The Euro Prisoner’s Dilemma

Diego Valiante

The intergovernmental agreement reached in December among 25 EU countries – the so-called ‘fiscal compact’ – aims at levelling the playing field among member states' public finances in the euro area to promote greater institutional interaction and ease the current debt crisis. In addition, the European Stability Mechanism would also provide a potential means of coordination of fiscal policies in the eurozone. Political decisions so far, however, have not effectively tackled this crisis.

A non-cooperative equilibrium

The eurozone debt crisis has fallen into a classic prisoner's dilemma. One party does not cooperate because it would expose itself to the potential non-cooperative decision of the other party, the latter of which would be able to extract a greater payoff than the cooperative solution would yield in the short-term. In other words, weaker countries, if they decide to give away part of their sovereignty to a supranational institution, would expose themselves to the imposition of supervisory and governance mechanisms in favour of creditor countries. The recent proposal by an influential member of the Bundestag to place Greek public finances under the direct control of a European Commissioner was not made in jest.

Countries with better public finances, instead, would expose themselves to the moral hazard of debtor countries that, once protected by the solidarity mechanisms of the federal institution, would have insufficient incentive to carry out structural reforms and austerity measures. As a consequence, so far few member states have shown any real interest in transferring additional sovereignty to a more federal and politically united governance of the eurozone.

Fear of losing control over the political decisions taken by the euro area is triggering a series of rational (but sub-optimal\(^1\)) choices incapable of dealing with the core issues of the crisis and so leading to an outcome/equilibrium that no one really wants (and everyone will regret \textit{ex post}), i.e. the total or partial break-up of the euro area.

The roots of the dispute

Two key issues emerge from this crisis. First, it is essential to rebalance the competitiveness among the member countries of the eurozone. To avoid austerity measures becoming self-defeating, less competitive countries should be assisted in their attempt to boost growth and development through additional investments in productivity and support to structural reforms. This is a long-term and costly action, however, that can only be achieved secondly by empowering European institutions to redistribute a bigger EU budget with part of the surpluses that some countries are steadily enjoying over time. This in turn will require fundamental reform of the current European institutions, which does not appear high on EU leaders’ agenda.

While it is unquestionable that peripheral countries were myopic in postponing structural reforms when refinancing costs were at their lowest levels, it is true as well that the monetary union has largely helped more competitive countries by freezing exchange rates at that time. An implicit currency devaluation in more productive countries occurred, as that decision blocked the dynamic evolution of exchange rates, which typically adjust over time to reflect the ever-changing economic and political realities of a country.

\(^1\) A leaked document by the Financial Times, prepared by the Commission, ECB and IMF, casts doubt on the effectiveness of current Greek debt deal of €130 billion, even though the deal opens new scenarios for a systematic debt restructuring of eurozone member states’ debt (see [http://blogs.ft.com/brusselsblog/2012/02/more-on-leaked-greek-debt-report/#axzz1mwwHvkIm](http://blogs.ft.com/brusselsblog/2012/02/more-on-leaked-greek-debt-report/#axzz1mwwHvkIm)).
The common currency has therefore widened the original divergences in competitiveness. For instance, since 2002, Germany has enjoyed on average a current account surplus of roughly 5%.\(^2\) The German economy thus has been able to reinvest (at current GDP levels) almost €100 billion a year, which has fuelled additional investments in productivity and growth. The gap between member countries with different levels of competitiveness has been widening with the common currency.\(^3\)

The second key aspect is the absence of an effective emergency liquidity mechanism to seal the eurozone off from further contagion effects coming from the Greek debt restructuring. If the ECB is not allowed to carry out a direct intervention (in primary or secondary markets) or an indirect one through standing facilities (the ESM and EFSF) or to continue with the LTROs,\(^4\) financial markets will certainly test the limited resources available through the funds (currently up to €500 billion) and thereby the effectiveness of the implicit guarantees posted by member states (see Valiante, 2011). Markets are already discounting that, due to tough economic and financial conditions, some countries will not be able to generate sufficient cash flow to repay their debt. The recent ECB intervention (LTRO) to inject liquidity in the banking system is just a temporary solution to tap a continuous problem on the asset side.

**Inching towards the optimal equilibrium**

A sequence of sub-optimal, non-cooperative equilibria condemns any agreement that would entail a transfer of sovereignty to supranational institutions to fail. However, it is not in the member states’ interest to let the euro area go. Therefore, when a new crisis looms over EU financial markets, the payoffs of the non-cooperative behaviour drop, as countries perceive the risks of the alternative option if they do not find an agreement. In the end, even though fundamental institutional decisions are gradually taken, decisions come at a very slow pace and therefore at high implementation costs for member countries. Overall, the ‘game’ moves towards the optimal equilibrium, but it moves on a sequence of sub-optimal solutions, which are costing the eurozone a lot in terms of worsening financial and economic conditions (lower growth) and rising social conflict.

The real question is: what will the final optimal equilibrium will look like? Firstly, it is crucial to set up the proper institutional framework that would allow member states to interact on the same playing field. Secondly, increasing the firepower to backstop widespread liquidity crises across the eurozone would create a stable safety net. Whether this will be done through the ECB’s indirect intervention (through support to banks and current funds) or through a direct one (via a classical quantitative easing), it will be a political decision. As a matter of fact, the euro area will need to seal off from further contagion effects the debt of countries such as Italy and France. Once this is done, a parallel process of debt restructuring (using collective action clauses introduced in national laws) and the swap of parts of national debts with Eurobonds or Eurozone-guaranteed bonds would provide solid grounds for growth measures to thrive on a solid ground. Europe should be able to combine debt restructuring (deleveraging) and growth. The process will be certainly long and painful, but it will strengthen the common market and the political and economic role of the euro area in the global economy. A long-term cooperative equilibrium among member states would make sure that all citizens will not feel caught as prisoners of the eurozone and its unresolved dilemma.

**Sources**


Luce, R.D. and H. Raiffa (1957), Games and Decisions, New York: John Wiley.


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\(^2\) Just before the introduction of the euro, Germany went through important reforms, e.g. labour market reforms, but this does not entirely justify the sharp evolution of its current account surplus.

\(^3\) For instance, Spain has implemented some important reforms in the labour market, as well as promoted huge investments in infrastructure and development, but the country has lost competitiveness in any event and has only partially succeeded to boost productivity.

\(^4\) Long-Term Refinancing Operations.