Designing a Eurozone *Takeoff*

By Andreas Dombret

Removing the ballast and pushing to full throttle.

The already modest economic recovery in the euro area faltered in the second quarter. Seasonally adjusted GDP remained unchanged in spring. The biggest three euro area economies—Germany, France, and Italy—did not provide any growth impetus, with Germany and Italy contracting by 0.2 percent and France's economy stagnating. Euro-area GDP is still 2.4 percent below its pre-crisis level, and indicators suggest only a moderate upward movement in the coming quarters.

Looking at the recovery so far, one could be reminded of a starting aeroplane. It has entered the runway and begun to roll, but it is not yet clear whether the euro area jet will reach the necessary take-off speed. The obvious question, then, is: What can we do to remove ballast, and push the plane into full throttle? Let me start by taking a look at what ballast is still weighing on the euro area.

REBALANCING AND REFORMS FOR GROWTH

For many euro-area member states, the introduction of the euro ushered in a new era of abundant capital due to the elimination of exchange rate risks. And standard economic reasoning does suggest that capital should flow from capital-rich to capital-poor economies, where returns should be higher.

However, the favorable financing conditions in the euro-area countries with previously higher interest rates stimulated their domestic demand. A procyclical real interest rate effect then ensued. Higher domestic demand

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led to above-average inflation rates in the respective countries. While nominal interest rates hardly differed across the euro area, real interest rates were below average in the countries concerned.

At the same time, higher demand caused wages to rise as well, which pushed the real exchange rate up and

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reduced price competitiveness. This in turn dampened exports. But the dampening effect on the tradable sector was not sufficient to moderate overall wages. In other words, the interest rate effect dominated the exchange rate effect. Consequently, worsening exports did not trigger the necessary adjustment, and current account deficits continued. As a result, the deficit countries built up ever-larger external imbalances.

Structural rigidities amplified this process. Labor market barriers that protected insiders and shut out outsiders impeded wage adjustments. In so doing, they worsened the shift from the tradable to the non-tradable sector. And product market regulations hampered competition, innovation, and, ultimately, productivity.

When the financial crisis erupted and investors' risk perception shifted, the financing of the external deficits came to a screeching halt, triggering a crisis whose repercussions are still felt to this day.

In order for the euro-area recovery to get off the ground, we must rid ourselves first of the ballast of imbalances. And this is exactly what is happening now. Unit labor costs and current accounts of deficit countries have already improved substantially—not only because of shrinking imports, but also because of expanding exports.

There are clear signs for sectoral change. The construction sector in Ireland, for instance, has accounted for over half the decrease in aggregate employment. In Spain, Italy, and Portugal, it has accounted for around two-fifths. In industry, by contrast, either far fewer jobs have been cut or—as in Ireland—new jobs have recently been created. Thus, factors of production are being reallocated to sectors with a strong focus on exports.

Already in 2012, real value added in particular far exceeded its pre-crisis level in the export-intensive information and communication sector in Spain and Ireland. In Ireland, other business-related services also showed substantial growth. Compared to its pre-crisis level, real value added in trade and tourism increased in Portugal and remained virtually unchanged in Spain.

These sectoral differences are also reflected in credit reallocation in Spain, for example. While loans to the Spanish construction sector have fallen, the more productive export-oriented industrial sector is able to receive loans. This aspect is often forgotten when discussing credit growth in peripheral countries.

This shift from the non-tradable to the tradable sector, however, can exert a temporary drag on the recovery. This is because internal demand is reduced faster than the tradable sector expands. In other words, the plane has to slow down a bit to open the hatch and unload the ballast. But after completing the manoeuvre, it will be in a much better position to accelerate to take-off speed.

Progress has also been made by overcoming labor market rigidities. A number of labor market reforms have been introduced to foster employment and reduce adjustment costs during economic downswings. As an additional measure, the retirement age has been raised as well.

Product market rigidities that weaken competition, produce regulatory red tape, and inhibit growth are also being addressed. And according to the World Bank's *Doing Business* report, the efforts should be starting to pay off: Portugal, Italy, and Spain have climbed up the ranking ladder by seventeen, thirteen, and ten positions

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respectively over the last four years. Greece has moved up by thirty-seven positions.

But it is obvious that there remains ample room for further improvements. While Portugal, Spain, Italy, and Greece have climbed up the ladder in the *Doing Business* report, they are still a considerable distance from the top, with Portugal ranking thirty-first, Spain fifty-second, Italy sixty-fifth, and Greece seventy-second.

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Accordingly, recent estimates[1] by the European Commission suggest a medium-term growth potential (2014–2023) for the euro area of only 1 percent.

The potential gains from structural reforms therefore remain especially large. A study[2] by economists from the OECD suggests that a comprehensive package of labor, product, tax, and pension reforms could raise GDP per capita in the European Union by about 11 percent after ten years. For the United States, the growth potential of structural reforms is 5 percent, less than half compared to the European Union.

And gains in Europe are by no means restricted to the peripheral countries. Ranked 111th in the World Bank *Doing Business* category "ease of starting a business," for instance, Germany has ample room for improvement as well.

REFORMS FOR STABILITY

Reforms are needed to remove barriers for investment and growth. But once take-off speed has been reached, it is equally important to ensure that the euro area is resilient enough to withstand turbulences. In this regard, a sound financial system is crucial. What is the yardstick of success with regard to this? It is simple enough: the financial markets have—at least in principle—to work like any other market, and this pertains particularly to market entry, market exit, and market power.

The problem of too-big-to-fail is one of market exit and market power. If the exit of a single financial institution can jeopardize the whole system, the stability of this system obviously leaves much to be desired. But the market power of the institution in question derived from this phenomenon gives rise to even further risks. If a bank knows it will be bailed out no matter what happens, it will be less diligent when deciding on and monitoring loans. And as we have learned the hard way in the euro area, careless lending can and will eventually come back to haunt you.

With regard to the problem of market exit, much has already been achieved in the euro area in the context of the banking union. The single supervisory mechanism ensures supervision at arm's length, guided by the same, strict standards. Excessive bank risks should hence be detected earlier. And if push comes to shove and a bank is no longer viable, the Single Resolution Mechanism stipulates that shareholders and creditors are first in line to bear banks' losses—and not the taxpayer.

However, history has shown that fear of contagion effects is a strong deterrent when it comes to actually resolving an important bank. And whether bailing in creditors would lead to contagion naturally depends on who these creditors are—if they are other financial institutions, the chances are high that regulators will shy away from resolution.

Within the framework of the Financial Stability Board, work is ongoing at the global level to define a minimum standard on liabilities in terms of both quality and quantity that are eligible for bail-in. In order to tackle the issue of contagion, this standard should discourage other financial institutions from holding these liabilities.

The euro area already has a minimum requirement for such eligible liabilities. But so far, these liabilities can be held by other institutions without restriction. In the interest of financial stability, Europe should lead the way and change this.

Resolution is obviously only the last line of defense against a bank failure. Higher bank equity is the first. Basel III with its more stringent requirements reduces the likelihood that losses will run a bank into trouble. And as the banks' shareholders have more "skin in the game," their risk appetite should moderate, which reduces the likelihood of losses in the first place.

The new capital requirements are not exactly loved by bankers. Their argument is straightforward: equity is expensive. This is undoubtedly true. But as Franco Modigliani and the University of Chicago's Merton Miller already pointed out in the late 1950s, in theory, the total cost of a bank's capital stems from the riskiness of its assets, not from the composition of its liabilities.

This theorem, however, obviously does not hold today, mainly for one simple reason. Interest on debt is tax deductible; pay-outs on equity are not.

How sensitive are banks to this difference in tax treatment? A study[3] by International Monetary Fund economists suggests that they are as sensitive as any other firm. What does this imply for the leverage of banks? IMF economists estimate that abolishing the preferential tax treatment of debt would raise average unweighted bank equity by 2.2 to 4.2 percentage points. Even though the authors caution that the effect is likely to be lower for the biggest banks, these numbers are sizable by any measure, especially considering that the proposed Basel III leverage ratio is 3 percent.

Doing away with the preferential tax treatment of debt could therefore provide a major boon for financial stability. Of course, equity still carries a risk premium, since it comes first with regard to absorbing gains as well as losses. But if equity ratios are low, debt must bear a bigger part of total risks, which makes it more expensive—at least when banks are allowed to fail. Correspondingly, higher equity ratios will lower the cost of a given unit of equity, since risks will be more widely shared, and the cost of debt will also go down. The total cost of capital will therefore be unchanged, regardless of the equity ratio.

With regard to macroeconomic imbalances, much has already been achieved in the euro area. But for the recovery to reach take-off speed, more is required in terms of structural reforms.

To make sure financial turbulences do not knock the monetary union off course, resolution regimes should be strengthened so that banks do not hold each other's loss-absorbing liabilities. And to further strengthen banks' equity buffers, the preferential tax treatment of liabilities should be abolished. ◆

NOTES

1. European Commission (2013), "The euro area's growth prospects over the coming decade," *Quarterly Report on the Euro Area* 12(4).
2. Bouis, R. and R. Duval (2011), "Raising the Potential Growth after the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond," OECD Economics Department Working Paper No. 835.
3. de Mooij, Ruud A., Michael Keen, and Masanori Orihara, "Taxation, Bank Leverage, and Financial Crises" (February 2013). IMF Working Paper No. 13/48.