SPEECH

Bridging the gap: reviving the euro area's productivity growth through innovation, investment and integration

Keynote speech by Luis de Guindos, Vice-President of the ECB, at the Latvijas Banka and SUERF Economic Conference 2024

Riga, 2 October 2024

It is a pleasure to talk to you today about reviving productivity growth in the euro area – a critical challenge that demands urgent attention and collective action.

The euro area's economic recovery

I would like to start by outlining recent economic developments.

After more than a year of stagnation, economic activity in the euro area recovered mildly in the first half of 2024, with considerable variation across countries and sectors. Growth, however, was weaker than expected in the second quarter of the year. The euro area growth outlook was revised down in September, compared with the June Eurosystem staff projections, with risks to growth remaining tilted to the downside. Looking ahead, we expect the recovery to strengthen over time, as rising real incomes and the gradually fading effects of restrictive monetary policy should support consumption and investment. Exports should also continue contributing to the recovery as global demand picks up.

The recovery should be underpinned by an expected recovery in productivity growth, which has been particularly weak since the onset of the pandemic. Weak labour productivity can be partly attributed to cyclical factors, especially given the relative rigidity of the euro area labour market, where employers do not fully adjust their workforce at times of low growth, resulting in labour hoarding.[1] Cyclical factors that incentivise labour hoarding are expected to gradually diminish, leading to a recovery in productivity.

However, productivity growth has not only been dampened through cyclical channels. It has been decelerating for decades in the euro area, mirroring a broader global trend. This structural weakness has been a significant drag on economic activity and continues to constrain medium-term growth prospects in the euro area, particularly in light of demographic developments. The population is shrinking and our societies are ageing, so sustaining the workforce will rely on higher participation rates, especially among women and older people, alongside well-designed immigration policies to address labour shortages and support long-term growth.

But allow me to delve deeper into the core drivers of this sluggish productivity growth, particularly when compared with the United States.

The productivity gap and how to address it

Over the past 30 years, the productivity gap between the euro area and the United States has widened considerably. This divergence has been driven by relatively weak total factor productivity growth in the euro area and, since the global financial crisis, insufficient capital deepening.

To understand this productivity gap, we must look at the structural challenges we face.

As Mario Draghi highlighted in his recent report on European competitiveness, one key issue is that Europe largely missed out on the digital revolution.[2] While the United States capitalised on its high-tech sector, many of the euro area's most productive "frontier" firms are concentrated in mid-tech sectors with limited potential for productivity growth. This divergence is not due to the level of public R&D expenditure or the quality of our research, but rather to sectoral specialisation and the lack of coordination in investment and innovation policies across Member States.[3]

Total investment ratios, both private and public, as a percentage of GDP are also lower in the euro area than in the United States.[4] Despite an increase in public investment since 2020, driven by the Next Generation EU initiative, there is still a substantial gap in private investment, particularly in the areas of R&D, digital innovation and digital uptake.

The decline in total factor productivity growth among high-tech frontier firms in the euro area partly reflects their age, as older firms are typically less productive. Moreover, a secular decline in business entry rates and the winner-takes-all dynamics of new technologies have reduced competition, limiting the process of creative destruction needed for productivity growth. In the services sector, a widening total factor productivity growth gap between leading and lagging firms suggests that the adoption of new technologies by non-frontier firms, particularly small and medium-sized enterprises, remains sluggish.

The European ecosystem of small and ageing firms struggles to compete globally. If we do not act quickly, their comparative disadvantages will only grow in this era of rapid technological progress. Our firms face scaling-up challenges, skill shortages, and framework conditions that are not conducive to radical innovation, but instead favour marginal improvements in mature technologies.

Business dynamism is stifled by intricate regulations and overlapping governmental institutions and tax systems. This restricts the creation of innovative firms and the reallocation of resources to the most productive, undermining productivity growth and competitiveness. These complexities are amplified across national borders, further limiting the ability of European businesses to scale up.[5]

Ensuring a Single Market that's fit for purpose

Europe's productivity would be higher if more innovative firms had a better environment in which to become established, grow, innovate and thrive. Since its inception, the Single Market has made significant progress in fostering growth and convergence across Europe, but the environment for innovative firms still leaves much to be desired.[6]

Enrico Letta's recent report offers a comprehensive perspective on the Single Market, highlighting the as yet untapped potential.[7] His proposals to streamline the regulatory burdens, favour regulations instead of directives for greater harmonisation, improve administrative capacity and introduce a European business code as a 28th regime merit particular attention.

Advancing the capital markets union

A larger and more integrated Single Market would call for a single, deep capital market to finance the EU's competitive firms. Greater economic integration in the EU will bring greater financial integration. Numerous proposals have been made to develop the capital markets union, and the ECB's Governing Council issued a statement on the topic in March 2024.[8] Let me first focus on the proposals aimed at fostering the growth of competitive European firms.

As companies progress from developing an idea to becoming large and successful enterprises, they require diverse sources of financing and need to be connected to stakeholders who can best support them through their growth phases. However, Europe's financial system is predominantly reliant on bank lending, which is not ideally suited for financing young high-risk firms. During the scaling-up phase in particular, innovative companies need access to risk capital and investors with the networks, experience and risk tolerance to allow them to experiment and potentially fail. Venture capital funds are particularly well-suited for this purpose.

However, the venture capital market segment in Europe is underdeveloped. As a percentage of GDP, venture capital financing in Europe is a third of that in the United States.[9] In addition, individual EU venture capital funds are smaller owing to a fragmented market. This has direct consequences for firms: not many EU venture capital funds are large enough or have deep enough pockets to meet firms' financing needs or cope with the high failure rate of start-ups or young high-risk firms. It is not uncommon to see failure rates of 80% for risky frontier-tech investments, for example.[10]

If firms need to seek funding in countries outside the EU, such as the United States, their activities can end up being relocated abroad, affecting Europe's economy. Companies that source foreign funding in the later stages of their scaling-up may then be listed on foreign exchanges, further depriving Europe's equity markets of large and innovative firms that contribute to the markets' depth and liquidity. The recent listing gap between the United States and Europe is due, at least in part, to the greater attractiveness of US stock markets for foreign firms. The percentage of foreign companies among all companies listed in the United States rose from around 18% in 2017 to 24% in 2022. By contrast, foreign listings in European markets have shown a slight downward trend over the same period.[11]

Europe lacks a single, sufficiently deep and liquid equity market where firms listing in the EU could aim for similarly high valuations as those they can currently aspire to in the United States. The average market capitalisation of US companies has historically been much higher than that of European companies, with the gap having widened significantly since 2010. In 2022, US companies achieved, on average, a market capitalisation that was 3.3 times higher than that of EU companies.[12]

Overall, Europe's underdeveloped venture capital environment, fragmented equity markets and heterogenous national markets are leading to higher financing costs and inefficiencies in the allocation of capital when compared with the United States. To overcome Europe's private investment gap and give European firms access to the financing they need, especially in terms of equity, we need a more ambitious agenda for both developing and integrating EU capital markets.

First, household savings should be directed towards capital markets. A retail savings product that offers tax incentives and could be sold across the EU would be a step forward. The same goes for lowering the entry barriers for retail investors to participate in equity and bond markets. Increasing the share of equity investments in funded pension systems would also have mutually reinforcing benefits. It would give institutional investors, such as pension funds, a greater role in providing a large investor base for equity markets, similar to the role they now play in the United States.[13] Ensuring the portability of pensions across borders, as envisaged when launching the Pan-European Personal Pension Product, will also be fundamental in supporting the single labour market by enhancing mobility for workers in Europe.

Second, regulatory action can encourage investment in equity by addressing the debt-equity bias in taxation. Simplifying regulation can attract investors, promote risk-taking by Europe's companies and boost cross-border market developments. For instance, streamlining eligibility requirements in the UCITS[14] and European Venture Capital Fund[15] directives could incentivise investment in venture capital funds and make the most of the "passport" system that facilitates the distribution of funds throughout the EU.

Third, to develop the equity market, we need to make listings in Europe more attractive and efficient. To this end, we should aim to create a single pool of liquidity for public equity markets that would provide sufficient market depth to issuers and investors, including asset managers, pension funds and other large EU-based investors.[16] This requires (i) deeper integration in the trading and post-trading landscape; (ii) further harmonisation in difficult areas like insolvency regimes, accounting, and securities law; and (iii) more centralised supervision for systemic cross-border entities, including stock exchanges and market infrastructures. Where political agreement on harmonisation is not yet reachable, intermediate solutions mentioned before, such as a 28th regime, or enhanced cooperation, should be considered.

A way of deepening the securitisation market would be to set up a European securitisation platform. Besides fostering standardisation, this would support the development of green and other strategic segments while maintaining a sound prudential framework. Finally, public-private partnerships will be critical in future for stepping up investment in innovative firms and the green and digital transitions.

Mobilising EU-level financing for the provision of European public goods

The complementarity between public and private investment leads me to my final point on the need to mobilise fiscal resources at EU level.

The EU needs a massive amount of financing to close the productivity gap and support the digital and green transition.[17] Europe has to reflect on how it can use targeted public investment to help meet these financing needs. The EU and Member States should explore a reorientation of the EU budget as well as options for jointly funding investment in specific projects.

The Recovery and Resilience Facility (RRF) was a step in the right direction. Joint European action can successfully bring about key investments as well as growth-enhancing structural reforms, while fostering national ownership, mitigating fragmentation risks, enhancing economic resilience and improving risk sharing. But the RRF is a temporary tool, and once it elapses in 2026, the EU budget will shrink significantly owing to the cliff effect.[18]

We should be determined to permanently enhance the EU's fiscal capacity, also to support cross-border and pan-European projects. These could include the provision of European public goods such as energy infrastructure, innovative technologies and common defence, further strengthening risk sharing by ensuring that key investments take place even in adverse macroeconomic conditions.[19] Besides common spending initiatives, essential elements for supporting innovative projects are well-targeted subsidies and a cohesive European industrial policy.[20] A level playing field needs to be restored, fully phasing out the State Aid Temporary Framework adopted during the pandemic.

Conclusion

Let me conclude. Broadly speaking, the problems we are discussing today derive from the incompleteness of the Economic and Monetary Union: greater integration in the markets for goods and services, as well as in the capital and labour factors of production, are essential for the success of the European project.

The recent high-level reports from Enrico Letta and Mario Draghi correctly emphasise that the key to Europe's success is to leverage on all aspects of EU collaboration and coordination, including the completion of the Single Market. This would boost EU productivity and competitiveness for the benefit of our economies and citizens.

Regarding the topic of today's conference, advancing on the agenda for the capital markets union will require efforts to dismantle the barriers to enlarging segments of the capital markets and provide the financing needed by innovative firms to develop throughout their lifecycle.

But the capital markets union alone will not deliver those benefits if economic integration is still in the starting blocks, the Single Market remains fragmented, the banking union is not yet complete, and EU industrial competition and trade policies are not part of an overall EU strategy. This calls for an ambitious and comprehensive agenda with a more focused Europe. To reignite European productivity and competitiveness, ensure sustainable growth and rising living standards for all European citizens, the EU response must be determined and cohesive.

1.

Arce, O. and Sondermann, D. (2024), "Low for long? Reasons for the recent decline in productivity", *The ECB Blog*, ECB, 6 May.

2.

European Commission (2024), EU competitiveness: looking ahead.

3.

See Bergeaud, A. (2024), "The past, present and future of European productivity", *ECB Forum on Central Banking 1-3 July 2024*; Fuest, C., Gros, D., Mengel, P.-L., Presidente, G. and Tirole, J. (2024), "EU Innovation Policy: How to Escape the Middle Technology Trap", *EconPol Policy Report*, April.

4.

Private investment refers to real gross fixed capital formation of the private sector (excluding dwellings) over real GDP.

5.

See Raudla, R. and Spendzharova, A. (2022), "Challenges to the European single market at thirty: renationalisation, resilience, or renewed integration?" *Journal of European Integration*, Vol. 44, No 1, pp. 1–17. See also Ebeke, C.H., Frie, J.-M. and Rabier, L. (2019), "Deepening the EU's single market for services" *Working Paper Series*, No 2019/269, IMF.

6.

Lehtimäki, J. and Sondermann, D. (2022), "Baldwin versus Cecchini revisited: the growth impact of the European Single Market", *Empirical Economics*, Vol. 63, pp. 603-635 finds that the Single Market boosted real GDP per capita by around 12-22% for the group of members as a whole.

7.

See Letta, E. (2024), "Much More Than a Market-Speed, Security, Solidarity: Empowering the Single Market to deliver a sustainable future and prosperity for all EU Citizens", April.

8.

ECB (2024), Statement by the ECB Governing Council on advancing the Capital Markets Union, 7 March.

9.

See Arnold, N.G., Claveres, G. and Frie, J. (2024), "Stepping Up Venture Capital to Finance Innovation in Europe", *Working Paper Series*, No 2024/146, IMF.

10.

See Coatanlem, Y. (2024), "Why Europe is a laggard in tech", *Opinion – Technology sector*, Financial Times, 26 February.

11.

See Gati, Z., Lambert, C., Ranucci, D., Rouveyrol, C. and Schölermann, H. (2024), "Examining the causes and consequences of the recent listing gap between the United States and Europe", *Financial Integration and Structure in the Euro Area*, May.

12.

ibid.

13.

The equity share of private pension investment is particularly low in countries with large pay-as-you-go systems. By contrast, countries with large funded pension systems, and, therefore, large aggregate private retirement savings, typically have the most developed capital markets. See, for example, Scharfstein, D. (2018), "Presidential address: Pension policy and the financial system", *Journal of Finance*, Vol. 73, No 4, pp. 1463-1512.

14.

The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive 2009/65 is an EU directive that allows collective investment schemes to operate freely throughout the EU on the basis of a single authorisation from one Member State.

15.

The European Venture Capital Fund (EuVECA) Regulation 345/2013 offers a voluntary EU-wide marketing passport to smaller fund managers, sparing them the costs associated with authorisation and compliance with the general regulation for alternative investment fund managers.

16.

See European Investment Bank (2024), "The scale-up gap: Financial market constraints holding back innovative firms in the European Union", *EIB Thematic Studies*.

17.

See Bouabdallah, O., Dorrucci, E., Hoendervangers L. and Nerlich C. (2024), "Mind the gap: Europe's strategic investment needs and how to support them" *The ECB Blog*, ECB, 27 June.

18.

For reference, the final RRF envelope amounts to €648 billion, equivalent to around 33.7% of the EU budget for the period 2021-27.

19.

Schang, C. and Vinci, F. (2024), "Marrying fiscal rules & investment: a central fiscal capacity for Europe", *Working Paper Series*, No 2962, ECB, July proposes a central fiscal capacity (CFC) design focused on euro area-wide investment in European public goods (EPGs), assuming that these underpin productivity across the entire bloc and advance strategic European goals. The EPG-focused CFC reallocates their cost across regions over the business cycle, in effect resulting in stabilisation, while ensuring common investment needs are met.

20.

See Borota, T., Defever F., Impullitti, G. and Spencer, A. (2022), "Innovation Union: Costs and Benefits of Innovation Policy Cooperation", *CEPR Discussion Paper,* No 17549.

CONTACT