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The Euro Area Crisis: Politics over Economics

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Abstract

This paper explores the dominant role of politics in decisions made by euro area governments during the crisis. Decisions that appear to have been driven by local political considerations to the detriment of the euro area as a whole are discussed. The domination of politics over economics has led to crisis mismanagement. The underlying cause of tension is identified as a misalignment of political incentives. Member state governments tend to defend their own interests in a noncooperative manner. This has magnified the costs of the crisis and has resulted in an unbalanced and divisive incidence of the costs across the euro area. The example of Cyprus is discussed, where political decisions resulted in a transfer of about half of 2013 GDP from the island to cover losses elsewhere. In the absence of a federal government, no institution can adequately defend the interests of the euro area as a whole. European institutions appear weak and incapable of defending European principles and the proper functioning of the euro. Political reform is needed to sustain the euro but this is unlikely to pass the political feasibility test with the current governments of Europe.

KEYWORDS: Currency union, euro, European integration, sovereign debt, Deauville, Cyprus.

JEL Classification: D72, E32, E65, F34, G01, H12, H63.

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1 Introduction

The euro area crisis has been the focus of attention on both sides of the Atlantic over the past few years. At stake is the future of European integration, with economic and political implications. The promise of the euro was to leverage economic benefits that the common currency could bring to soften political resistance towards deeper integration. Instead, the crisis has brought to light political obstacles that have obstructed the functioning of the economic and monetary union.

The focus of my remarks is the political obstacles that hinder European integration. Through a brief review of economic developments and examination of some key decisions made by euro area governments during the crisis, I discuss how politics has interfered with the management of the crisis, complicating efforts towards a positive resolution. Drawing lessons from this experience, I then discuss the broader implications for the future of the euro area.[1]

The euro has tightly bound together the fates of the member states that adopted it as their common currency. The interconnectedness raised the stakes for cooperation among the member states. The project was incomplete when it started and its success rested on the ability of governments to work together when difficulties appeared. Political incentives faced by member state governments did not keep up. In the face of a severe global crisis, some member state governments were inclined to defend their own interests first. In the absence of a federal government, no institution could ensure that the interests of the euro area as a whole would be defended. The resulting mismanagement of the crisis elevated its overall costs.

The tragedy for Europe is that politics has dominated over economics. This has resulted in an unbalanced and divisive incidence of the costs of the crisis across the

[1]By necessity the review is brief and eclectic. A large literature discusses in detail the history of the euro area and various economic and political aspects of the crisis. See e.g. Goodhart (2011), Bini-Smaghi (2013), Soros (2014), and the Symposium on the euro, published in the Summer 2013 issue of the Journal of Economic Perspectives, and references therein (Spolaore, 2013; Fernandez-Villaverde, Garicano and Santos, 2013; O'Rourke and Taylor, 2013; and Schmitt-Grohe and Uribe, 2013).

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euro area. The euro was meant to complete the European project. Instead, its flaws have been exploited for local political gain to the detriment of Europe.

2 The economic cost

A comparison of the economies of the United States of America (US) and the euro area is a useful place to start. Comparisons of the two largest common-currency areas in the world, on opposite sides of the Atlantic, is particularly appropriate in this forum. The two economies share several commonalities but have significant institutional differences that are useful in highlighting some aspects of the crisis.

The crisis we are going through did not start in Europe. It started as a disturbance in the money markets in the United States in 2007 and became a global crisis following the collapse of Lehman in September 2008. The associated recession caused a steep decline in output and a rise in unemployment in virtually all advanced economies. Figure 1 shows how the unemployment rate increased both in the US and the euro area during 2009, in a more or less synchronized fashion. Figure 2 shows comparable quarterly data for real GDP per person, indexed to equal 100 in the fourth quarter of 2007 for each economy.

The virulence of the crisis in late 2008 blindsided policymakers. Following the initial shock, however, the recession was handled decisively by authorities with a massive policy easing that led to a recovery starting in 2009. The shock following Lehman left the global economy more vulnerable than its position following the 1929 financial collapse. The decisive and coordinated policy easing saved the global economy from a repetition of the Great Depression of the 1930s. Although the recession was costly in terms of growth and employment, by 2009 the global economy was on the mend on both sides of the Atlantic. This recovery has continued uninterrupted in the US since then. The unemployment rate has been declining, albeit at a pace many policymakers in the US consider frustratingly slow. By contrast, in the euro area, the recovery was interrupted and a second recession was experienced. Since 2011, the unemployment

rate has been increasing and has reached 12%, an all-time high in the history of the euro area.

The 2011 recession and its aftermath reflect the economic cost of the euro area crisis. The gap in the performance of the US and euro area economies shown in Figure 2 offers a metric of the average economic cost of the euro area crisis, in terms of output. Unlike the 2009 recession, which was triggered by an economic shock, the 2011 recession was the result of policy decisions taken by euro area governments. These decisions shaped the crisis and magnified its cost. The initial impulse for the crisis could have been easily manageable for the euro area as whole. The trigger of the crisis was fiscal difficulties that surfaced in Greece and required resolution in the Spring of 2010. From an economic perspective, the problem was small—smaller than one percent of euro area GDP (Orphanides, forthcoming). From a crisis management perspective, the situation was grossly mishandled. Policy decisions driven by politics rather than economics transformed the initial impulse into the existential crisis for the euro area that we are still experiencing today. The total cost for the euro area so far, in terms of lost euro area GDP, appears to be an order of magnitude higher than the initial impulse.

3 The disintegration of the euro area

The aggregate statistics for the euro area as a whole do not provide an accurate depiction of the drama that is tearing Europe apart. The increase in the average unemployment rate in Figure 1 obscures the social cost and unrest that has swept across the euro area as a result of the collective policy failure in dealing with the crisis.

The crisis has divided the euro area into "strong" and "weak" member states and has magnified differences in economic performance. Member states were forced to seek assistance from the IMF and the EU after experiencing difficulties in markets. These are the "program" countries: First Greece was in crisis, in early 2010, then

Ireland in the Fall, followed by Portugal in 2011, then Spain and Cyprus in 2012 and 2013. One after the other, these five member states faced severe stress.

The disintegration of the euro area is evident when we compare the performance of the program countries and Germany, the largest member state in the euro area and the strongest country in the so called core of the euro area. Figure 3 presents data for the unemployment rate for these countries since 1999, when the euro area was formed. The comparison suggests that the divergence in these economies was smaller prior to the crisis. To be sure, country variation is expected in any monetary union. One test of success or failure of a monetary union is whether the common currency amplifies divergence during a crisis. By this criterion, the experience during the euro area crisis suggests a failure.

What is perhaps more remarkable in the comparison is that while the economic calamity in the program countries can be easily detected by following the rapid rise in their unemployment rates, the crisis is barely noticeable in the data for Germany. In 2006 and 2007, before the global crisis, the unemployment rate in Germany was somewhat higher than that of any of the program countries. It rose slightly during the global recession but it has been steadily declining during the euro area crisis. The comparison raises the question whether the euro area crisis has been managed to achieve optimal performance for the German economy, perhaps to the detriment of member states that have been under stress. Recognizing that the performance of various economies is intimately interlinked in a monetary union, collective decisions can influence positively or adversely individual member states. In principle, policy decisions could be optimized for a specific economy to the detriment of others. Obviously this is not how the euro area should work.

The social costs of the disintegration in the euro area are more visible if we focus on youth unemployment. Figure 4 presents the unemployment rate of the population aged 25 and under for the same group of countries. The scale of the problem is staggering. More than half of the youth in Spain and Greece has been unemployed. Prospects for the future do not suggest that this situation is likely to reverse soon.

This is particularly distressing since long spells of unemployment among the young have permanent scarring effects on lifetime income prospects. One of the tragedies of the crisis is that we may have already created a lost generation of young adults.

The underlying source of the disintegration in the real economy of the euro area is the disintegration of credit markets. Figure 5 plots the yields on two-year sovereign debt for the four largest member states of the euro area. The four—Germany, France, Italy and Spain—represent about 80% of total euro area GDP so focusing on them is sufficient to illustrate the systemic nature of the crisis.

Two-year government yields serve as a good proxy for monetary policy. The divergence in the yields illustrates the impossible task the ECB faces in setting appropriate monetary conditions. In the context of the 2011 recession, near-zero rates would have been appropriate for the euro area overall. In the group of the four largest economies, this was especially true for Italy and Spain, the two states hit hardest among the four. Instead, a significant tightening of monetary conditions was experienced in these two states during the recession. This tightening reflects the combined outcome of government decisions regarding the crisis and ECB policy.

4 Crisis mismanagement

Why is the euro project crashing to earth? Is the problem fiscal in nature, high deficits and increasing debts, as was originally described when Greece experienced difficulties? Is it a competitiveness problem, relatively high wage increases without the accompanying productivity increases, as observed in Portugal? Is it a banking problem, as the Ireland case was described early on? Is it a current account deficit problem? Undoubtedly, these and other elements individually have been contributing factors. But these elements also represent symptoms of the crisis. If the euro area functioned properly, none of them individually could have been the primary cause of the catastrophe we have observed over the past few years in so many countries.

The distinction between causes and symptoms is important because treating symp-

toms does not provide a durable positive resolution of the crisis. Unfortunately, narratives of the crisis have often focused on the symptoms. Asking experts to provide solutions for particular symptoms while the underlying causes of the crisis remain unresolved may make the problem worse. This is a phenomenon that has been observed in spades in the euro area over the past few years.

From the perspective of the euro area as a whole, what we have is a clear case of crisis mismanagement. Let me mention two specific examples. First, consider the decision taken in Deauville on 18 October 2010: A decision to introduce credit risk in what used to be considered "safe" government debt. Second, consider the decision taken in Brussels on 16 March 2013: A decision to introduce credit risk in what used to be considered "safe" deposits. The last thing a crisis management team would want to do during a financial crisis is inject additional risk and uncertainty in markets and in the minds of businesses and households. And yet, the two examples above violated this very simple principle causing havoc and making the crisis worse.

What is the cause of these haphazard decisions? Two possible explanations have considerably different implications. One explanation is that the blunders we have repeatedly observed during the crisis reflect incompetence. If so, this could be corrected with more enlightened advisers. Another explanation is that these blunders are a predictable manifestation of the decision making process of the euro area. If so, the problem may not be trivial to overcome and a correction may not be feasible.

How could things get so bad? Briefly, the euro area project was incomplete by design. When the euro was introduced, no crisis management mechanism existed for dealing with temporary liquidity problems that a member state might experience. The risk of launching the project with an incomplete design had been identified before the euro was introduced. During the 1990s, when key decisions about the creation of the euro area were made by European governments, agreement could not be reached on completing the project. The political decision to go ahead meant that the common currency was introduced despite the risks implied by the shortcomings of the design. Ultimately, the success of the euro rested on the belief or hope that if and when a

crisis erupted governments would work together towards completing the project in a reasonable fashion. The experience of the last few years suggests that this belief or hope was misplaced.

5 Political constraints and incentives

In order to understand the reasons for the political failure to manage the crisis, it is useful to delve deeper into the political constraints and incentives of the decision making process. Once again, a comparison of the United States and the euro area is helpful. When the global crisis hit the US, the Federal government and federal institutions worked together to do what was deemed best for the country as a whole. There may have been debates and disagreements about the actions but the objective to serve the country as a whole was commonly accepted and respected. This could be done because institutions existed whose mandate was the common good for the country as a whole. One of the key differences is that Europe or the euro area is not a federal state. As a result there is no single government that can take decisions and enforce solutions for a common problem in a manner that advances the common good. Europe is a confederation governed by a Treaty, with all the associated weaknesses and not dissimilar to the US before ratification of the constitution.[2]

In Europe, solutions on key issues that may involve adjusting the Treaty require unanimous agreement by governments of the member states. But governments of member states must face their own electorates and some element of any solution may be unpopular to the electorate in some state. The incentives faced by each government are very different from the incentives necessary to internalize possible negative externalities that might arise from any particular decision. Good solutions may be unpopular to the electorate in some state and vetoed by the government of that state if the government places its own short-term electoral support above the common good. In addition, election cycles vary from state to state. At any given

[2] Sargent's (2011) Nobel lecture highlighted the similarities of the dysfunction of the euro area with the US under the Articles of Confederation.

moment, some government may prefer to postpone decisions or misuse a problem for local political gain associated with an upcoming election.

Particularly during a crisis, this decision making structure creates severe tensions that can be destructive in the absence of strong political leadership. Leadership is essential to avoid the dominance of short-term political calculations to the detriment of the common good over the long run. Unfortunately, political leadership has been in short supply in the euro area during the crisis.[3]

Why are decision-making tensions more salient during a crisis? In short, because crises involve losses that are tough to manage. Every crisis generates losses. Economic cost and political cost are unavoidable in crisis management. Management of the incidence of these costs is crucial. A key question is: "Who pays?" Proper management of an economic crisis should aim to minimize the overall economic costs over time and achieve a fair distribution of these costs. This requires political leadership to achieve the common good and courage to accept political cost.

In the context of the euro area crisis, proper management of the crisis required that the governments involved work together, in a cooperative manner, disregarding short-term local political cost. This proved untenable.

During the crisis, key decision makers exhibited neither political leadership nor political courage. Rather than work towards containing total losses, politics led governments to focus on shifting losses to others. The result was massive destruction in some member states and a considerably higher total cost for Europe as a whole. European institutions could have been the last line of defense against this destructive dynamic but instead served to facilitate and enable the destruction.

Numerous decisions could be identified where the details of implementation shifted losses from stakeholders in one member state to stakeholders in another member state. Without going into details, one could examine a few cases that remain controversial and where the accrual of costs and benefits was blatantly unbalanced. One could

[3]The absence of political leadership was identified during the crisis. See e.g. Temin and Vines (2013) and Schmidt (2011).

ask about Greek sovereign debt in 2010. Who was exposed? Who was protected by postponing the resolution of the crisis and enforcing a deep haircut in 2012 instead of a much smaller haircut in 2010? Who benefited and who lost from protecting the ECB purchases after banks in some member states unloaded their holdings to the ECB while banks is other member states did not?[4] One could ask about Irish bank debt in 2010. Who was exposed to it? Was it stakeholders in other euro area member states? Who gained from forcing the Irish taxpayer to accept all losses? One could ask about the bail-in in Cyprus in 2013. Who benefited from destroying the "business model" of the island? Who benefited from associated asset transfers that took place at the time?

6 The Deauville blunder

One of the clearest examples of the mismanagement of the crisis was the decision to inject credit risk in euro area sovereign debt markets on 18 October 2010. The decision was made at a meeting between French President Sarkozy and German Chancellor Merkel in Deauville. Germany and France together represent more than half of the euro area and other governments often appear unwilling to oppose decisions proposed by these two. Remarkably, in light of how costly this decision was for other member states, other governments went along. Notably, the agreement was reached despite warnings and objections by the ECB.[5]

Deauville introduced the Private Sector Involvement (PSI) doctrine for euro area

[4]The disclosure of the minutes of the IMF Board meeting on 10 May 2010 is quite revealing in this regard. The minutes suggest that some directors thought that a restructuring of Greek sovereign debt was advisable at that time. But this was opposed by others, in favor of an alternative plan that included the maintenance of exposures by banks in numerous countries which reduced the risks IMF staff had identified. The minutes note that: "The Dutch, French, and German chairs conveyed to the Board the commitments of their commercial banks to support Greece and broadly maintain their exposure." (International Monetary Fund, 2010, p. 3.) As is well known, in the Summer and Fall of 2011 the German government led the effort to impose a severe haircut on Greek sovereign debt. The exposure of German banks to Greek sovereign debt had been significantly reduced by then, despite the commitments made in May 2010.

[5]The decision was accepted at the European Council meeting in Brussels on 28-29 October 2010. The President of the ECB is also invited at these meetings. ECB objections were communicated at that meeting by ECB President Trichet. See Orphanides (forthcoming) for additional discussion.

sovereign debt. The concept was that whenever a euro area member state faced liquidity pressures (as opposed to solvency concerns), losses would be imposed on the private creditors of the sovereign debt of that member state before the other euro area governments agreed to provide any temporary assistance. Effectively, a haircut would be imposed on the private sector even if the country that needed a loan was solvent. The PSI doctrine reversed long-standing IMF principles for providing temporary assistance. The message to potential investors of euro area sovereign debt could not be clearer: Euro area sovereign debt should no longer be considered a safe asset with the implicit promise that it would be repaid in full.

The introduction of credit risk in sovereign debt raised the cost of financing for most euro area member states. A first casualty was Ireland which lost market access within weeks of that decision. That was followed by Portugal a few months later. Deauville was a blunder for the euro area as a whole. However, the PSI doctrine proved beneficial to Germany, the country whose government had proposed it. Damaging the market for euro area sovereigns perceived as "weak" introduced a safety premium to German bunds since Germany was perceived as "strong" among the euro area member states. The global demand for euro-denominated sovereigns was adversely affected. This was costly for the euro area as a whole. But the relative demand for German bunds was positively affected, which was beneficial to Germany.[6] This was a serious and clear indication that an adversarial approach to the crisis was taking hold among the member states.

7 Are solutions available?

The problem plaguing Europe is not the absence of technical solutions. Without political interference focused on protecting local interests, considerable progress in improving the functioning of the euro area could have already been achieved. Consider, for example, the most obvious current threat: the adverse feedback loop be-

[6]Boysen-Hogrefe (2012) and Broyer, Petersen and Schneider (2012) present quantitative evidence of the benefit to Germany due to the crisis.

tween sovereigns and banks. The problem arose from another flaw in the design of the euro area. To deepen the common market, European Union Directives (agreed among EU governments) effectively liberalized banking in the EU and removed barriers to interstate banking activities. This was desirable, in principle, to engender greater competition and efficiency. Before the crisis these policy decisions led to a welcome intertwining of banking operations throughout the euro area, consistent with the functioning of the single market. Efficiency considerations in a monetary union would suggest that banks should channel excess savings to investments throughout the common area, creating a level playing field across member states. However, this proved problematic during the crisis because other elements needed for an effective banking union were left out. When the crisis erupted, questions arose about who would be responsible for supporting banks facing pressure. Although it was recognized that the common market required a common platform, this was not pursued. Instead, a series of decisions led to ring-fencing of activities in some member states and the effective balkanization of banking in the euro area. Rather than promote a level-playing field during the crisis, the common currency penalized efficient banks in stressed states and provided implicit state support to inefficient banks in states perceived as strong (Orphanides, 2012).

In the summer of 2012 concerns about the survival of the euro, and recognition of "the vicious circle between banks and sovereigns" brought governments in the euro area very close to an agreement for the creation of a true banking union. At the 29 June 2012 summit, euro area governments announced:

> "We affirm that it is imperative to break the vicious circle between banks and sovereigns. . . . We affirm our strong commitment to do what is necessary to ensure the financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise markets . . . "

Three elements are important for the creation of a true banking union: a common

banking regulation and supervision framework; a common deposit guarantee scheme; and a common resolution mechanism. These elements would be easy to identify in the US, where the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) effectively combine these functions and provide a level playing field across US states. An equivalent structure would represent significant progress in the euro area.

Following up on the June 2012 agreement, the Presidents of the European Council, the European Commission, the Eurogroup and the European Central Bank published a roadmap for improving the functioning of the euro, including a true banking union. The report of the "four presidents" was published on 5 December 2012:

> "This report lays down the actions required to ensure the stability and integrity of the EMU and calls for a political commitment to implement the proposed roadmap. The urgency to act stems from the magnitude of the internal and external challenges currently faced by the euro area and its individual members."

Unfortunately, by the time it was completed, the plan outlined in the December 2012 report was already condemned to oblivion. A true banking union appears out of reach.

Why are technical solutions to the crisis blocked? Time and again, local political considerations dominate. On this occasion, the German government blocked the plan. Two factors were crucial in guiding the German government's decision. First, the existential threat to the euro that had convinced all governments to move towards a true banking union in June 2012 had subsided. By introducing its Outright Monetary Transactions (OMT) program in September 2012, the ECB removed the urgency that had led to the June 2012 decision. This allowed governments that preferred to avoid implementation to withdraw their support. Second, for Germany in particular, the September 2013 elections had become a constraint on action. A true banking union was not popular in Germany and faced significant opposition by some German banking interests. An agreement to solve the crisis by completing a banking union be-

fore the elections would have compromised the Chancellor's reelection. Consequently, progress was blocked. National political considerations dominated over the common good.

Several lessons could be drawn from the failure of the plan advanced by the four presidents. Europe has many presidents indeed, but no one who can take a presidential decision. Anything of substance that is necessary to move forward may be blocked by a single government. Unfortunately, some governments use their veto power to leverage the flawed construction of the euro. Regardless of the cost to Europe as a whole, local short-sighted political interests may dominate. Europe has no institution that can enforce the common good over local political interests. European institutions are caught in the middle and appear powerless to avert predictable blunders.

8 The Cyprus blunder

The next blunder I wish to highlight as an illustration of the dominance of local politics over economics is the shocking decision taken in Brussels on 16 March 2013 to introduce credit risk in what was considered "safe" bank deposits until then.[7] The Eurogroup decided to impose a haircut on deposits of Cypriot banks, insured and uninsured, and use the proceeds to inject capital in banks.[8] The decision was contrary to any known framework and violated basic EU principles. It was subsequently amended on 25 March. In the meantime it had succeeded to effectively destroy the "business model" of the island and condemn Cyprus to a long-lasting depression. The 16 March decision was recognized almost immediately as a blunder. Although it was supposedly unanimous, the next day no one was willing to admit that they had supported it.[9]

[7] See also Apostolides (2013), Michaelides (2014) and Zenios (2014) for pertinent analysis about the crisis in Cyprus.

[8] As usual in European politics, the language used was more circumspect. The confiscation of deposits was described as a "stability levy" and the collective decision was presented as a "Cypriot authorities' commitment" that was welcomed by other parties to the agreement (Eurogroup, 2013).

[9] See Steinhauser, Stevis and Walker (2013); Spiegel (2013); Breidthardt and O'Donnell (2013); and Neuger (2013) for reports about the meeting. Neuger's report was aptly titled: Europe Plays I-Didn't-Do-It Blame Game on Cyprus Bank Tax Plan.

Introducing credit risk in deposits during the crisis was obviously "not smart" as ECB President Draghi admitted later. Much like the Deauville blunder, it was a risk for the euro area as a whole. The introduction of credit risk in deposits was particularly risky for the banking sectors in weaker member states. Taking such a risk to solve a problem that was tiny in magnitude (smaller than one-tenth of one percent of euro area GDP) cannot be explained in terms of sound crisis management from the perspective of the euro area as a whole. How then could a decision like this come about?

The Eurogroup decisions, both on 16 March and on 25 March, violated earlier commitments made by governments to protect deposits and support major financial institutions in order to ensure support for the economy. These commitments had been communicated by the European Council:

> "The European Council reaffirms its commitment that in all circumstances the necessary measures will be taken to preserve the stability of the financial system, to support the major financial institutions, to avoid bankruptcies and to protect savers' deposits. Inter alia, such measures aim, in conjunction with the central banks and supervisory authorities, to ensure sufficient liquidity for financial institutions, to facilitate their funding, and to provide them with capital resources so that they can continue to finance the economy properly." (Council of the European Union, 2008, p. 2)

Indeed, these commitments were honored until then. In the case of Cyprus, and unlike in any earlier program, the Eurogroup decisions neither protected deposits nor preserved the stability of the financial system. Instead they crippled the two largest and systemic banks on the island. How could a decision that violated earlier European commitments and discriminated so openly against the island be justified?

9 Background to the Cyprus blunder

Without getting into the gory details, a brief review is in order.[10] The economy of Cyprus is tiny. Cypriot GDP in 2013 was 16 billion euro, less than 0.2 percent of the euro area. Before joining the euro area on 1 January 2008, Cyprus had a stable currency and its public finances were in good order.[11] The island had developed into a regional financial center, similar to Malta, the Netherlands and Luxemburg (albeit at a considerably smaller scale). Its relatively large banking system with exposures and operations in Greece made it vulnerable to financial stress during the crisis. The system weathered well the global stress and wave of banking collapses following Lehman.

The tragedy for the island was that in the presidential elections that took place two months after it adopted the euro, the communist party gained power. The communist administration was in place for five years, from 1 March 2008 until 28 February 2013. The philosophy and approach of the communist party was decidedly hostile to banks, which eventually proved fatal for the system. While in power, the communist party inflicted significant damage to the economy, first with populist overspending that made public finances unsustainable within two years of gaining power, and subsequently by deciding to assault the banking system of the country as a platform for the February 2013 elections.

The government faced a fiscal crisis in May 2011 when it lost access to markets following two years of unsustainable increases in public expenditures. In July 2011, an explosion on the island destroyed the largest power station. The disaster weakened the economy further and led to a political crisis when gross negligence by government officials (including the President of the Republic) was documented.

Faced with unsustainable public finances, Cyprus should have asked for assistance then. However, the communist party opted to avoid the political cost associated with a program and postponed resolution of the crisis.

[10]This section draws on Orphanides (2014), where more details are provided.

[11]A historical overview of the economy is collected in Orphanides and Syrichas (2012).

Two things made Cyprus unique. The first was the long delay in resolving the crisis after market access was lost. To achieve this delay, the communist party secured a bilateral loan from Russia that covered the financing of deficits and debt repayments until just after the February 2013 election. The delay is evident in Figure 6 (reproduced from Orphanides, 2014), which compares daily CDS spreads of program countries. As can be seen, for every other program country, assistance was sought when the CDS spread reached 500 to 600 basis points, and the program was finalized about three to five weeks later. In the case of Cyprus, although the government lost market access in May 2011, it refused to ask for assistance until June 2012, after CDS spreads had exceeded 1500 basis points. The government subsequently delayed finalizing a program which was concluded right after the communist administration left office.[12]

The second element of uniqueness was the communist party's decision to assault the island's banks in an attempt to divert attention from the explosion disaster and the fiscal crisis that had caused loss of market access.[13] In October 2011, the government imposed a disproportionately high capital loss to the two largest banks by supporting the Greek PSI without demanding equitable treatment, as it could have done to protect the country's interests. The capital loss amounted to 4.6 billion euro, about 25% of GDP. This exceeded the banks' existing buffers and created a potential need for assistance of about 10% of GDP, which the government subsequently exploited for political purposes.[14]

The assault intensified when the communist party gained control of the central bank in May 2012. Leading to the February 2013 election, the central bank started

[12]The government asked for assistance on the same day as Spain. In the case of Spain a program was finalized within three weeks.

[13]To be sure, banks have been an easy target for politicians everywhere in Europe during the crisis. A key difference is that in other countries governments criticized banks while providing support to avoid damaging the economy, when needed. In Cyprus the government not only criticized banks, it deliberately inflicted damage for political purposes.

[14]For example, Government Spokesman Stefanos Stefanou stated on 31 May 2012: "The basic problem facing the Cypriot economy is the large exposure of Cypriot banks to Greek government bonds, whether some want to hear it here in Cyprus or not" (author translation, quoted in Michaelides, 2012).

describing the banking model in Cyprus as "casino banking," suggesting that bankers on the island had been "gambling" with depositor money (Demetriades, 2012). The central bank also took steps to exaggerate the capital needs in the banking system to bolster the communist party's claim that the banks were the only problem in the economy. Estimates of the exaggeration vary but it likely exceeded 20 percent of GDP.[15]

The communist party lost the election in February 2013, but by then it was too late for the new government to avert a bad outcome in March 2013. The coordinated campaign against the banks succeeded in raising questions about the "business model" of the island and its sustainability. If the exaggerated estimates for the capital needs promoted by the communist-controlled central bank were used, and if the government provided the capital to the banks, then government debt might be deemed unsustainable by the IMF.[16] This generated considerable uncertainty about how the program for Cyprus would be structured.

10 The German elections

The problem in Cyprus started with the irresponsible actions of the communist-controlled authorities and the politics of the election in Cyprus in February 2013. The surprisingly bad resolution of the crisis in March 2013, however, was shaped by the politics of the German election in September 2013. The delay in finalizing a program made Cyprus an issue in the German election cycle.[17]

[15]The exaggeration was achieved mainly by subjecting banks to a stress test used to estimate potential future losses. PIMCO was selected as a consultant for the exercise, but the central bank guided the methodology and key assumptions which were out of line with similar exercises. Zenios (2013, 2014) presents alternative estimates.

[16]Concerns regarding sustainability would not have arisen without the exaggeration. Based on the exaggerated capital needs, the debt to GDP ratio could reach 140% before declining. Assistance to banks enters such calculations even if it is temporary and the methodology does not account for the fact that the government can recoup its investment in banks where capital is injected in subsequent years.

[17]The German elections would not have been a factor had the Cypriot government completed negotiations for a program in July 2012, along with Spain, or earlier, instead of seeking financial assistance from Russia. See also Apostolides (2013).

How could elections in any single state matter for a program in another state? Because, in the context of the euro area crisis, each member state has veto power that can be exploited whenever another euro area member state might need temporary assistance.[18]

The German elections were particularly important because during the crisis the German parliament needed to approve the participation of Germany in European support programs and the Chancellor's party (CDU) relied on support from the main opposition party (SPD) to pass the legislation.[19] The Chancellor obtained support from the opposition SPD in the earlier programs, for Greece, Ireland, Portugal and Spain. However, the German public was generally not supportive of any programs and with the elections approaching the political cost of supporting another program was increasing.

Cyprus became a major issue when German press and some German politicians noted that among depositors in Cypriot banks were numerous Russians. Claims were made that helping Cyprus would be equivalent to "giving away German taxpayer money to Russian oligarchs." A report that appeared in Spiegel with the headline "EU Aid for Cyprus: A Political Minefield for Merkel" is characteristic. The report noted:

> "The EU is likely to bail out the banks of tiny member state Cyprus with 10 billion euros of credit. But a secret German intelligence report reveals that the main beneficiaries of the aid would be rich Russians who have invested illegal money there. It's a big dilemma for Chancellor Angela Merkel." (Spiegel Online, 5 November 2012.)

The existence of an intelligence report with such claims was never confirmed and claims of illegal activities were never substantiated but this was of little importance

[18]EU member states not in the euro area do not face this threat because they are not bound together by the common currency. Germany does not have veto power on IMF programs for countries that are not in the euro area.

[19]FDP, the junior partner in Germany's ruling coalition, consistently took an anti-European stance during the crisis and generally opposed support programs.

in the election climate.[20] What was critical for the German government was to find a way that would diffuse criticism from the program that had to be agreed for Cyprus.

Agreement to an ordinary program, consisting of fiscal measures and structural reforms to the economy, presented a political risk for the German government and might have compromised the Chancellor's reelection. Fortunately, from the perspective of the German government, a simple solution was at hand that could address this risk.

In light of the "casino banking" description that the communist-controlled government and central bank had used in Cyprus during the election campaign, it could be argued that the "business model" of the island had failed. Consequently, changes could be demanded as part of the program. It could be demanded that the Cypriot government confiscate a significant part of deposits in Cypriot banks as a precondition for a loan. In addition, it could be demanded that assets of Cypriot banks be sold to reduce the size of the Cypriot banking system. Such conditions would inflict permanent damage to the banking system, but the damage would be justified based on the positions that had been presented by the Cypriot authorities.

Indeed, the outcome of the Eurogroup meetings was consistent with this approach.

11 The domination of local politics

The outcome of the 16 March Eurogroup meeting was a tremendous political success for German Finance Minister Wolfgang Schaeuble. Although, according to press reports, European Institutions and most other governments initially resisted the German approach, in the end the German government's position dominated:

[20]The performance of member states regarding the effort to combat money laundering is being monitored in Europe by the Financial Action Task Force (FATF). The compliance with recommendations to deter criminal activity is reviewed periodically in each country. According to the available reports as of the end of 2012, Cyprus had a considerably better compliance record than both Germany as well as key financial centers in Europe, such as the Netherlands and Luxemburg. For example, Cyprus was the only country among these four that had been found in compliance, at least partially, with all 49 FATF recommendations, and fully with 12 recommendations. By contrast, Germany was deemed non-compliant with 5 recommendations and was fully compliant with only 5.

"It was the position of the German government and the International Monetary Fund that we must get a considerable part of the funds that are necessary for restructuring the banks from the banks owners and creditors—that means the investors." (Wolfgang Schaeuble, 17 March 2013, ARD interview quoted in eKathimerini on 17 March 2013.)

By engineering the destruction of the Cypriot banking system as a precondition for agreeing to a loan, the Chancellor's government effectively diffused criticism about a loan to Cyprus during the German election campaign. The strategy paid off handsomely for the German Chancellor in the September 2013 elections.

The political success could be observed immediately in Germany. Following the 16 March announcement of a haircut on deposits, the opposition party SPD tried to share credit for it. The budget spokesman of the party announced: "It was one SPD demand that bank depositors should share the costs of rehabilitation" (Peel, 2013).

Chancellor Merkel promoted the German success in political election rallies already on the day the decision was made:

"[A]nyone having their money in Cypriot banks must contribute in the Cypriot bailout. That way those responsible will contribute in it, not only the taxpayers of other countries, and that is what's right." (Angela Merkel, 16 March 2013, remarks at a German election rally quoted in eKathimerini on 17 March 2013)

A few weeks later, the German Finance Minister highlighted that the real issue for Germany was the low corporate tax rate on the island.[21] He also explained the role of "leverage" in the process:

"We don't like this business model and we hope it is not successful ... In the case of Cyprus we have leverage that we don't have with other tax havens." (Wolfgang Schaeuble, 5 April 2013, Reuters.)

[21] Cyprus was not the first country where Germany introduced discussions about changing the corporate tax rate of a country seeking assistance. Ireland was an earlier example.

12 Shifting losses

The German success with regard to the program for Cyprus successfully shielded Chancellor Merkel from the political cost her government would have incurred with an ordinary program for Cyprus. The political cost did not vanish. Instead, the political burden was shifted to the newly elected government in Cyprus, under President Anastasiades. Interestingly, unlike the previous government, which was controlled by the communist party, the new government was controlled by center-right party DISY which shares a similar political ideology as Chancellor Merkel's CDU. Both the CDU and DISY are members of the European People's Party (EPP). This highlights the dominance of local politics, at the member state level, as opposed to broader politics relating to ideological differences as the driving force for decision making during the crisis.

The Cyprus decisions also generated an interesting case of transfers of crisis-related economic losses from stakeholders in one member state to stakeholders in another member state. Two separate episodes can be identified. Both were results of political decisions that transferred resources from Cypriot banks to Greece.

The first episode was the one that also generated the initial vulnerability of the banks. This was created when the Cypriot government agreed with the imposition of a loss of about 4.6 billion euro to Cypriot banks in the context of the Greek PSI.

An additional transfer from the banks was completed in March 2013 when Greek operations of Cypriot banks were sold as part of the program. This sale had two consequences. First, it fully protected depositors in these banks in Greece from losses, discriminating against depositors in the same banks in Cyprus who were consequently subjected to bigger losses. Second, it resulted in a net transfer to Greece because the terms of the sale severely underestimated the value of the assets that were sold.[22] An indication of the magnitude of the transfer was provided in the statements of the

[22] This is because the sale price was based on the valuation of assets that had been used to exaggerate the capital needs of the banks. The exaggeration was achieved by undervaluing bank assets so a sale of these assets based on these valuations was equivalent to a transfer.

beneficiary of the transaction, Piraeus Bank. The financial results for Piraeus Bank for the first quarter of 2013 recorded a windfall profit of 3.4 billion euro from the deal (Piraeus Bank, 2013).[23] In essence, the losses imposed to Cypriot depositors served to recapitalize Piraeus Bank in Greece.

In summary, the direct transfer from Cypriot banks to Greece as part of the management of the crisis was about 8 billion euro—4.6 billion to the Greek state and 3.4 billion to Piraeus Bank. The transfer represents one half of the 2013 GDP of Cyprus. Questioning the "business model" of the island after political decisions imposed such a great loss to its banks raises uncomfortable questions about the functioning of Europe.

13 The role of European Institutions

In the context of this debacle, one may ponder what is the role of European Institutions? Ideally, European Institutions should serve the interests of Europe as a whole and defend fundamental rights and equal treatment for all. The European Central Bank is an independent institution that acts in the interest of the euro area as a whole and is protected from political pressures from any individual government, at least in theory. The European Commission is an independent institution with the mandate to enforce the Treaty which places significant weight on equality and solidarity among the people of Europe, at least in theory. Specifically, according to Article 2 of the Treaty:

> The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail.

[23] As a result of this transfer, the negative equity position of Piraeus Bank was reversed, from −2.7 billion euro on 31 December 2012 to +0.9 billion euro on 31 March 2013.

And according to Article 3:

> [The Union] shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child.
>
> It shall promote economic, social and territorial cohesion, and solidarity among Member States.

In principle, European Institutions could have done more to defend the euro area from governments which leveraged the flawed design of the euro to serve objectives other than the common good.

In practice, because Europe is a loose confederation, European Institutions face difficulty in blocking decisions, even when these are clearly detrimental for the euro area as a whole, as was the case with the Deauville and Cyprus decisions. At the same time, European Institutions consider it imperative to preserve the euro at all costs. Defending against immediate risks of collapse of the project puts European Institutions in an impossible position. Potentially, the effort to protect the euro may render the role of European Institutions counterproductive.[24] European Institutions also face the risk of political capture by the governments of specific member states that could misuse the crisis for local political gain.[25]

14 Conclusion

The euro area crisis is fundamentally a political crisis. The loose confederation structure of the European Union, proved incompatible with the proper management of a major crisis in the common currency area. The common currency intimately interlinked the performance of the economies of the member states. This elevated the importance of crisis management. Proper crisis management should have aimed to

[24]Orphanides (2013) examines the role of these considerations for some controversial decisions taken by the ECB.

[25]This risk was recognized by some analysts even before the creation of the euro area. A prominent example is Connolly (1995) who titled his insightful insider account: The Rotten Heart of Europe.

contain the overall economic costs of the crisis for the euro area as a whole and to achieve a fair distribution of these costs. This has not been observed. The incomplete design of the euro has been exploited by some governments to serve short-sighted local political interests. In the absence of a federal government, the resulting non-cooperative behavior has magnified the cost of the crisis and has led to an unbalanced and divisive incidence of these costs. European Institutions have been weak and incapable of defending European principles and the proper functioning of the euro.

The crisis has divided Europe. Politics has dominated economics. Rather than deepen the Union, the common currency has created divisions. Rather than complete the economic union, the common currency has contributed to its disintegration. The malfunctioning of the euro has become a threat to the European project.

Is a positive resolution of the euro area crisis feasible? The underlying cause of tension is a misalignment of political incentives. At present, no political authority has the power and incentives to advance and protect the common good. Political reform of the European Union is needed to address this glaring omission. The required reform needs to pass the political feasibility test. Support by the current governments of Europe is needed to break the logjam. Is this presently feasible? Moving forward requires political leadership very different from that experienced during the crisis. The political reform needed for the advancement of the European project seems unlikely with the current configuration of leaders and governments.

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Figure 1

Unemployment in the US and euro area

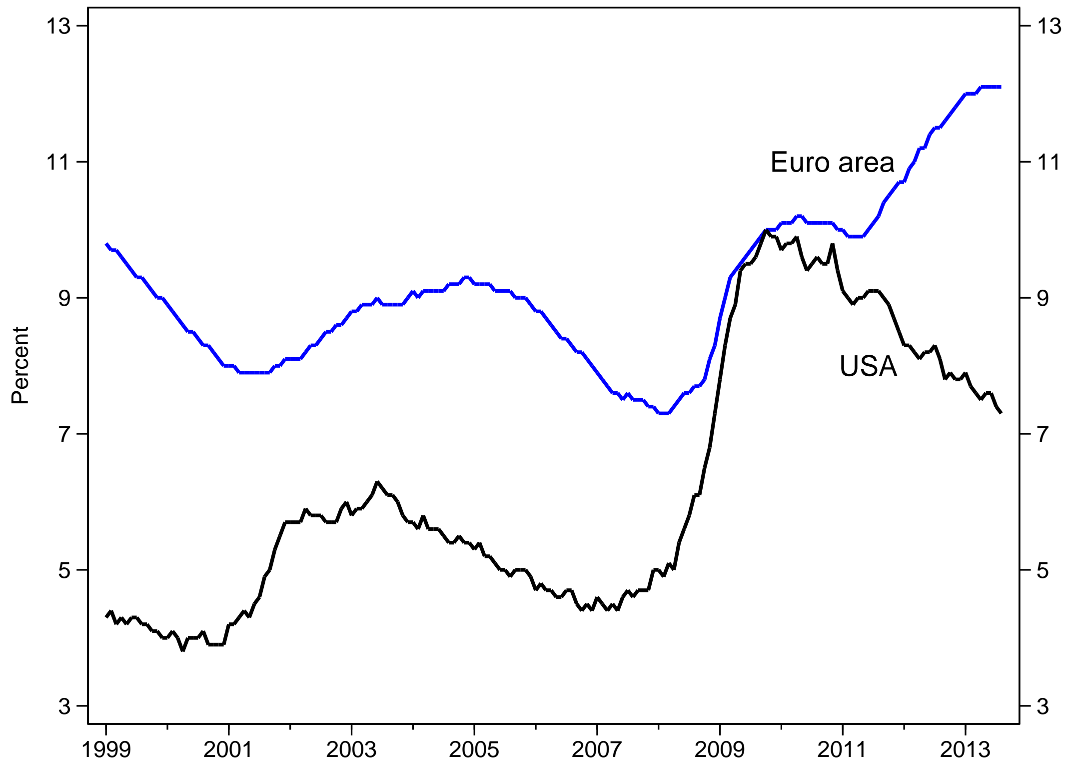


Figure 2

GDP per person in the US and euro area

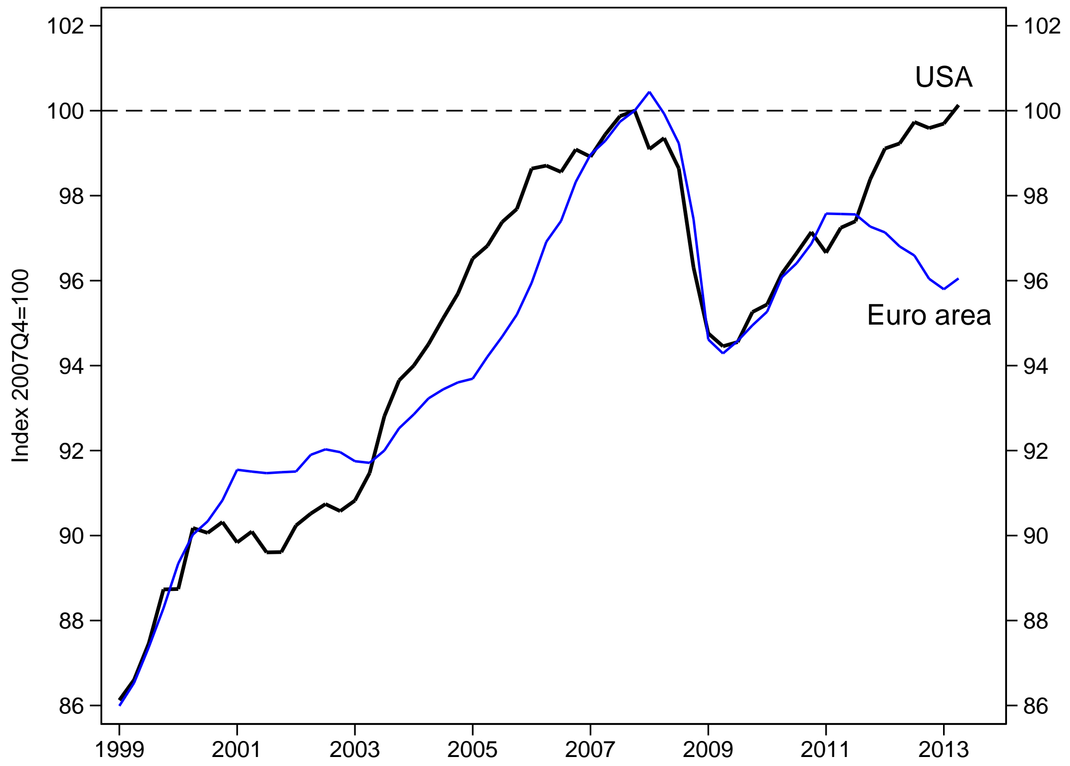
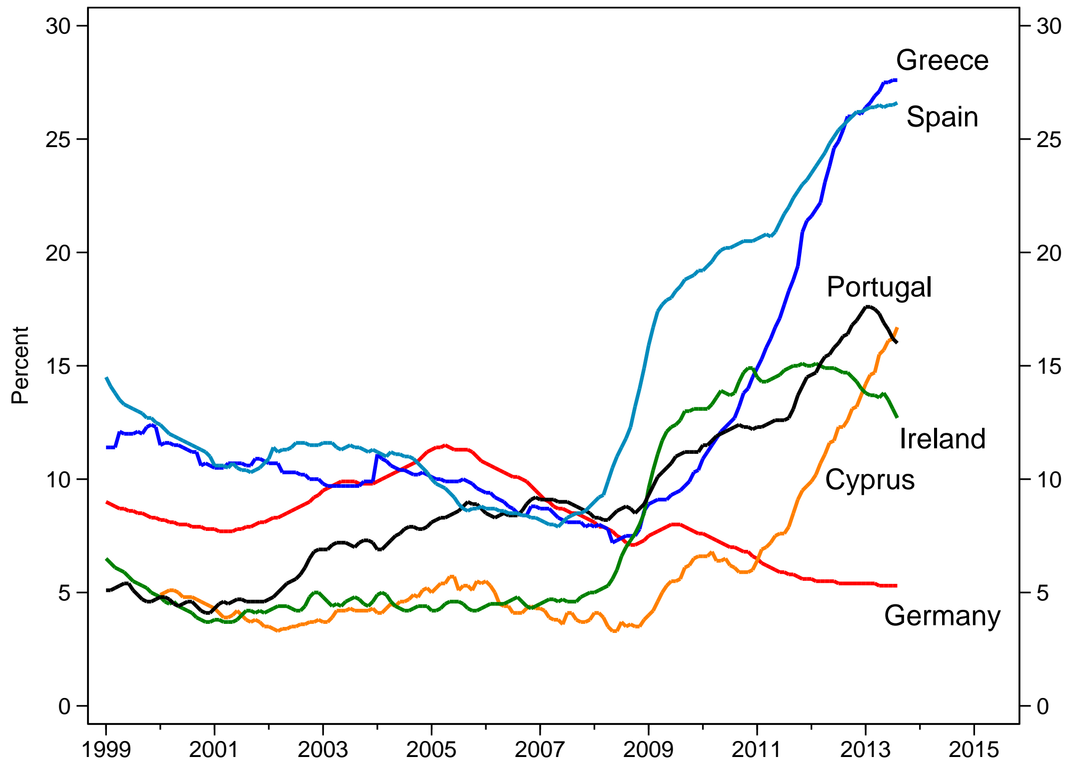


Figure 3

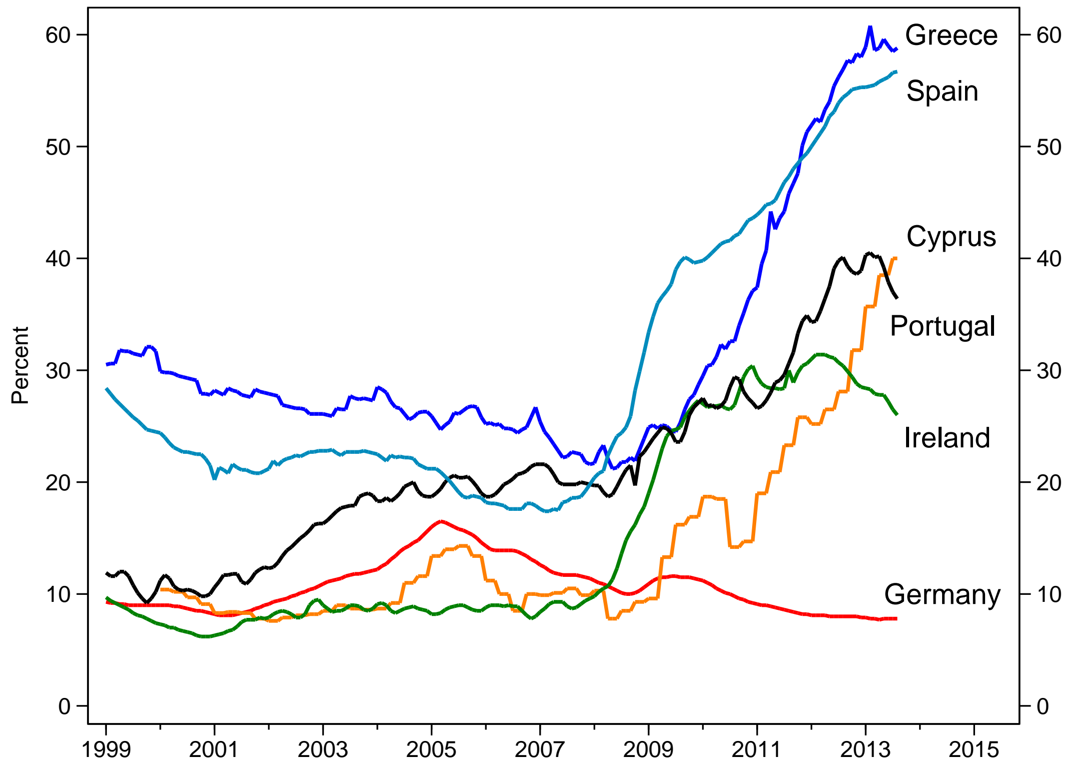
The disintegration of the euro area economy



Unemployment rate in Germany and program countries.

Figure 4

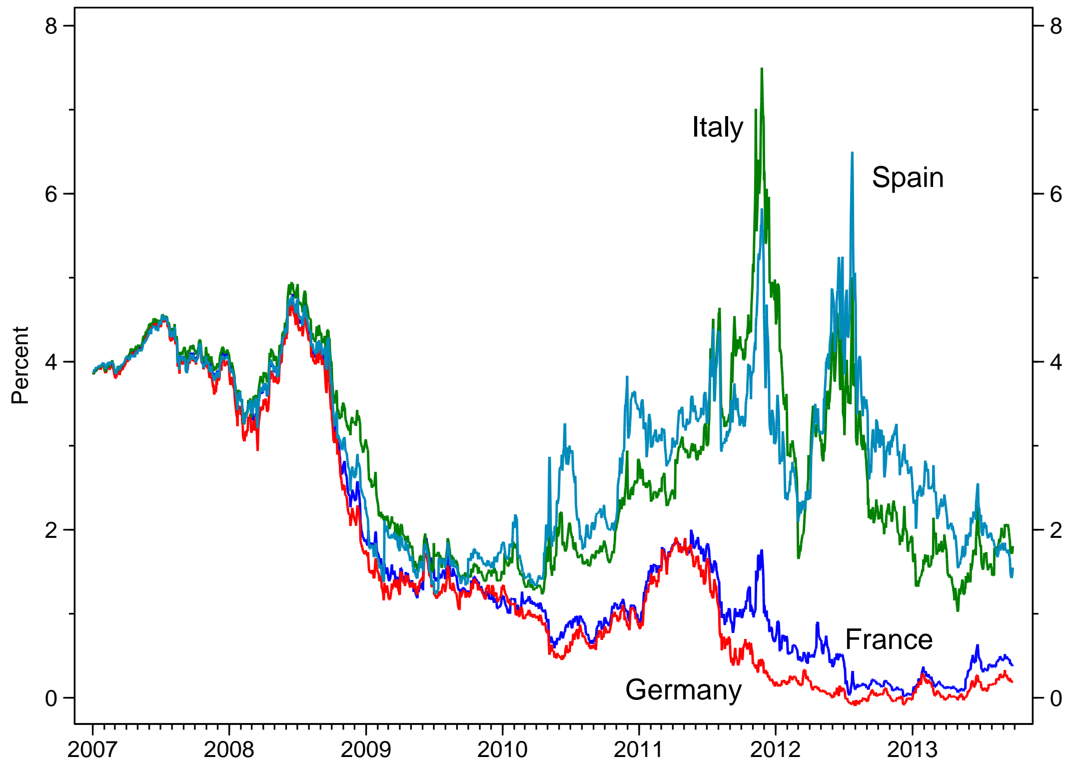
A lost generation in the making



Youth unemployment rate in Germany and program countries.

Figure 5

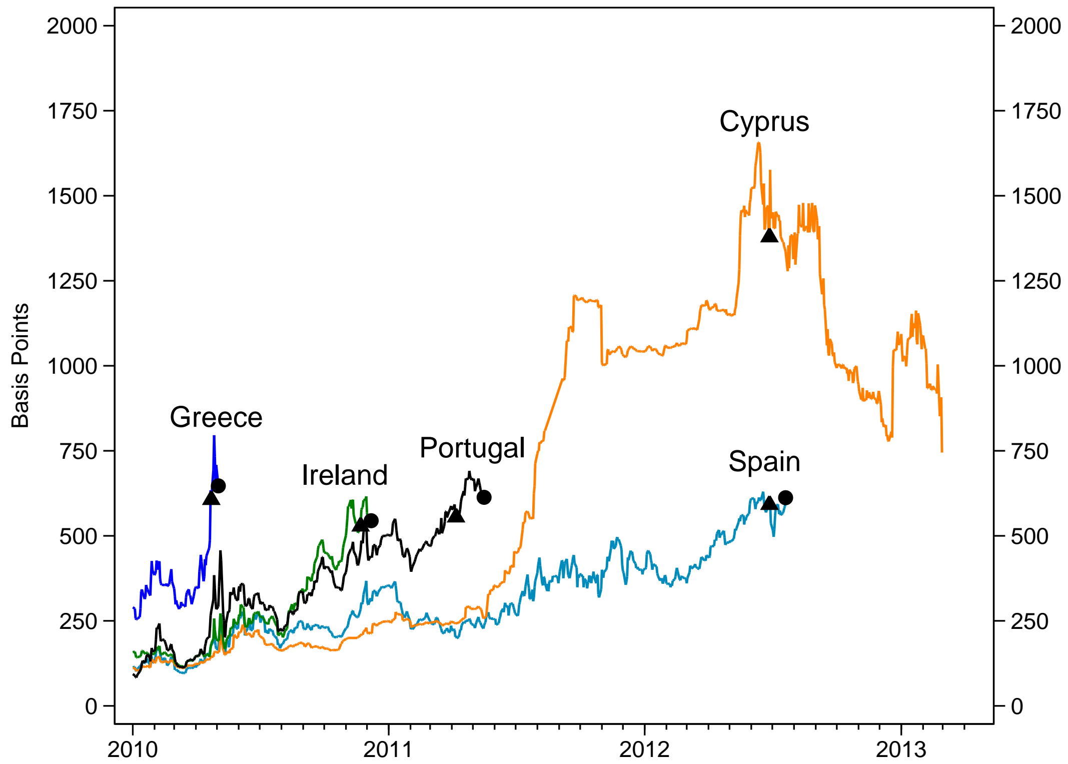
The disintegration of euro area sovereign markets



Yields on two-year sovereign debt.

Figure 6

The delay that made Cyprus unique



Daily data for five-year CDS of program sovereigns, ending February 28, 2013. Triangles mark dates when assistance was sought. Circles mark dates on which a program was agreed and is also the last point plotted for each country except for Cyprus for which no program was agreed by February 28, 2013.