Don’t blame the victims, Mr.Weidmann!

A working paper published by the European Central Bank (ECB) shows that strong wage increases have not been the cause for troubles of the euro zone’s crisis countries. Rather, capital flows have caused bloated house and asset prices and exaggerated construction activity and unsustainable economic activity in general, which in turn has pushed up wages. This diagnosis flies in the faceof the of the story often retold by the ECB and

other European policy makers that peripheral countries lost their competitiveness, because they did allow exaggerated wage increases for many years, and that declining wages are the appropriate cure for a crisis caused in this way. Even countries not in crisis are expected to increase their competitiveness, according to the Euro Plus Pact, signed in March 2011 by 23 countries.

It is all the more embarrassing, that two members of the Competitiveness Research Network of the ECB and other central banks and international organizations have published a paper called “[The Euro Plus Pact: Competitiveness and External Capital Flows in the EU Countries]” in the ECB’s working paper series, which shows that the focus on labor cost is mistaken, because the diagnosis behind it has it the wrong way round. Hubert Gabrisch of the German research institute IWH and Karsten Staehr of Estonia’s central bank find in their empirical analysis for the years 1995 to 2012 that increases in the current account deficit exerted a clear positive influence on subsequent wage increases, but not the other way round.

This is easy to understand. If countries like Ireland or Spain get a reputation as being successful, they attract foreign capital. German and French banks channeled large sums of money into these countries via loans and investment in assets of these countries. All this money resulted in a real estate boom, which inflated wages and employment in the construction sector. Employment and wage developments in the industrial sector and other sectors not connected to the real estate bubble behaved fairly normal.

Those in charge of economic policy, notably the ECB, did not pay any attention to the bubble, because with their dogma of unfettered credit and capital markets, there was nothing they could do about it. Now, they want to make ordinary workers’ pay for their own mistake by pushing down their wages. This is not only unjust; it is pointless, since the trouble is not wages, which are too high, but a lack of demand and financing.

In a recent speech, **Bundesbank-President Jens Weidmann** gave a fairly similar diagnosis, even though he focused on low interest rates in the peripheral countries, rather than on capital inflows, which are the flip side of low borrowing rates. This becomes important, when he declares that there was:” a sudden stop in the inflow of private capital that required a correction of unsustainable developments and policies.” In this sentence there he makes the switch from describing developments which were external to the respective countries, to blaming it all on them. He talks of unsustainable policies that the sudden stop of capital exposes, as if it had not been the capital inflows themselves which had created the imbalances.

Weidmann further distracts from the real source of the problem and blames the victims again by claiming that in order to prevent the build-up of such imbalances, excessive public deficits have to be avoided by strict deficit rules. In truth, public deficits were not at all the problem in Ireland and Spain and only partly in Portugal.

He continues to blame the victims by criticizing that inflowing “capital has not always been put to its most productive use…and structural rigidities have hampered adjustment through a shift from the non-tradable to the tradable sector, and curbed growth potential.” What structural rigidities is Weidmann referring to here, to explain why a real estate bubble created by inflowing dumb money has caused a boom in construction and not in export oriented manufacturing?

On a positive but rather cynical note, Weidmann then claims that “factors of production are being reallocated to sectors with a strong focus on exports.” He explains that the construction sector in Ireland accounted for over half the decrease in aggregate employment, and two-fifths in Spain, Italy and Portugal. “In industry, by contrast, either far fewer jobs have been cut or – as in Ireland – new jobs have recently been created.” So, the fact that fewer people have been laid off in industry than in construction constitutes a favorable “reallocation of factors of production” according to Weidman. Apart from being said in technocratic language which is dehumanizing people, it is plain nonsense. People are not being reallocated, if employment shrinks in both sectors. There is simply a severe loss of employment in one sector, without anything making up for it in another. Witness, the increase of the unemployment rate to over 25% in Spain.