Jürgen Stark: The agenda for the competitiveness of Europe's economy and financial system

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at Ambrosetti Finance Workshop, Cernobbio, Italy, 5 April 2008.

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Ladies and gentlemen,

I wish to thank the organisers of this event (Ambrosetti) for their invitation, which allows me to speak about the competitiveness of the euro area – a topic which has even become more of a prime concern in many advanced countries in view of the increasing challenges resulting from globalisation. Given the varied facets of "competitiveness" – that I broadly define as "the ability of an economy to compete in international markets" – I would like to start by reviewing some specific aspects of economic and financial performance of the euro area. I would continue thereafter with some aspects regarding the performance of the euro area banking sector, including the link between financial development and the transmission of monetary policy. Finally, with a view to reforms which aim at improving further the performance of the euro area economy and financial system, I will draw some lessons from the recent financial turmoil.

Real and financial aspects of euro area competitiveness

Starting by an assessment of the competitiveness of euro area firms and thus their capacity to play a leading role in world markets, losses in world export market shares over the last decade point to increasing challenges for the euro area. While being partly an adjustment to the emergence of new competitors, and most notably China and India, with lower labour costs, this may in principle also reflect losses in price competitiveness against other advanced competitors or a more unfavourable export specialisation. Nevertheless, it is important to note that most other advanced competitors have also experienced export market share losses over the same period. On a more positive note, recent analyses of highly disaggregated data, at the product and variety level, further show that instead European firms have gained market shares in the high-price and high-quality segment of mature sectors.[1]

However, important differences remain with regard to the export performance across individual euro area countries. Unfavourable price and cost developments thereby often seem to have been a major cause of a weaker export performance. Contrarily, the relatively stronger export performance of Germany appears, to a large extent, be due to very moderate increases in labour costs. Other factors such as differences in the export specialisation – the product range and product quality – and the geographical orientation certainly have also played a role. For example, due to its higher share of capital goods exports, Germany might have also benefited, to a greater extent, than both Italy and France, from the sustained world demand. Italy and France, by contrast, have a significantly higher export specialisation in consumer goods.

In the medium-term, however, it is in particular the lower productivity growth, which weighs on the competitiveness of European firms. Since the mid-1990s, productivity has slowed down substantially in the euro area, leading to a productivity gap with the US. While this gap is closing more recently, improvements in euro area productivity seem to be cyclical and not of a structural nature. At the same time, labour markets in euro area countries have

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1 See Fontagné et al. (2008).

witnessed an increase in participation rate and a decline in the unemployment rate. However, the employment rate still falls behind the objective of 70% set by the Lisbon strategy, and unemployment rates remain unacceptably high in a number of euro area countries. These weaknesses in economic performance point to continued rigidities and imperfections in the euro area economy.

To ensure that the advantage of European exporters in specific high value added varieties is not eroded over time, to regain price competitiveness across all euro area countries, and to improve labour market performance and potential output growth, the euro area needs to implement structural reforms directed to boost productivity growth and enhance the functioning of both labour and product markets.

This is even more crucial in a monetary union. Since euro area countries can no longer rely on monetary policy and nominal intra-euro area exchange rate adjustment to adjust to adverse shocks and the challenges posed by globalisation, other adjustment mechanisms become even more important. In this context, wage and price flexibility plays a pivotal role. The smooth functioning of the price mechanism is a prerequisite for the efficient allocation of resources across different sectors and over time. In the same vein, the mobility of capital and labour across countries and regions and between different sectors is of particular importance in a monetary union. It is therefore essential that governments establish an institutional framework which allows the economic adjustment processes to function efficiently and effectively. In particular, setting appropriate incentives for economic agents and thus enhancing the overall growth performance of the economy require further progress in following 5 main policy areas:

- Policies enforcing competition in product markets and promoting further integration, which will reduce excessive price margins and set incentives for entrepreneurs to become more productive.
- Improving the business environment, enhancing innovation and increasing the skill level of the workforce play a key role in boosting labour productivity.
- Increasing the flexibility of labour market, which would ensure that wages are aligned with productivity developments and reflect competitiveness at the sectoral and firm level as well as the regional employment situation.
- Other measures devoted to human capital accumulation, through improving higher education systems and supporting training and life-long learning, and a higher share and more efficient expenditure in research and development, enhance productivity growth in the long-run and also increase non-price competitiveness.
- In addition, further efforts are also needed to improve the access to financing, especially as regards small and medium-sized enterprises (SMEs) and the access of start-up firms to venture capital financing. As most recently highlighted in empirical work[2], small successful European firms are apparently less able to grow than comparable US firms due to the poorer access to financing.

Over the past decade, progress in these areas has been uneven across euro area countries. Some significant efforts have been made and countries see the benefits from these reforms coming in. However, the reform process needs to continue and the past years of good economic performance are no reason for complacency or even a reversal of past reforms. There is still a long way to go if we want to attain the objective of the Lisbon Strategy to make the European Union “the most competitive and dynamic knowledge-based economy in the world”.

[2] See, among others, Philippon and Véron (2008) and Aghion, Fally and Scarpetta (2007).

Let me now turn to the competitiveness of the euro area financial sector. Financial efficiency has made large progress since the introduction of the euro and has contributed to the competitiveness of the euro area, by accelerating the speed of capital reallocation. Generally, in an efficient financial system, information is accessible and widely distributed. An efficient financial system usually enhances economic growth, whereas, by contrast, information asymmetries or insufficiently developed markets may lead to financing constraints, often especially for SMEs. Therefore, a well-functioning financial system is an EU policy priority as it allows the economy to fully exploit its growth potential, fosters the accumulation of capital and the diversification of risk.

Evidence on euro area financial development

Let me start with the size of capital markets, on the basis of which financial development can be assessed, which is an important feature also for the competitiveness of the financial system.

The size of euro area capital markets has increased markedly since the introduction of the euro. On average, euro area capital markets, when measuring size including both domestic securities (bonds and stocks) markets and the amount of bank lending to the non-bank private sector, tend to be smaller than the capital markets in the United States and the United Kingdom, but roughly comparable in size to Japanese capital markets.

In the euro area, Luxembourg, the Netherlands and Ireland have the largest capital markets relative to their economy (GDP). In addition, some euro area countries with smaller financial sectors have experienced strong growth in their capital markets over the past 15 years, for instance Ireland, Portugal and Spain.

This development of euro area capital markets is important as financial systems with larger overall capital markets generally allow a faster reallocation of capital and provide easier financing for real investment, thus fostering productivity. Financial development increases the ability of industries to exploit global growth opportunities that may arise from technological innovation, unanticipated demand shocks or price changes.[3] In particular, industries which are structurally highly dependent on external financing, benefit from better financial development in the sense that they are able to grow faster compared with an environment of less developed financial systems.[4] It is also important to note in this context that both securities markets and the amount of loans granted contribute positively to economic growth. The sometimes cited relative share of market versus bank financing therefore appears not to be a key variable for the positive impact of capital markets on economic growth.[5] In addition, with the "originate and distribute" banking model, the borders between bank and market-based financing became blurred to some extent during recent years.

With respect to the current turbulences, the relative advantages of traditional bank financing versus market-based financing and the symbiotic relationship between bank and market-based financing may be re-discussed. Generally, traditional relationship banking implies close monitoring and a reduction of information asymmetries, whereas market-based financing (including securitisation) allows a wide (re-)distribution of risk. Some rebalancing of these two key features may be necessary in order to achieve both an appropriate monitoring and sharing of risks.

With respect to monetary policy, more developed financial markets, such as developed bond markets or the availability of securitisation, tend to increase competition and the speed of the

[3] See Fisman and Love (2004).

[4] See Rajan and Zingales (1998).

[5] See Levine (2002).

pass-through of market rates to bank rates in the banking sector for specific bank product segments.[6] Especially in those segments, for which market-based financing is an alternative (for instance for long-term loans to non-financial corporations), an increase in the speed of pass-through seems to have occurred in the euro area during recent years.

Overall, the monetary transmission mechanism benefits from integrated and well-developed financial systems in the sense that it leads to a more similar and, in part, faster pass-through of market rates to bank rates. Efforts to strengthen bank competition and enhancing the availability of alternative capital market-based instruments as well as access to financing should therefore be expected to improve the monetary transmission mechanism.

At the same time, one has to acknowledge that several studies[7] on the productivity of the EU (euro area) from an industry point of view come to the conclusion that the differences in productivity growth between the US and the EU (euro area) may be partly due to differences in the financial sector. While the productivity performance of the financial intermediation and insurance and pension funds sub-sectors was comparable between the EU and the US, according to some studies the main difference was in the sub-sector "activities auxiliary to financial intermediation".[8] While productivity measurement is particularly difficult in the services sector, and, hence, also in the financial sector, such differences in productivity growth may be partly related to a higher development and integration of the US financial system, which may facilitate the exploitation of economies of scale. At the same time, with respect to the current situation, it is still too early to assess the longer-term effects of the current turbulences on the gap in productivity growth between the two economic regions.

In this context, there is evidence of a considerably positive effect of financial development on EU economic growth. Assuming that the EU would reach the same level of financial development (defined as the sum of domestic credit and stock market capitalisation to GDP) as the US, it is estimated that the overall effect on annual EU value added growth would be between 0.5 and 1.0 percent.[9]

Evidence on euro area financial integration

Let me now turn to financial integration, which is one important dimension of the efficiency of a financial system. Let me begin by recalling that the ECB and the Eurosystem have a keen interest in the progress towards financial integration in Europe as it is of key importance for the conduct of the single monetary policy, as it enhances the smooth and effective transmission of monetary policy throughout the euro area. In this respect, the Eurosystem strongly supports the initiatives of the European Commission in the field of financial integration.[10]

In a fully integrated financial system market players follow a single set of rules and have equal access to the market and are treated equally when operating in the market. In this

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6 See Gropp et al. (2007).

7 See several papers and books written by Bart van Ark, Robert Inklaar, Robert McGuckin, Mary O'Mahony, from the University of Groningen, The Conference Board and the National Institute of Economic and Social Research and in particular the report "EU productivity and competitiveness: an industry perspective. Can Europe resume the catching-up process?" office of Official publications of the European Communities, Luxembourg, 2003.

8 According to the OECD, this sub-sector "… includes the provision of services involved in or closely related to financial intermediation, but not themselves involving financial intermediation.". These services include for instance the activities of stock exchanges and brokerage services.

9 See Guiso, Jappelli, Padula and Pagano (2005).

10 In December 2005, the European Commission released its "White Paper on Financial Services Policy 2005-2010", which shapes the current policy programme in the field of financial services.

light, let me mention some key achievements which were reached during the past with respect to financial integration of the euro area.

Generally, market segments close to the single monetary policy are very much integrated, especially the unsecured interbank money market.

The high integration in the euro area money markets has been supported by the high degree of integration of large-value payment systems.

TARGET 2, which was introduced in November 2007, provides now an even more uniform wholesale payment system infrastructure by means of a single technical platform. Besides the technical harmonisation, TARGET 2 also discontinued the differentiation in the fees between intra- and inter-Member State payments and thus, led to a further harmonisation of prices. Last but not least, a reduction of average prices is also expected in TARGET 2.

Let me now turn to euro area bond markets. Besides the euro area government bond markets which are increasingly driven by common factors since the introduction of the euro and the removal of the exchange rate risk, also the euro area corporate bond market is quite well integrated. In fact, euro area corporate bond markets seem to be largely driven by common factors, rather than by country-specific ones. In addition, cross-border holdings of debt securities increased markedly over the past ten years, suggesting that investors are increasingly diversifying their portfolios across the euro area.

Progress has also been made in the integration of euro area equity markets. [While local shocks to equity markets continue to be important, an increasing share of the total domestic equity volatility can be explained by euro area-wide shocks ("variance ratios").[11]] As regards cross-border equity investments, it can be noted that euro area residents doubled their holdings of equity issued in other euro area countries between 1997 and 2005 (as a share of their total portfolio of shares issued in their own country and elsewhere in the euro area) to reach around 30%, in particular on account of institutional investors. By contrast, the share of euro area equity assets held outside the euro area remained at a much lower level and increased only slightly.

The euro area banking sector – strong and weak points

Compared with securities markets, the process of financial integration has advanced more slowly in the banking sector. Against this background, let me discuss the strengths and weaknesses of the euro area banking sector.

Let me start the discussion of strengths and weaknesses from a structural point of view, with respect to the integration and efficiency of the banking markets.

First, on the positive side, the internationalisation of EU banking groups has increased during recent years. This has resulted, to a large extent, from the overall rise in terms of value in cross-border mergers and acquisitions in the euro area banking sector since 2004. In 2005, the value of cross-border bank M&A deals was particularly high, mainly owing to the acquisition of the Bayerische Hypo- und Vereinsbank by UniCredito Italiano. Generally, cross-border M&A activity is one way to increase competition in the banking sector, which tends to contribute positively to economic growth.

While cross-border M&A activity tends to increase competition, extensive public ownership of banks constitutes a possible distortion of competition in the banking sector, which also works against the development of capital markets.

[11] The indicators report the variance ratios, i.e. the proportion of total domestic equity volatility explained by euro area and US shocks.

In addition, while the integration in the wholesale and capital-market related banking market has advanced well during recent years, the still fragmented retail banking market can be regarded as a further weakness of the euro area banking sector. This can be seen, for instance, in the dispersion of interest rates on loans and deposits from banks to non-financial corporations and households.[12]

In addition, in contrast to large-value payment systems (TARGET, TARGET 2), retail payment systems in the euro area are still fragmented. However, the SEPA (Single Euro Payments Area) initiative aims at achieving a fully integrated market for retail payment services in the euro area with no distinction between cross-border and national payments, meaning that in the end all euro payments will be "domestic". In fact, since the end of January 2008, the first step has become reality with the launch of "SEPA Credit Transfer", which allows sending euro payments quickly, and in the same way, to any beneficiary in Europe. Overall, the launch of SEPA is a major step in the integration of the euro area retail banking sector.

In addition to a structural discussion of the strengths and weaknesses of the euro area banking sector in the light of the performance of the financial system, one may also look at the banking sector in the context of the financial turmoil.

Starting from the US sub-prime market, several reasons may lie behind the spill-over of the turmoil to other market segments. A global macroeconomic environment characterised by sustained growth, low inflation, muted long-term interest rates, a long period of very favourable credit conditions, abundant market and funding liquidity, and relatively low official rates may have strengthened investors' appetite for risk and increased the "hunt for yield". This, in turn, may have brought about an under-pricing of risk. In addition, the "originate and distribute" banking model, compounded with the proliferation of new and complex financial instruments, notably structured finance products has contributed to a dispersion of credit risk in the financial system and an increased indebtedness of non-financial sectors.[13]

In this context, the loosening of credit standards and a probably riskier lending attitude may be identified ex post as a weakness of the banking sector. As banks were able to transfer part of their credit risk, they were able to extend further loans.

In addition, there was a widespread underestimation of risks and a lack of transparency in the context of the extensive use of derivative products, partly related to their evaluation by rating agencies, leading to mistrust between market participants, an increase in the cost of funding and liquidity shortages in the course of the turbulences. This underestimation of risks may be seen as another key weakness of the banking sector.

Against this background, let me finally discuss the need for potential reforms with respect to preventing and handling financial crises. It seems clear that some very important lessons can be drawn from the turmoil for market players as well as for public authorities.

Let me just mention few key areas where reforms are needed. First, with respect to banks, the turmoil has highlighted that some risk categories have been underestimated, especially liquidity risks relating to banks' commitments to structured investment vehicles and conduits. Second, market players seem to have relied excessively on ratings of complex assets. This has been the case in part due to the wide distribution of risks through the financial sector which made the assessment of the value of the underlying asset difficult for the investor. While, on the positive side, credit risk transfer has facilitated a widespread sharing of risk in the financial system over recent years, the recent financial turmoil made clear that more transparency and monitoring is needed on the credit risks and where they ultimately reside in

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[12] In particular the dispersion of the interest rates on loans to households for consumption purposes remained relatively high. This is probably the case due to both differences in product availability and statistical issues.

[13] See Cappiello, L., Briefing for the visit of the Conseil Economique et Social (CMT/0208), 18 February 2008.

the financial system. Finally, with respect to public authorities, it seems of high importance that there is a smooth and effective cooperation and exchange of information between supervisory authorities as well as between them and central banks in the detection of threats to the financial system. Particularly, with respect to central banks, it is their own interest to contribute to an orderly functioning of money markets and to solidly anchor inflation expectations in order to avoid additional volatility in already highly volatile financial markets.

Concluding remarks

Let me briefly conclude by summing up what all of this means for the outlook of the euro area.

First, from the real economic side, there are encouraging signs indicating the good potential of the euro area to successfully adapt and to remain competitive going forward. Nevertheless, there are important challenges ahead and to implement the necessary structural reforms will be decisive to raise productivity growth and, hence, to foster the competitiveness of euro area firms.

Second, with respect to the financial side, the financial development of the euro area has increased markedly since the introduction of the euro. This is particularly important as a well developed financial system allows economies to better allocate resources to industries with good growth opportunities and thus experience faster overall economic growth. In addition, the financial integration of the euro area has made large progress during recent years. This has increased the competitiveness of the euro area. Notwithstanding some reforms, which appear necessary especially following the experience of the recent financial turmoil and further steps which are needed on the way to a fully integrated euro area financial system, the progress already achieved is highly beneficial for the efficiency and competitiveness of the euro area financial system and will ultimately foster the performance of the euro area economy.

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