

# Rules and Incentives in the Eurozone Crisis

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*It has been attempted to explain the crisis of the Eurozone by a number of economic arguments, including uneven macroeconomic developments among Member States, current account surpluses (North) against deficits (South), a lack of labour mobility and the creation of a Monetary Union without common fiscal and banking policies. However, on a more fundamental level, even the most basic rules of the Eurozone were hardly ever monitored sufficiently, let alone enforced. The convergence norms of the Maastricht Treaty were not implemented according to the “logic of appropriateness” outlined in New Institutionalism, leading instead to widespread strategic behaviour (gaming) on a massive scale. Weak surveillance and an absence of enforcement mechanisms have resulted in a situation where only the principle of debt mutuality can provide the Eurozone with urgently necessary breathing space. The question remains, however, whether the new institutions to be put in place as a “quid pro quo” for debt mutualisation – the Fiscal Pact, a banking union and tighter debt and deficit surveillance – will be respected and enforced.*

*Mit Blick auf die Ursachen der gegenwärtigen Krise der Eurozone wird häufig auf eine Reihe ökonomischer Aspekte verwiesen, darunter ungleiche wirtschaftliche Entwicklungstendenzen, mangelnde Arbeitnehmermobilität sowie die Schaffung einer Währungsunion ohne gemeinsame Fiskal- und Finanzmarktpolitiken. Allerdings gilt es zu beachten, dass nicht einmal grundlegendste Regeln der Währungsunion je lückenlos überwacht oder gar angewandt wurden. Die Konvergenzkriterien des Maastrichter Vertrages wurden kaum im Sinne einer „logic of appropriateness“ umgesetzt, sondern führten zu strategischem (Vermeidungs-)Verhalten der beteiligten Staaten. Unzureichende Überwachung und mangelnde Vollzugsmechanismen schufen eine Situation, die nur durch die gemeinsame Haftung für individuelle Schuldenlasten (zeitweise) aufgelöst werden konnte. Zudem verbleibt die Frage, ob und wie die neu geschaffenen Einrichtungen und Verfahren – darunter der Fiskalpakt, eine Bankenunion und die strikte Überwachung öffentlicher Haushalte – die benannten Defizite beheben können.*

## I. Introduction

Creating a new permanent institution, the ESM, and building upon the *ad hoc* EFSF, the EU seems to have found – after much deliberation since the Greek drama began many months ago – a response to the debt crisis: a potential mutualisation. Debt mutuality is to be accomplished in a variety of ways, including

- direct purchases of financial assets of private banks by the EFSF-ESM,

- increased purchases of state bonds by the EFSF-ESM,
- massive lending at low interest rates by the ECB to countries in difficulties, and
- large-scale ECB lending to banks and financial institutions, generally against their assets as collateral.

This sizeable increase in lending, credit exposure and acquisition of financial assets that can only be sold at high interest rates (while possibly being toxic) is to be financed partly via the sale of EFSF-ESM bonds at low interest rates on the global financial markets, and partly via increased liabilities of the ECB itself, not least the printing of money. These significant steps towards debt mutualisation, reducing the borrowing costs of both states and banks in difficulties, are combined with the introduction of new rules concerning a stronger fiscal pact and a future banking union. *Cui bono?*

## II. Opportunistic Behaviour with Guile

Social interaction involves two fundamental components: incentives and rules. In human motivation, incentives offer the balance of expected gains and costs that drive activity, whereas rules, when institutionalised, restrain the choice of options in action, by forbidding, demanding or permitting certain alternatives of action. Motivation and normativity result in action or interaction – what *Max Weber* called “*Handeln*”<sup>1</sup>.

The crisis in the Eurozone has its roots in a failure to enforce the rules of the club – mainly the Maastricht Treaty convergence criteria, i.e. norms concerning debts and deficits. Several Member States managed to renege upon these rules.

The consequence is that some countries now play games with an unsustainable debt situation, calling for assistance from other Member States in the currency union and demanding so-called bailouts. These countries have strong incentives to ask for various forms of debt mutualisation, although they intentionally neglected the basic regime of the monetary club they voluntarily chose to enter.

The EU’s political elite – the Commission and the Council – have not prevailed in developing a credible response strategy. Thus, the entire Eurozone faces a difficult situation and an uncertain future in the face of burgeoning debt.

1 *Weber, M.*: *Wirtschaft und Gesellschaft*, Tübingen, 2002 (first published in 1922).

### III. The Eurozone Crisis: Optimality and Reality

One may look at the unfolding Eurozone crisis from two different perspectives, economically and politically. Thus, one may raise the issue of whether something is fundamentally wrong with the construction of the Eurozone from a normative economic standpoint.<sup>2</sup> Here, one finds arguments drawing, in particular, upon the theory of optimal currency areas, but also on various other macroeconomic theories. The economic perspective tends to focus upon what could have been the best regime or set of policies for the Eurozone. On the one hand, some scholars point at

- the impossibility of an effective common economic policy from the Union, or
- the undue number of restrictions upon the national government policy-making from a Keynesian perspective.

On the other hand, scholars fear that the restrictions in the new fiscal pact will not really effectuate redistribution from North to South on a grand scale.

Alternatively, one may concentrate upon the way the rules of the Treaty on the Eurozone have been implemented as a matter of *fact*. The economic perspective tends to focus upon what would have been the *best* regime or set of policies for the Eurozone, whereas the political economy perspective concentrates on how the various actors manoeuvre in relation to the existing regimes and institutions – their *strategies*.

The aim of this contribution is not to add to previous arguments presented in this journal which outlined that and how the fiscal constitution of the Eurozone is not easily changeable, especially in view of the requirements of democratic legitimacy.<sup>3</sup> Instead, the argument is that the Eurozone crisis is an outcome of game-playing behaviour, where European leaders failed to embark on a strategy that puts the vital interests of the core members of the monetary club first. We can trace a set of nested games in which core EU leaders confront a number of countries in difficulties. Each country faces its own problems, but EU leaders need to

2 Cf. *Sapir, A.*: European Integration at the Crossroads: A Review Essay on the 50th Anniversary of Bela Balassa's Theory of Economic Integration, in: *Journal of Economic Literature*, 49/4 (2011), 1200–1229; *Blanchard, O.*: The Economic Future of Europe, in: *Journal of Economic Perspectives*, 18/4 (2004), 3–26; *ibid.*: Is there a viable European Social and Economic Model?, in: MIT Department of Economics: Working Paper, 2006, 6–21; *Dominguez, K.*: The European Central Bank, the Euro and Global Financial Markets, in: *Journal of Economic Perspectives*, 20/4 (2006), 67–88.

3 Cf. *Scharpf, F.*: Monetary Union, Fiscal Crisis and the Pre-emption of Democracy, in: *ZSE* 9/2 (2011), 163–198; *Schorkopf, F.*: Europas politische Verfasstheit im Lichte des Fiskalvertrages, in: *ZSE* 10/1 (2012), 1–29.

develop a strategy to deal with these problems in a consistent way. Nested games – and the ensuing complexity – may be decomposed by identifying various kinds of game-playing behaviour and attempting to develop relevant strategies.<sup>4</sup>

#### IV. Wrong Treaty or Implementation Deficit?

One may suggest that one fundamental game has dominated the interaction between the EU and Greece, starting when the country joined the Eurozone. It may surface when a regime is to be enforced: the “Prisoner’s Dilemma” game.

It is difficult to explain the crisis in the Eurozone, especially the Greek crisis, with general arguments about the impossibility of a currency union in Europe. For a considerable amount of time, there has been a debate on the viability of the Eurozone in general, with several, mainly American economists claiming that the construction of the currency union had major flaws.<sup>5</sup>

These arguments are, in general, based on theories on fiscal federalism and optimal currency areas, in addition to standard macroeconomic models that underline policy flexibility, including the strategic employment of monetary devaluations.<sup>6</sup>

Whatever the set of necessary and sufficient conditions for a successful currency club may be, the EU failed in a much more elementary way: it did not enforce its own rules. The golden rules of the Eurozone – a maximum 3% annual deficit and a maximum of 60% in accumulated public debt – were frequently mentioned, but they never became institutions (in the sense of rules with a high probability of enforcement).

When rules are not properly enforced or implemented by means of the credible threat of sanctions, they are reduced to the state of mere recommendations (or moral guidelines). This enforcement dilemma has weighed most heavily upon the Eurozone. Several countries took advantage of the lax respect for the Maastricht convergence rules, but hardly any Member State cheated on these rules to the extent that Greece did. Not only did Greece disrespect the basic rules of the Eurozone, it also did not convey accurate information on the extent to which it

4 Cf. *Tsebelis, G.*: *Nested Games*, Berkeley, 1992.

5 Cf. *Feldstein, M.*: *The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability*, in: *Journal of Economic Perspectives*, 11/4 (1997), 23-42; *ibid.*: *The Failure of the Euro. The Little Currency That Couldn’t*, in: *Foreign Affairs*, 91/1 (2012).

6 Cf. *Alesina, A./Perotti, R.*: *The European Union: A Politically Incorrect View*, in: *Journal of Economic Perspectives*, 18/4 (2004), 27-48.

reneged (guile). The logic of renegeing in group games leads to rational foolishness, as all actors are increasingly tempted to renege.<sup>7</sup>

It will become a most relevant topic for EU research to explain why the Greek deficits were not brought under supervision and reduced in the early years of the last decade. This would have been the task of the EU Commission, which evidently neglected the extent of Greece's cheating. A currency union cannot survive if its rules are bent year in and year out.

Reneging is, of course, a rational strategy where the renegeing player is fully informed about the advantages as well as the risks involved. It may be conducive to the accumulation of short-term gains, but it comes with huge risks for long-term losses. The Greek political elite – most of them still in power or with considerable influence upon policy-making – pursued the strategy of renegeing, or defection in a “Prisoner's Dilemma” game, deliberately and with much zeal, allowing the country to attain a higher level of affluence than otherwise feasible or likely – in the short run (myopia). The visible outcome is the mountain of debt built up since the accession of the country to the Eurozone.

## V. Rules and Incentives

Examining the data on Eurozone rule compliance, i.e. compliance with the Maastricht norms, one may establish that few countries took them seriously while disrespect grew as time progressed. Incentives appear to be stronger than norms, at least when enforcement is weak. The players involved in budget development draw up strategies, as suggested by classical budgetary theory that rely on opportunism, guile, the exploitations of options for renegeing, and the use of asymmetric information advantages.<sup>8</sup> The same forms of gaming would reoccur in multi-level “governance”, where the risks for moral hazard or adverse selection could only increase. What, then, is a stronger determinant of interaction: incentives or rules?

New Institutionalism within the social sciences claims that, in addition to the “logic of consequentialism” (i.e. basic rational choice modelling), there exists a “logic of appropriateness”. Two major scholars in organisation theory state:

The logic of appropriateness is a perspective on how human action is to be interpreted. Action, policy making included, is seen as driven by rules of appropriate or ex-

7 Bierman, H.S./Fernandez, L.: Game Theory, New York, 1998.

8 Cf. Wildavsky, A.: The Politics of the Budgetary Process, Boston, 1979.

emplary behaviour, organized into institutions. The appropriateness of rules includes both cognitive and normative components. Rules are followed because they are seen as natural, rightful, expected, and legitimate. Actors seek to fulfil the obligations encapsulated in a role, an identity, a membership in a political community or group, and the ethos, practices and expectations of its institutions. Embedded in a social collectivity, they do what they see as appropriate for themselves in a specific type of situation.<sup>9</sup>

Evidently, incentives have trumped any logic of appropriateness in the Eurozone, as several Member States have been driven by incentives to defect from the basic rules in the Maastricht Treaty.

In any form of intentional behaviour, it is incentives, expected benefits and costs that drive motivation. Rules or norms restrain behaviour but action is never “driven by rules”, as players decide to take them into account, respecting them or renegeing upon them, depending upon which strategy is most beneficial to them, in view of their incentives. To be considered “natural, rightful, expected and legitimate”, rules must be combined with an enforcement mechanism. Norms are never self-enforceable. As *Weber* emphasized in his painstaking critique of *Stammler*, one has to be careful not to commit the sin of social teleology, assuming that “natural” or “legitimate” rules are simply fulfilled because they are “rightful” norms or institutions.<sup>10</sup>

## VI. Greece: What is the EU Strategy?

In relation to Greece, the EU as a player is now involved in two types of games, one “Chicken Game” about whether Greece can stay in the currency club or must leave, as well as a “Battle of the Sexes” (or bargaining) game, concerning how much Greece should pay back on its total sovereign debt. These two games require different strategies but have nevertheless been confused in reality.

Although Greek leaders hold different preferences in relation to maintaining their membership in the currency union, they employ only one strategy, given the situation of the country and its total indebtedness, namely to delay everything. It has been successful for several months, involving election and re-election, demands for renegotiation with additional debt reduction or extended time for eventual repayments. This strategy of delay is in line with protests and rallies by

9 *March, J.G./Olsen, J.P.*: The logic of Appropriateness, in: Rein, M./Moran, M./Goodin, R.E. (eds.): Oxford Handbook of Public Policy, 2008, 689-708.

10 *Weber, M.*: Gesammelte Aufsätze zur Wissenschaftslehre, Tübingen, 1988 (first published in 1907).

social movements in Greece. However, these activities change nothing concerning the fundamental problem of the country: bankruptcy. Delay is a rational strategy in bankruptcy, as creditors need time to come to an agreement with the debtor about how these engagements are to be dismantled. Greece can hope for clemency from the EU as time drags out for negotiations about how the losses are to be divided between creditors and debtor. Greece aims for maximum debt relief, given its impossible situation, but this question is not logically related to whether the country should stay in the Eurozone or introduce a *New Drachma*.<sup>11</sup>

## 1. The Debt Negotiation Game

The EU has engaged in a strategy of attempting to control Greek public finances. Thus, it has imposed austerity measures as a *quid pro quo* for delayed repayment and various forms of debt relief. This represents a most unfortunate choice of strategy as it transfers responsibility for the hardships of the Greek people to the EU in a situation where Greece faces unprecedented rounds of budget cuts in its public sector and social services. This strategy – austerity – also invites the full use of delaying tactics and demands for renegotiations by the Greek side.

The EU could have employed an entirely different strategy from the beginning of the Greek crisis, when the full scale of the debt disaster began to unravel. Instead of interfering in Greek domestic affairs – budgeting and taxation – it could have forced the creditors to immediately acknowledge their losses, allowing them to find whatever agreements they could get from Greece. It would no doubt have been very painful for French and German banks, but not as painful as throwing good money after bad money. The problem would have been resolved in accordance with standard practices in bankruptcy.

As things now stand, the EU has become involved in Greek politics, following events on a quotidian basis. It has also taken over policy responsibility for the welfare of the Greek people while making no advances on the question of debt repayment. An agreement about a so-called haircut has been made, but Greece remains insolvent. Instead of following the same road, the EU should have accorded Greece sufficient debt relief to return its country economy to a viable state and relieved itself of the whole problem by asking Greece to leave the Eurozone. The austerity strategy that the EU imposes instead is likely to be self-

11 Cf. Hesse, J.J.: Die europäische Verschuldungskrise. Eine dreifach unerledigte Agenda, in: ZSE 9/3 (2011), 338-351.

defeating, as lower economic activity in the country leads to a higher relative debt burden and larger risks for creditors, including the ECB and the EFSF/ESM.

## 2. Austerity: The Vicious Circle

Surprisingly, it is only the Greek leaders who have publicly discussed a departure from the currency union, not the core EU leaders (who keep repeating that they want Greece to remain a member). This amounts to a serious strategic mistake, as it allows Greece to play the “Chicken Game” with full vigour. And it allows Greece to connect the exit question with the debt question, to its advantage.

However, for peculiar reasons, the EU fails to employ its best strategy, explaining why Greece prevails in this interaction with only one visible consequence: just talk, no action. The longer Greece has the upper hand in this “Chicken Game”, the higher the costs for the other EU and Eurozone Member States.

The strategy of the EU in relation to Greece – austerity in combination with debt relief – will not succeed in creating a sustainable economic situation in the country, or increasing the probability that it would be able to serve its debt in the near future. Table 1 offers a picture of the Greece predicament, relating its GDP to its total public debt.

*Table 1: Greece: GDP and Debt in Euros (billion)*

Year	GDP	Total Debt	Total Debt / GDP
2009	232	298	128%
2010	227	328	144%
2011	215	368	171%
2012	200	280	140%
2013	190	280	174%

Note: 2012 figures include the debt forgiveness of 107 billion Euros, which is the "hair cut" of the private banks. The GDP of Greece is predicted to contract between 5-10 per cent in 2012 and 2013. Figures for 2012 and 2013 represent projected estimates. *Source:* Eurostat, KS-EK-12-001, 2012.

The outcome of the game played between the EU leaders and the Greek political elite results in an unsustainable situation, despite a considerable debt write-off in 2011. The strategies employed – austerity in combination with debt relief against delay and renewed claims for additional debt forgiveness – result in a *vicious circle* where Greece as a country is rendered more and more impoverished and the EU finds itself burdened by loans to the country that will most likely never fully service or even repay.

## VII. Credibility of a set of Rules or a Regime

The interaction between the EU and Greece over the last two years has resulted in gaming where, so far, the latter is the winner. Greece has the upper hand in the evolving “Chicken Game”, being able to claim ever renewed debt forgiveness without having to face any harsh counter-strategies. Having reneged upon its commitments towards the basic regime of the Eurozone club for more than a decade in a one sided “Prisoner’s Dilemma” game, Greece is now capable of forcing the EU to assume larger and larger responsibility for its debt mountain as part of the negotiation game. In addition, Greece receives one of highest annual per capita payments from the EU funds.

The weakness of the EU’s core leadership, especially the Head of the Commission, is stunning, given the aforementioned lessons from game theory. The basic problem with the Eurozone is not the faulty construction of its regime, but the complete lack of monitoring and enforcement. This invites moral hazard, or the incentive to take undue risks because the rules of the game are such that the eventual costs are not borne by the party taking the risk.<sup>12</sup>

The search for a so-called solution to the Greek crisis is, according to game theory, rather straightforward:<sup>13</sup> (1) Greece leaves the Eurozone and (2) creditors recover as much of their loans as possible – a task for negotiations. EU Member States may well ponder various proposals to reform their regime for the Eurozone, but they must first and foremost strive to implement existing rules. If they could turn the rules of the Maastricht Treaty into a real and binding institution, the risk of a catastrophic Eurozone break-up would decrease considerably.

## VIII. Conclusion: Debt Mutuality?

Given the crucial decisions on 29 June 2012, the EU must decide on a new economic regime for the Eurozone, one part comprising rules that would allow for the financial monitoring of both Member States and private financial institutions, including enhanced common economic policies, and the other part involving debt mutuality in the form of ESM bonds. In view of the defection from the Maastricht rules, one may wish to cast doubt on the likelihood of any logic of appropriateness developing in relation to any new rules that may be introduced in

12 Cf. *Rasmussen, E.*: Games and Information, Oxford, 1994.

13 Cf. *Gintis, H.*: The Bounds of Reason: Game Theory and the Unification of the Behavioral, Princeton, 2009; *Morrow, J.D.*: Game Theory for Political Scientists, Princeton, 1994.

the second half of 2012. Why would they not also be bent by the force of incentives, myopia and asymmetric information?

The ongoing severe debt crisis in the Eurozone will doubtlessly reduce the relevance of the all too general debate on “Europeanisation” that figured prominently - but analytically “soft” - in the sizeable literature on the EU and its common currency. Other existing coordination mechanisms, such as ASEAN, UNASUR, ECOWAS, or SADC, will pause to reflect on the possible disadvantages of a currency union, reinforcing the observation that regional integration is not limited to one single model.