STRUCTURAL DEVALUATION

*Financial mechanism **for the improvement of productivity in the framework of inclusive capitalism** to overcome the crisis*

This document, ***written by the Plataforma Pymes,*** based on excerpts of the main European economists -reported at the end of the text- presents the mechanism of "Structural Devaluation", ***in the framework of inclusive capitalism outlined by the Plataforma Pymes on its Framework Document,*** as a solution to the financial situationtriggered after the 2007 financial crisis, by analysing its causes, the measures taken, the influence of its cadence, and the proposals to prevent similar situations in the future.

I. Background: the Financial Crisis in EU low-income countries

1. Three countries that joined the Eurozone between 1999 and 2001 -Greece, Spain and Portugal- were considered cohesion countries. They received EU structural funds to speedup their convergence to the EU average income per capita.

2. When the exchange rate disappeared, the convergence process was facilitated thanks to the capital flows originated by Eurozone countries with the greatest GDP and capital. Between 1999 and 2008 Greece and Spain were the object of a significant -and apparent- convergence of their income per capita with regard to the Eurozone average.

3. Capital flows to cohesion countries generated an excess of credit, high indebtedness of the private sector, excessive increases of salaries and excess of risk taking by financial entities.

4. Capital was focused on non-productive sectors with great inflexibility. Authorities did nottake action during the boom years:

   - The public sector did not generate the necessary fiscal margin and the boom of assets simulated a sounder fiscal position than real. The Debt/GDP ratios improved, but based on fiscal income from unsustainable asset markets.

   - The prices of the non-tradable sector (non-exportable goods and services) grew, generating persistent losses of competitiveness.

5. The outbreak of the financial crisis in a scenario of high private indebtedness, external unbalances and structural weaknesses brought a sudden stop to the economy.

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6. Countries with high external debt have to face their payment through services and goods exports. That requires an increase of exports, and a change to the internal demand towards products produced internally, which involves a relative adjustment of prices:

   - Exports have to be cheaper and imports more expensive.
   - Internally, the prices of non-tradable products have to fall more to stimulate their demand.

The importance of the correct location of capitals

With the arrival of the euro, capital flows moved to the countries where the marginal product of capital was higher. This did **not** contribute to convergence for two reasons:

- In the non-tradable products and services sector there was a total absence of competition which allowed providing high income, by distorting the market.
- The non-existence of a capital single market.

According to the neoclassic model, the convergence process between low- and high-income countries should be addressed through capital flows and the obtaining of high marginal returns of capital. Due to this, the exposure of financial entities in high-income countries towards low-income countries increased fivefold.

However, contrary to the neoclassic theory, foreign capital flows in low-income economies did not settle in sectors with a higher productivity and the TPF factor (Total Productivity Factor) did not grow. On the contrary, capital concentrated in the non-tradable sectors which suffered significant productivity losses. Capital concentration was higher in the construction and real estate sector, followed by trade, transports and leisure.

Reasons for capital concentration in non-tradable sectors:

a. In some sectors the fall of marginal product counterbalanced with the increase of benefit margins, thus generating a compensation for investing in these sectors. This was a consequence of the absence of a full single market and the lack of competition, which allowed companies to charge excessive income and distort prices, thus affecting productivity, the wrong channelling of financing sources and deficit creation.
b. Other specific factors that contributed to the wrong location of capital:
   i. Even though the marginal product of capital and profitability were low in construction and trade, capital formation remained high.

      This apparent contradiction took place because net remuneration was high due to the low financing costs. There was a concentration of credit in mortgages, due to insufficient bank supervision. Furthermore, there was a shift of labour to those sectors, thus contributing to weaken productivity.

ii. Commercial banking, although it was taking funds from the international interbank market, boosted the positioning of the "national champions" in non-financial companies,without analysing their productivity.

After the crisis, structural reforms were difficult to implement in low-income countries for variousreasons:

- The rigidity of their structures and institutions: it was easier to change the rules in thelabour market than in the product and service market. The nominal decrease that took place in salaries did not translate into an instant adjustment of product and service relative prices. The weakest workers were the ones that suffered the adjustment, which affected the acceptance of reforms among citizens.

  For example, in Greece labour costs fell by 18% from 2009 to 2013 but price adjustments did not start until the first quarter of 2013. This, apart from being detrimental to exports, reduces the real income of workers.

- Fiscal policy: it was easier to increase taxes than reducing expenditure, and to eliminate capital investments than current expenditure, which has reduced the quality of fiscal consolidation.

- The credit transmission channel was damaged: difficulty for credit to reach SMEs.

For its part, the weak growth of TPF was influenced by various factors. The neoclassic theory didnot consider certain facts in low-income countries:

a. The relationship between asset prices, debt ratios and productivity was ignored.
b. Companies and households overestimated their future income.
c. The excess of domestic demand, combined with a low productivity growth, translatedinto a price increase above the EU countries average.

The error in the neoclassic theory: capital did not flow to the sectors where the marginal return was higher.

II. Structural Devaluation

That is why it is necessary to start **a new process in convergence**, guaranteeing the conditionsto adequately distribute resources and creating a sustainable legal framework.

The **STRUCTURAL DEVALUATION,** ***which has nothing to do with salarydevaluation,*** is a mechanism pursuing similar goals to fiscal devaluation, but based on different methods. Structural devaluation reduces external unbalance by increasing productivity and competitiveness.

Low-income countries have to face the subsequent effects of a wrong location of capital.

Flowstowards the service and non-tradable sector were associated with an appreciation of the realexchange rate, by increasing unit labour costs and increasing dependence on external financing. When the financial crisis broke out, capitals abandoned said countries. With a dry external financing, these countries faced the risk of a sudden stop. That is why they have implemented fiscal and structural policies aimed at achieving internal devaluation in order to restore external balance. Since 2009, all low-income countries (Greece, Ireland, Portugal and Spain) have slowed down the increase of their unit labour costs and have improved their current-account balance on: 11 points of its GDP in Spain and 16 in Greece.

However, this internal devaluation improves the sustainability of the external position, but by itself does not produce a sustainable convergence. There is a risk that, if the unit labour cost mainly adjusts with the drop of salaries and this improves the current-account balance, law-makers will relax in the solution to productivity problems. If this happens, unbalances will reappear in the future. So, the experience of devaluation in the 90s suggests that adjustment only with relative prices with no increase in productivity is not sustainable. That is why ***productivity reforms to increase productivity are the backbone of the sustainable convergence process.***

Most urgent actions on the short term

1. To intensify measures so that capital is positioned in the truly productive sectors. To achieve this it is necessary to go in depth into the single market and the competitive power in non- tradable and service sectors.
2. Relocation of the rest of resources in the most productive sectors and, within them in the most productive companies. The relocation of labour has a special relevance: there is evidence that low adjustments of unit labour cost in the non-tradable and service sector in low-income economies discourage the movement of labour to the tradable sector, as salaries are higher in the non-tradable. It is necessary to face this distortion through the reform of the labour market, by introducing mechanisms that link training with salary conditions.
3. To eliminate financial constrictions that limit capital relocation. There is evidence that weaknesses in the balances of financial entities delay the process: financial entities with low capitalisation have been more prone to keeping financing for less sound debtors. This behaviour blocks the exit of companies and the granting of credit for newcomers.

Low-income countries have developed reforms in the legal framework that increase competition. For example, the strengthening of competition authorities, the reduction and flexibilisation of administrative charges and authorisations and the improvement of fair participation in public tender. However, the progress in reducing excessive income or the market dominant position of the so-called superstars firms, in certain good and service markets has been less ambitious, especially in network industries, such as energy, telecommunications and transport. The reduction in excessive income would mean fighting against vested interests. Implementing reforms in these sectors is essential, not only because they involve the relocation of capitals, but because they increase competitiveness in the tradablesector, by reducing the cost of their inputs.

Relationship between the supply and demand policies

In times of post-crisis, with high indebtedness and low productivity, supply policies may intensifythe effectiveness of demand policies:

- By increasing the growth potential, which generates more expenditure and investmentcapacity in States and households.
- By improving labour qualifications.
- By ensuring that the increase of demand is channelled to the correct sectors.

The short-term positive effect of structural reforms depends on its pace -instead of the traditionalgraduation, they must be speeded up- and their composition: they should not only focus on competitiveness but also on increasing productivity.

While the short-term positive effects of structural reforms surface, aggregate demand should be stimulated, through fiscal and monetary policies that compensate for the effects of the structural reforms on the reduction of prices and real negative interests.

To achieve sustainable growth, both demand and supply policies are necessary. Both intertwine.

The pace of structural reforms

Some defend that reforms should be implemented as a "big bang", while others claim a more gradual implementation.

Quick reforms have been more efficient than gradual ones, which have caused deflationary expectations and real increase of interests. That is, slow reforms cause a contraction effect.

Therefore, countries that brought the structural reforms forward have achieved better results than those that applied them more slowly. In countries such as Greece, Portugal or Spain, reforms were slow. In Spain, the delayed implementation of the labour reform meant that salaries continued growing until the end of 2011.

Speeding up reforms is more advisable. Against this, we should not oppose the lack of political capital, as we *haveseen that action was preferred against a greater group of the population by reducing salaries instead of actingagainst vested interests. Failure to apply structural reforms in the product market, and only applying themin the labourmarket, hasslipped the ideaofinjustice among the population.*

In general, talking vaguely about reforms without implementing them is destructive. It creates uncertainty about the evolution of real interests without increasing the expectation for the improvement of growth potential. Furthermore, while in normal circumstances it might be acceptable to reform a sector in due time, in times of crisis, justice should be the main value, andthe best way to combat vested interests is to reform them all at the same time.

The European Union policies: against the fall of the economic growth potential

Growth potential in the Eurozone decreases since 1990 due to a fall in productivity. Before the financial crisis no attention was paid to this fact.

The fall of growth potential occurs for two reasons:

a. Long fall of investment: near 20%. The downturn since 2008 has been very strong compared to other periods. There is a slow increase of capital stock and its average age increases, especially in machinery.
b. Hysteresis -long-term unemployment- workers lose their skills and become unemployable.Structural unemployment has grown up to 10%.

A vicious circle takes place: growth potential decreases because households and companies slow down consumption and investment due to their lower expectations. This translates into a loss of competitiveness and, therefore, of employment.

Supply policies should increase growth potential. For its part, monetary policy should act:

- By reducing the gap between activity and growth potential: if the latter falls, expectations of income and investment fall and this pushes inflation downward, making monetary policy more complicated.

- The fall of growth potential forces to reduce interest rates.

Both policies are necessary, but the monetary one cannot wait for the supply policy if inflation islow.

There were several circumstantial aspects that had an influence on the monetary policy measurestaken by the EU to reduce the differential between activity and growth potential:

1. High public indebtedness means that the fiscal policy to support the demand is limited.
2. Nominal interest rates were already low, which limited the goals of the conventionalmonetary policy.
3. The fragmentation of financing, which affects the transmission of monetary policy.

In this scenario, the **monetary policy** measures promoted by the ECB have been:

1. Reduction of nominal interest rate
2. Forward guidance (previous information on ECB monetary policies)
3. Negative interest rate in ECB deposits (deposits of commercial banks in the ECB)
4. TLTRO (Targeted Longer-Term Refinancing Operations)
5. Purchases of ABS and Covered Bonds
6. ECBs Comprehensive Assessment and AQR in bank balances (assessments on the financialsoundness of banks). Banking Union
7. Launching of the APP (Asset Purchase Programme by the ECB).

When demand is weak, short-term structural reforms can be costly. With the monetary policy, thedemand is strengthened and access to credit is improved, by limiting the costs of short-term reforms.

The **supply policies** to increase growth potential are the following:

1. Reform of the product market.
2. Debt reduction, by facing loans. Reforms in the restructuring legislation.
3. Increase of TPF: during 2000-2014 in the Eurozone it was increased by 1.4% while in the USA by 10.7%. The mere implementation of the monetary policy, without an increase in productivity, will not overcome the financial crisis.

Dangers caused by the persistent policy of low interest rates

The lengthening of low interest rate policies has, among others, the following effects:

- The drop of interest margins for financial entities.
- Incentives for excessive risk taking.
- Inflation of asset prices.
- People of advanced years can worry about their retirement due to the low interest rates, by increasing, as a precaution, savings and by reducing consumption. This may reduce financingcapacity in companies who manage pension schemes and, thus, reduce their investments.

Furthermore, a persistent low-interest rate policy in advanced economies spreads to othereconomies less affected by the crisis. Contagion occurs in various manners:

- Among investors, looking for greater profitability and movements in the global bondmarket, which could fuel imbalances in the host economy.

- A fast increase of real estate asset prices, spreading credit and indebtedness,including in foreign currency.

When infected economies enter the last phases of the boom, their vulnerabilities could turnto the countries which started them.

III. Structural reforms to overcome the financial crisis

Improving the Net International Investment Position (NIIP)

In countries with current-account deficit on the side of the supply, there is evidence that structuralshift would help to keep exports. The cost of competitiveness, measured in terms of the real exchange rate, deflated by the Unit Labour Cost, has strongly improved since the beginning of thecrisis. What is less known is that in countries with current-account surplus, like Germany, the UnitLabour Cost has grown with regard to the Eurozone, protected by salary increases and low productivity growth. However, thanks to the euro depreciation, Germany's competitive position with regard to the rest of the world has been maintained.

However, the rebalancing process was not achieved for two reasons:

1. There can be no real external adjustment without creating employment.

   To achieve the real external adjustment and employment growth, a better allocation of the available resources is necessary, which means moving resources to the tradable sector and,more specifically, to more productive companies in each of the sectors. This will boost the TPF and, therefore, growth potential, causing a more sustainable relative adjustment in prices.

   In many countries, Unit Labour Costs have fallen and relative prices between the tradable and non-tradable sector have adjusted. At the beginning of the crisis, however, one could see there was no relocation of the labour sector towards the tradable sector and employment fall was similar in all sectors. And even though recently in some countries tradable employment has been increased, the sector that has contributed to most to the creation of employment was the service sector, which in many countries is essentially non-tradable.

   Hence the importance of reforms in the product market. For example, completing the single market, by opening services to the competition; this would encourage intra-sector relocation among the most productive firms of the service sector, making them "more tradable", and contributing to the creation of employment.

2. In spite of the enhancement of flows, the external imbalance in terms of variable stock remains high. The NIIP (Net International Investment Position) of many countries with a negative exterior net balance was stabilised thanks to the improvement of the current account, but has not decreased to safe levels. The five countries under programmes, amongthem Spain, still have a negative NIIP in an excess of 90% of the GDP and one of them even more. However, countries with current-account surplus continue to improve their NIIP, as isthe case of Germany and The Netherlands.

   More adjustments are necessary to achieve a sustainable external position. The European Commission considers that the NIIP of Greece, Spain, Cyprus and Portugal will remain in levels associated with strong external vulnerabilities during the next decade. To achieve the required level -established in NIIP/GDP at 35%- substantial improvements should take place in said countries.

On the other hand, we should highlight that the level of internal debt -what the country owes itself- remains also very high in several countries. For example, in Spain, more than 60% ofthe public debt and 80% of the private sector are in the hands of residents. This does not worsen the NIIP but contributes to the general dependence on debt. Therefore, internal debt should also be addressed to achieve a sustainable internal adjustment.

Thus, countries with current-account deficit should address two challenges: to reduce their external net liabilities and to continue adjusting their economy internally.

The difficulty is to tackle these two challenges without one cancelling the

other.The possibilities regarding the external position are several:

a. Advanced payment of the debt: it would require important surpluses with significant nominal adjustments. Given that the adjustment towards tradable sectors did not take place, it is difficult to achieve it without depressing income and employment. Furthermore, it would generate long deflationary expectations, with rises in the real interest rate and depression of the demand.
b. Leave debt to grow: through GDP nominal growths. But reducing the NIIP only through the denominator requires unreal growth rates beyond what structural reforms and fiscal and monetary policies can provide.
c. Changing the composition of external net liabilities, by replacing debt with equity and foreign direct investment. It would not solve the NIIP but would reduce external vulnerability by increasing the shared risk. Therefore, the Capital Market Union could be a good instrument, but in the long term.

The only way would be to find a combination that improves the current-account surplus and the nominal GDP, which could achieve internal and external adjustment. This would be achieved:

I. In the nominal aspect:

- To support employment and resource relocation.
- Growth of productivity: by reducing ULC (unit labour costs), supporting exports, increasing growth potential and supporting debt reduction with the nominal increase of GDP. This favours investment, which, targeted at the tradable sectors, would improve exports in the future.

  The reforms that generate more productivity have fewer negative effects when monetary policy is in the lower bound. That is because these productivity increases act more on fixed costs than on marginal costs. For example, judicial reforms and the opening of closed liberal professions are more likely to encourage investment and, thus, productivity, with a small deflationary effect. Among the structural reforms that reduce fixed costs, one that would most likely have an impact is the improvement of insolvency systems. It would help face dependency on debt for viable companies, by reducing their debt services. This would also allow liquidating non-viable companies more quickly, by favouring the relocation of resources in more productive companies.

That is why it is a mistake to consider adjustments as a mere cut on costs, which is what many politicians think competitiveness is. Productivity growth is essential in competitiveness and to reduce debt. The IMF considers that the benefits of salary cuts decrease when more countries commit to them. On the contrary, when many countries commit to structural reforms, productivityincreases and benefits are greater and more uniform.

Reforms in the labour market

Structural reforms to increase growth potential in a Monetary Union have to fulfil two criteria:

1. They have to be thorough: only focusing on the labour market is not sufficient. They have to encourage innovation, competitiveness and fight against income extractors and monopolistic structures. This means offering new income opportunities, especially to younger generations, by reducing and distribution income and encouraging the adjustment of economic players.
2. They have to be sequenced and measured: not only focusing on Member States inefficiencies, but also on externalities and deficiencies at the Union level. This means reforms in institutions and completing the Single Market.

The growth potential in the Eurozone, like in other advanced economies, has had a sustained decreasing path for several decades. But in the Eurozone it was more pronounced with regard to other important economies: it was stronger than in the USA, with a worse TPF.

High-risk projects with high income that would help increase growth potential are more difficult to finance in the Eurozone than in other parts of the world. This is due to Europe's bias in favour of bank financing instead of equity, as it happens in the USA, and the fragmentation of our financialsystem, apart from administrative obstacles.

Furthermore, the relocation of the labour factor is damaged by the rigidities in the national markets as well as cross-border mobility obstacles, with the impossibility to transfer social rights.

The demographic handicap should also be taken into account: the most innovative population between 26 and 50 years old has decreased: in Germany, 12%, 2% in France, 11% in Italy and 29% in Spain.

Youngsters, in spite of being highly qualified, have many problems to access the labour market. Youth unemployment increases. Furthermore, they inherit a high debt level. To avoid losing a generation, immediate action is necessary.

In the last few years we have been witness to a significant number of labour market reforms. Nominal and real rigidities of the labour market have led to the unemployment's disease in Europe. Since 1970, during financial crises, both in the USA and Europe, unemployment has increased. But while in the USA employment grew quickly with economic growth, in Europe it took longer, without returning to the previous level. Unemployment has been growing in Europe for the last 40 years.

Labour market reforms have been out of step and before the product market reforms. If it had been the other way round, its effects on the long term would have been softened. It was not done that way due to the lobbies who respond to vested interests. Labour market reforms may also be softened with expansive lax monetary and fiscal policies.

In the Eurozone, a common growth strategy is needed. In this strategy, productivity and employment should take priority, as these are positive factors, unlike competitiveness, which means fighting among Eurozone countries and, as a whole, does not provide a positive differential due to the compensation effect. In this strategy, improving the service market is essential, and thus restrictions on competition should be eliminated. A step forward would be the application of the "country of origin principle" and not having to adapt to the regulations of 28 countries of destination.

We can also underline the low compliance with the Country Specific Recommendations from the Commission and the European Council to Member States. The proposal by the IMF of linking the recommendations to objective and measurable data to determine compliance is very interesting.

There are two sources of labour productivity growth:

1. Amount of capital available for each worker.
2. Efficiency of the use of resources, including aspects such as innovation: this is TPF.

The reforming momentum seems to be slowing down. One of the reasons is because, on the shortterm, the distribution effect of reforms may have an unpopular impact. **Reforms have to be inclusive to avoid being unpopular and eliminate inefficient high economic income in protected sectors,** especially in the non-tradable sector, in order to have beneficial effects on social well-being. For that reason, governments will have to face pressures from lobbies that defend vested interests.

Elimination of financial constrictions

The elimination of financial constrictions may be addressed with short- or long-term solutions:

Short term: it would involve managing legacy assets and for that it would be necessary once again for capital to flow from high-income countries to low-income ones, and that banks from low-income countries were sufficiently capitalised to grant credits.
Hence the ideas of Banking Union and the AQR. The goal of AQR is to clarify doubts about the quality and levels of capital and provisions, thus speeding up the deleverage and restructuring process of the European financial system.

Long term:

-The supervision of the SSM (Single Supervisory Mechanism) must be separated from the national nature

- The SSM must establish the conditions so that foreign capital inflow in national banking markets contributes to a good capital location, thus increasing the independence between the main shareholders, bank managers and vested interests in the country where the bank operates.

- To eliminate barriers for commercial banking. A greater integration would entail that the losses caused by the local banking crises could be shared through multiple jurisdictions, as ishappens in the USA.

The possibility of a new financial danger should be accepted, momentarily, and it should be counteracted by implementing macroprudential measures inspired by the principles of "loan to value" and "loan to income".

Origin of the texts:

Benoît Coeuré and Peter Praet, members of the Executive Committee of the European Central Bank. January,April and October 2014
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Mario Draghi, Annual Assembly of BIS, 27th June 2016