

Opening remarks at the conference on Financial System Modernisation and Economic Growth in Europe

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Ladies and gentlemen,

I am pleased to welcome you to Berlin for the seventh conference of the ECB-CFS Research Network on Capital Markets and Financial Integration in Europe. After conferences in cities such as Frankfurt, Helsinki, Athens, Brussels and Vienna – each of which is the financial centre of its respective country – we have chosen Berlin. You might ask: why Berlin?

A hundred years ago, nobody would have asked this question. At that time, Berlin was without doubt the financial centre of Germany, having clearly marginalised Frankfurt, Germany’s traditional banking centre. In a recent article, the economic historian Carl-Ludwig Holtfrerich describes quite interestingly how Berlin managed to overtake Frankfurt in the second half of the 19th century.^[1] Summarising his account, three factors played a decisive role.

- First, integration and institutions: following the creation of the German Empire in 1871, a single currency based on the Prussian currency standard and later linked to gold was introduced and the Berlin-based Preußische Bank was turned into the new central bank of the Empire. This diminished Frankfurt’s role as the key trading place for the various former currencies and clearly relegated the Frankfurter Bank which had formerly fulfilled key central bank functions in Germany. Frankfurt lost its status as a free city, and unification in Germany created a climate of political stability and regulatory certainty that had previously been the privilege of the free cities.
- Second, industrial growth and infrastructure: the creation of the German Empire also speeded up the process of industrialisation. New industries and modern means of transport ended Berlin’s disadvantages as a city at the periphery. Traditional trading centres, such as Frankfurt, lost their importance and financial services went where industry boomed.
- Third, innovation and human capital: industrialisation brought new financial products and the need for new expertise. Much of the financing for industry became equity-based. Big

banks in Berlin were themselves listed companies and the Berlin stock exchange did most of the equity trading. Frankfurt's exclusive private banks distrusted equities and realised too late that their specialisation in bonds had cut them off from new developments in the financial sector.

Needless to say, the Second World War and the division of Germany ended Berlin's short "reign" as the financial centre. However, I think that integration and institutions, industrial growth and infrastructure, and innovation and human capital are still key ingredients not only for fostering financial centres but also for financial modernisation in general. In my view – and this is the key message of my introductory remarks – we should closely focus on the modernisation of the financial system, which is strongly linked to economic growth and chiefly contributes to it.

I am highly delighted that so many distinguished speakers will share their thoughts with us during the conference. This conference on financial system modernisation and economic growth in Europe comes both at the right place and at the right time.

The timing is fortuitous because the role of financial markets in promoting research and development (R&D), innovation and productivity was one of the main topics that the EU finance ministers and central bank governors discussed in the informal ECOFIN meeting that took place earlier this month in Helsinki. At that meeting, EU finance ministers stressed the importance of creating an environment conducive to private capital investment, which finances innovation and fosters economic growth, and invited the European Central Bank (ECB) to assess the institutional features that hinder the efficient functioning of the financial system.

I see this conference as one of the tools that help the ECB to stimulate top-level research on this issue and also as a way to raise general awareness of the benefits of European financial system modernisation, which are perhaps not always fully perceived by our fellow European citizens.

I will structure my opening remarks as follows: First, I will briefly explain the choice of the conference topic. Second, I will stress the need for modernising the European financial system. Third, I will elaborate on the relationship between financial system modernisation and economic growth. Finally, I will give an overview of the programme of the conference.

Financial modernisation and growth as a priority for the ECB-CFS Research Network

The issue of financial system modernisation and economic growth in Europe has been high on the agenda of the ECB-CFS Research Network for some years. In 2004 the ECB's Executive Board and the Center for Financial Studies (CFS) decided to add this topic to the list of priorities of the network, which had until then mainly been related to financial market "integration" rather than to financial "modernisation".

The two notions are interrelated but distinct. A market for a given set of financial instruments and/or services is integrated if all potential market participants with the same relevant characteristics; (i) face a single set of rules when they decide to trade in those instruments and/or

services; (ii) have equal access to the above-mentioned set of instruments and/or services; and (iii) are treated equally when they are active in the market. In contrast, financial development and modernisation refer to the process of financial innovation and organisational improvements in the financial system that reduces asymmetric information, increases the completeness of markets, increases opportunities for agents to engage in financial transactions through (explicit or implicit) contracts, reduces transaction costs and increases competition.

Why focus on financial development? Because the capacity of financial systems to promote economic growth depends not only on their level of integration but also on their quality and the efficiency with which they channel savings into investment. Financial efficiency is the condition under which resources available in a financial system are allocated to the most valuable investment opportunities at the lowest possible costs. Efficient financial systems make it possible to overcome market frictions, such as asymmetric information, and promote economic growth by accelerating the allocation of capital to better investment opportunities.

When tackling the issue of economic growth, financial integration and financial development are two processes that go together. While a number of financial systems may be very closely integrated, they may not be developed to such an extent as to achieve a greater volume or efficiency of financial intermediation, and therefore may not improve the growth performance of the economy. On the other hand, financial integration is a prerequisite for financial modernisation. By ensuring that all potential market participants are subject to a single set of rules, are treated equally and have access to the same set of financial instruments, financial integration fosters competition, stimulates the creation of new instruments and markets, generates the opportunity to reap the benefits of economies of scale and scope, and thereby paves the way to financial modernisation.

Disappointing growth in the EU and the need for a more efficient financial system

Economic growth and prosperity were among the goals of the founding fathers from the inception of the European Union. As early as 1955, Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and the Netherlands declared in Messina that the establishment of a united Europe through, among other things, the creation of a common market, “seems indispensable if Europe is to improve steadily the living standard of the population”. The desire to create a common market has since driven Europe’s economic integration, which reached an apex with Economic and Monetary Union (EMU).

However, the rejection of the European constitution by the people of the Netherlands and France, two countries that were among the founders of the European Union, sent quite a strong signal that European citizens do not fully perceive and reap all the potential benefits of EMU or of the financial integration process it has triggered.

A fair assessment of the last seven and a half years of economic developments in Europe cannot avoid mention of the fact that, despite the success of EMU, output growth has been disappointing and below that of Europe’s main competitors. Average growth in the EU25 has been about 2.3%

since 1995, compared with about 2.7% in non-EU industrial countries and 3.3% in the United States. The increasing GDP growth gap with the United States has sparked the belief that Europe needs structural reforms in order to make the EU economy more flexible, innovative and competitive. It has also reinforced the idea that while financial integration is an important factor in promoting growth, other factors, like financial system modernisation, are equally important and should not be neglected.

The Lisbon strategy

In March 2000 the EU Heads of State and Government agreed to make the EU “the most competitive and dynamic knowledge-driven economy by 2010” and launched the Lisbon strategy. To modernise the EU economy, the Lisbon strategy for EU economic reform has identified the strengthening of innovation as a means to boost productivity and achieve higher rates of sustainable economic growth. Estimates of the macroeconomic impact of innovation suggest that a permanent 1 percentage point increase in R&D as a share of GDP (used as a proxy for innovation) would increase the long-run growth rate of productivity by 0.6 percentage point.^[2] Greater innovation is, therefore, a key element in the EU's strategic response to the opportunities and challenges presented by globalisation.

Empirical evidence generally supports the existence of such relationships, suggesting that innovation has a significant and positive effect on productivity at the level of the firm, industry and the economy as a whole.^[3]

Evidence also suggests that a crucial factor in fostering economic growth through innovation is the availability of financing opportunities. At a very general level, the financial system plays a crucial role in the growth process by channelling savings to investment and so efficiently allocating capital among economic agents. Progress in EU financial integration since the introduction of the euro, and the implementation of the Financial Services Action Plan (FSAP), have generally improved financing conditions for European firms, with substantial benefits expected for Europe's growth performance.^[4] However, based on the evidence available, financing opportunities for investment in innovation appear to be more constrained at the level of small and medium-sized enterprises and individual entrepreneurs.

The broad focus on the achievement of a single market in the second half of the 1990s and the financial integration process triggered by the introduction of the euro gave cause to hope that financial modernisation would almost automatically follow financial integration. Although this belief proved to be correct for some aspects of the European financial system – consider for instance the increase in the size of the capital market, the higher quality of accounting information and better shareholders' rights – there are still large differences in the performance of the financial system across market segments which suggest that there is further room for structural reforms of financial sectors.^[5]

There is scope for improving financial market efficiency

EU banking markets still remain rather fragmented, in particular at the retail level, in segments such as mortgages and loans to households, but also loans to small and medium-sized enterprises, which are crucial for the financing of innovation. This fragmentation of the EU banking market reduces its efficiency, as it constrains the range of financing sources and investment opportunities and limits economies of scale. In this respect, lessons can be drawn from a comparison with the results of banking sector deregulation in the United States: between 1970 and 1994, 38 US states removed restrictions on branching, and between 1978 and 1992, almost all states removed restrictions on interstate bank ownership. Studies that quantify the growth and productivity effects of banking deregulation in the United States in the period 1970-1995 show that the annual average gross state product increased after the reforms by approximately 1 percentage point.^[6] The evidence suggests that the gains stemmed from enhanced productivity rather than from increased investment. These findings are particularly relevant for the banking and financial system integration that is taking place in the EU and should encourage us to make further progress in the modernisation of the banking sector.

What can financial system modernisation contribute to economic growth in Europe?

What is the link between financial modernisation and economic growth? Not surprisingly, empirical research has established a strong connection between financial development, financial integration, productivity and economic growth. The general effects of financial development and financial integration on growth are quantitatively important. I will give just two examples of transmission channels.

First, financial modernisation helps channel funds from low growth sectors to sectors with high potential growth. It has been found that financial development exerts a disproportionately positive effect in industries that for technological reasons depend heavily on external finance (pharmaceuticals, for instance) and have good growth opportunities^[7]. Raising the level of financial development may result in an increase in firms' value-added growth of approximately 0.5 to 0.9 percentage point in the countries that made up the EU before 1 May 2004.^[8]

Secondly, financial modernisation helps to finance innovation. An important difference between the US and European financial systems is the greater "breadth" of markets in the former. In other words, the "financial architecture" of the United States builds on a wider range of financial instruments traded in more liquid markets. New markets are also emerging in Europe, and some of them have developed rapidly in the recent past. Clearly, investment in innovation has benefited from the emergence of larger and more liquid securities markets, which offer larger-scale enterprises access to a wider range of more competitive financing options. Securitisation is developing alongside other, more innovative, forms of financing (such as derivatives markets, etc.). However, given the importance of the availability of a wide range of funding and investment options for innovation and risk sharing – and hence ultimately for growth – there is no doubt that the development of "new" equity markets and venture capital would work to foster R&D, innovation and growth in Europe.

Let me now conclude my opening remarks by giving an overview of the programme of the conference.

Programme and focus of the conference

The fact that there is scope for boosting growth by improving the efficiency of the European financial system prompts the challenging questions of how can one further improve the efficiency of an already highly developed financial system and what are the channels through which financial market efficiency might be turned into economic growth? Although we will not find all the answers to these questions over the two days of the conference, we are going to cover several aspects of the relationship between financial modernisation and growth which are not often looked at.

Various channels through which financial development affects growth will be analysed during the conference, including households and start-up financing, efficient capital allocation across industries, and the effects of financial modernisation in developed countries, in transition economies and in developing countries.

Some aspects of financial development will also be analysed. These relate notably to the scope of banking, transparency, legal systems and corporate governance. The presentations in the first session this morning will confirm that financial systems have an impact on growth but will also show new evidence that financial development also affects the speed of efficient capital reallocation across industries. Empirical results thus suggest that better enforcement of insider trading legislation or hastening the resolution of pecuniary legal disputes tend to improve intersectoral investment responsiveness to innovation.

As regards the special presentations, Professor Aghion will give an exciting keynote lecture today about the effects of financial development on innovation, technology transfer, and growth, in which he will explain how financial development affects not only productivity and economic growth, but also the way countries cope with various sources of macroeconomic volatility, and the way financial development affects business fluctuations.

Tomorrow there will be a special session on the performance of the European financial system, with a presentation of a series of indicators developed and used in-house at the ECB.

Finally, the panel will address the relative roles of local financial institutions and global players in the process of financial system development and in financing economic growth.

I would like to thank all the speakers and paper presenters. I am looking forward to an interesting and stimulating seventh conference of the ECB-CFS Research Network and I now leave the floor for the first session on financial development and economic performance.

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