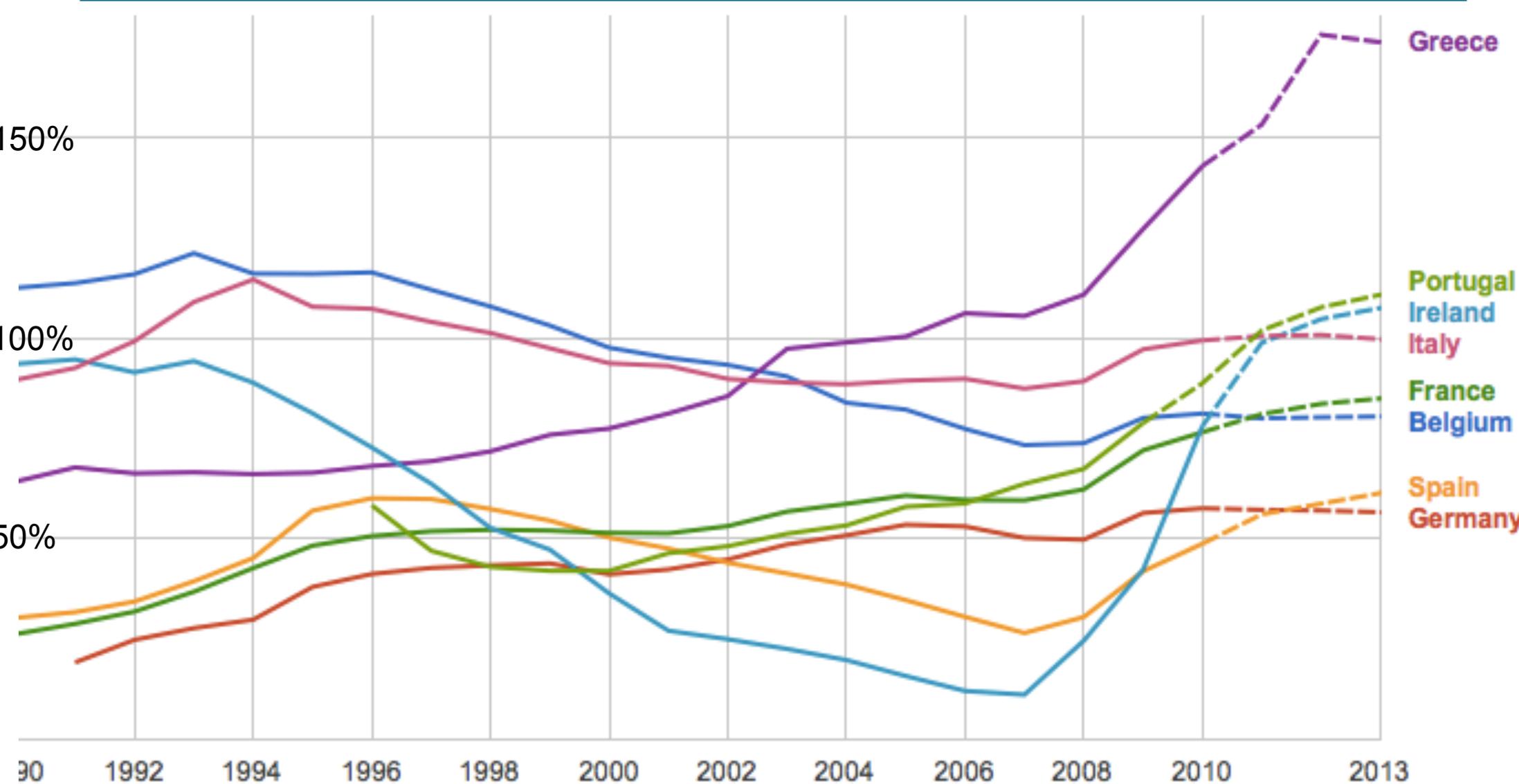


# Balance of payments as % of GDP, selected countries

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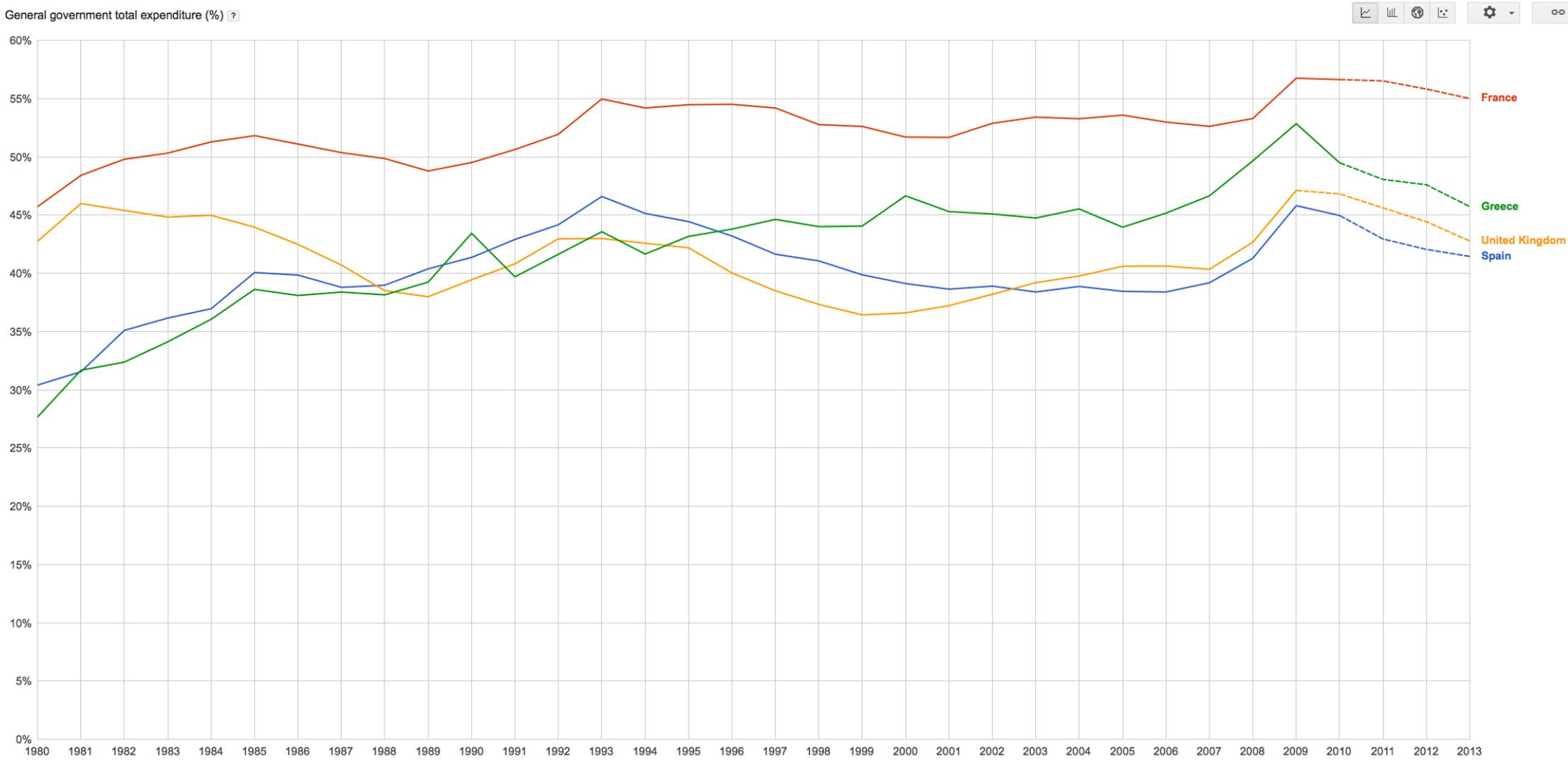


# Evolution of net government debt (% of GDP)

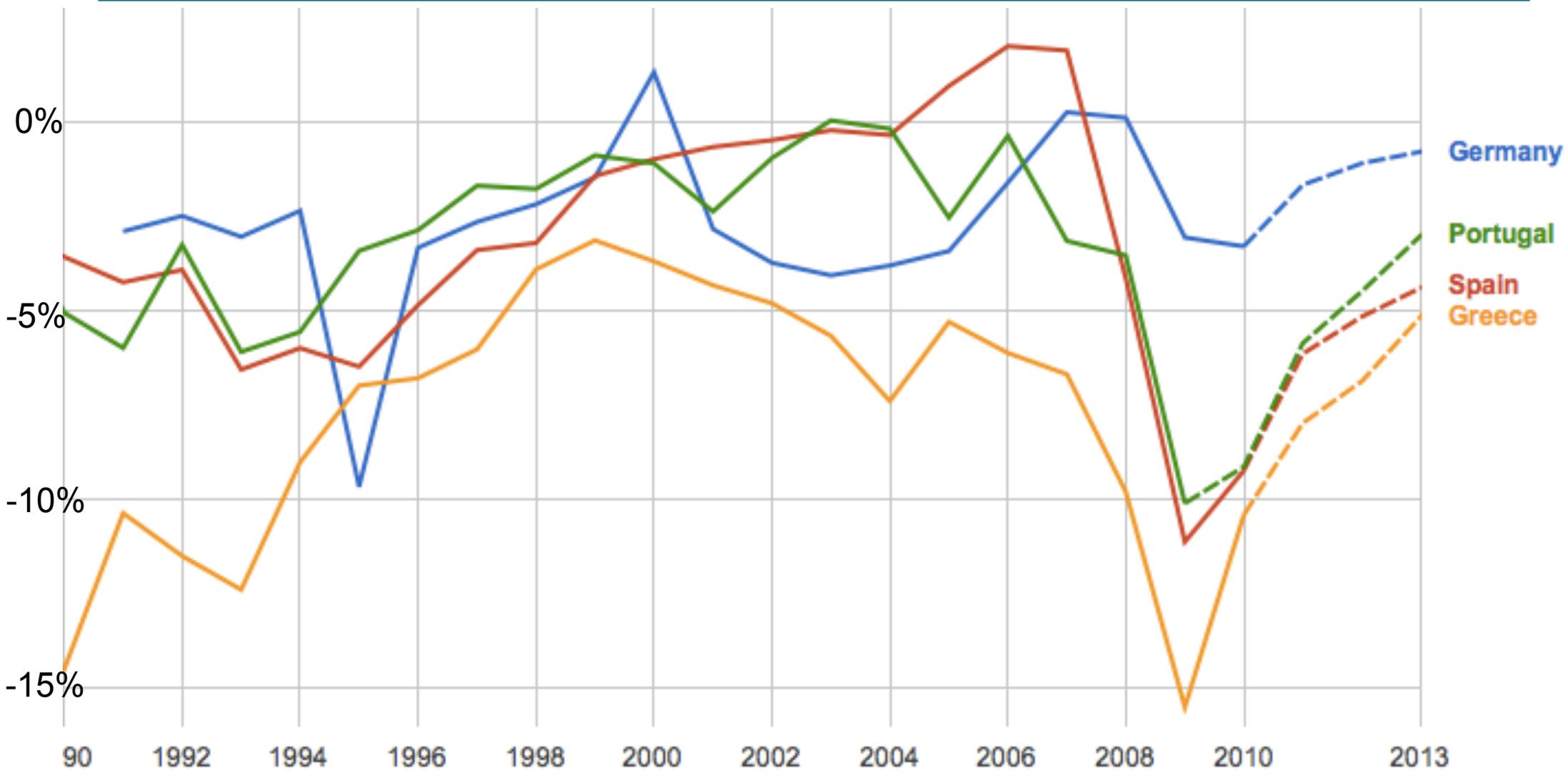


# Evolution of government spending as a share of GDP

General government total expenditure (%) ?

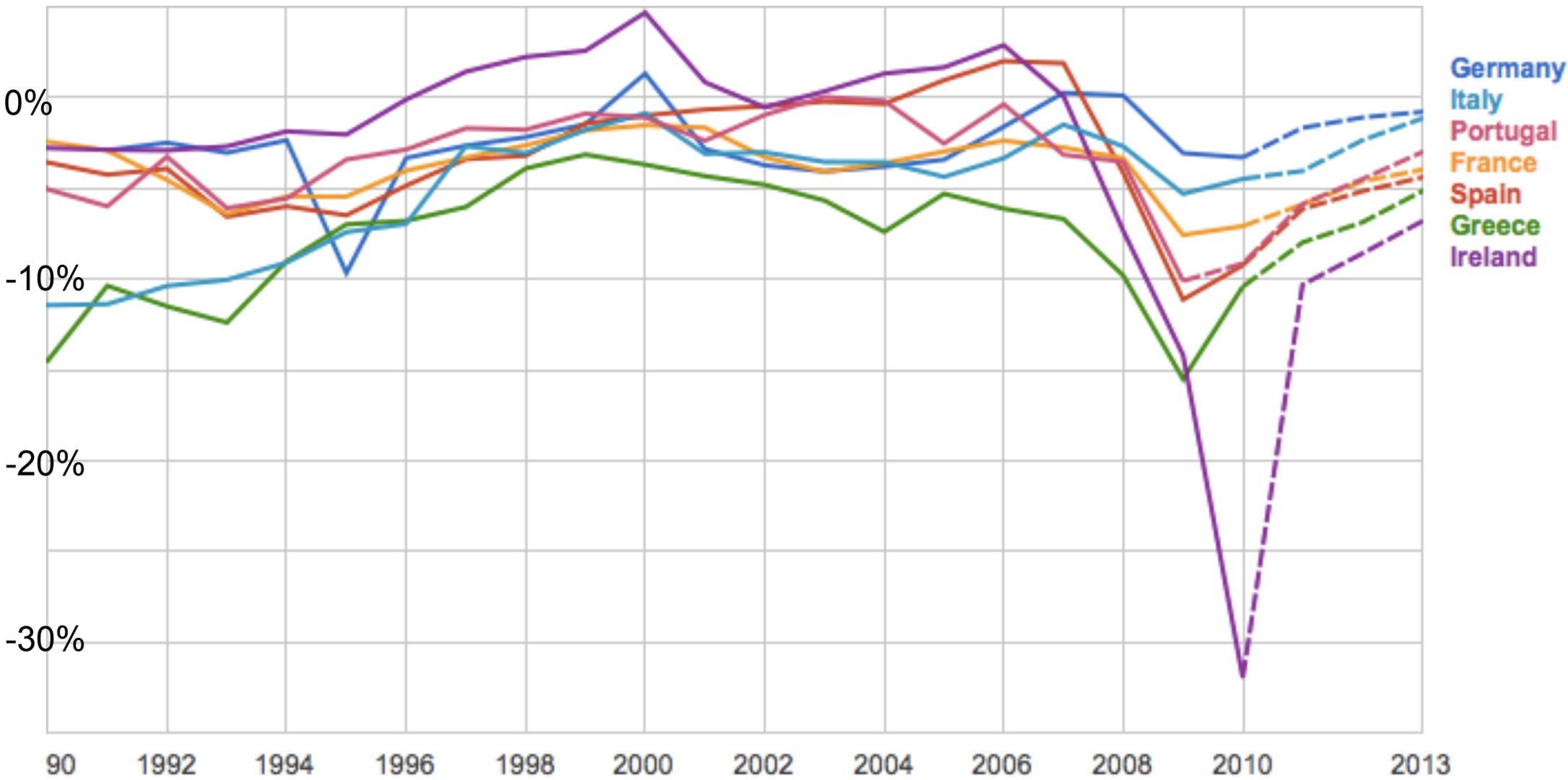


# Government surplus/deficit as % of GDP

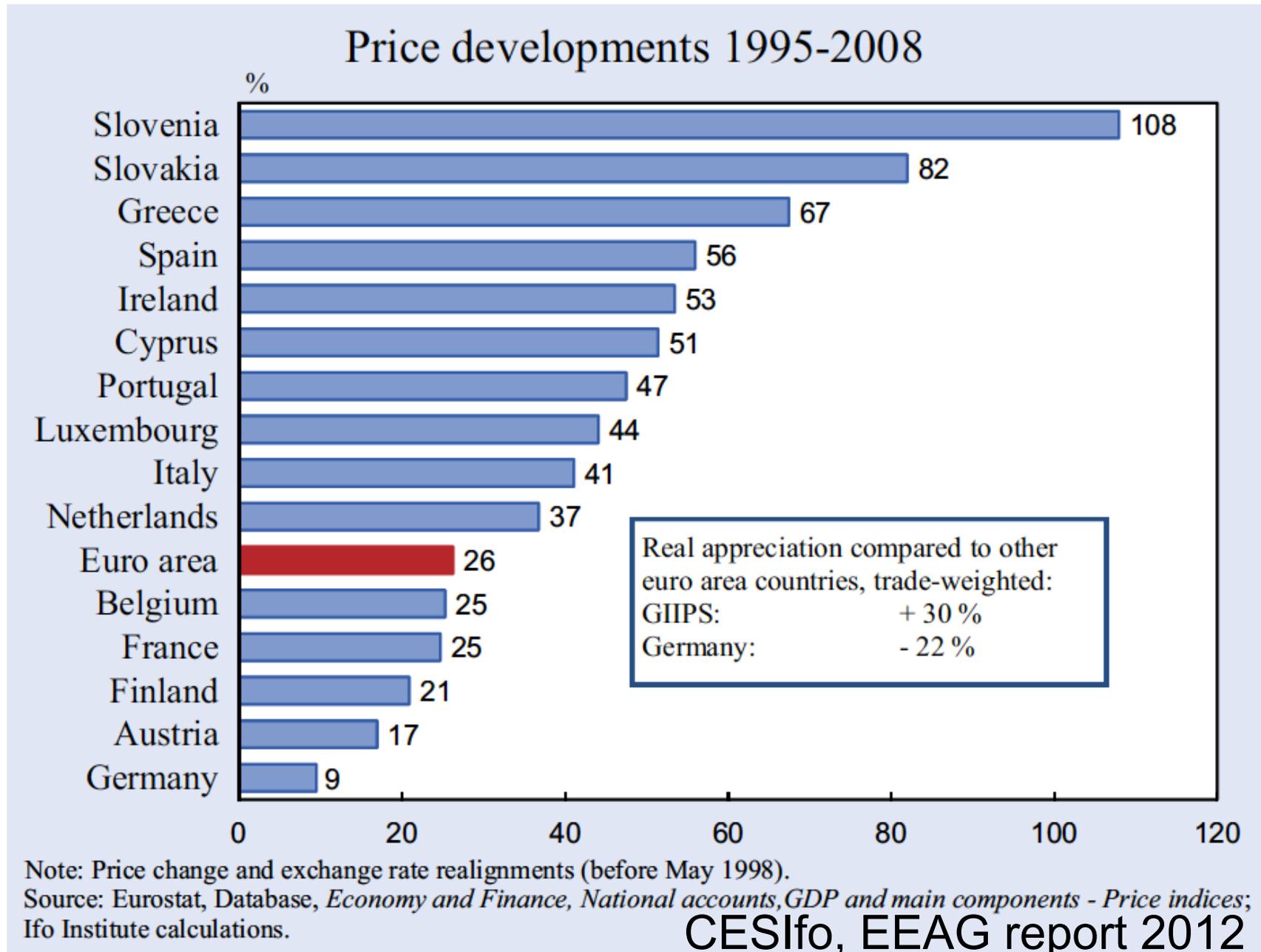


Source: IMF WEO, 2011

# Government surplus/deficit as % of GDP



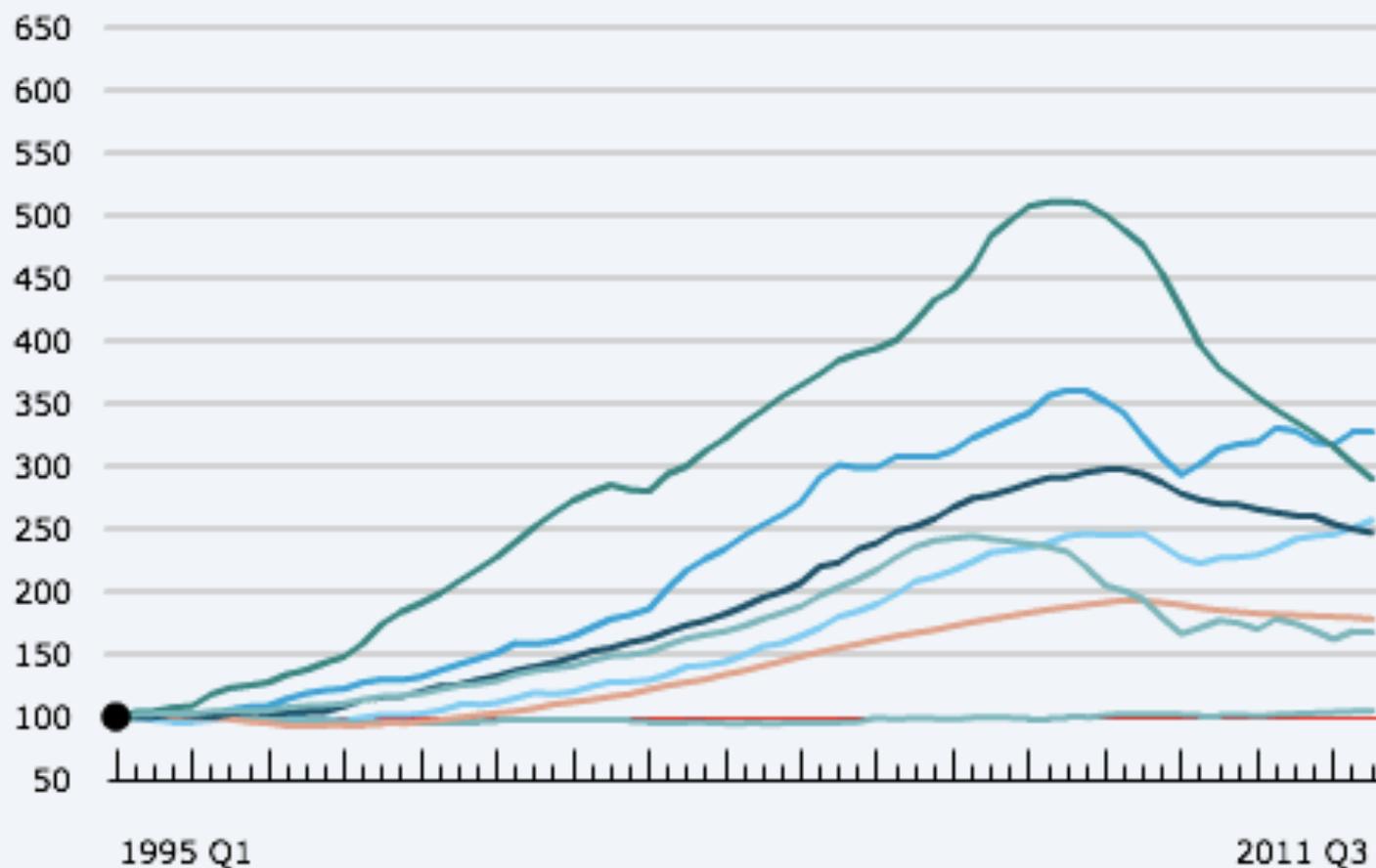
# Divergence in competitiveness:



# The Economist house-price indicators

House-price index

1995 Q1=100



- Australia
- Belgium
- Britain
- Canada
- China
- Denmark
- France
- Germany
- Hong Kong
- Ireland
- Italy
- Japan
- Netherlands
- New Zealand
- Singapore
- South Africa
- Spain
- Sweden
- Switzerland
- US

1995 Q1

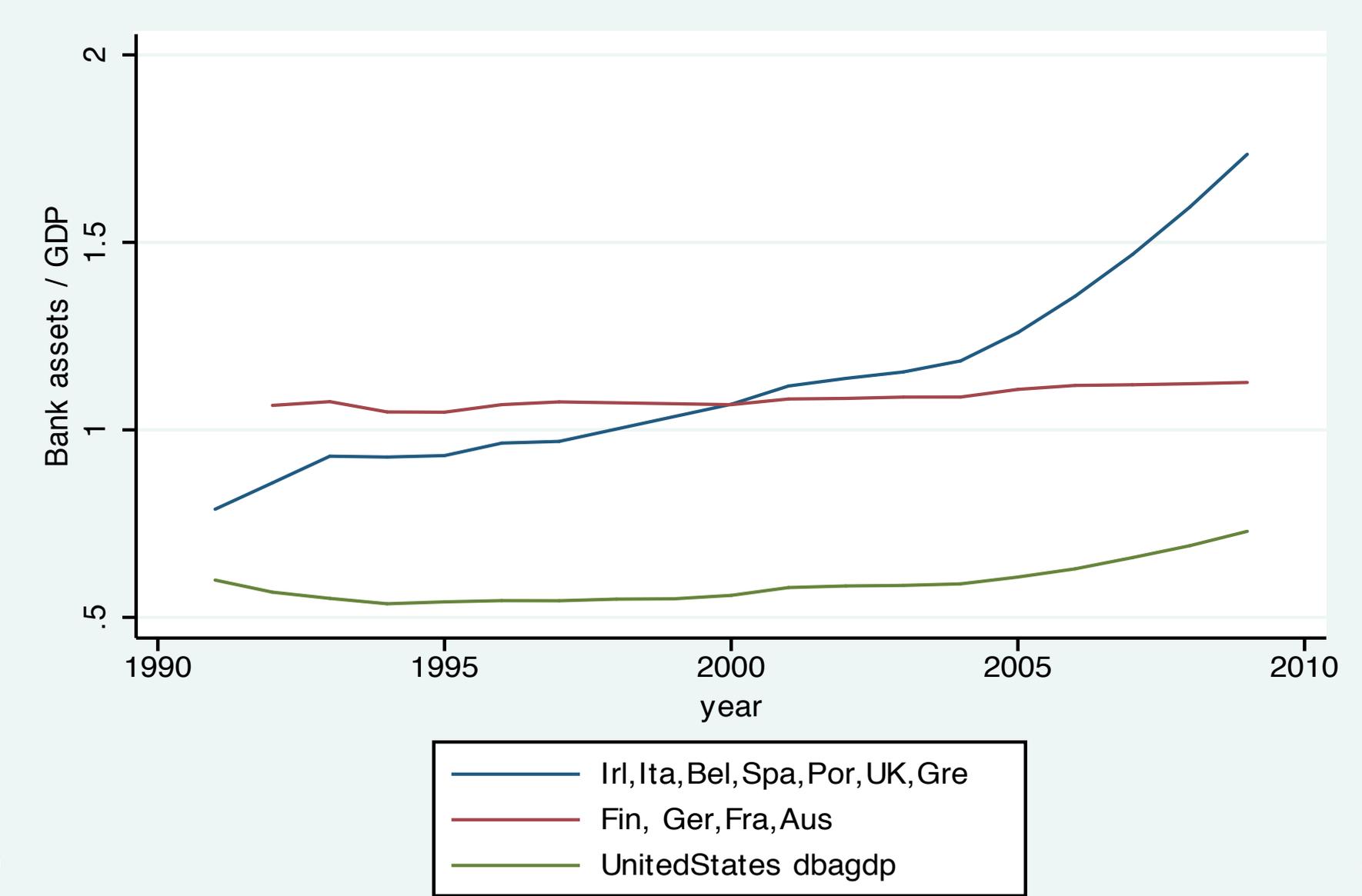
Start

Select dates

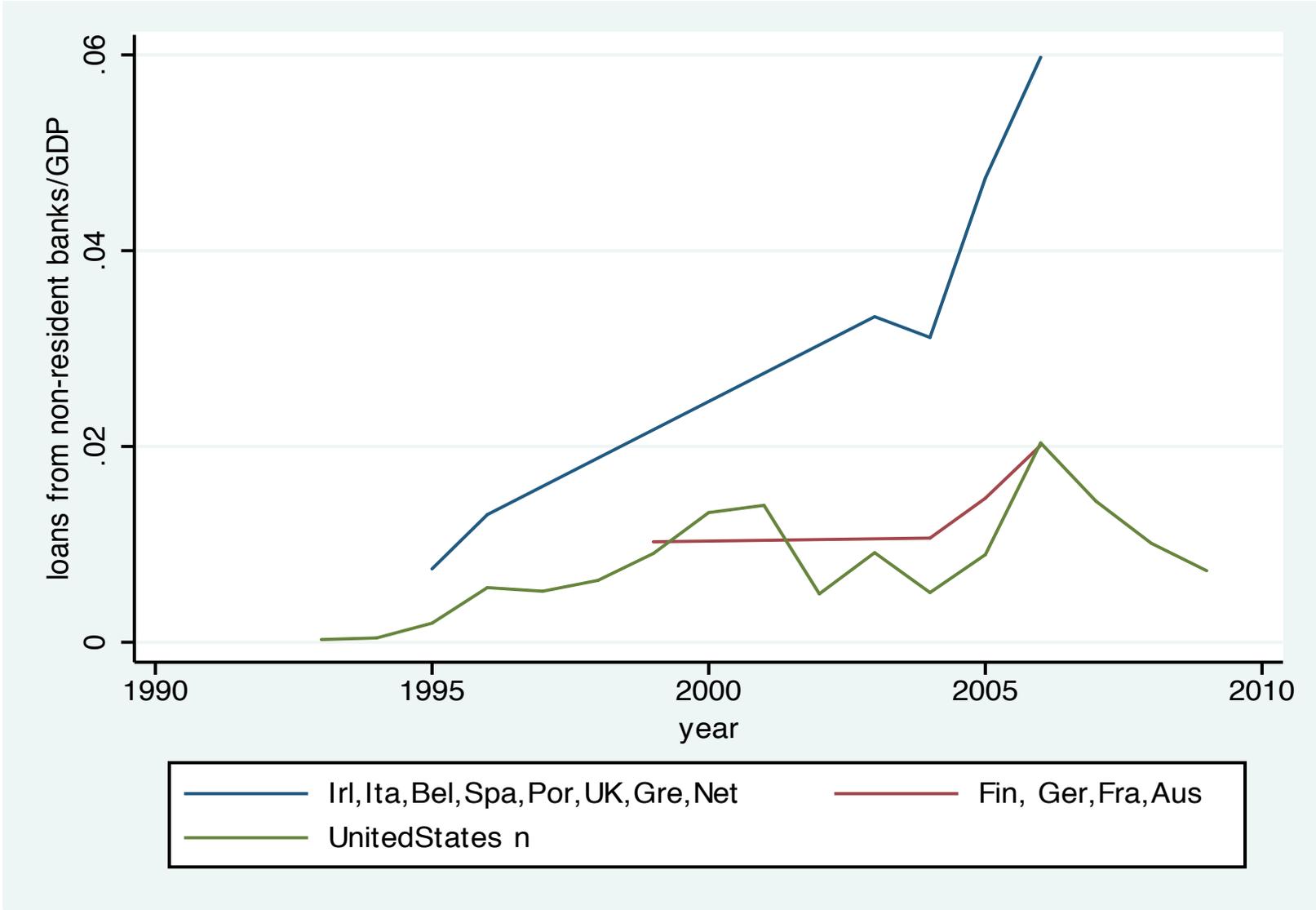
End

2011 Q3

# Banking system expansion:



# banks borrowed abroad

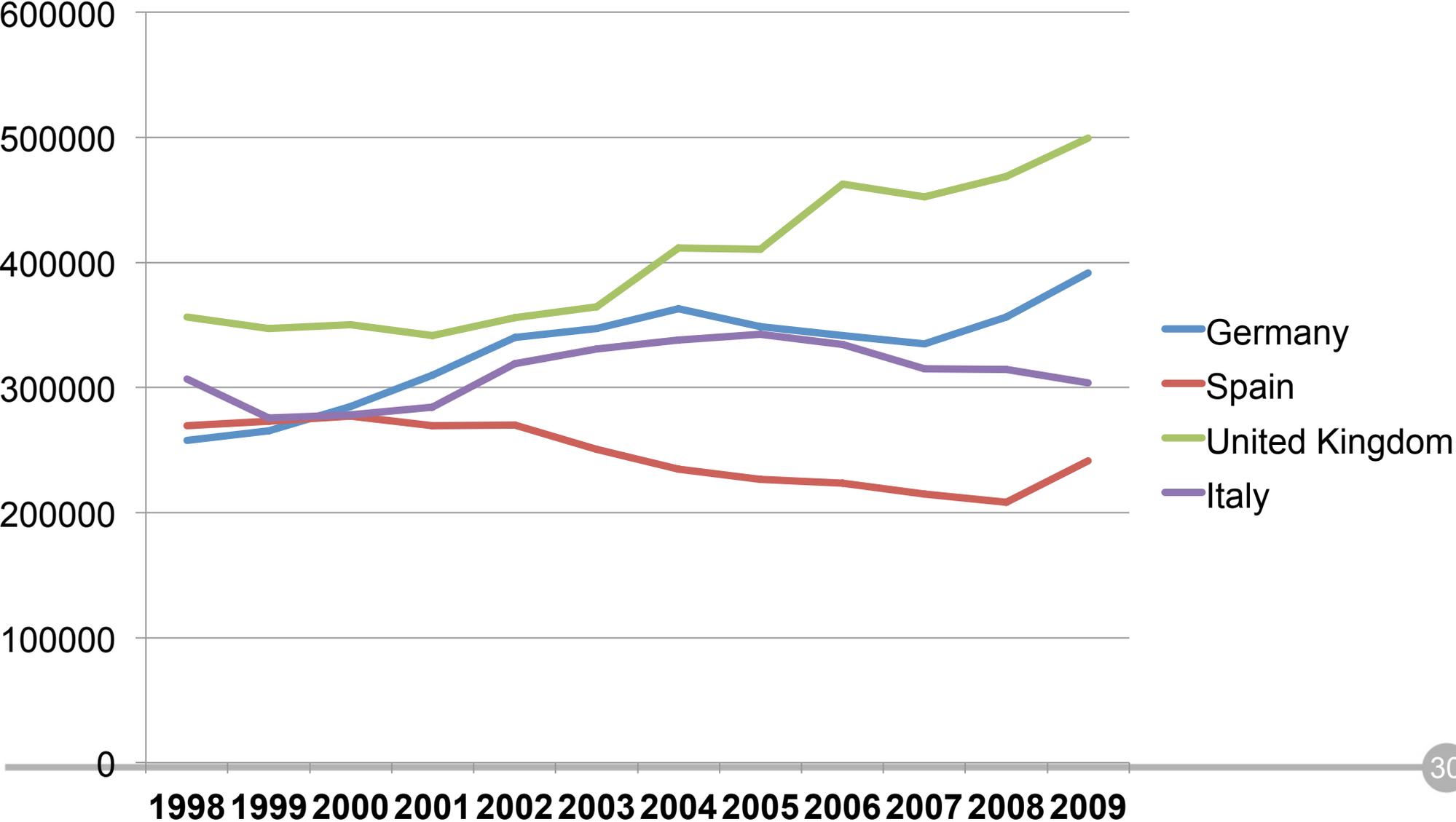


# How much did this flow of resources equip the borrowers to repay?

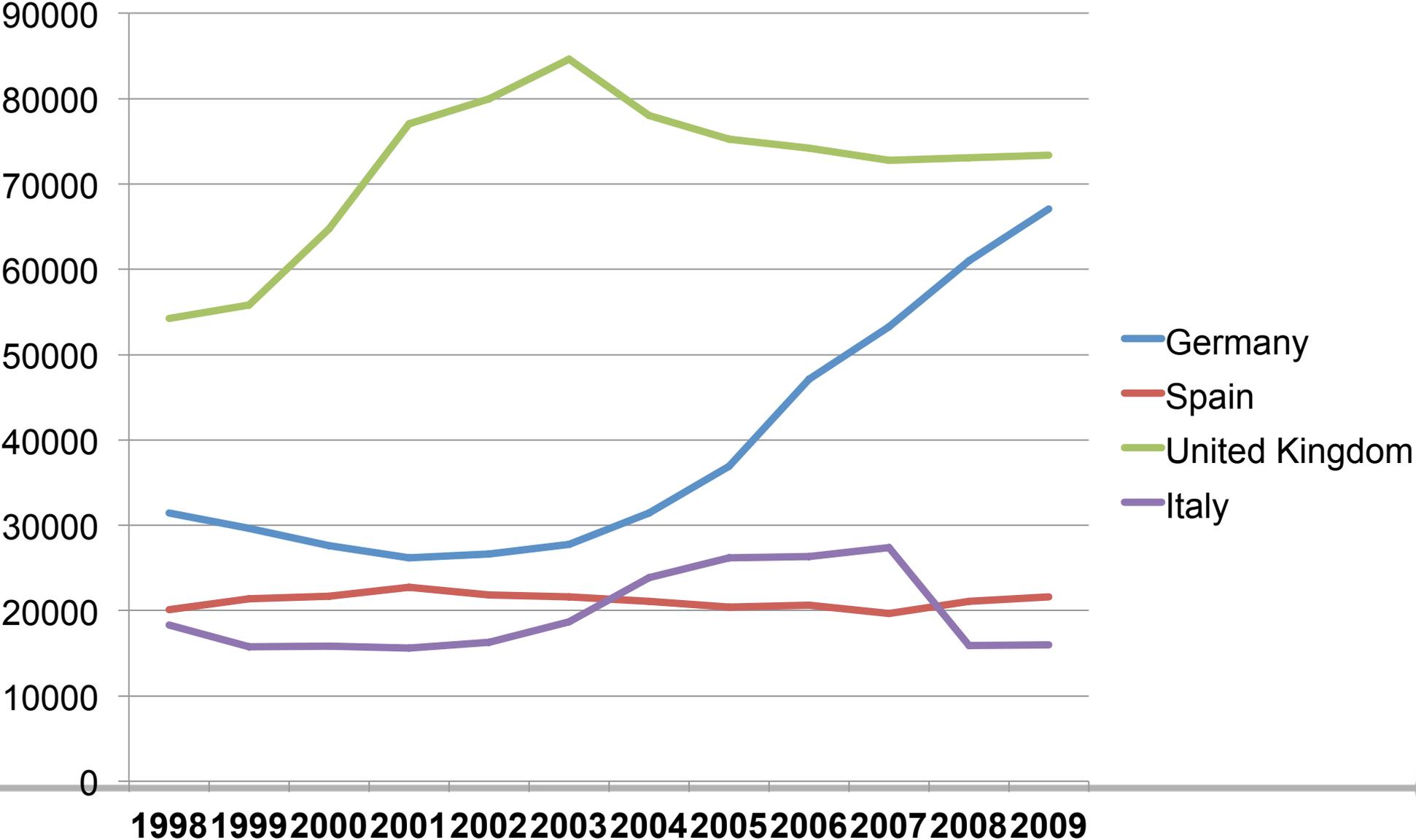
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- The Spanish story
- The Italian story
- The Greek story

# New entrants to higher education, 1998-2009

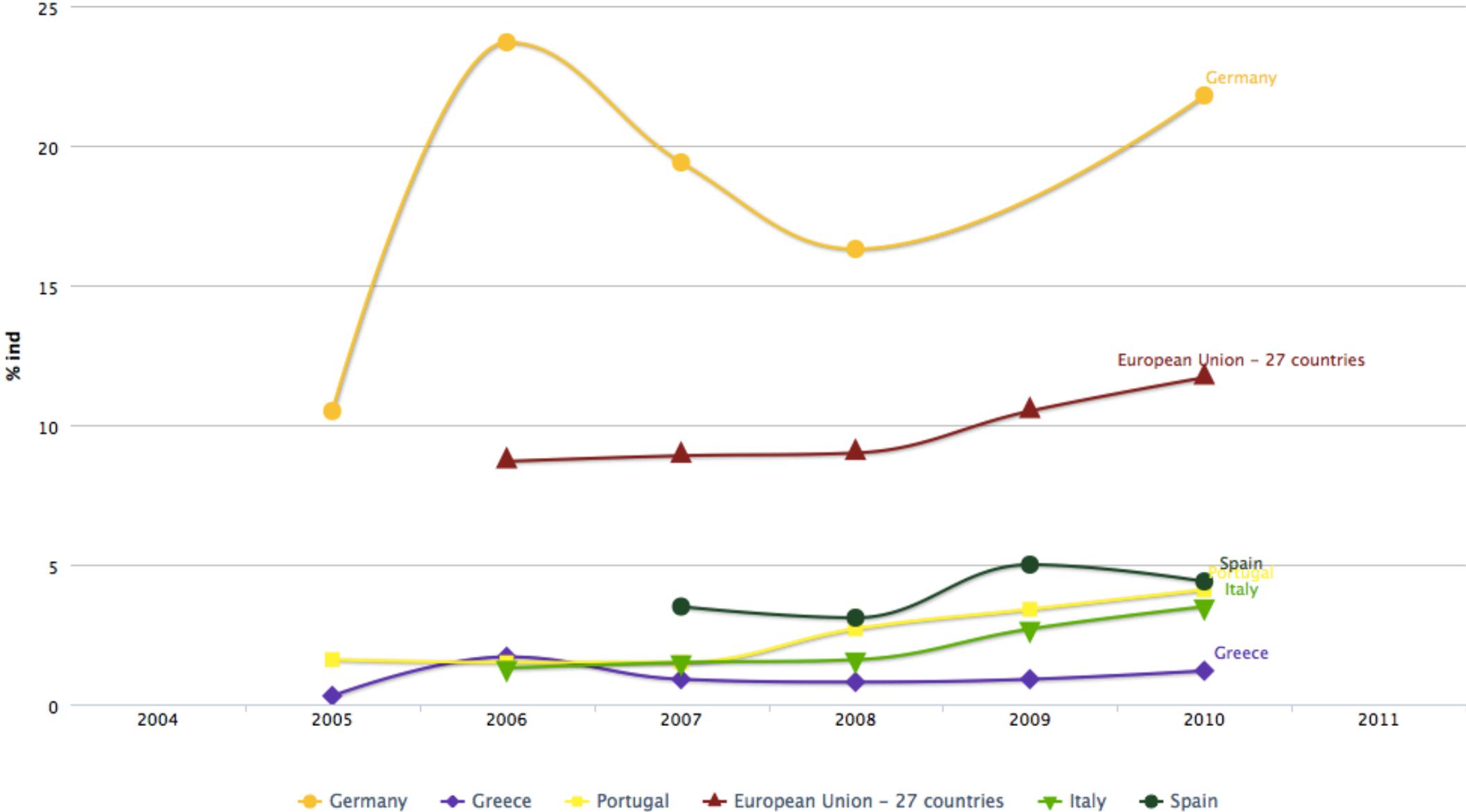


# Science graduates, 1998-2009



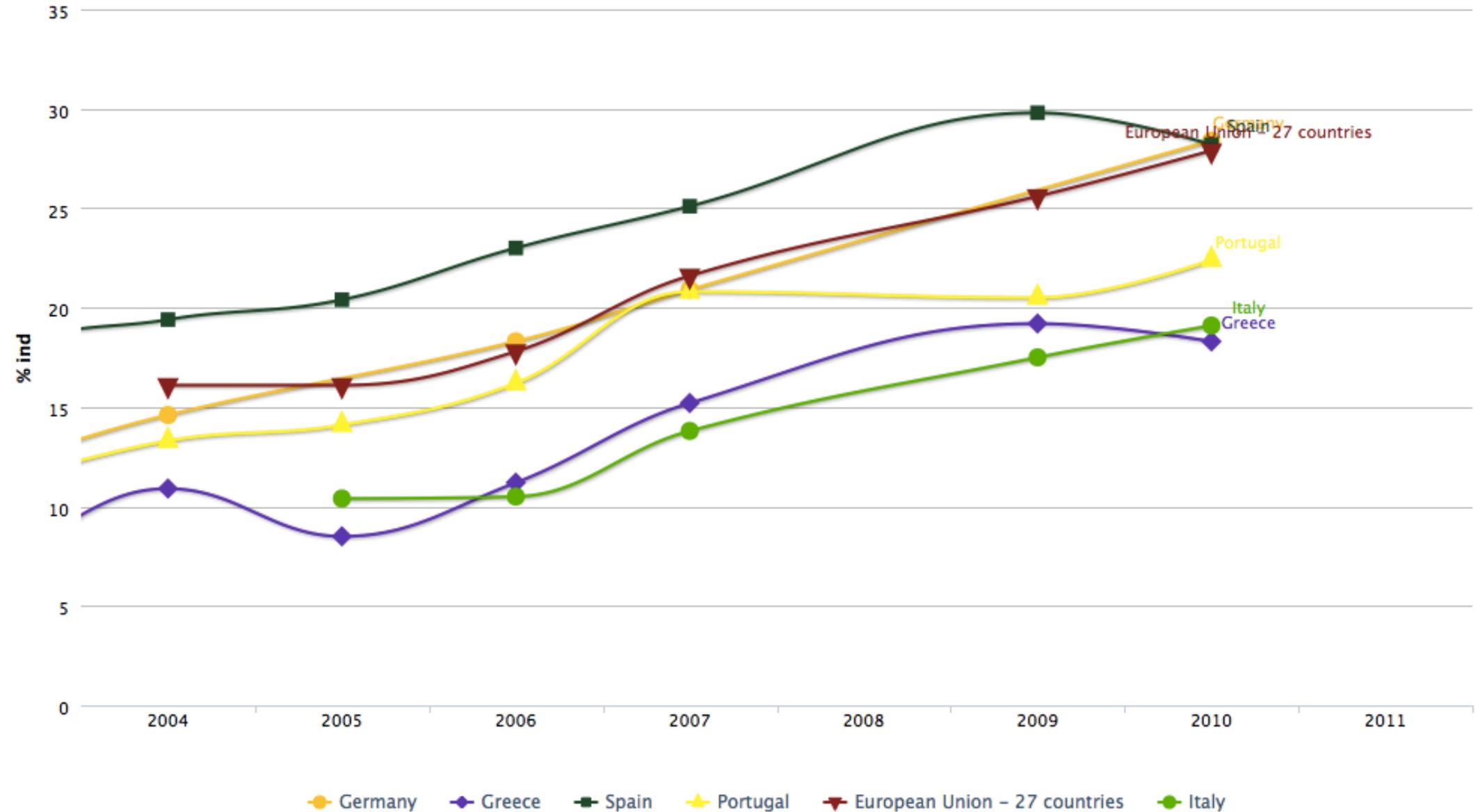
# Evidence on the IT skills of the population

% of population ordering content or software that were delivered or upgraded online



# Evidence on the IT skills of the population (II)

% of population playing or downloading games, images, films or music

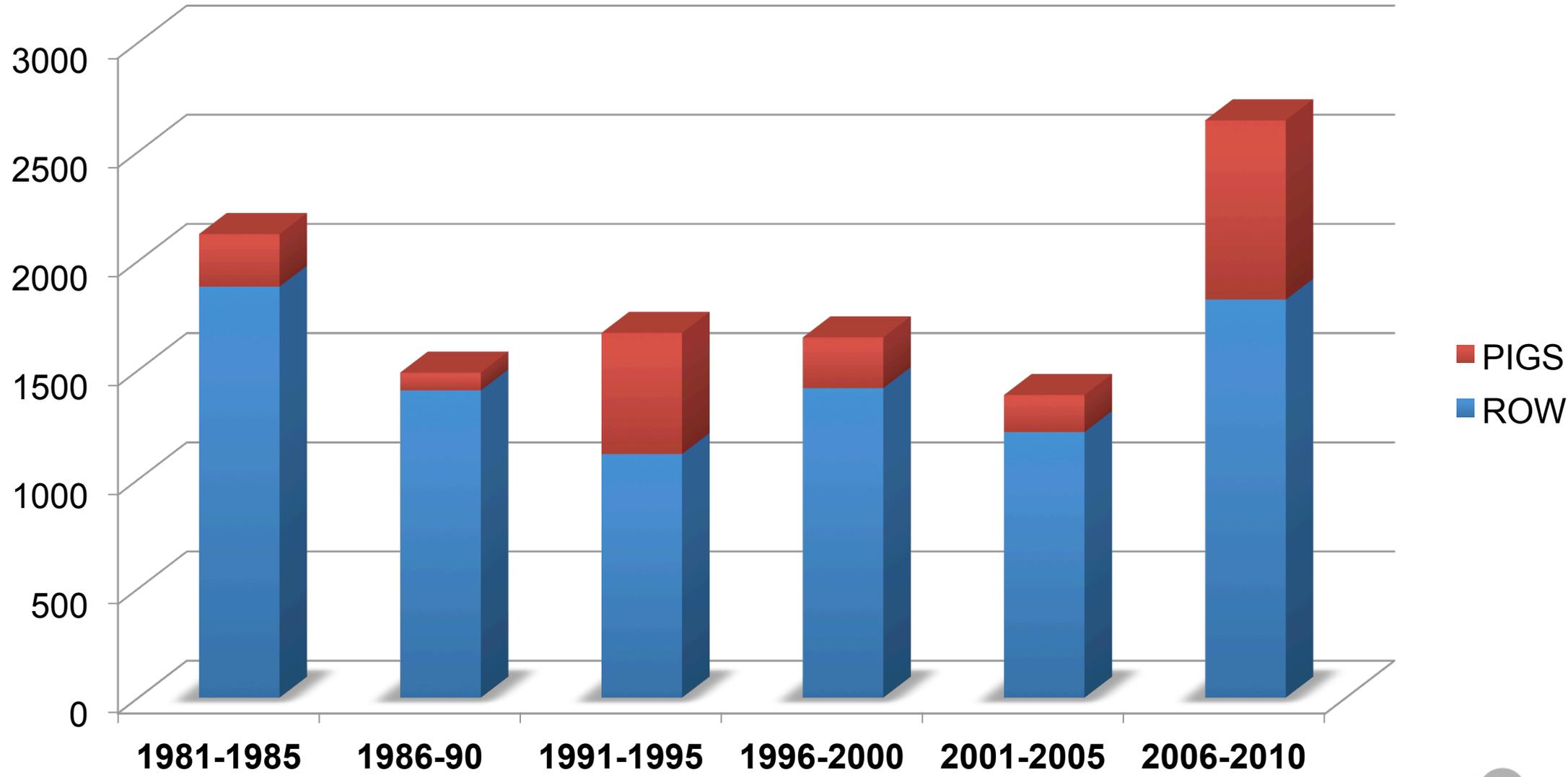


# From 2000-2010:

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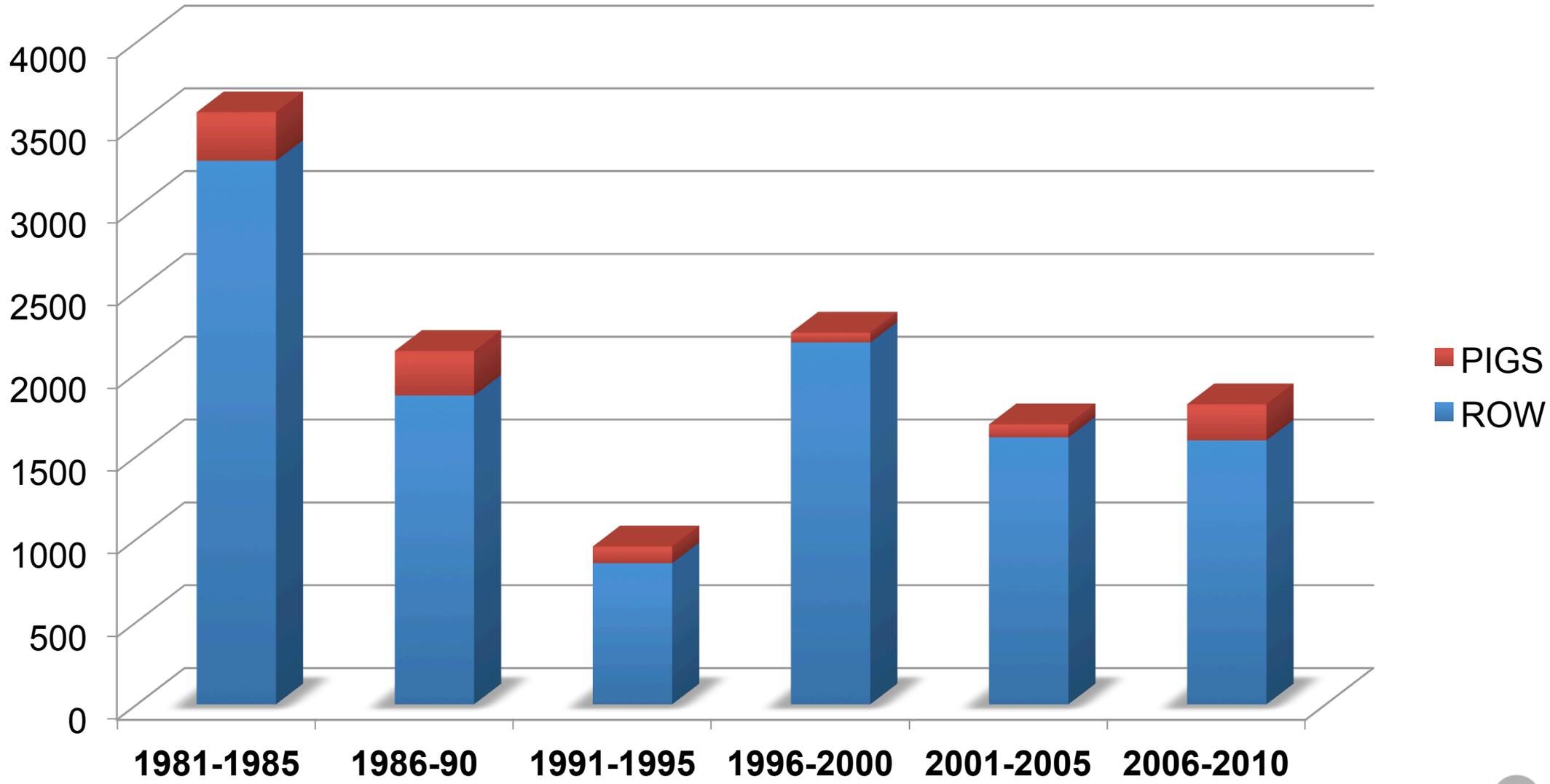
- From 2000-2010 Greece was the world's fourth largest arms importer, after China, India, and South Korea (source: SIPRI)
- These three countries had GDP respectively 28, 7 and 4 times that of Greece.
- Their arms imports were respectively 2.4, 1.9 and 1.2 times those of Greece
- Greece spends around twice the EU average % of its GDP on its armed forces

# German annual average arms exports to Portugal, Italy, Greece, Spain, and ROW, \$m 1990 prices



PIGS  
ROW

# French annual average arms exports to Portugal, Italy, Greece, Spain and ROW, \$m 1990 prices



# Who were Greece's financiers?:

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- As late as April 2010 Barclays Capital was reporting large exposures of French and German banks to Greek debt (28bn for German banks, 50 bn for French banks)

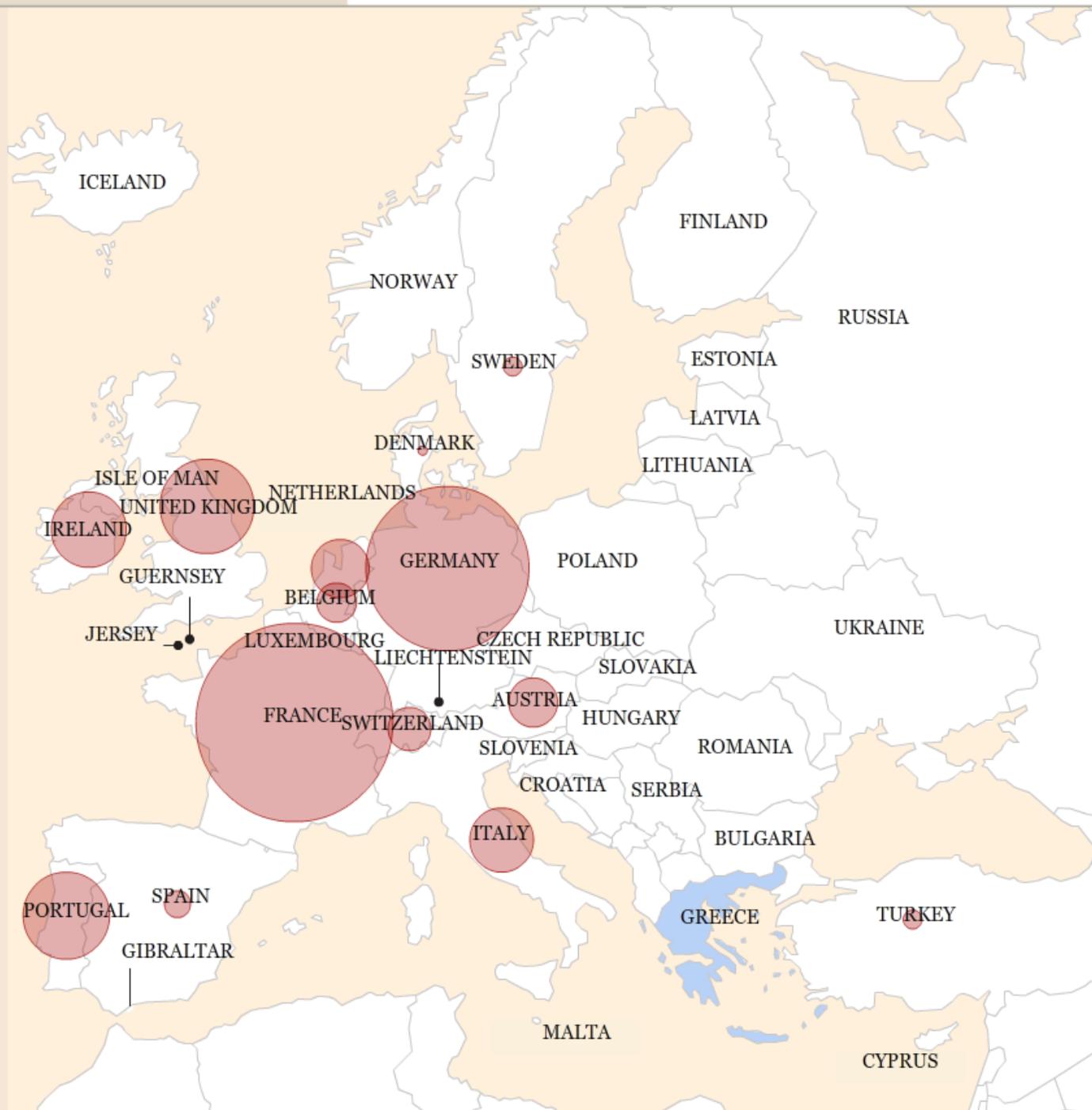
## Greece

European banks' total exposure to public and private debt of Greece **\$141.6bn**

*Click on a country to see other European countries' banks' exposure to its public and private sector debt.*

*This interactive graphic is based on data published by the Bank of International Settlements, and shows foreign claims vis-à-vis individual countries by the nationality of reporting banks.*

*These include banks' local subsidiaries and branches of foreign banks. It therefore provides a way to measure the risk exposures of lenders' national banking systems and shows one way in which "contagion" could potentially be transmitted through the financial system.*



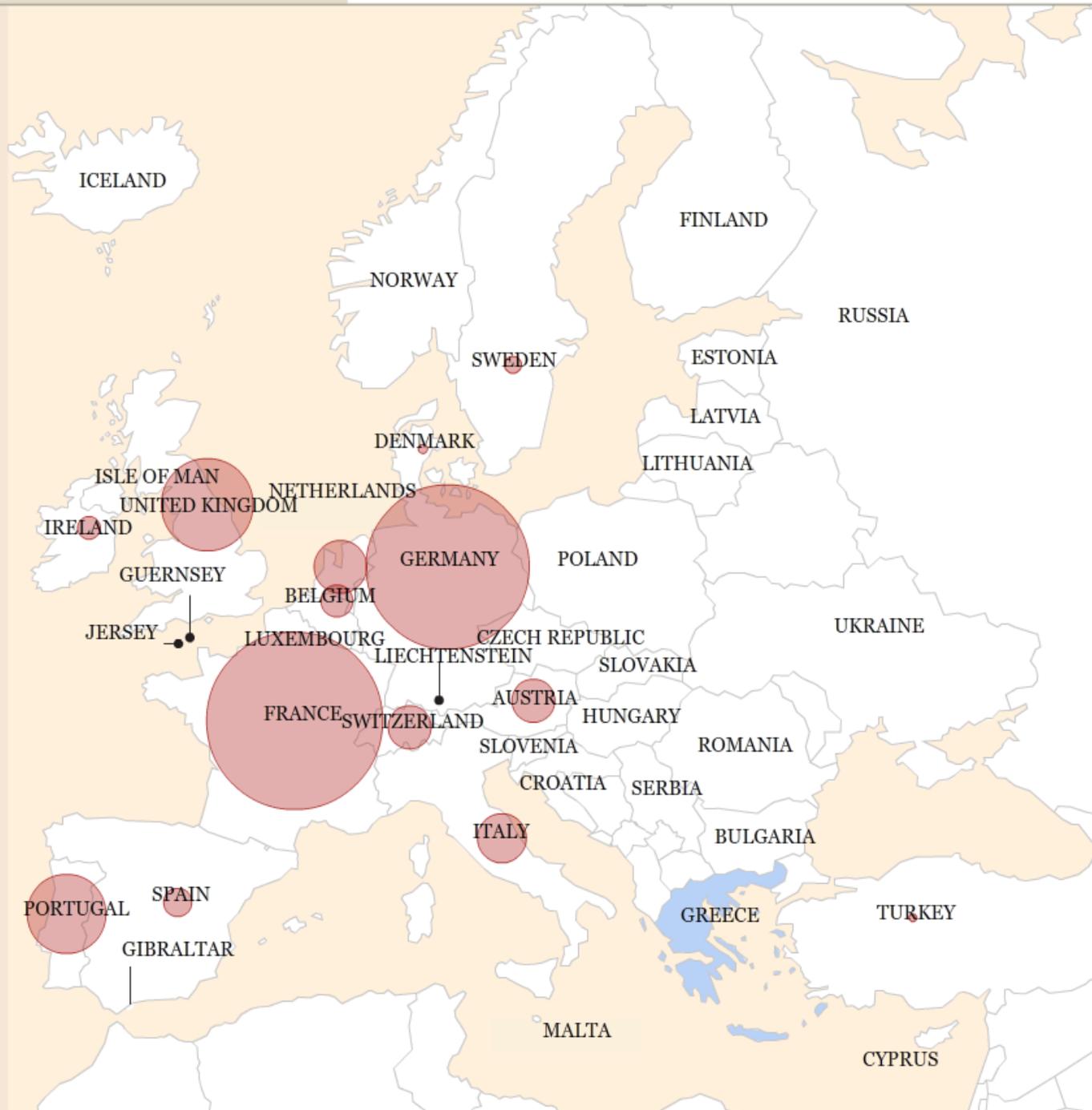
## Greece

European banks' total exposure to public and private debt of Greece **\$116.7bn**

*Click on a country to see other European countries' banks' exposure to its public and private sector debt.*

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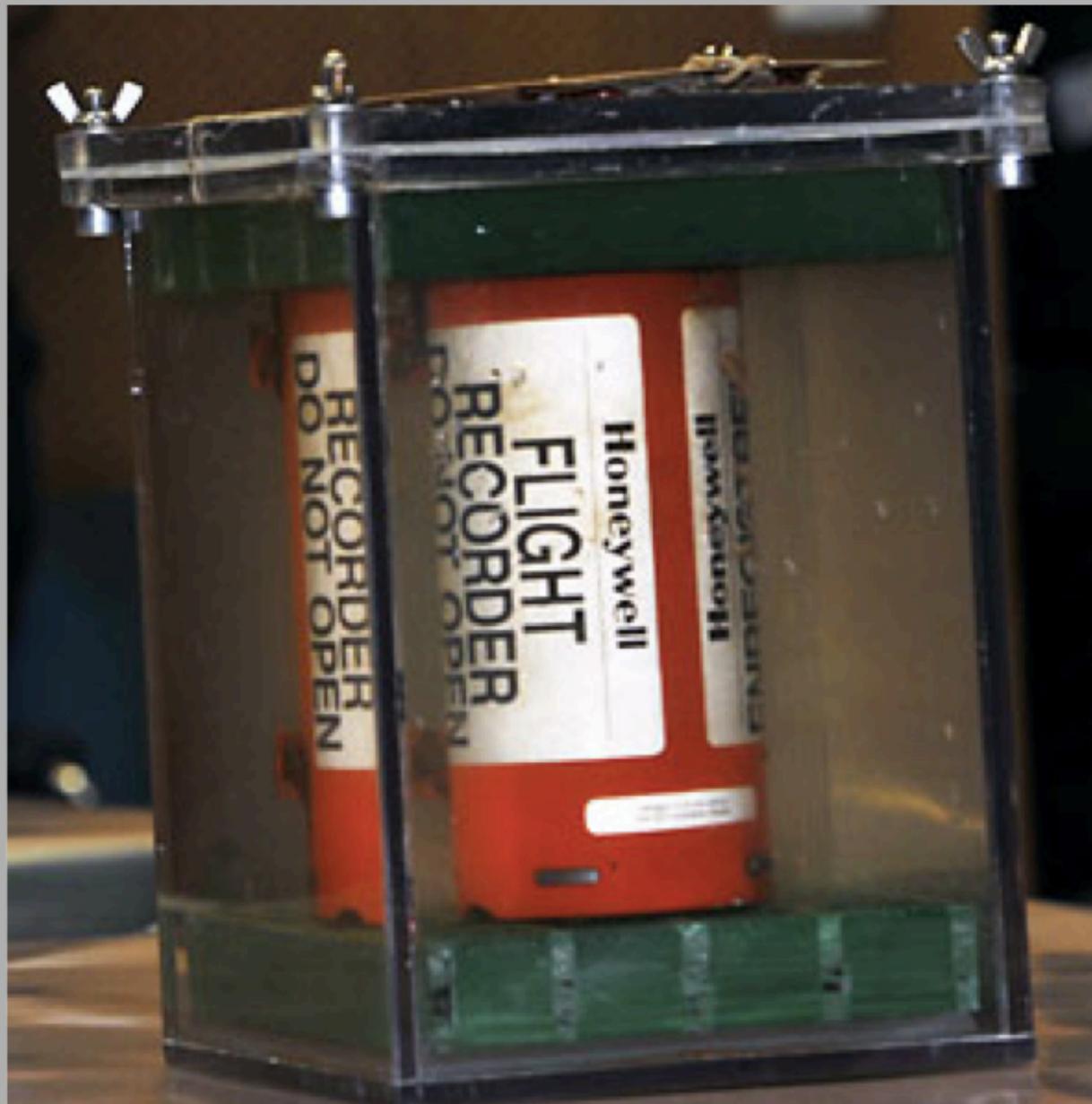


# (III) The illusion of panoramic vision

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- An analogy with our visual field: our attention is patchy – but we have no idea just how patchy it is!
- We have change sensors that alert us to developments outside the center of our field of vision
- But these sensors can be disabled! Two main mechanisms:
  - Gradual change, especially when our attention is focused elsewhere
  - When too much change happens at once
- Most experiments disable the change sensors over short time periods – but real life can disable them at significantly longer time scales. We can fail to see what is in front of our nose!

# A tragic example: AF 447, 1<sup>st</sup> June 2009



# Air accident:

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- AFF 447 en route from Rio to Paris, flew into a thunderstorm over the Atlantic, then crashed into the ocean
- The cause: an elementary pilot error that two co-pilots and a pilot « failed to see »

see Jeff Wise: What Really Happened Aboard Air France 447,  
*Popular Mechanics*, July 2011

- <http://www.popularmechanics.com/technology/aviation/crashes/what-really-happened-aboard-air-france-447-6611877>

# Failing to see the crash coming:

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- The initial pilot error was puzzlingly elementary – was that why did the 3 pilots did not see it?
- Reliance on the autopilot created false assumptions about what might be wrong
- The link between the climb and the stall was gradual
- When the stall happened, too much began to happen at once – the obvious cause
- The pilots each delegated choices to each other – so there was confusion as to who was doing what

# Some gestures at a conclusion:

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- Why didn't we see it coming? There will *always* be things we cannot see coming
- We rewarded people for disabling our change sensors
- By turning the crisis into a morality play solely about irresponsible borrowing we are sending the message that the citizens of the Northern countries have no part to play in preventing future crises
- And that suffering by the citizens of periphery countries is a necessary signal of their countries' contrition
- Crash dieting is inimical to healthy eating in the long run

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