

Princeton University Press in Europe Annual Lecture
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On Lying, Risk Taking and the Implosion of the Euro

Paul Seabright, Toulouse School of Economics







“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

18th April 2012...

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

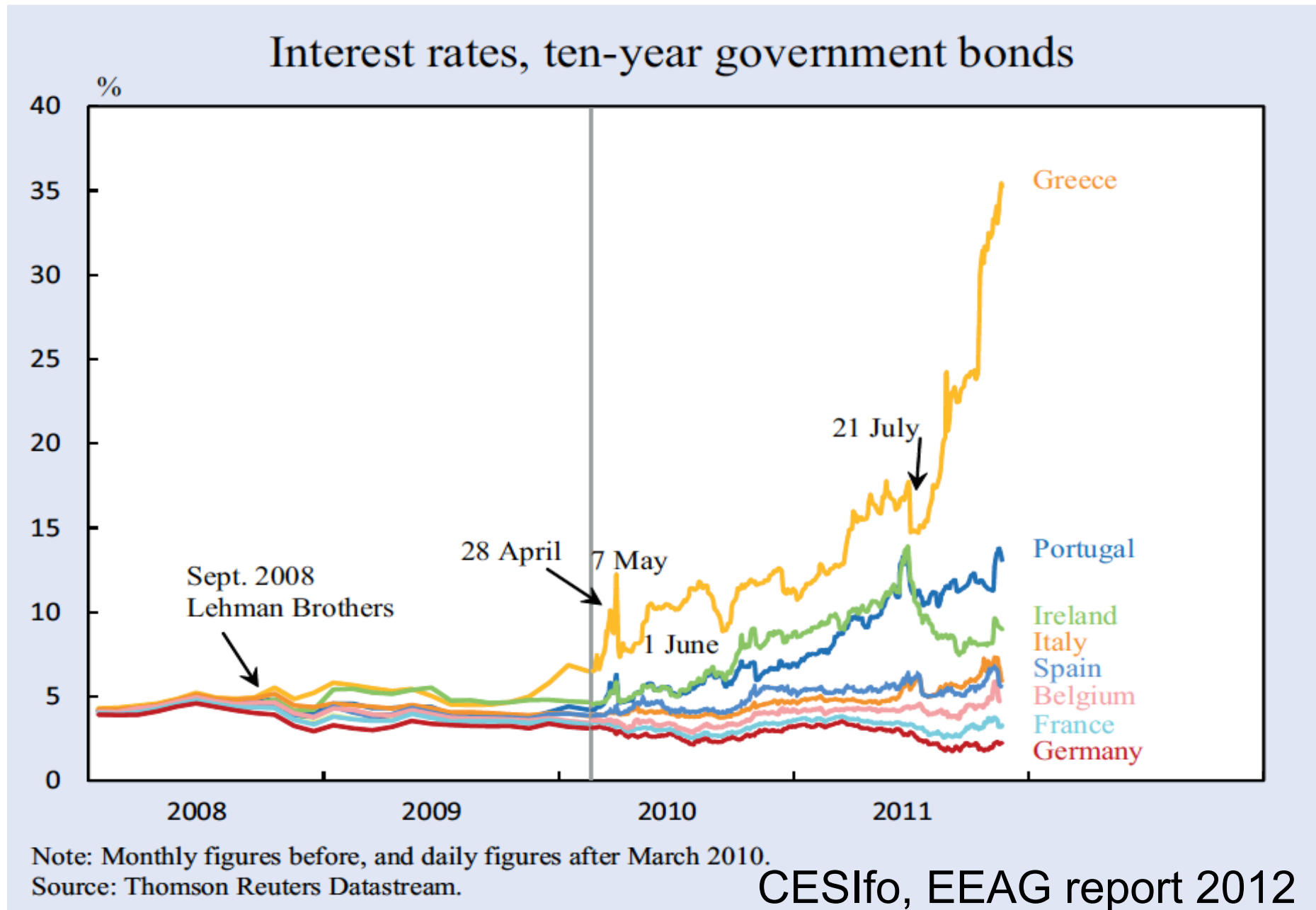
Some strange features of a family drama:

- 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?

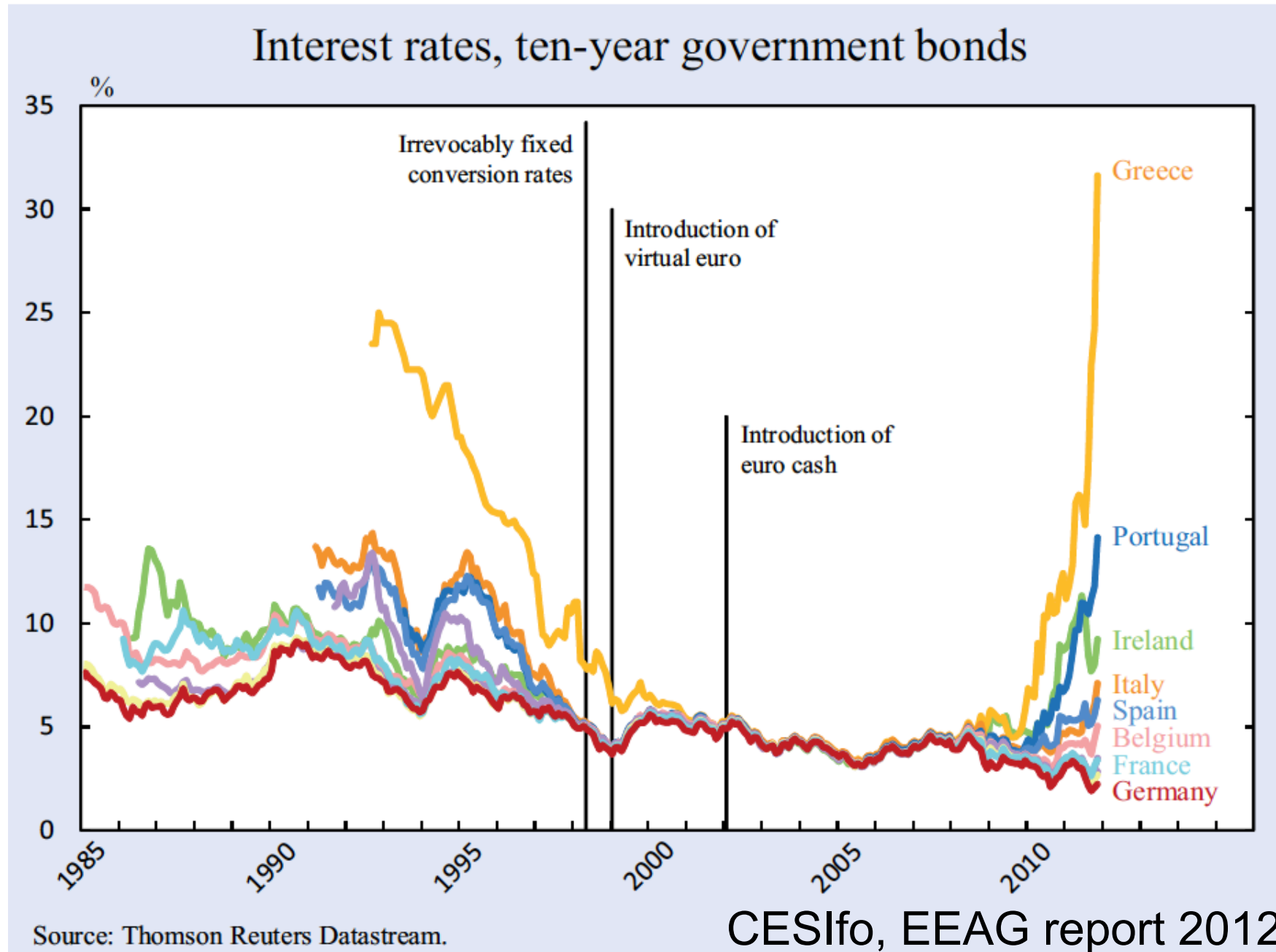
A moralizing storyline

- “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:



Fear and loathing in the bond markets:



Betting on an exit from the Euro: prices on Intrade

Closing prices chart

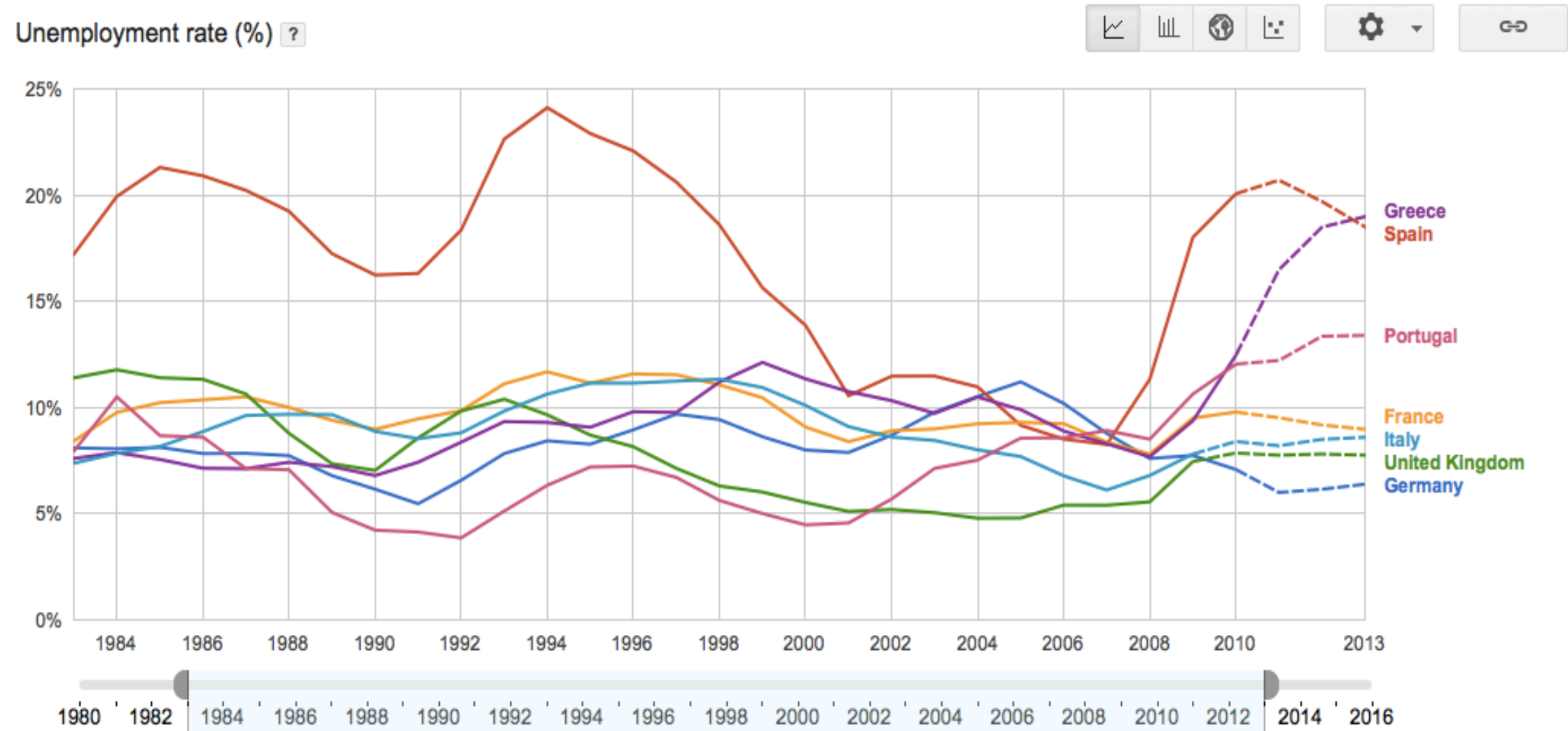
EURO.DROPPED.2014

Apr 10, 2010 - Apr 16, 2012



Source: www.intrade.com ©

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:

- 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

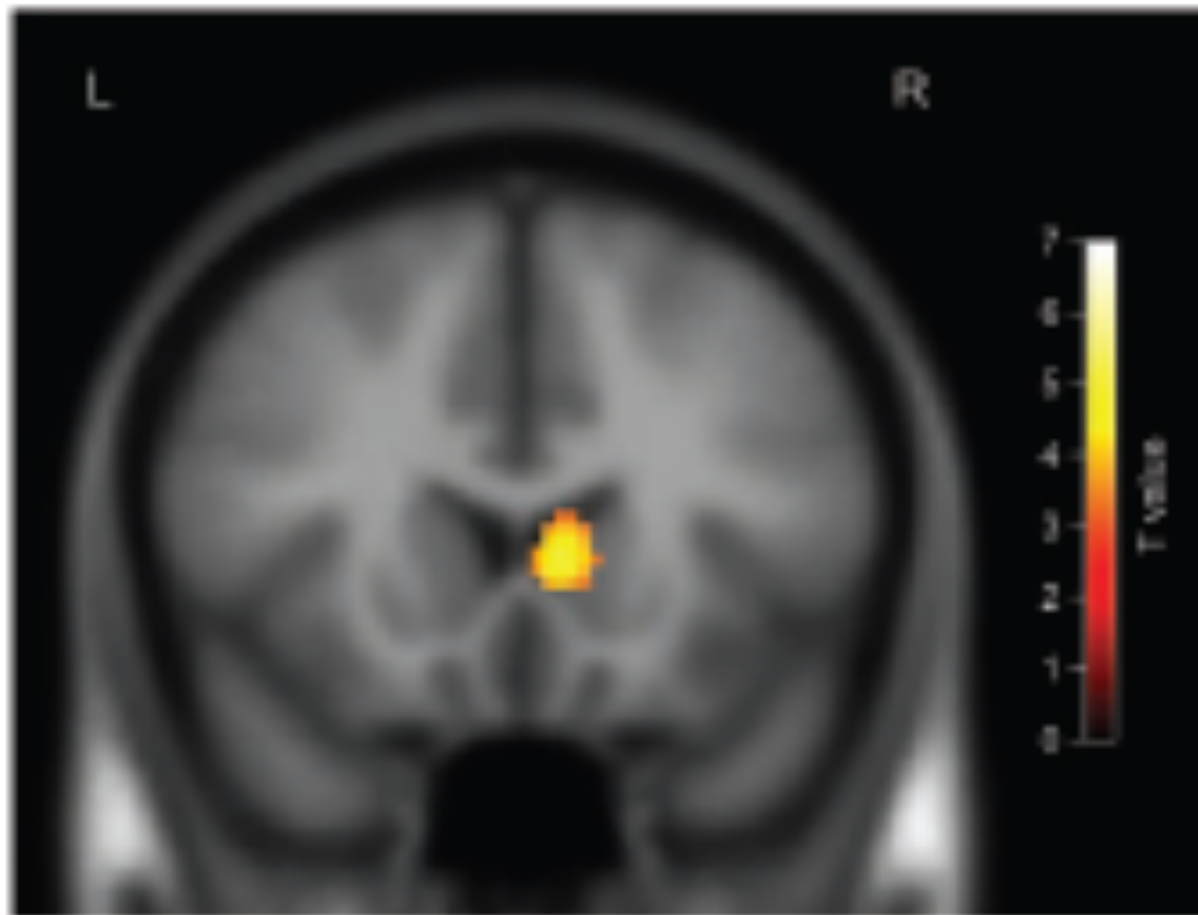
(I) Why didn't we see it coming? A first narrative

- 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)

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):



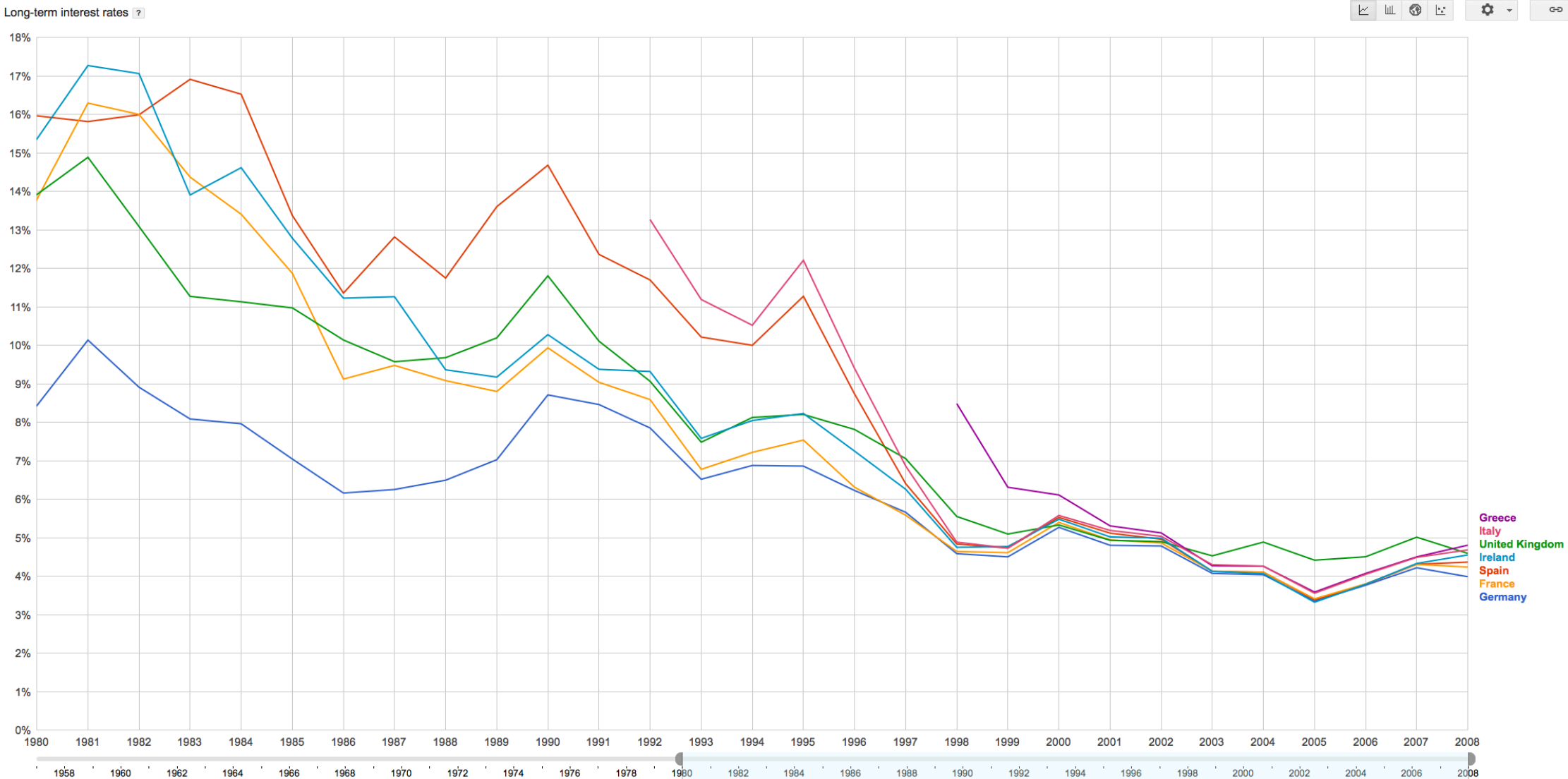
(I) Why didn't we see it coming? A first narrative

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

- What exactly did the Euro promise?

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

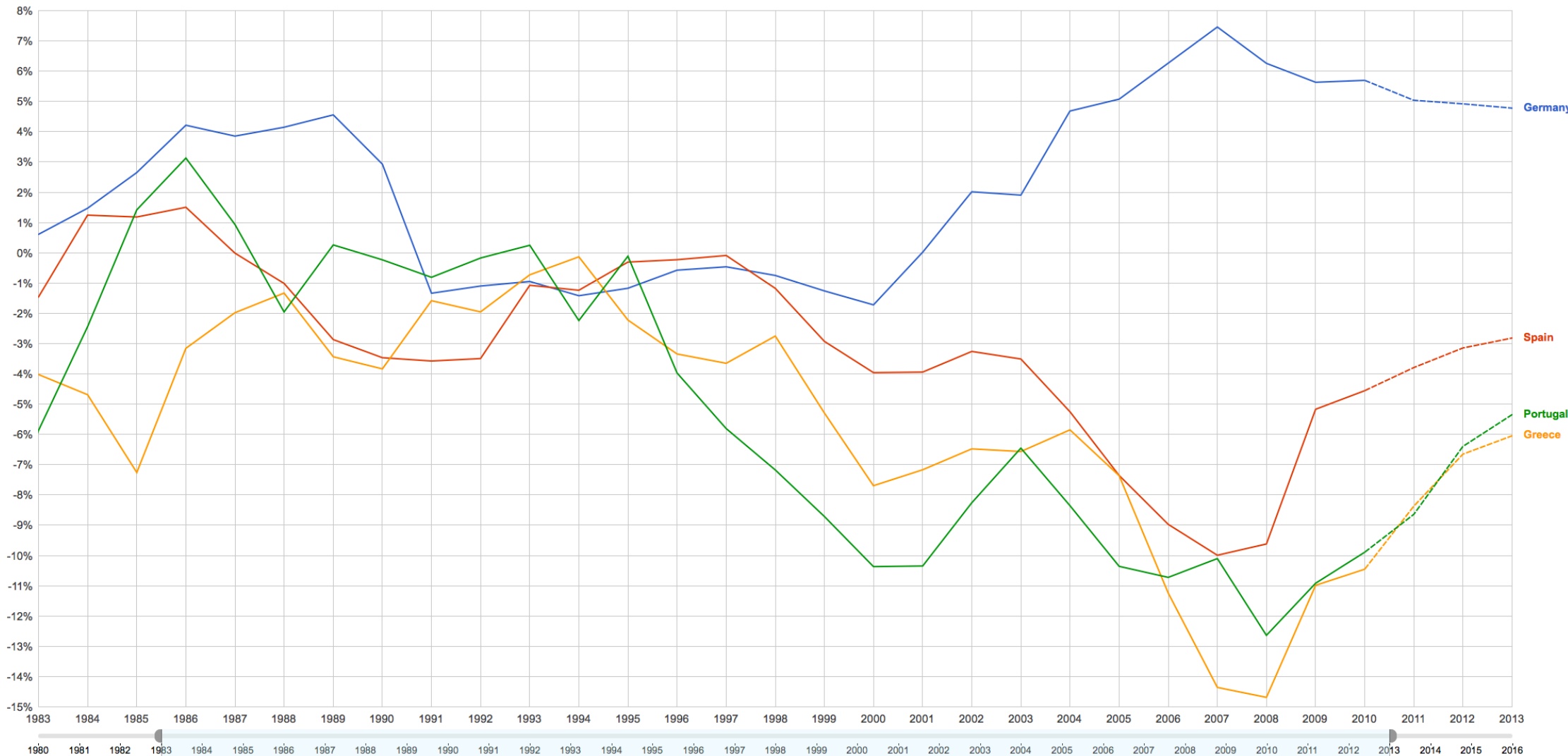


The promise...and the performance:

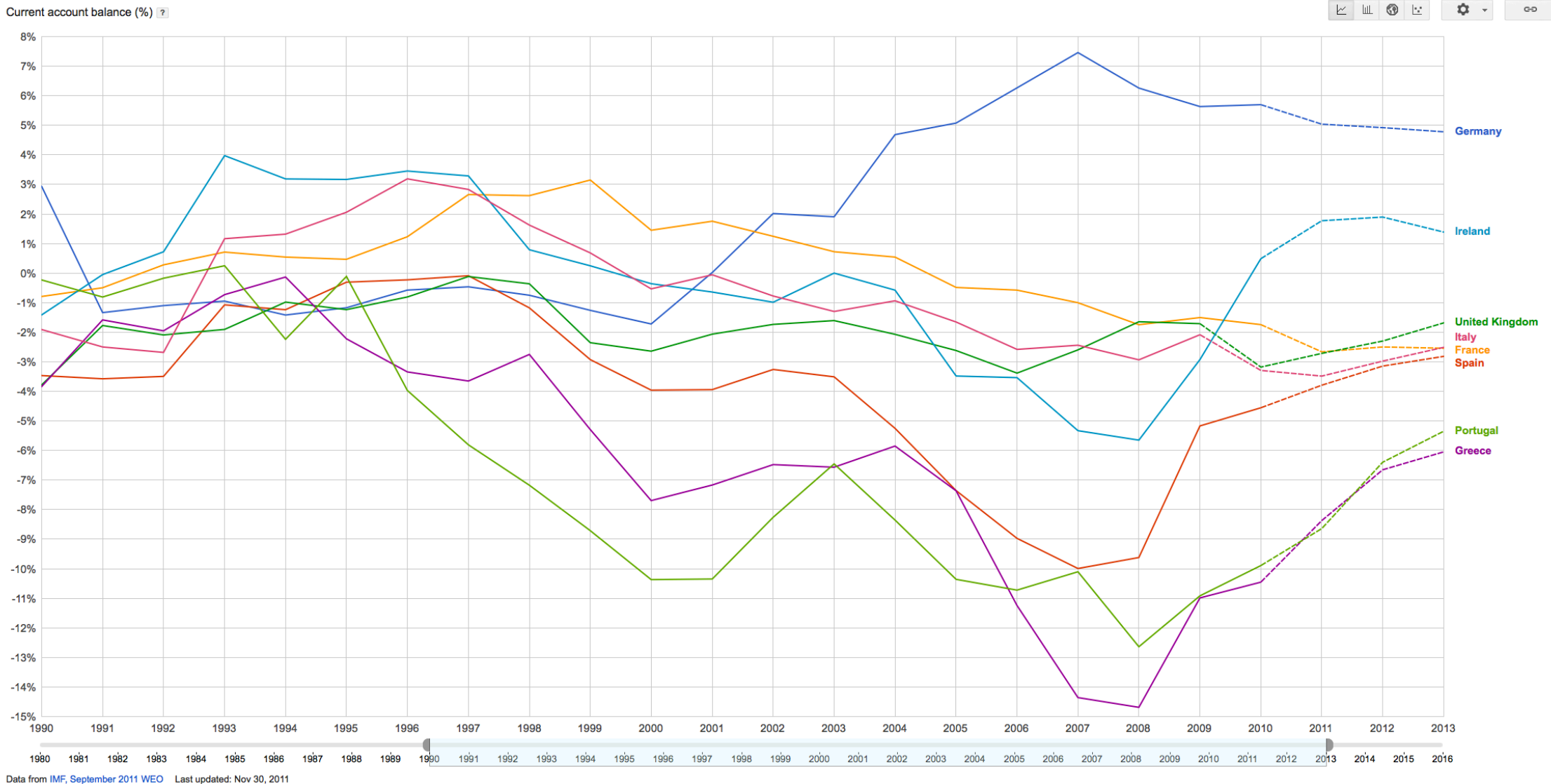
- And what did the Eurozone deliver?

Balance of payments as % of GDP, selected countries

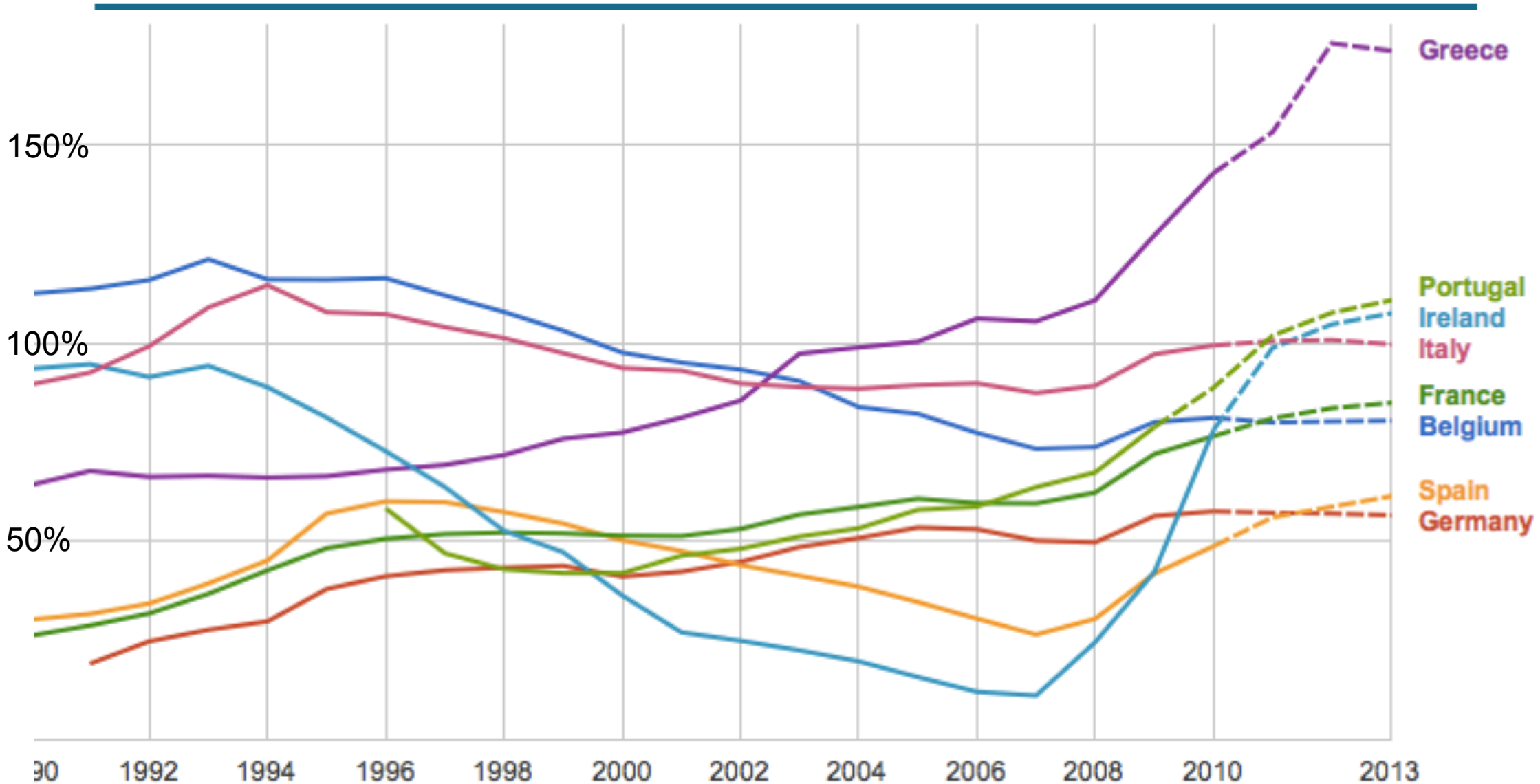
Current account balance (%) ?



Balance of payments as % of GDP, selected countries



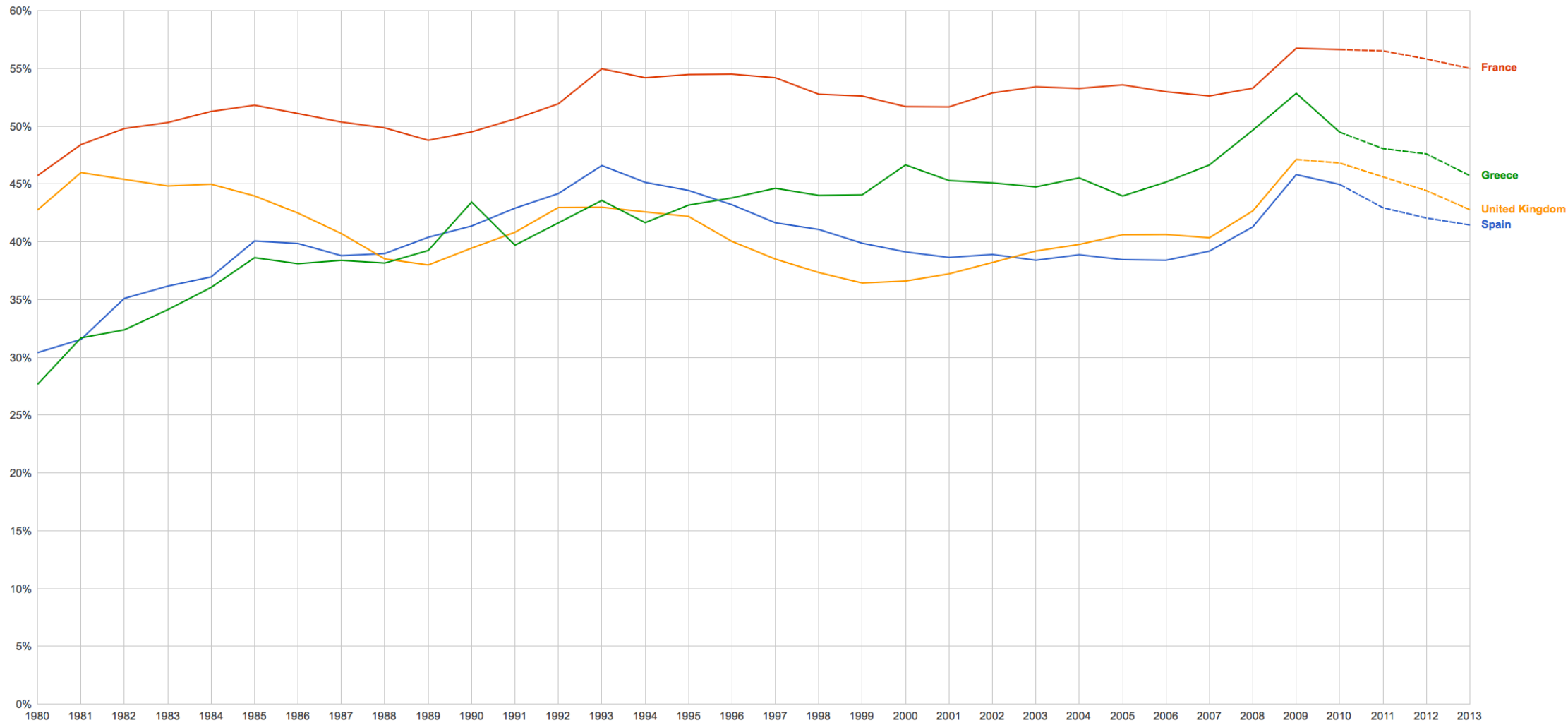
Evolution of net government debt (% of GDP)



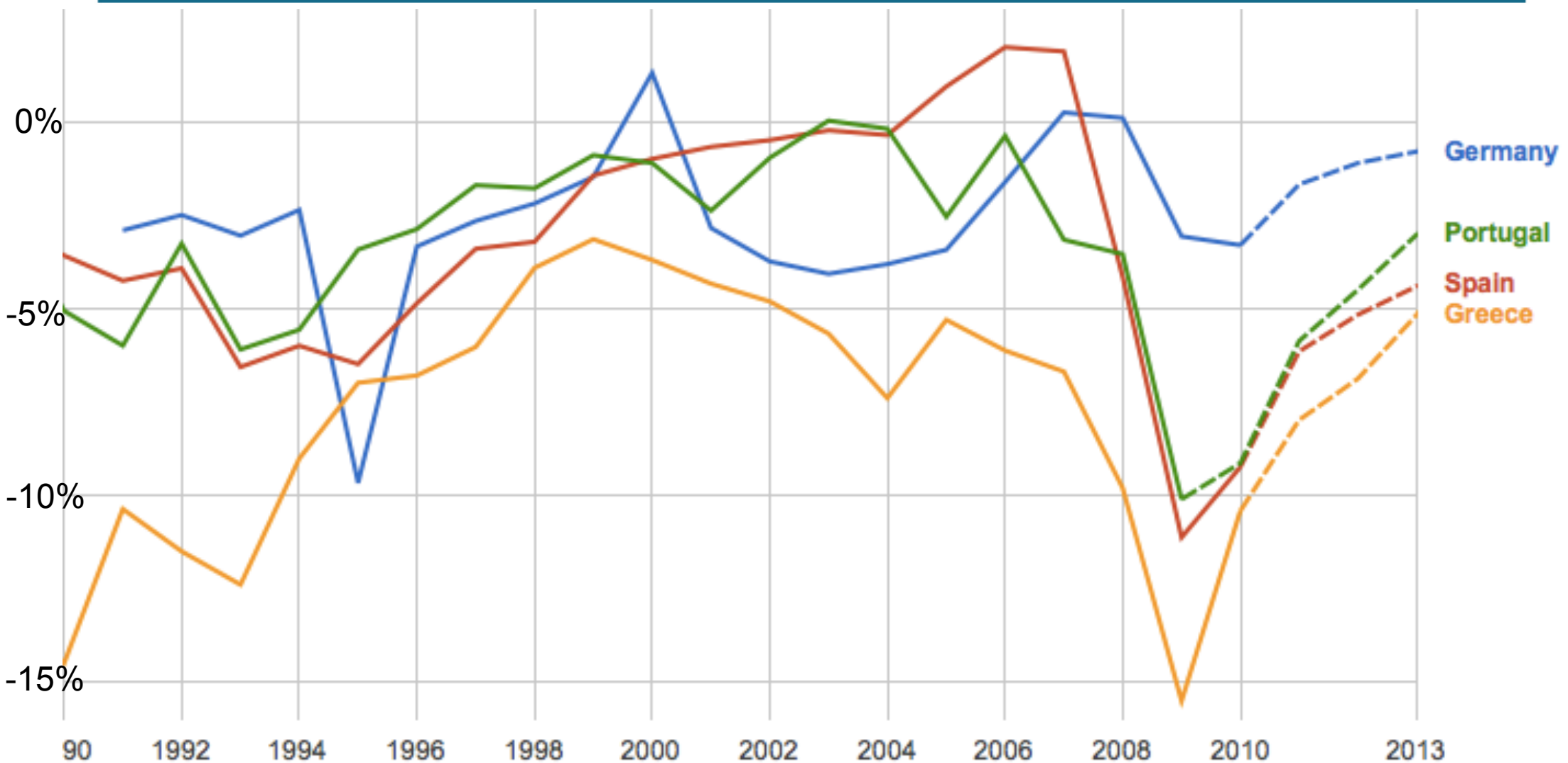
Evolution of government spending as a share of GDP

General government total expenditure (%) ?

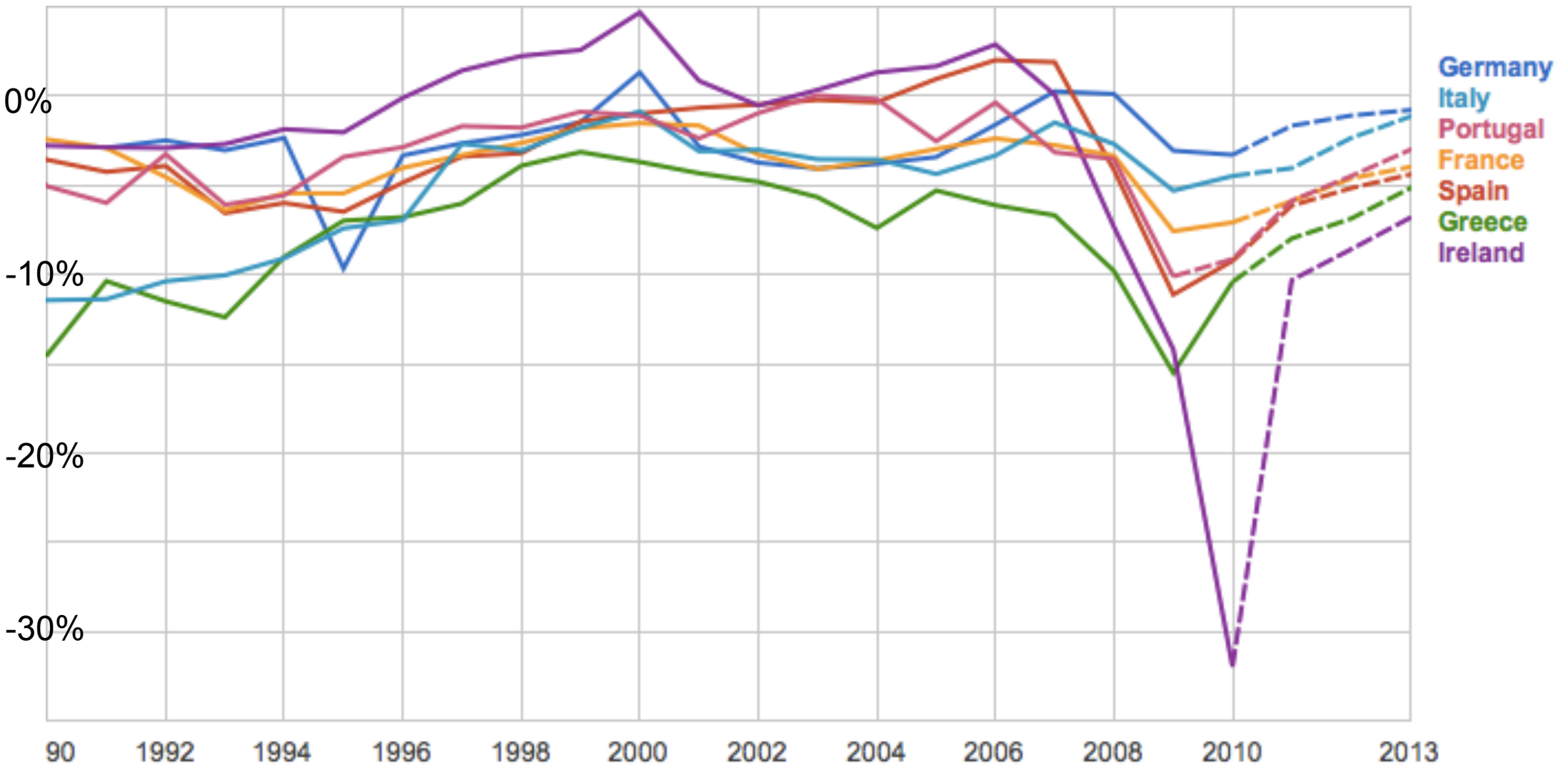
GO



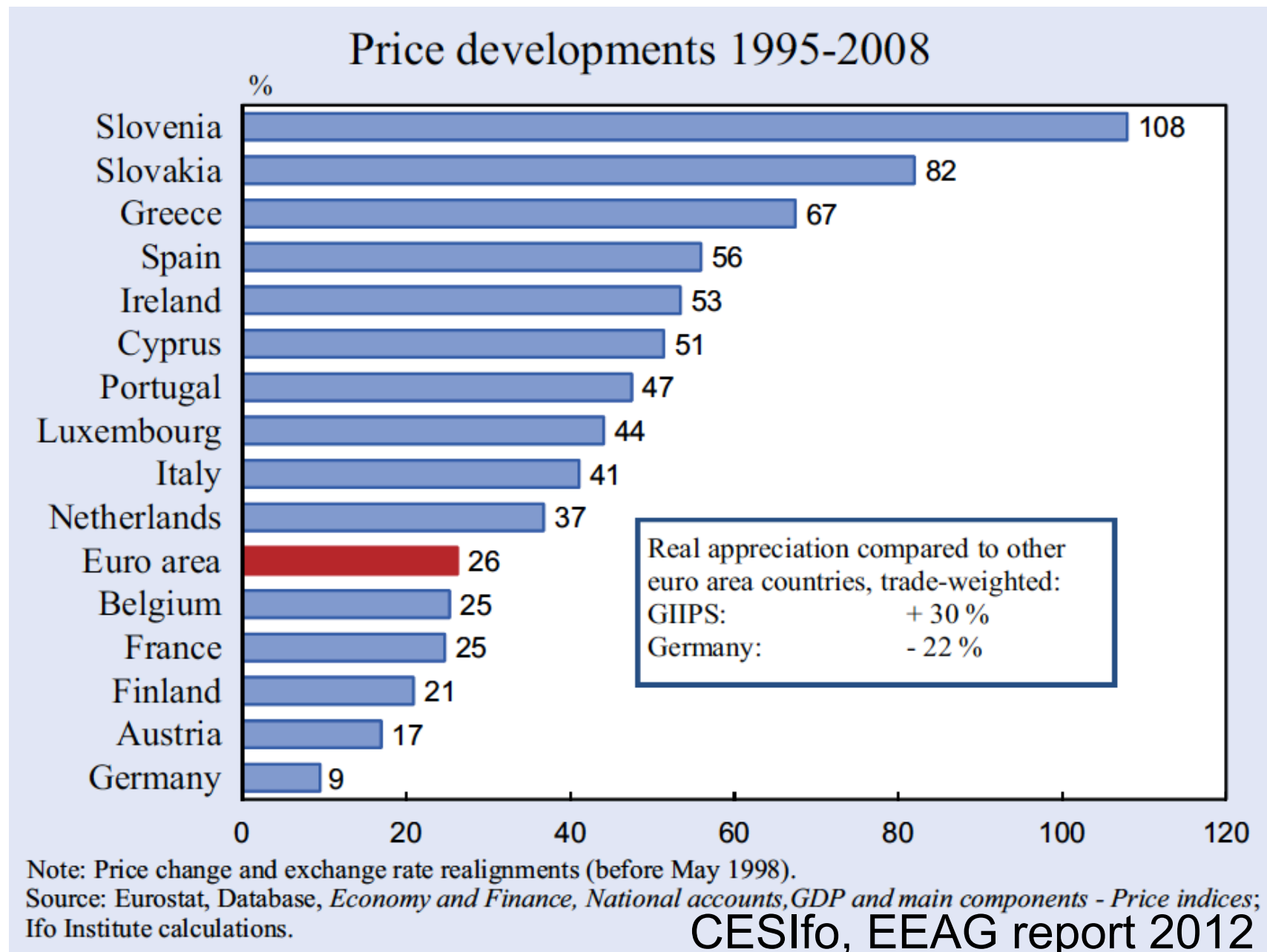
Government surplus/deficit as % of GDP



Government surplus/deficit as % of GDP



Divergence in competitiveness:

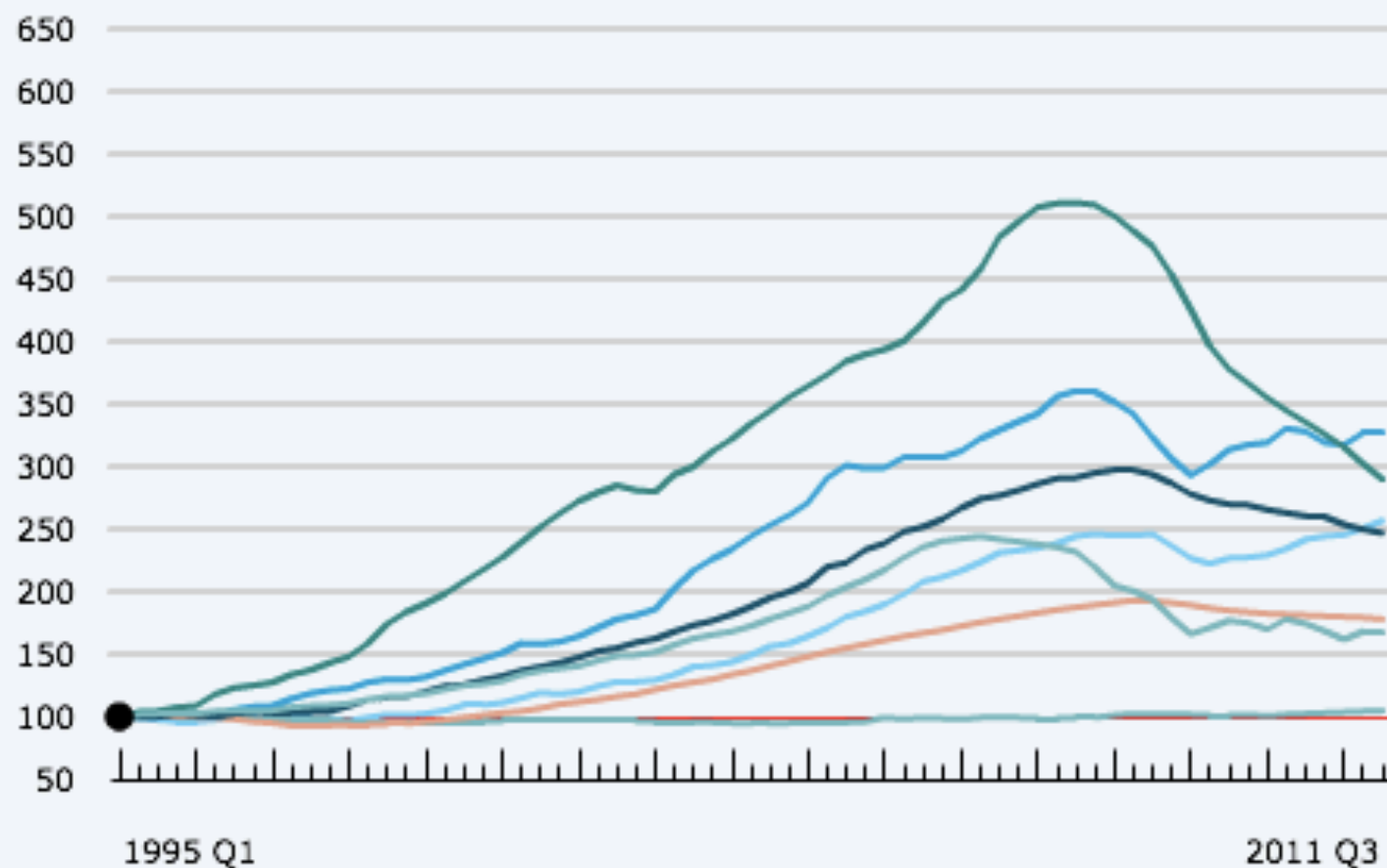


The Economist house-price indicators

The Economist

House-price index

1995 Q1=100



1995 Q1

Start

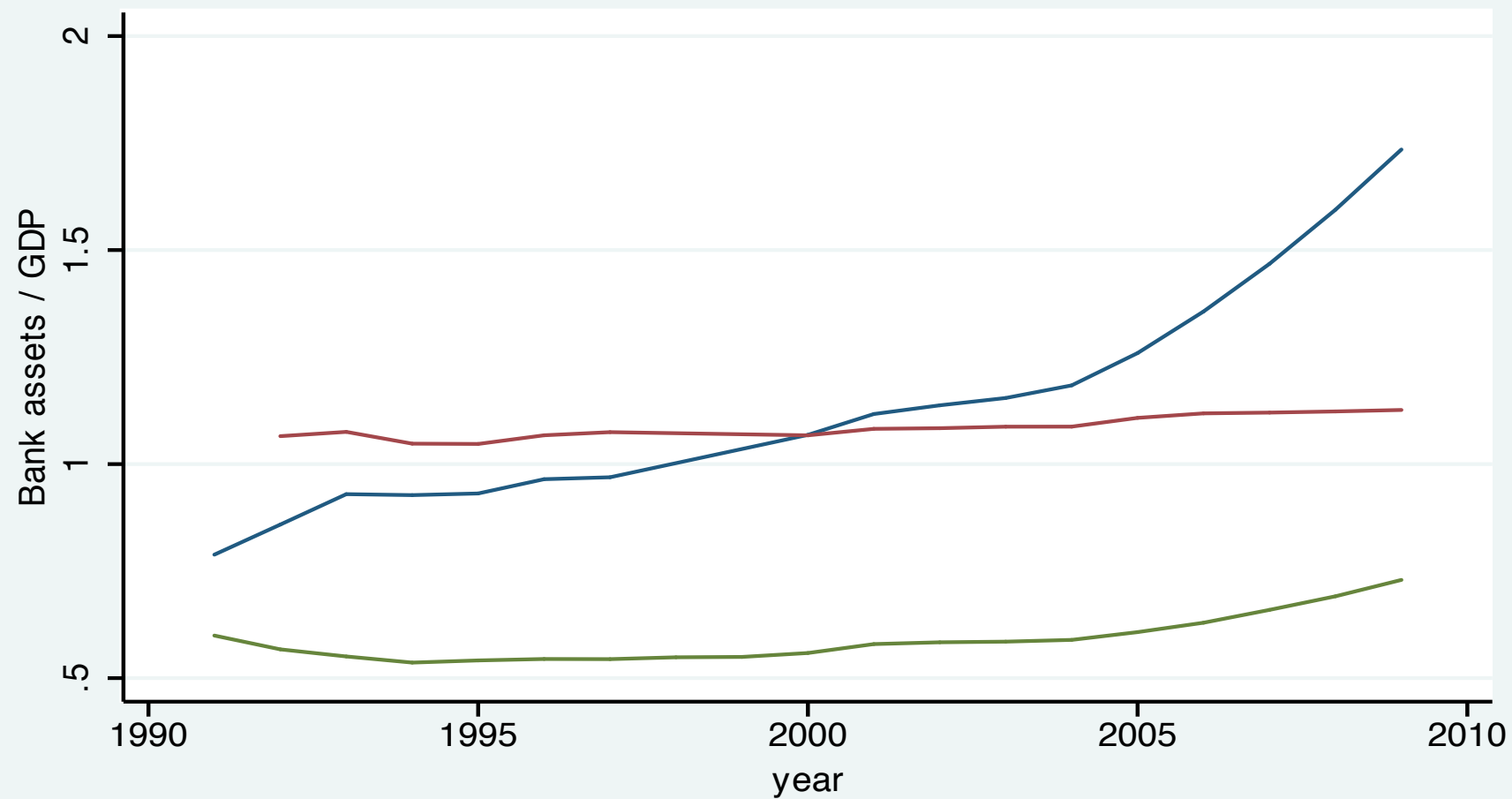
Select dates

End

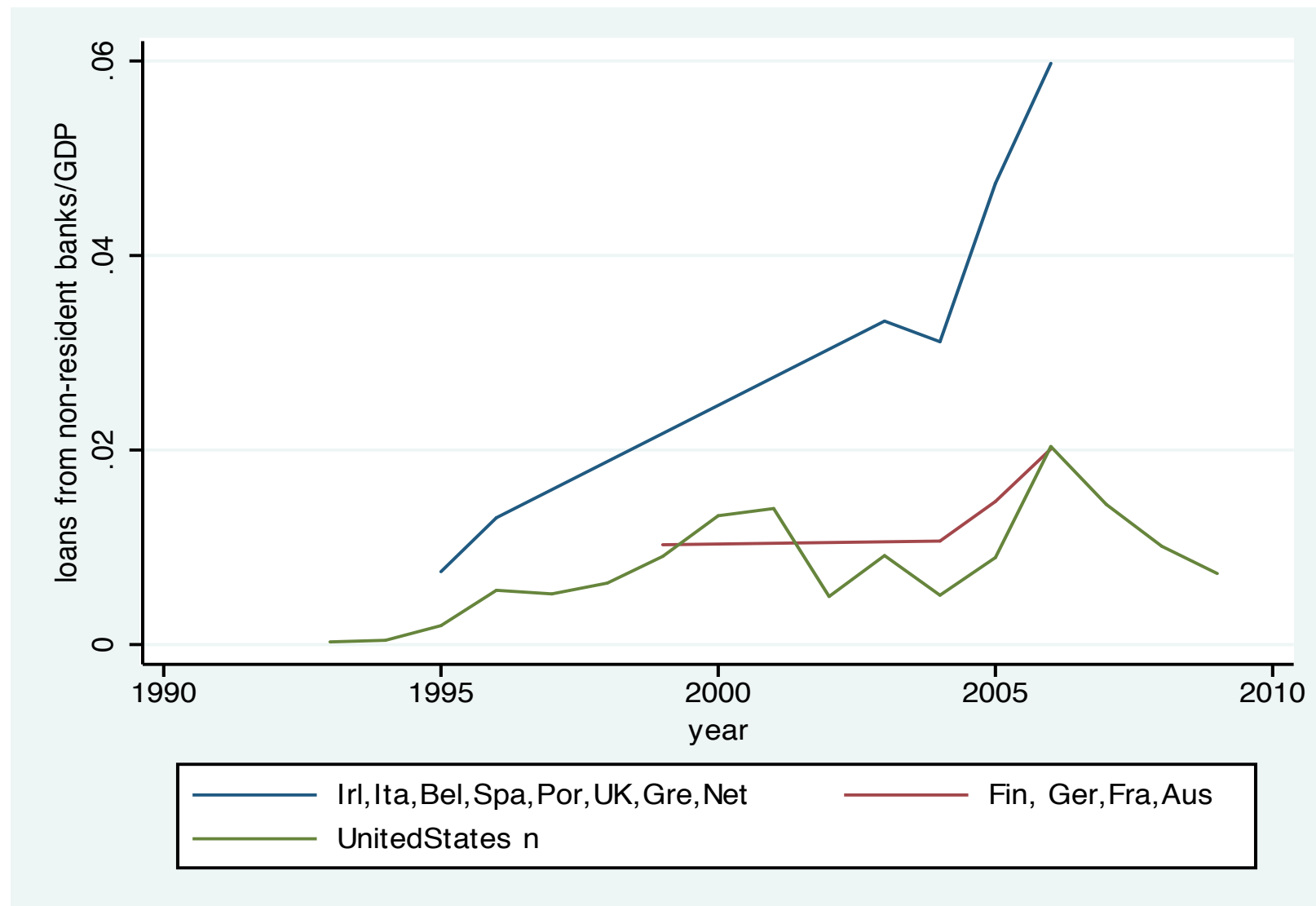
2011 Q3

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

Banking system expansion:



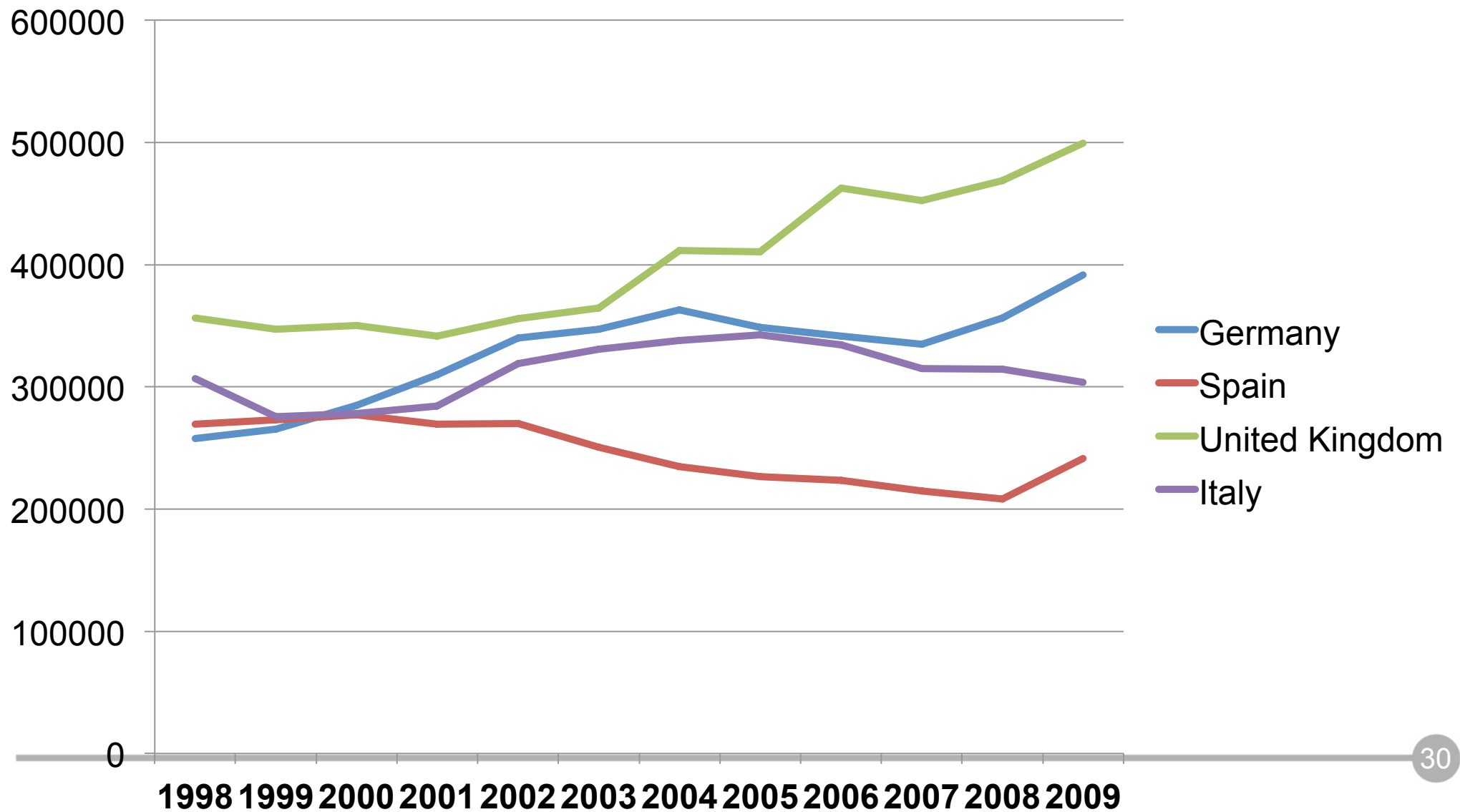
banks borrowed abroad



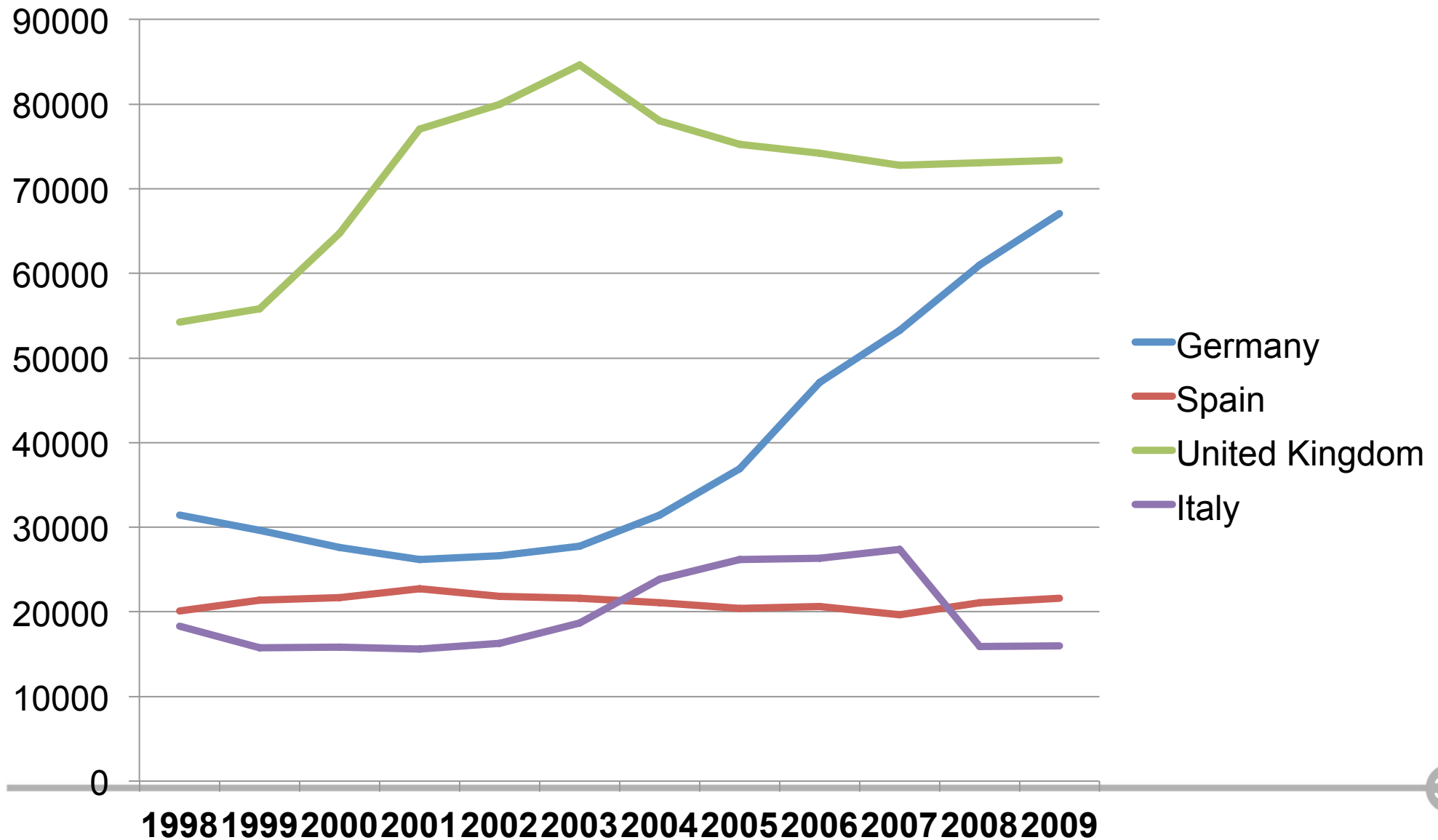
How much did this flow of resources equip the borrowers to repay?

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

New entrants to higher education, 1998-2009

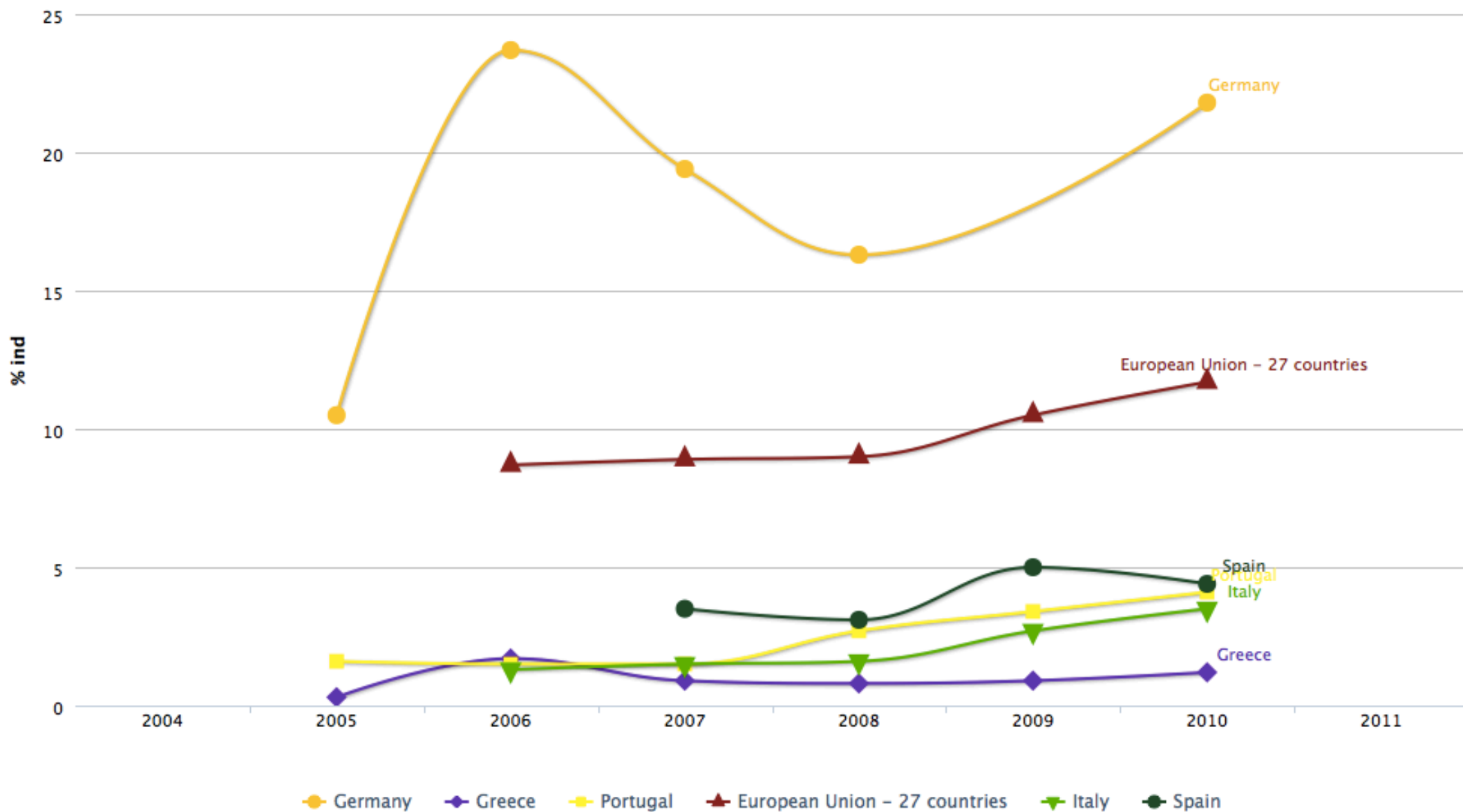


Science graduates, 1998-2009

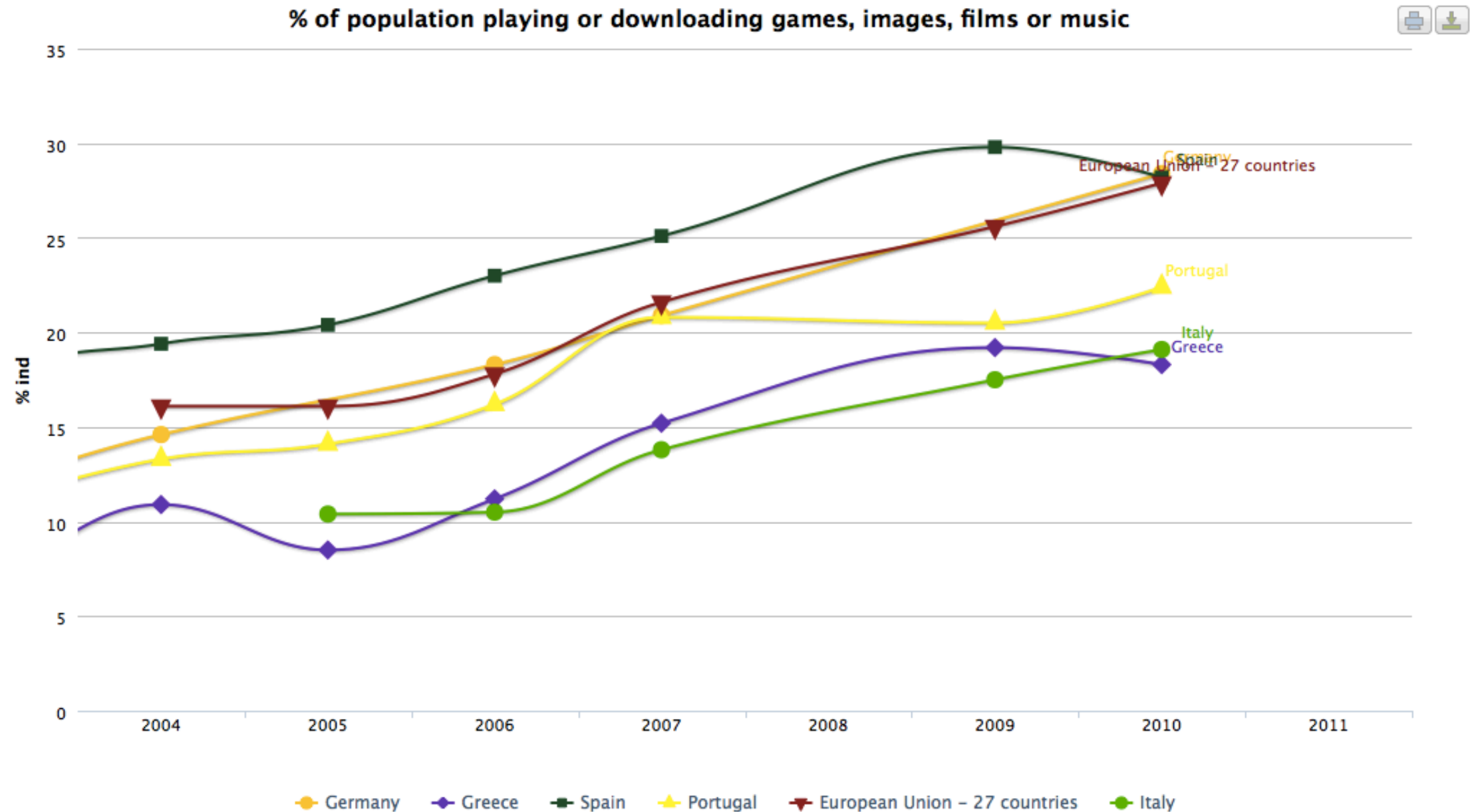


Evidence on the IT skills of the population

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



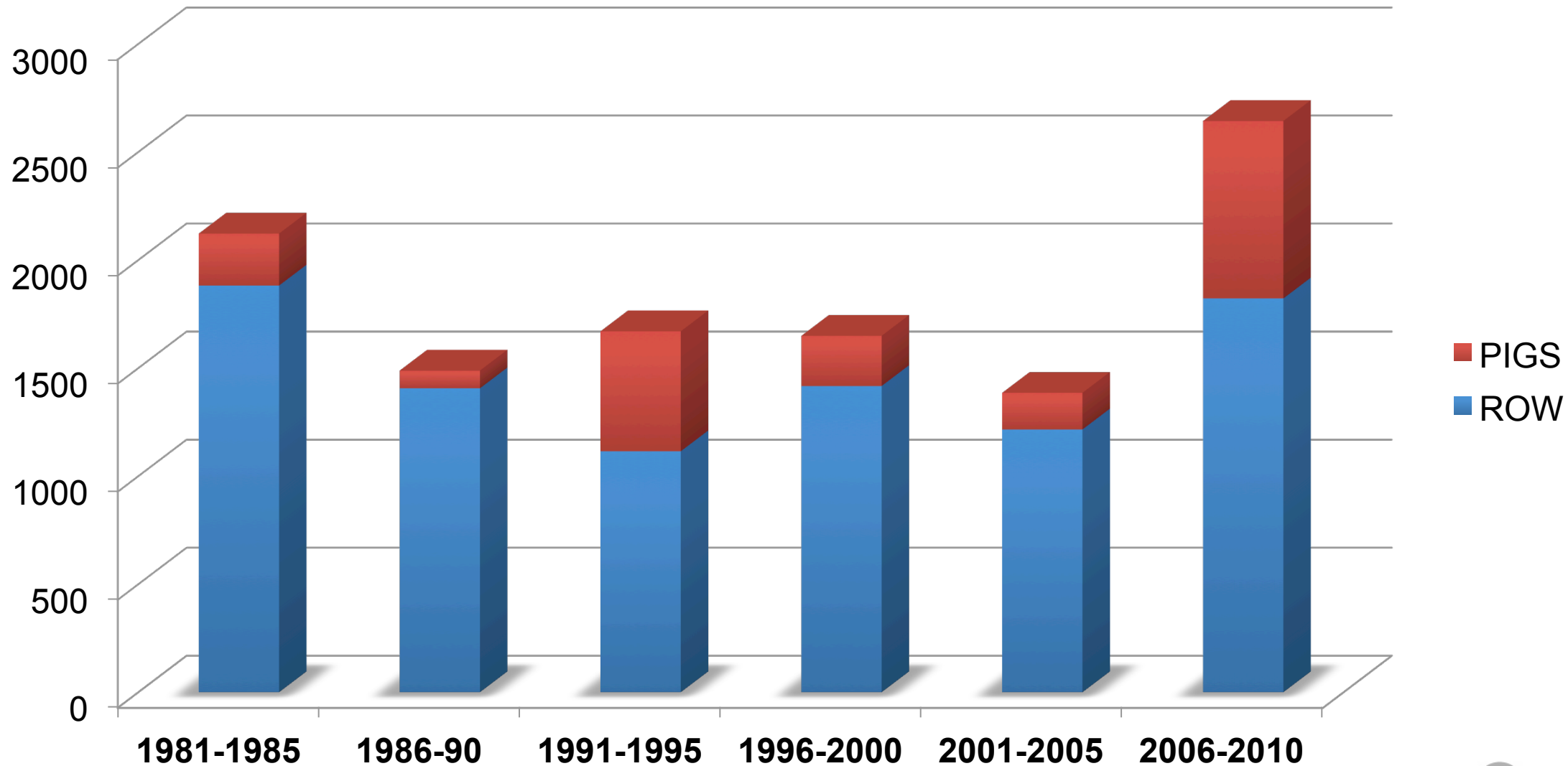
Evidence on the IT skills of the population (II)



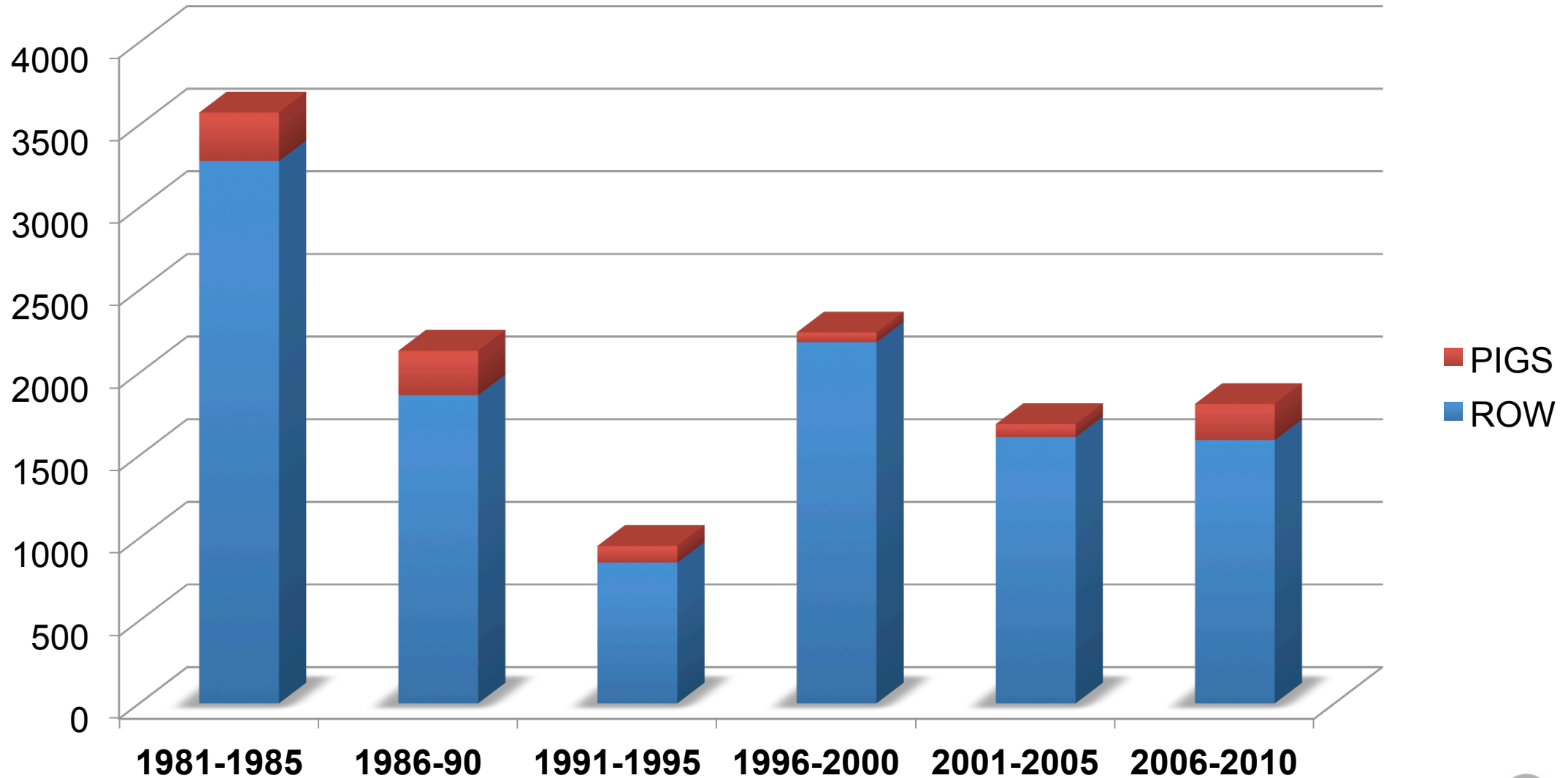
From 2000-2010:

- 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



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



Who were Greece's financiers?:

- 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)

BANK EXPOSURE: THE EUROZONE RISK

Q2 2010

Greece

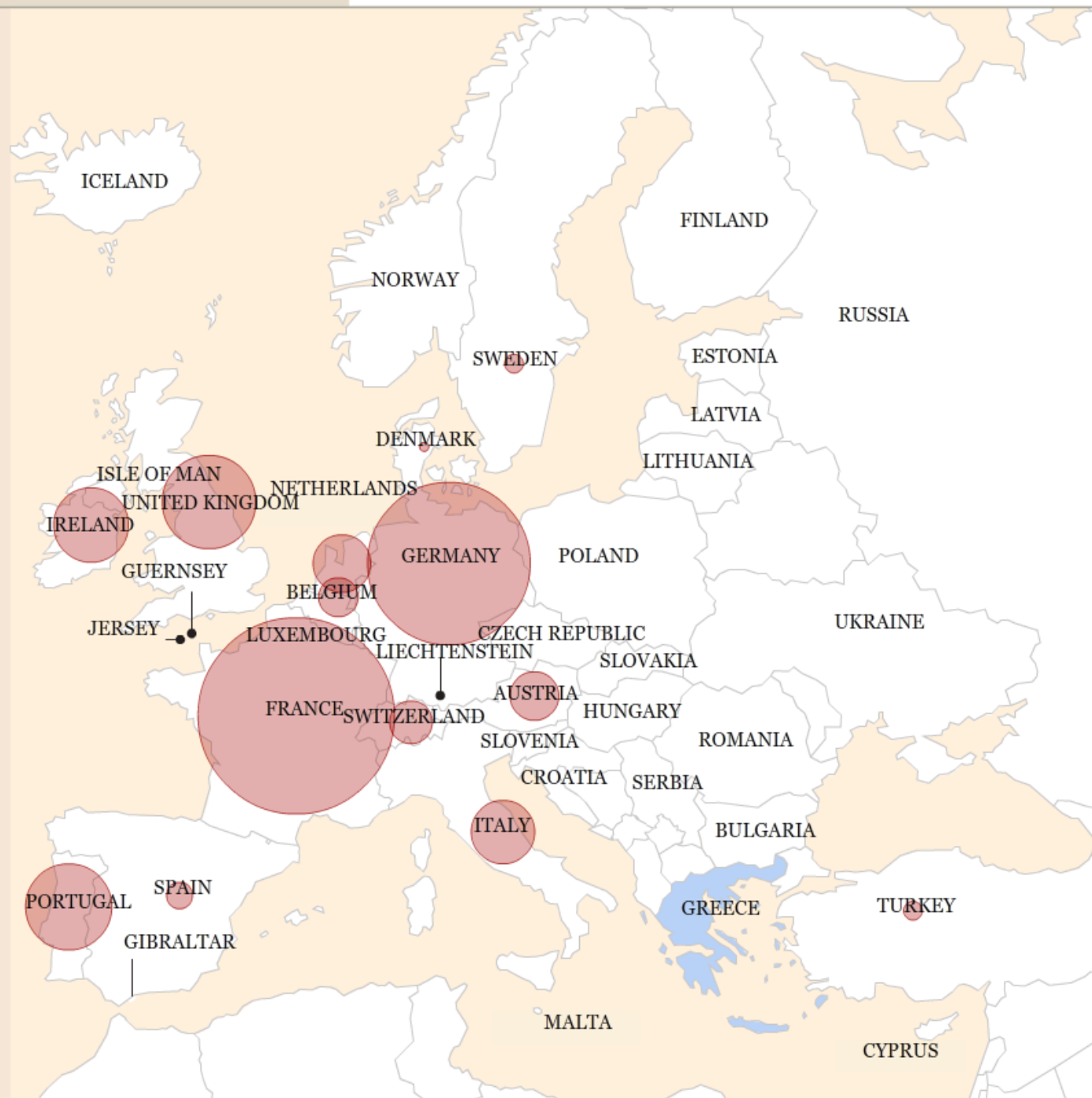
European banks' total exposure to public and private debt of Greece

\$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.



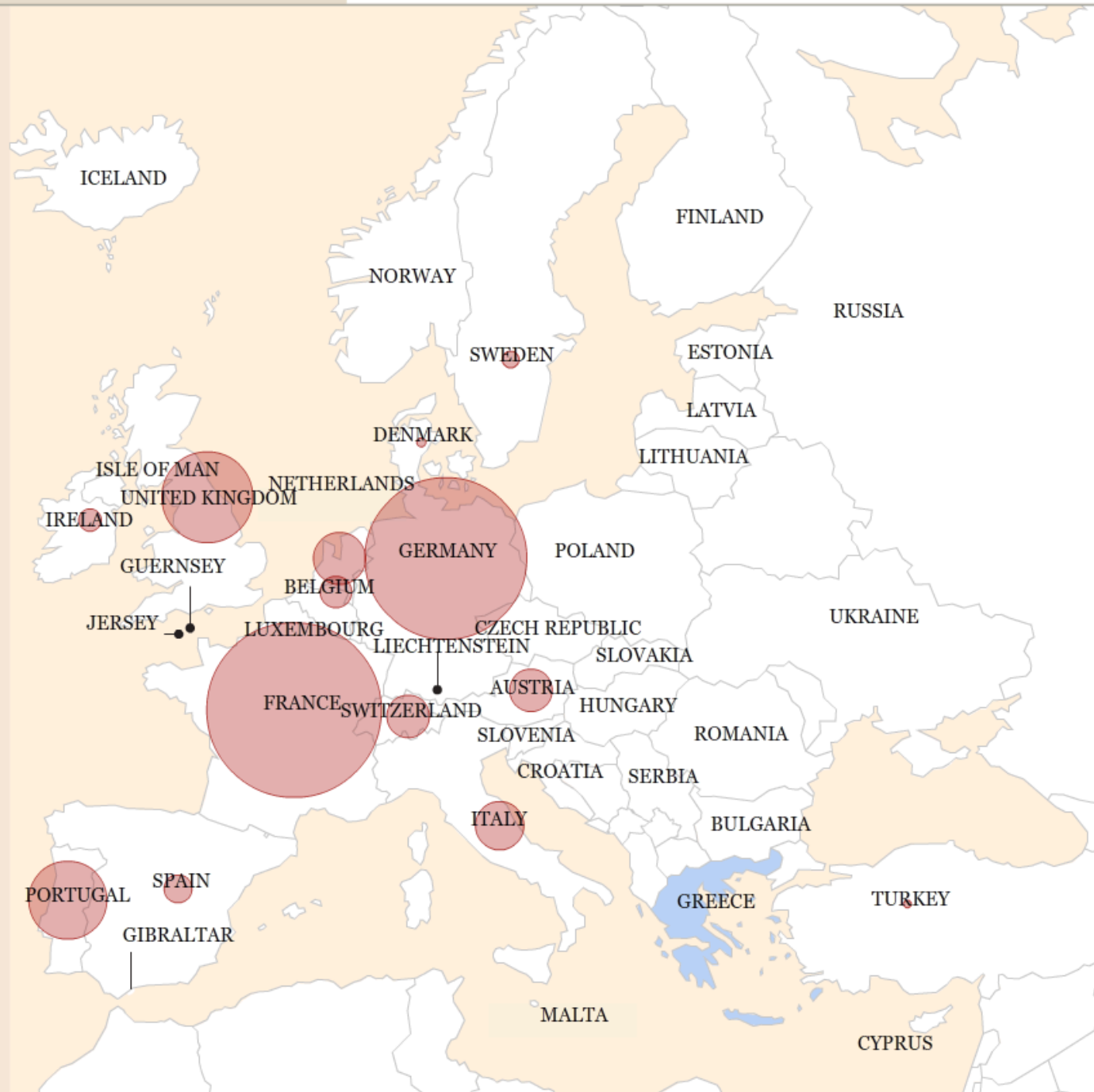
Greece

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.

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.

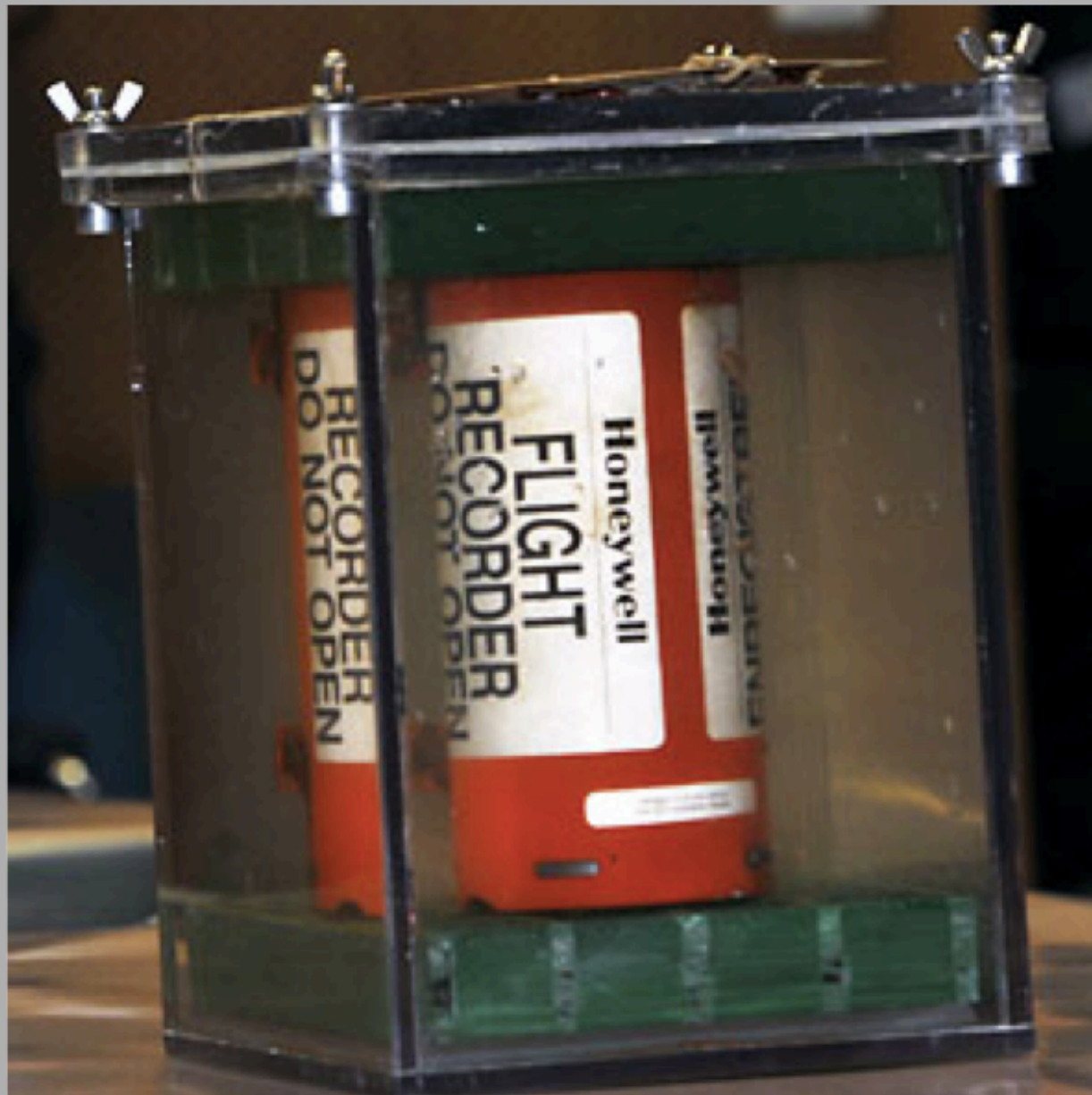
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(III) The illusion of panoramic vision

- 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, 1st June 2009



Air accident:

- 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:

- 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:

- 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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