The Day the Capital Was Flowing

- Pursuing new paths in economic thinking is difficult as long as one cannot let go of old thinking patterns -

by

Heiner Flassbeck

FTD, 31 August 2012

The Institute for New Economic Thinking (INET), which was established on the initiative of George Soros, recently assembled an INET Council on the Euro Crisis (ICEC) which in a memorable statement has addressed a wake-up call to politicians in Europe in an attempt to prompt serious reflection on the current situation. However, this laudable initiative may have come too late as the euro zone is about to slip into that sort of comatose state which calls for a prayer in resignation rather than an attempt to find ways to bring the patient back into life. Worse yet, instead of engaging in new economic thinking, the ICEC signatories are caught up in the most obsolete economic thinking patterns the world knows; as a consequence it is not surprising at all that they have failed to find a way out of the crisis.

Not unlike Mr. Sinn, ICEC report identifies “capital flows” as the root cause of the crisis: capital flows to the current deficit countries, in particular to the countries in Southern Europe, which the surplus countries may not welcome, but at least tolerate. This explanation comes as a surprise, indeed. Why should capital flows in a monetary union present a problem? Countries have agreed on a common inflation target, nominally the interest rates are entirely identical, the countries concerned are part of a European Union which as its utmost goal envisions freedom in capital flows. Then all of the sudden precisely these capital flows are deemed to be the cause of the problem. Problems related to capital flows indeed exist in the world outside of Europe. However, these countries lack a common inflation target, a common currency and a common monetary policy so that evil speculators can play their yoyo games with the currency resulting in unacceptable appreciations and depreciations. However, precisely these kinds of hazards are prevented through the existence of the monetary union. So why should this no longer be true?

If the deficit countries at least suffered from the same ailment that one could then attribute to the capital flows. However, this is not the case at all: in fact Spain has a real-estate problem, but no budgetary problem, whereas Italy and Greece are grappling with high public debts, but do not have a real-estate problem. Is it already a problem in a monetary union when capital markets finance unchanged government debt ratios of countries, as in the case of Italy, or that they finance even decreased government debt ratios, as in the case of Spain? The INET Council’s answer is *no*, this cannot actually be a problem; yet as a kind of afterthought they add that the deficit countries had also appreciated in real terms and that in a monetary union this was difficult to correct.

Newsflash: the deficit countries have actually appreciated! How is this possible when adherence to the old German 2% inflation target had been agreed upon in clear and

explicit terms? How is it possible that at the exact moment when one agrees that changes in foreign exchange rates are no longer required and possible, huge current account imbalances arise and exchange rates are required again? How can inflation differences emerge when the same monetary policy is pursued? Why was there no competition to level out the prices at least with regard to tradable goods? And finally what are the reasons that support the belief that capital flows are responsible for the differences in the inflation rates? Interestingly, at the beginning the nominal interest rates were entirely identical. Differences in the real interest rates emerged only as a result of inflation differences. Does this imply, however, that the inflation differences cannot be explained through the capital flows?

So many questions, yet so few answers! Answers cannot be expected from the old way of thinking because of its inherent fear of putting the topic of wages up for discussion. Yet only wage developments can explain how the real appreciations and depreciations in the monetary union came about and why correcting them is so difficult. If one firmly believes in the existence of an independent labor market in which prices are determined by the principle of supply and demand, a wage discussion makes no sense and there is actually no need for it. Acknowledging the undeniable, empirically founded fact that unit labor costs (i.e. the distance of nominal wages to national productivity) dominate price increases would imply the loss of what is most precious to an economist: the belief in flexible labor markets which will easily create full employment if only the laborers would allow this.

If wages were up for discussion, one would also have to admit that with its extremely weak wage development Germany has decisively contributed to the appreciations and depreciations. And in a further step one would also have to ask whether this was justified considering the common inflation target of two percent. Finally, one would have to acknowledge the most painful realization: In order to emerge from this crisis a control of the wage development in the euro zone over a period of several years needs to be proposed in order to eliminate the appreciation of the deficit countries. However, in the old thinking pattern such measures are regarded as works of the devil and cannot be pursued. Instead, crisis management under these circumstances cannot go beyond a superficial treatment of the symptoms and new thinking impulses are delayed to the next time around.