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How to ensure the survival of the monetary union

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Abstract At present the biggest threat to the monetary union is posed by the anti-European political parties. These parties call for their countries to leave the union. They are thriving especially in countries with slower economic growth and high unemployment rates. The best remedy against them is to increase economic growth and thus reduce the unemployment rate in their home countries. The measures taken to achieve this need to be systematic, rather than merely temporary patches. In peripheral and semi-peripheral economies, undercapitalised banks and the lower competitiveness of domestic producers are slowing down growth. The correct measures to address these problems include banning dividend payouts by undercapitalised banks and creating minimum standards for competitiveness.

Keywords Euro area | Competitiveness | Banks | Dividends | Growth | Unemployment

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Introduction

The crisis within the monetary union is now a political one, the economic crisis having ended in 2012 when the European Central Bank (ECB) introduced a de facto guarantee for euro-area bonds (the Outright Monetary Transactions programme). The ECB thus eliminated the problems encountered by the peripheral economies (i.e. Italy, Spain and Portugal) in financing their sovereign debt, with Greece being an exception and a special case due to its extremely high levels of debt.

Currently, the greatest risk to the monetary union is political in nature. In the (semi-) peripheral economies, where slow growth has resulted in high unemployment, we have seen a sharp rise in support for parties whose programmes include leaving the euro area. Two such parties are the French National Front and the Italian 5-Star Movement. If economic growth in these economies remains slow—and the unemployment rate high—these parties may come to power and carry out their threats.

Accordingly, the principal challenge for the monetary union now is to increase economic growth in the periphery. In this regard, the ECB has already done everything it can, by guaranteeing government bonds, reducing long-term interest rates and flooding the banking sector with liquidity. It is now up to the politicians to capitalise on the space that has been created for reforms by the ECB.

The problems of the periphery take two forms: the quality of the banks and the level of competitiveness.

Undercapitalised banks must pay lower dividends

One of the main causes of weaker economic growth on the periphery is that banks are undercapitalised. This lack of capital, in turn, has four causes.

1. *Non-performing loans* Banks still have a high volume of non-performing loans on their books from the crisis period. Overvaluing these creates additional costs and thus reduces capital. According to the European Banking Authority (2016), the current volume of non-performing loans in the EU amounts to around one trillion euros, or 5.4% of all loans. This very high ratio is due to the situation in the peripheral economies: roughly 45% of loans in Greece and Cyprus are categorised as non-performing, while for Portugal, Slovenia and Italy the figure is 15–20%.

2. *Low profitability* Banks also have problems on the income side. Poor economic growth, especially in the peripheral economies, has dampened credit growth, while the ECB's policy of low interest rates is squeezing the margin in this sector. In conjunction with the costs of non-performing loans, this meant that large banks in the euro area

achieved a return on equity of less than 6% in the second quarter of 2016. Their cost of equity is estimated at 8–10%. In comparison, the return on equity in the US has been around 9% for some years. Therefore, economic activity results have a significantly lower potential for strengthening the capital position of banks in the euro area than they do in the US.

3. *Stringent capital adequacy rules* Significantly stronger rules on capital adequacy underpin the new regulatory environment created in response to the financial crisis (Basel III). Since 2013 banks have been increasing the volume of capital they are required to put aside with respect to their assets. This process will continue until 2019, making capital a scarce commodity.

4. *Payment of dividends* If a bank's situation is sound, the usual course is to pay out profits to its shareholders. Where the situation is less sound, however, profits should be used to strengthen the bank's capital adequacy instead of paying the shareholders a dividend. In many countries, this is not the case. For instance, according to the Bank for International Settlements (Shin 2016, 3), Spanish and Italian banks paid out 74 billion euros in the form of dividends in the period between 2007 and 2014—more than they spent on strengthening their capital cushion over the same period.

The lack of capital available to banks in the peripheral economies is hampering their lending role. This applies in particular to business loans, since current rules require larger capital buffers for them than for mortgages. Entrepreneurs' poorer access to credit is obstructing economic growth in these countries. Moreover, the preference for mortgages at the expense of business loans creates a risk of future problems in the real-estate market.

Putting the banking sector in order is a long-term process. Reducing the volume of bad loans or the operating costs of banks will not happen overnight. One approach is to ban dividend payouts by banks with insufficient capital. If the banks used these funds to strengthen their capital rather than to pay their shareholders, they would be able to spend significantly more on loans.

A ban on dividend payments by undercapitalised banks cannot be perceived as unfair to shareholders. The ECB saved these banks by providing unlimited liquidity to them, which allowed those that were embattled to pay their liabilities. Had it not done so, the banks would have been liquidated and the share value would have dropped to zero. Therefore, such a ban would constitute a fair tax on the shareholders of troubled banks, effectively paying for the assistance rendered in the past.

The US implemented a similar measure after the crisis. The Federal Reserve carried out robust stress testing of banks with capital-adequacy problems and restricted dividend payments to one cent per share. For years this limited-dividend regime applied even to such giants as Bank of America (until 2014) and Citigroup (until 2015). Restrictions on dividend payments significantly helped to revitalise the US banking sector,

which subsequently succeeded in boosting the economy. The euro area should take these measures as an example.

More even geographical distribution of job creation

If the monetary union is to survive, investors have to be interested in creating jobs in all countries. At present, this is not the case.

A competitive economy is one in which institutions and legislation allow private firms to prosper and create jobs. Peripheral economies had been suffering from a lack of competitiveness even before the introduction of the euro. The causes vary from economy to economy, with the most important being:

- low flexibility in the labour market,
- a poor business environment,
- over-regulated product markets,
- lengthy court proceedings, and
- a large proportion of inefficient public companies.

Before the introduction of the euro, the *modus operandi* was to offset this competitive deficit by devaluing the currency. A weaker currency makes a country's exports cheaper and its imports more expensive, thus helping the domestic business sector. For instance, between the collapse of the Bretton Woods monetary system in 1973 and the introduction of the euro, the Italian lira depreciated on average by 5.7% per annum against the Deutschmark.

Such devaluation was no longer possible after the establishment of the euro area. Problems did not arise immediately because the peripheral economies began to tackle their low competitiveness by borrowing abroad. This was done by both the private and the public sector: in countries where private-sector loans were dominant, real-estate bubbles grew; in countries with predominantly public-sector loans, public debt rose sharply.

However, these foreign resources were not used for investment to boost competitiveness and in this way to increase exports and help repay the loans. Instead, the real-estate market and social programmes swallowed these resources. Deficits in the balance-of-payments current accounts nicely illustrate this development. They show that by 2008 the peripheral economies were importing significantly more goods and services than they exported. This was all funded by loans from the euro-area core countries. Greece and Portugal had a current-account deficit of more than 10% relative to GDP, with Spain's deficit just below that figure.

These capital flows to the periphery ceased when the financial crisis hit in 2008. Thus, the peripheral economies could not compensate for the deficit in competitiveness either by devaluing their currency or by creating major deficits in their current account (i.e. borrowing from abroad). Their problems then materialised as deep recessions and sharp increases in unemployment.

These competitiveness deficits persist to this day in most peripheral economies. Several years have passed since the financial and debt crises, and many euro-area countries have already recorded low unemployment. However, the situation in the periphery is improving only very slowly. Greece and Spain still have rates of unemployment of above 20%, while in Italy, Portugal and Cyprus they remain above 10%. Young people are especially affected as labour legislation protects employed people to the detriment of those entering the labour market.

The result is clear: when investors are deciding where to create jobs, they do not consider the peripheral economies (or some semi-peripheral economies, such as France) because it does not pay to create jobs there. These economies have improved their competitiveness little in recent years. The competitiveness rankings *Global Competitiveness Report* (World Economic Forum 2016) and *Doing Business* (World Bank 2016) show that these economies are trailing most of the other euro-area countries.

ECB policy is partly to blame for this situation. By guaranteeing government bonds, the ECB has removed any market pressure for reforms. Nevertheless, it is quite true that without the ECB, the euro area would not exist today. Doing away with bond guarantees is therefore not the way to combat the situation. Instead, measures should be taken at the euro-area level to stimulate more geographically even job creation. These measures must be systemic and not take the form of a transfer union. A transfer union does not address the problem itself, merely its consequences.

Accordingly, it would be effective to create minimum competitiveness standards. Some of these have already been outlined in the *Five Presidents' Report: Completing Europe's Economic and Monetary Union* (Juncker et al. 2015), which proposes the establishment of independent national competitiveness authorities. Their role would be to monitor whether wage trends reflect productivity developments and to propose remedial measures if they do not. Establishing such offices, responsible for coordinated activities, would certainly provide the right basis for reducing the competitiveness gap between individual euro-area countries.

To achieve this, it is necessary to reduce imbalances between euro-area countries. Developments in the balance-of-payments current accounts must be monitored, as this is the most prominent external expression of competitiveness. This applies not only to those countries with a deficit, but also to those with a surplus. For example, Germany achieved a current account surplus of 8.5% of GDP in 2016, and the Dutch surplus was one percentage point higher still.

It cannot be disputed that the most competitive euro-area countries benefit from the ECB's policy. It weakens the euro and improves their competitiveness in markets outside the euro area, at the expense of the periphery. Without the euro, their exchange rate would be much higher, and they would most probably not be able to achieve high current account surpluses and the associated low rates of unemployment.

The most competitive euro-area countries should permit faster wage growth as they currently do not face any labour-market problems. They should also take advantage of both the low interest rates and sound public finances to invest in infrastructure. Higher wages, consumption and investment within the core euro-area countries have the potential to boost the demand for products, services and labour from the periphery, allowing periphery countries to breathe more easily. Lowering current-account imbalances should therefore be part of the coordinated policy agenda for competitiveness.

However, it is questionable how seriously individual governments will consider the recommendations of the competitiveness authorities. If the measures are purely advisory, it is likely that they will remain only on paper. The enactment of certain standards in EU (or euro-area) legislation should be considered if the periphery's job-creation problems persist and the recommendations of these authorities are not implemented, as was the case in 2012 with regard to the Fiscal Compact. The *Five Presidents' Report* includes this as a medium-term goal.

Conclusion

The monetary union brings great benefits through the reduction of transaction costs for cross-border capital movements. At the same time, however, it requires responsible behaviour from national governments. With no scope for devaluing the currency, bad policies result in jobs being transferred to other EU countries. These bad policies are already in place in the peripheral countries.

Job creation in the euro area must be more evenly distributed across the member states. To achieve this, peripheral economies need to resolve their bank and competitiveness shortcomings.

The situation in the banking sector is gradually improving as the economy grows. However, a ban on dividend payments by undercapitalised banks could significantly accelerate this process—such a ban helped heal the US banking sector after the crisis, allowing it to support the growth of the economy now. On the European periphery, by contrast, the banking sector is acting as a brake on growth.

Competitiveness can only be enhanced if legislation in the periphery is more closely aligned with that of the core, so as to attract investors who are currently shunning these countries. Peripheral economies are no longer able to resolve their competitive deficits by devaluing their currency or by taking out unsustainable loans from abroad. These countries must make their economies more attractive for investors. A good starting point

would be minimum standards of competitiveness for individual member states, thus providing the basis for a coordinated competitiveness policy within the monetary union.

Banning the payment of dividends by undercapitalised banks and taking a coordinated approach to competitiveness would be appropriate measures to help increase the growth of these economies—and thus the right way to reduce the anti-European sentiment which constitutes the greatest threat to the future of the monetary union.

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