Erkki Liikanen: The euro, integration and growth

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Brussels Economic Forum 2008 on Economic and Monetary Union in Europe: 10 Years On, Brussels, 16 May 2008.

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Ladies and Gentlemen,

Ten years of experience have shown that the monetary union has made a tremendous contribution to the underpinnings for stable growth in the euro area.

The most important channel has been the maintenance of monetary stability, which reduces distortions and costs caused by price uncertainty. In this respect, the euro has done very well and this has been reiterated many times today. Rightly so.

I want to discuss other important aspects of growth in the euro area, many of which benefit from the common currency. I will start by saying a few words about the role of financial integration in catalyzing financial development. Related to this, I will discuss briefly some recent studies that show how equal access to financial markets is an important determinant of competition in the broader economy.

And finally, I will talk about productivity in non-market services; in particular, how improved productivity in the provision of public services will be indispensable in reconciling sharply rising old-age dependency with acceptable level public services. The last aspect is particularly crucial now in Finland, which is the first EU country to face population ageing, but it will soon been a major issue for the others, too.

But let me start with financial integration.

Financial integration and growth

It is difficult to think of a less opportune time to preach the virtues of financial integration. Things being as they are, one gets the impression that what global financial markets are propagating today is not growth, but risks and instability.

The persistent turbulence since last August has demonstrated once again that financial markets suffer from bipolar tendencies. Overshooting tends to be followed by undershooting. This time, a period of exuberance and indifference towards risk has been followed by a period of exaggerated nervousness, risk aversion and distrust.

Once again, there are lots of lessons to be learned for financial institutions, central bankers, regulators, supervisors. Our vocabulary has been enriched by great many acronyms that were hardly heard of a year ago, such as ABS, CDO's, SIV's, ABCP's and so on. We are just starting to form a picture of what this debacle means for policies. Eventually, the storm will pass, and we will draw some conclusions. Here the recent report of the Financial Stability Forum, chaired by my Italian colleague Mario Draghi, has made a major contribution.

The issues that we are facing are serious but they must be put in a perspective. Many countries gradually liberated their capital account and removed credit controls in 1980'ies. The consequences for the Nordic financial markets were profound. There was a period of exuberance in the late 1980s, a housing and credit boom, followed by a banking crisis and a deep depression.

The Nordic experience was not uncommon in those times, when many countries were liberalising their markets, and it carries some resemblance to what we are experiencing today. In both cases, advances in financial integration, combined with lack of sophistication

from market participants and policy makers, led to excesses and, eventually, to a costly correction.

But what is important to bear in mind is that no country experiencing difficulties in those times, seriously considered reinstating capital controls as a response to the crisis. Although the pain at the time was real, there simply was no question that the benefits of financial integration far outweighed any costs of transition.

The rapid growth experienced by Nordic countries including Finland over the last 15 years would have been simply inconceivable without liberalised financial markets. The cost of learning was high, but we emerged from the crisis stronger and competitive. And so it is today. We should recognise and learn from the risks and vulnerabilities that manifest themselves in the market turmoil. We should design the appropriate policy and regulatory responses.

But we must not lose sight of the simple fact that the very same financial innovations that now propagate turmoil also carry the potential of tremendous benefits in terms of lower cost of finance and better diversification of risks. The challenge is to find the right balance of risks and rewards. We need better incentive structures. We need better performance from rating agencies. We need to enhance transparency. The regulators need to pay more attention to liquidity risks. But still, we cannot design policies that eliminate risks.

The EU has made progress in financial integration. Last year, the ECB and the Commission each published a report (Financial Integration, ECB 2007; European Financial Integration Report, EC 2007) on the state of financial integration in the EU. The same issues were further elaborated in the Commission report EMU@10, released just ahead of this forum. These reports found that, in markets closely linked to monetary policy, the euro has catalysed substantial integration. In particular, interbank markets are well integrated – or at least were, and hopefully will be again, once the turmoil passes – as are government bond markets and, increasingly, also corporate bond markets.

On the other hand, much remains to be done in other areas. The infrastructure supporting bond and equity markets is fragmented and hinders competition. And, retail banking continues to be mainly national.

Even a cursory look at how, say, housing finance works in the EU reveals that EU citizens face a different reality in different EU countries. Interest rate linkages differ, loan margins differ, fees differ, collateral requirements differ, and so forth. Not all of these differences are undesirable; some of them may, for example, reflect quite legitimate variations in attitudes towards risk.

But it is difficult to avoid the conclusion that not all EU citizens have access to the same level of financial services. This carries a welfare cost, and that cost is carried by EU citizens in the form of diminished opportunities to allocate consumption and investment over time.

Ample evidence from various sectors of the economy shows that financial development goes hand in hand with financial integration. Protected sectors seldom develop. And so it is also in financial services: it is the pressure of cross-border competition that will motivate innovation and productivity improvement. The best way to guarantee a high level of financial services for EU citizens is to remove the remaining obstacles to competition.

Better provision of services is one benefit of financial integration, better diversification of risks is another. In times of turbulence, domestic orientation of a bank may look like a benefit – after all, it insulates the bank from trouble originating from abroad. But a purely domestic institution is highly exposed to country risk; when the crisis hits, it tends to hit hard, as we found out in the crisis fifteen years ago.

The nature of diversification is that risks materialise more often, but each bank shares a smaller part of them. Inherently, internationally diversified financial institutions are in a better position to weather turbulent times. This, of course, provided that we design appropriate

regulatory and supervisory structures that allow holding cross-border institution to the same prudential standards as domestic institutions.

Going international is one way for a financial institution to diversify risks. Another way is to securitize and sell those risks. I realise that this may sound like a bad idea these days. Fundamentally, securitization is an important innovation that carries substantial promise of better risk management and, ultimately, even better financial stability. It seems obvious that banks, which generally operate on a rather thin capital cushion, are not the institutions best equipped to carry the bulk of the systemic risks of housing booms and busts. Why not allow international investors such as insurance companies, pension funds, sovereign wealth funds carry part of the risk? There is nothing fundamentally wrong about securitization – it was the recent complex, structured applications that went wrong.

Besides cheaper funding and better diversification of risks, there is yet another reason why we should be interested in financial integration and, as a part of it, increased securitization. In the coming decades, the global population will age. Between now and then, those approaching retirement will want to save. As a result, there will be an increasing global demand for financial assets. Those economic areas that are able to generate good-quality financial assets are going to be the winners in the global allocation of capital and financial services. Securitization is one important way of generating such assets.

The euro, competition and productivity

As I noted in the beginning, the euro supports growth in various ways. Better anchoring of inflation expectations creates a more secure foundation for contracts and spending decisions. Broader home market helps European companies to utilise economies of scale. And finally, the euro creates a platform for financial integration and development which, in turn, are important determinants of competition and productivity.

On this last aspect, Rajan & Zingales wrote a couple of years ago a provocative book, “Saving Capitalism from Capitalists”. In the book they examined the various ways in financial markets spread wealth and opportunity. The message is that the most important function of financial markets is to promote competition and weaken the power of the incumbent.

Without well-functioning financial markets, economic power is in the hands of those who have liquid wealth, collateral and connections, not in the hands of those who have ideas. That is the recipe for stagnation. Financial markets create the opportunities for newcomers to dislodge the incumbent, to leapfrog them by innovating. Competition increases, monopoly rents fall, and productivity increases.

If Europe is to accelerate growth potential and promote the Lisbon targets, increased competition is a necessity. Many are familiar with the study by Bayomi, Laxton and Pesenti from 2004, which suggests that increasing competition in the euro area to the US level could boost its output by no less than 12 percent.

Another study, conducted in the Bank of Finland for the Finnish economy, examined the effects of a general increase in competition both in product markets and in labour markets. The increase in competition is defined as a reduction of excess rents in these markets by just a fifth – in other words, monopoly profits in the economy are reduced by 20 percent. This assumed reduction in rents is rather modest, and the model does not assume the increased competition to have any effects on the rate of technological change, so the total effect on output is not huge, only about three percent. But more interestingly, real wages, which initially fall, as wages are brought closer to the labour market equilibrium, soon rise again, and end up also three percent above their initial level. Also employment increases by almost two percent.

These are just model simulations and open to criticism, but the conclusion I draw from this is the following: Product market reforms, if implemented well, are an important counterweight to

labour market reforms. They can support real wage development at times when labour market reforms may have negative short-run effects on wages.

Productivity in public services

The single market, the euro, and free trade provide the right framework for the euro area private sector to flourish and employ in the coming decades. However, for that strategy to work we need to ensure that there is labour force for the private sector to employ in the coming decades.

Population ageing of the scale we are facing will exert tremendous demands on the resources of our economies. These demands are partly financial: the cost of old-age pensions and health care will increase substantially and will challenge the sustainability of public finances. To avoid taxes increasing to unsustainable levels, pre-funding is a necessity in most countries.

Private sector productivity growth may also help, but does not solve the issue. First, pensions tend reflect wages, through the accrual mathematics and through indexation, so that when productivity gains boost wages, pensions tend to follow, with a lag, but eventually almost one to one. And second, when private sector wages increase, so do the wages of health care professionals on public payrolls. This is the well-known Baumol's disease.

With population ageing, the real demand for public health-care and elderly-care services increases. So at the same time as working-age population shrinks, the public sector needs to hoard an increasing number of workers. The labour resources available for the private sector will diminish from two directions.

This is a challenge for which the response cannot be purely financial. If the economy simply lacks the labour force to meet the rising demand for health care professionals, no amount of prefunding can change that. Hence, the other part of the response must be to ease the physical constraints by increasing productivity in public services.

Increasing productivity in public services is an agreed policy priority in many countries. Still, experience shows that it is not an easy subject to discuss or to debate. When speaking about productivity, an economist thinks about more and/or better services from same resources. A health care professional may think about less personnel per patient, less time available to respond to individual needs, and longer queues to operations.

To win the case in a debate, we need to have a response to these concerns. One useful used way to conceptualise the issue is to think in terms of outputs and outcomes of public services. An output is the actual physical result of action: a consultation with a doctor, a home visit by a long-term care professional and so forth. Productivity in producing outputs measures the efficiency of public services.

In contrast, outcomes relate to the ultimate policy goals: better health for the population, safe and dignified life for the elderly. Productivity in terms of outcomes requires not only that outputs are produced efficiently, but also that the outputs that are produces are effective in delivering the desired outcomes.

So why does the debate on productivity tend to raise red flags amongst health care professionals. It is because there is a general temptation to focus a productivity program primarily on outputs rather than on outcomes. The reason is simple: First, outputs are typically far easier to measure than outcomes; second, the link from inputs to outputs tends to be far easier to establish than the link from inputs to outcomes.

A productivity program that concentrates on outputs may make great leaps in output productivity, but no gain in terms of outcome productivity, because it promotes outputs that do not correctly reflect the quality of services. This would be a sad result, indeed, and all too

common. It is what gives productivity a bad name and undermines public support for the reform of public services.

These concerns need to be taken seriously. We need to resist the temptation to concentrate only on what can be easily quantified. We have to accept that not all policy goals are easily measured. Sometimes we may need to rely on information that is qualitative, even anecdotal. Efficiency in producing outputs is vital for maintaining high quality public services, but we must never lose sight of the fact that the ultimate policy objectives are defined in terms of outcomes.

In short, we need to do right things and we must do them well.

Ladies and Gentlemen,

The euro has been a success to an extent few would have predicted ten years ago. Signs are good that this success will continue – that the euro will continue to underpin price stability and to promote economic and financial integration in the euro area and beyond.

But to be able to do that, the euro relies on strong political and public support. Population ageing will present a challenge for that. If the euro area fails to prepare for ageing appropriately, its economy will suffer, and eventually pressures will mount on monetary policy: monetary policy will be asked to do something it cannot do. And then continuing the success story would become much more difficult.

That is why it is so important for us to keep up the momentum in building a public sector that can weather the pressures of population ageing. It's a long journey, so we have to keep moving.

Thank you.