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The Eurozone as a Morality Play

It is no exaggeration to state that there is a deep cleavage between the North and the South of the eurozone. The cleavage is not only limited to economic differences: a relatively prosperous North that up to now has not been affected much by the sovereign debt crisis, and a troubled South (including Ireland) where the debt crisis has hit with full force, pushing countries into a bad equilibrium that is characterised by high interest rates, budgetary austerity, increasing unemployment and economic recession.

Parallel to this economic cleavage, there is a deep divide in the nature of the analysis provided by economists of the causes and the remedies of the sovereign debt crisis. The view of the causes and the remedies of the crisis that prevails in Germany and its satellites has two ingredients. First, governments' profligacy that led to excessive deficits and debts is to be blamed for the crisis. Second, punishment should be meted out to these governments so as to signal to them that they should not try "to sin again".

The "Northern diagnosis" of the crisis may apply to Greece, but it does not do so for most other eurozone countries. Prior to the crisis, the government debt to GDP ratio was declining in most eurozone countries. Debt to GDP ratios started to increase after 2007, when governments were forced to save the banking system and to sustain economic activity (by allowing automatic budget stabilisers to do their work). Instead of blaming these governments, "Northern analysts" should congratulate them for having saved the banking system and much of the private economy. The high budget deficits and debts inherited from that episode are testimonies to the public service provided by governments.

A diagnosis that blames governments for the crisis is almost surely not the one that provides the correct remedies. The insistence by Northern analysts that governments should be punished for their bad behaviour by tough austerity programmes has had the effect of bringing the eurozone to the brink of a new recession. This will not help to reduce budget deficits and debts. Invariably, recessions increase government deficits and debts, thereby offsetting a large part of the positive effects of budgetary austerity.

This being said, the levels of government debts and deficits are too high and should decline over time. The point is that the Northern analysis has the effect of imposing tough austerity too quickly and on too many countries at the same time. This leads to a deflationary spiral that is pushing the eurozone into a double-dip recession. Rarely has an analysis been simultaneously both so influential and unhelpful in solving a crisis. Why has Northern Europe been gripped by such an unhelpful diagnosis of the crisis?

One reason is that too many analysts in Northern Europe see the crisis as a problem of moral hazard. Many well-known economists in these countries have stressed the irresponsible behaviour of governments of peripheral countries as the root cause of the crisis and have warned that providing financial assistance will induce these governments to remain irresponsible.

This view has dominated the popular press in countries like Germany and the Netherlands. As a result, the popular sentiment in these countries has very much turned

against financial assistance for “irresponsible governments”. This popular sentiment has been very influential in shaping the official German and Dutch policies. But is the crisis the result of moral hazard?

Take the cases of Ireland and Spain. The government debt ratios in these two countries declined dramatically prior to 2007. More than in other countries, the governments of these countries were forced to rescue the banks and to sustain economic activity. The effect was that the government debt exploded in these countries. By no stretch of the imagination can one interpret these events as being the result of moral hazard. The Spanish and Irish governments did not increase their debt as of 2007 because they expected to be bailed out by Germany or any other country. They did this because any government responsible for the welfare of its people would have done the same thing. There was no other viable option except letting the economy and the market system in these countries implode.

Proponents of the moral hazard diagnosis may object here, by noting that even if the governments’ actions were not driven by moral hazard, the latter was at the core of the banking crisis that forced the governments to intervene. Thus, ultimately the cause of the crisis is moral hazard: banks took excessive risks because they expected to be bailed out by their respective governments.

This interpretation does not make sense either. It is true that bankers took excessive risks. But not because in the back of their mind they had this idea that governments would rescue them. The top management of the banks could not possibly have hoped that governments would bail them out, as such a bailout operation could have cost them their heads. They took excessive risks because the euphoria during bubble years prevented them from seeing these risks. The euphoria in turn was generated by financial markets that lacked any disciplinary mechanism, and by an absence of supervision as the supervisors were gripped by the same euphoria. Moral hazard had almost nothing to do with this.

Moral hazard thinking in Northern Europe has now degenerated into a morality play in which there are good and bad countries. The good countries should not assist the bad ones because doing so would simply reward bad behaviour. Punishment is necessary. This moralistic attitude is the single most important obstacle to resolving the crisis.

Paul De Grauwe
University of Leuven and CEPS, Brussels, Belgium