Erkki Liikanen: How to boost Europe's growth potential?

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the CEPS Breakfast Meeting, Brussels, 10 March 2006.

Slides for this speech can be found on the Bank of Finland's website.

*   *   *

Economic growth in the EU has been sluggish in recent years, despite the robust world economy. As a matter of fact, growth has been strong in almost all parts of the world except for Western Europe.

The weak performance of the euro area economy in recent years is not due to monetary policy. On the contrary, interest rates have been very low – both the long and the short term rates. Neither can the exchange rate be blamed for the sluggish growth. The external value of the euro has not been at a level that would have hurt the overall price competitiveness of euro area industries. Therefore, we have to look elsewhere for the reasons for the unsatisfactory growth performance.

Weak demographic trends have been one of the factors restraining the growth of the EU economy compared with many other parts of the world. In the future, the negative demographic trends will continue. In addition, rising oil prices have in recent years held back growth in the EU. Unfortunately, economic policies cannot do much to reduce the effects of demographics and oil prices on growth. Luckily, however, there are also issues that economic policies can deal with in order to increase Europe's growth potential. Let us now turn to those.

It appears that the European economy has not been able to take advantage of new technologies and globalisation as effectively as the United States. The growth of labour productivity in the U.S. has exceeded that of the EU since the mid 1990s.

This table shows that the difference in productivity increases between the EU and the U.S. is largely due to developments in the IT goods producing sector, and – even more importantly – in the service sector. Within services, it is retail trade, wholesale trade, and financial services that count for most of the diverging productivity developments. These sectors are important users of IT.

Indeed, there seems to be a lot of unexploited potential in the EU when it comes to labour productivity. First of all, productivity can improve within each industry and within each firm. Secondly, aggregate labour productivity can also be raised by the exit of industries and firms with weak productivity, and the entry of those with better productivity.

Public authorities can facilitate improvements of this kind by removing obstacles to a more productive private sector. In the EU, such obstacles are largely related to national boundaries and to regulation of private businesses. Policy measures that promote competition and economic integration within the EU can significantly enhance productivity, employment, and economic growth.

The relation between competition and productivity has been the focus of a significant amount of research in recent years. Several studies suggest that an increase in competition normally increases innovation and thereby productivity (e.g. Aghion et al. 2002).[1] This is because companies with monopoly power have less need to reform and to innovate.

*   *   *

Apart from the effect that competition has on innovations, it also directly improves the allocation of resources in the economy. This is the beneficial characteristic of competitive markets according to basic microeconomic theory. Competition increases production and lowers prices.

A few recent studies investigate the macroeconomic benefits from economic reforms that promote competition. These studies utilise modern dynamic general equilibrium models. Simulations performed with such models show the effects of increases in competition, essentially starting from the effects that are familiar from the basic microeconomic theory.

---

[1] Aghion, Philippe – Bloom, Nicholas – Blundell, Richard – Griffith, Rachel – Howitt, Peter (2002): Competition and Innovation: An Inverted-U Relationship. NBER Working Paper No. 9269.

One of these studies focuses on the euro area. It investigates how increases in competition affect the euro area itself, as well as the rest of the industrial world.[2] It is assumed that competition increases in the product and labour markets. In the language of the model, this means that mark-ups diminish in prices and wages. The mark-ups are defined as the deviations of prices and wages from the theoretical case of perfect competition. The study assumes that competition in the euro area increases so much that it reaches the estimated level of the U.S. economy. This means that the price mark-up declines by 12 percentage points (35 % → 23 %) and the wage mark-up by 14 percentage points (30 % → 16 %). The central results of the study are shown in this slide.

The slide shows the long-run effects of increased competition: first, in the product market and, second, in the labour market. The combined effect is shown in the last column of the table. Production, consumption, and employment are increased in each case. In addition, investment expands, as the increase in production requires an increase in the capital stock. One should note that the table does not show the values of the variables as such, but it shows how much they differ from the baseline case of no change in the level of competition.

It is assumed in the study that there is a very significant increase in competition. Therefore, the estimated consequences are dramatic. Euro area GDP increases by as much as 12.4 % in the case presented in the last column of the table.

The product market reform has greater effects than the labour market reform, particularly on production and investment. Regarding employment, the effect of the labour market reform is almost as large. Outside the euro area, there are some positive spill-over effects. This is partly because foreign consumers benefit from the decline in the prices of the goods produced in the euro area.

One way to look at the results of the study is to consider what they tell us about the possible future adjustment of the U.S. current account. According to the results, competition enhancing reforms in the euro area would make the adjustment less painful for the euro area itself, as well as for the rest of the world.

In Finland, increases in competition would benefit the economy in much the same way as in the case of the whole euro area. This is shown by a simulation study made in the Bank of Finland. The study uses a dynamic general equilibrium model of the Finnish economy, the AINO model of the Bank of Finland. Again, the effects of increased competition in the product and labour markets are studied. The results are briefly reported in the Bank of Finland Bulletin, the first issue of 2005. The results are summarised in this slide.

The slide shows the effects of decreases in the price and wage mark-ups in the Finnish economy. Both the short-run and the long-run effects are shown. The long-run effects are smaller than those in the previous slide. This is because in the study concerning Finland, the assumed increase in competition is much smaller. The price mark-ups are assumed to decline by 2 percentage points and the wage mark-ups by 5 percentage points. Two-thirds of the increase in GDP is due to the increase in competition in the product markets, and one-third is due to the increased competition in the labour market.

Again, one should note that the figures in the slide do not show the values of the variables as such, but rather their deviations from the baseline case of no change in competition. For example, the level of real wages after two years is 0.4 % higher than what it would have been without the increase in competition.

The next slide shows how the effects of increased competition propagate in the economy.

In the long run, increased competition boosts production, consumption, and employment. Obviously, the increase in competition does not benefit every agent in the economy. There is a decrease in the profits of the firms that face a reduction in their monopoly power. Also, the short run developments are affected by the fact that resources shift from production of consumer goods to production of investment goods. This is because there is an early increase in investment due to the need for a larger capital stock to support the long-run increase in the level of GDP. Indeed, consumption is decreased in the short run. However, in the long run it increases by almost as much as GDP.

---

[2] Bayoumi, Tamim – Laxton, Douglas – Pesenti, Paolo (2004): Benefits And Spillovers Of Greater Competition In Europe: A Macroeconomic Assessment. NBER Working Paper No. 10416.

Of course, these model simulations only provide rough estimates of the effects of economic reforms. However, the qualitative results are clear: an increase in competition boosts GDP and welfare. One should also keep in mind that these results are only based on the direct effects that the degree of competition has on resource allocation. As I mentioned earlier, competition also increases innovation and thereby productivity. This effect comes on top of those indicated by the studies just discussed.

*   *   *

As I already pointed out, the growth of labour productivity in the service sector has been slower in Europe than in the U.S., and the financial services production is among the sectors with the largest differences in productivity performance. Moreover, when discussing Europe's growth potential, the development of the financial services sector is far more important than what its direct contribution to productivity growth would suggest. The development of financial services is crucial to the dynamism of Europe's economy.

The function of financial services and financial markets in the economy is twofold. First, banks, capital markets, and other parts of the financial system play a central role in evaluating, trimming, and promoting innovations and business ideas. In this way, the financial sector takes part in developing the economy, while at the same time it acts as an intermediary supplying financing to those who need it. The second central task of the financial sector is related to payment systems. They form the basic structure that makes the financial markets to operate as one entity. Without well-functioning payment systems markets would be fragmented: locally, regionally, or nationally. Broad and competitive financial markets are impossible without an efficient and a unified payment system.

Financial integration within the EU offers great opportunities to improve Europe's growth potential. The integration promotes economic growth for several reasons:

- First of all, the required return on an investment project is reduced, because financing is available at a lower price. This increases investment and employ-ment.
- Second, consumers benefit directly from smaller interest rate margins and decreased service fees.
- Third, a greater variety of financial services becomes available. This adds to the benefits of the customers of the financial services sector.
- In addition, financial integration increases the stability of the EU economy, because an integrated financial system balances risks between countries. The effects of country specific fluctuations are dampened and shared more evenly, as the cross border ownership and trade of financial claims increase. In the U.S., a significant part of so called asymmetric region specific income fluctuations are neutralised through the integrated financial system.

The common monetary policy creates another, specific need for the euro area financial system to be as integrated as possible. Integration reduces the asymmetry of the effects of monetary policy across countries.

Today, we have a common monetary policy but we do not have an integrated internal market for financial services.

A lot has already been done within the EU to promote financial integration. An important instrument in this process has been the Financial Services Action Plan (FSAP). It contains 42 measures, and almost all of them have been adopted at the EU level. However, the national implementation of many of the measures is still incomplete. A continuation to the FSAP in the form of further measures has already been discussed.

Ultimately, the integration of the EU financial system, however, will not result from authorities' actions or regulation. Integration is realized when the market participants change their way of doing business. The task of the authorities is to remove obstacles to integration and to take care of the development of the regulatory and supervisory framework. The three main areas where financial integration should proceed are all related to market infrastructures. The first is to create a common European market in retail banking. Here, the development of payment systems plays an important role. Secondly, securities clearing and settlement systems need to be made more integrated and efficient. The third area where progress is most needed is the integration and coordination of financial supervision. Of these three areas, I will next briefly focus on securities trade.

A problem in the securities markets is their current lack of depth and integration. An important challenge is the fragmentation of clearing and settlement systems. It is an important factor behind the high price of securities transactions in Europe.

This applies particularly to trade in equities. The cost of an equity transaction across national borders but within the EU can be as much as four times the cost of a similar transaction in the U.S. It is exactly these costs that prevent the integration of equity markets. They hurt the issuer of a stock via reducing its price. The provider of financial services, in turn, faces higher costs. The infrastructure of the markets has too strong an effect on the location of transactions and businesses. In this situation, current national features of the clearing and settlement systems should be evaluated from the point of view of their future in the integrating European market.