EUROPEAN CENTRAL BANK
EUROSYSTEM

Growth and competitiveness in the euro area

Panel contribution by Luis de Guindos, Vice-President of the ECB, at The European House-Ambrosetti Forum, Cernobbio, 7 September 2019

- Growth, investment and competitiveness are topics of utmost relevance for monetary policy. Investment trends and productivity growth are key determinants of the potential growth rate of the economy. Measurement challenges aside, the resulting output gap – the deviation of actual economic activity from its potential – is a key driver of inflation over the short and medium term.
- Today I will focus on the factors behind weak investment and productivity, on the remaining barriers to competition and on the importance of deepening Economic and Monetary Union (EMU) and completing the capital markets union (CMU) to enhance the attractiveness of the euro area.

Let me start by looking at why investment has been so weak in Europe in recent years, despite historically low levels of financing costs.

- Anaemic business investment dynamics[1] have been observed in many advanced economies, but especially in the euro area, Italy being a case in point.
- Investment has been exposed to a number of adverse shocks, which slowed its return to pre-crisis levels.[2] The crisis was followed by a protracted adjustment of capital overhangs and high corporate indebtedness,[3] related to unsustainable investment and credit patterns before the crisis. The subsequent economic recovery, starting around 2013 and driven by cyclical accelerator effects, was particularly labour-intensive and firms appear to have invested relatively less in equipment. Global trade, which is particularly tilted towards investment goods in many euro area countries, has slowed markedly since the end of 2017, on the back of increasing trade barriers and broad trade policy uncertainty.
- At the same time, firms' profits, which are the main financing source of investment, have weakened over the past year in the euro area. High corporate taxation relative to other economic areas has also weighed on firms' profits and caused investment to shift abroad.[4] While bank lending has become easier, thanks to the lower financing costs and easier access to finance induced by monetary policy, equity finance is lagging behind in Europe. Economic policy uncertainty has also played a part in driving up hurdle rates[5] of investments as well as firms' cash holdings, making them net lenders.
- Longer-term structural factors are also at play. With increasing digitalisation,[6] a growing share of investment is gradually being directed towards intangible assets.[7] This might not be fully accounted for in national and firms' accounts. Firms tend to invest less in a declining and ageing economy, unless labour could be replaced by capital. Finally, production in advanced economies is gradually shifting from manufacturing to services,[8] where equipment matters less.

Weak investment since the crisis has been accompanied by slow productivity growth across virtually all advanced economies.

- Labour productivity growth had already begun slowing well before the crisis. Since 1995 it has averaged 0.3% per year in Italy, compared with 1% in the euro area as a whole and 2% in the United States.[9]
- There are many underlying reasons for this decline in productivity growth, so let me focus on two: the role of technology and population ageing.
- Evidence suggests that the failure of firms to adapt to the ICT revolution has played a central role. This may be why a relatively large number of very small firms are not growing,[10] and the resulting resource

misallocation may contribute to the productivity gap across countries.

- Some see the decline in the rate of radical innovation as a key factor in the global decline of productivity growth, simply because new ideas are becoming harder to find.[11] Others claim that the current lull can mostly be attributed to the depth of the Great Recession,[12] or to the fact that innovation comes in waves, and the economy has only recently begun to commercialise discoveries from fields such as nanotechnology, genetic engineering and quantum computing.[13]
- In any case, innovation is changing the nature of production and employment, with digitalisation having already transformed how we do business. Automation, in particular, is replacing labour in certain jobs, particularly in manufacturing, but it has also raised demand for highly skilled professionals in other areas.[14] Both of these processes are likely to contribute to higher productivity growth, but also to higher income inequality in the future. A more troubling scenario is one in which artificial intelligence focuses exclusively on automation. If it provides small productivity improvements over human activity it may destroy more jobs than it creates – take automated call centres as an example.[15] While past historical episodes of technological change have always seemed to deliver as many new jobs as they replace, it is important to remember that automation, by definition, always destroys tasks. The question is just whether it creates enough new tasks in the process.
- Simultaneously, the euro area is undergoing a profound demographic change. Fertility rates have declined, life expectancy has risen and sizeable cohorts are reaching retirement age.[16]
- Ageing societies tend to imply lower labour market participation and lower contribution to potential growth. Currently, this is only partly counterbalanced by the rising participation rate among older cohorts, partly as a result of pension reforms, and from movements of workers across borders.

This all points to a need for national economic structures to become more conducive to growth and competitiveness.

- The country-specific recommendations, proposed annually by the European Commission and endorsed by the European Council, tend to include, for example, dedicated reform recommendations for product, labour and financial markets in EU Member States.
- Further reducing barriers in product and services markets could help to improve firm entry, exit and growth.[17] Efficient insolvency frameworks would free up resources by enabling the restructuring or resolution of persistently unproductive and barely viable firms.[18]
- Labour market regulations and policies could support the uptake of rapid technological change and improve its distributional impact. Investment in human capital is key in this regard, and reforms that increase labour mobility could reduce labour market mismatches, support the diffusion of technology and mitigate the adverse effects of demographics.

The European Single Market has been a powerful tool for stimulating growth and competitiveness, but its functioning could be further improved.[19]

- The euro area services sector accounts for around two-thirds of gross value added and an even larger share of employment. Yet the Services Directive, which aims to reduce barriers to trade in services, has only been partially implemented and does not cover several key sectors.[20] Reinvigorating the Single Market for services therefore remains a challenge that European leaders will need to tackle jointly.
- In the same vein, the fragmentation of national corporate tax systems creates market distortions and impairs the functioning of the Single Market. Therefore, the long-debated Common Consolidated Corporate Tax Base would be a huge step forwards in deepening the Single Market. It would lower the administrative costs that firms face and mitigate competitive distortions created by diverse and often conflicting tax systems.

Deepening EMU and an ambitious CMU would facilitate investment, notably across borders.

- Fostering deep and diversified capital markets that provide a wide source of financing options to European companies and individuals is one of the CMU's primary objectives. This is key to enhancing innovation and growth and to strengthening the cross-border dimension of investments in the EU, thereby promoting deeper integration and development of markets.
- Better-integrated capital markets can also help to enhance the resilience of the euro area and complement the banking union by facilitating financial risk-sharing. Cross-border financial integration has not yet exhausted the potential for bringing cross-border private risk-sharing up to the level we would like to see in EMU. Compared with the United States, where 60% of shocks to GDP growth can be mitigated through diversification via capital markets, only 20% of shocks to GDP growth are mitigated in the euro area.[21]

- European capital markets are currently small and fragmented. Policies that foster innovation and market size and that remove cross-border barriers will help develop more vibrant European financial markets and intermediaries that are able to compete internationally.
- Let me point out here that the creation of a single rulebook for calculating taxable profits throughout the EU also offers a welcome opportunity for removing the debt bias in corporate taxation.[22] Most tax systems currently favour debt financing due to the deductibility of interest rate payments from the tax base, while other forms of financing instruments are not considered. This is an obstacle to a larger equity base for firms and is therefore a significant impediment to the creation of a CMU.
- Finally, fiscal policy can play a greater countercyclical and stabilising role. Fiscal space should be used wisely in countries where it exists, while all countries should work towards a more growth-friendly composition of public finances. Furthermore, a fiscal capacity at euro area level would be a great achievement that would complement national stabilisers.

Let me conclude.

- It is vital to continue implementing reforms to address the structural challenges facing the euro area. Reducing barriers to trade in services and disparities in national corporate tax systems could provide a new impetus to the European Single Market and stimulate investment. Deepening European integration requires us to pursue an ambitious agenda for the financial system, to push for European responses within the CMU and banking union agendas and to go beyond tendencies to retrench behind national borders. Deep European capital markets are crucial to enhancing innovation and growth and to strengthening the cross-border dimension of investments in the EU.

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