EUROPEAN CENTRAL BANK

The Performance of the European Financial System

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Introduction

- A lot of quantitative research suggesting that the efficiency of the financial sector is of great importance for productivity and growth (Demirguc-Kunt and Levine (2004), Levine (2005)).
- This is an important message to European and national public policy makers
- Think of the FSAP, financial sector policies 2005-2010 and more generally the Lisbon Agenda
- So we embarked on a paper that would review the performance of the European financial system (euro area, SE, UK, CH) compared to other countries (JP, US)
- Team involves several ECB business areas and an economist from a NCB (OeNB)

What the paper does

- Presents a comprehensive conceptual framework for the assessment on how a *developed* financial system performs its main functions
- Presents (currently) 41 indicators of financial performance covering the most important dimensions of a financial system (with particular focus on "financial development")
- Both parts, including each single indicator, are firmly rooted in the academic literature on how a well-functioning financial system improves growth and welfare
- This is an "indicators and measurement paper", as previous ECB work ("Indicators of financial integration in the euro area")
- However usual caveats apply to the exact measurement of the phenomena

Processes influencing performance

- Financial development/modernisation
  - *Process of financial innovations and organisational improvements in the financial system that reduces asymmetric information, increases the completeness of markets and contracting possibilities, reduces transaction costs and increases competition*
- Financial integration
  - *The market for a given set of financial instruments and/or services can be regarded as fully integrated if all potential market participants with the same relevant characteristics: 1) face a single set of rules when they decide to deal with those financial instruments and/or services, 2) have equal access to the above-mentioned set of financial instruments and/or services, 3) are treated equally when they are active in the market.*
- Distinct concepts but interrelated
- Both tend to increase financial efficiency
- (Relationships to financial stability more complex)

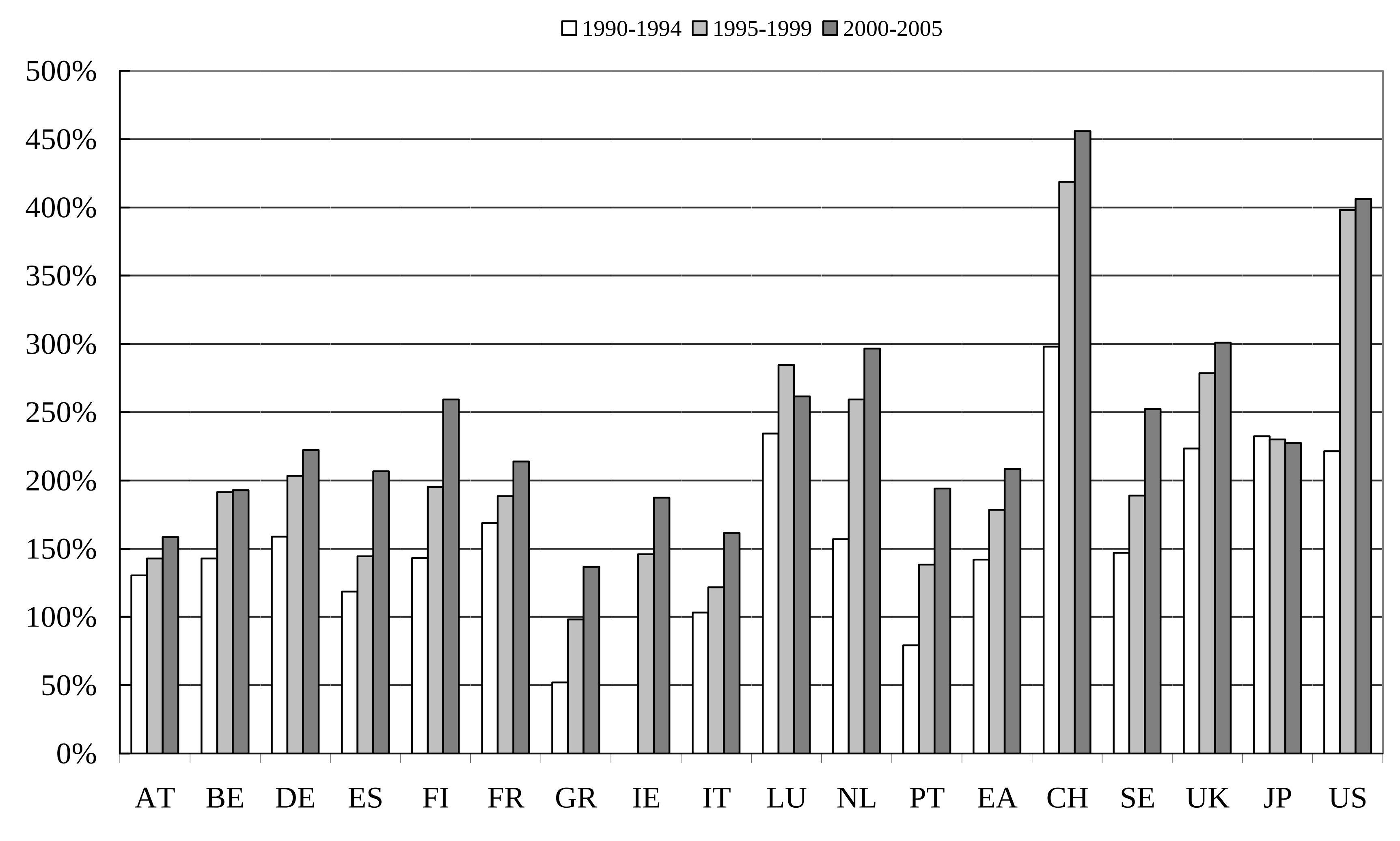
Overview of the presentation

- Not on the theoretical part of the paper
- Just introduce the 8 dimensions of a financial system by which we group the indicators
- Then present about one indicator per dimension and discuss the meaning
- Draw some conclusions from the above

Characterising features of a financial system

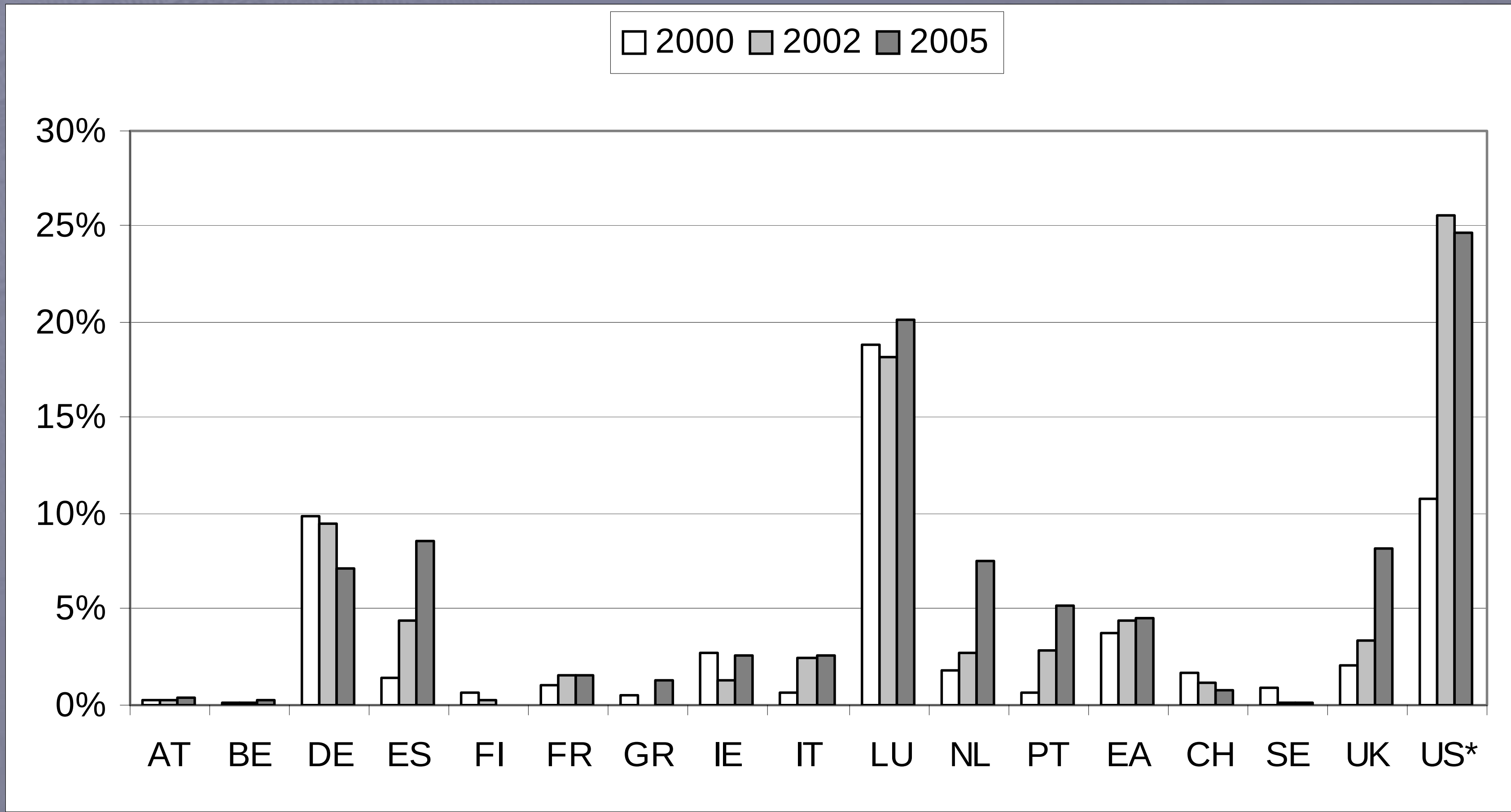
- One can characterise the performance of a financial system along 8 dimensions
  - Size of capital markets and financial structure
  - Financial innovation and market completeness
  - Transparency and information
  - Corporate governance
  - Legal system
  - Financial regulation, supervision and stability
  - Competition, openness and financial integration
  - Economic freedom, political and socio-economic factors
- In the paper we consider several indicators per group
- We compare euro area countries and their average to Sweden, United Kingdom, Switzerland, Japan and the US

Size of capital markets



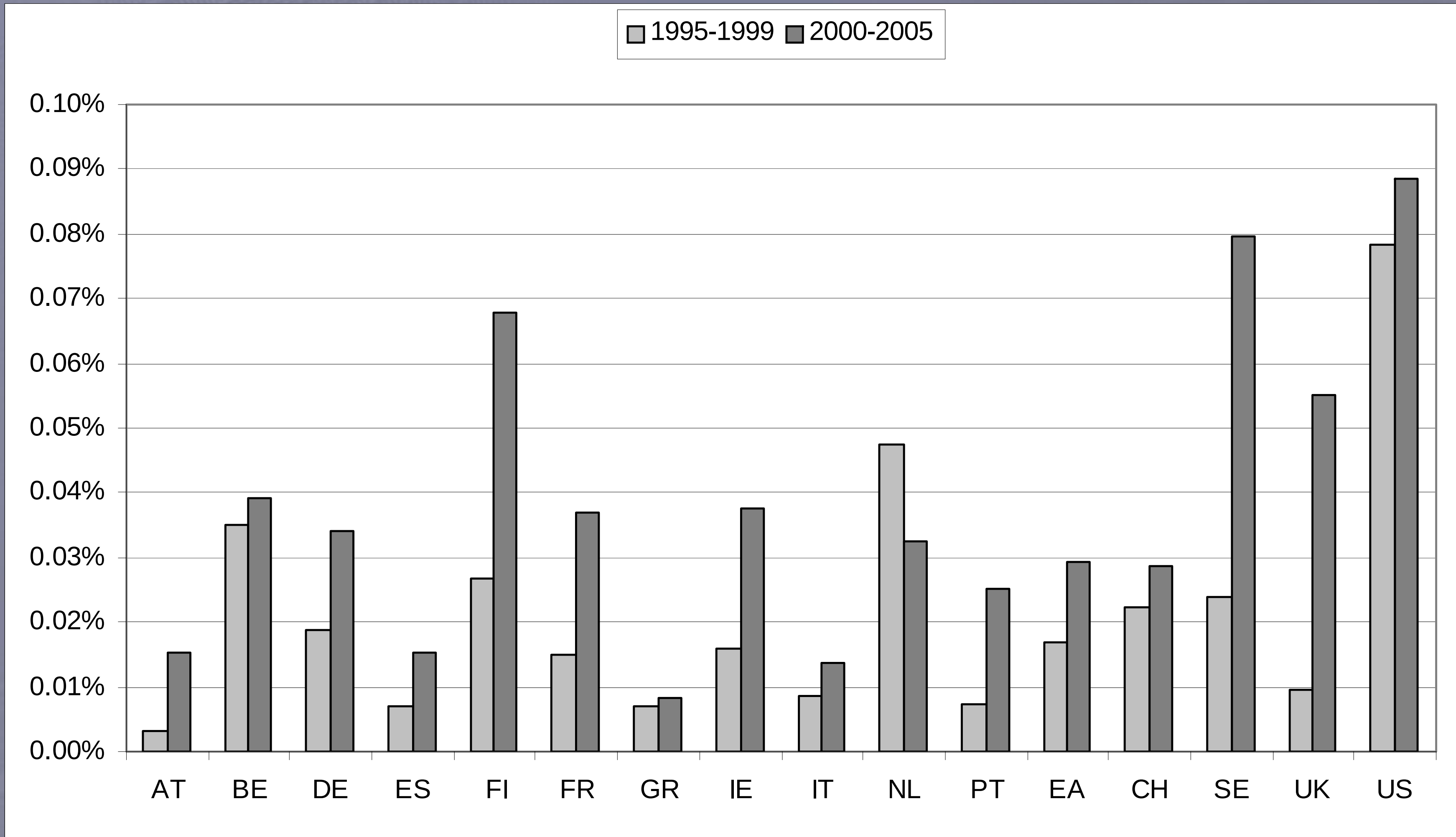
(% of GDP; sum of loans, equity and bonds)

Securitisation



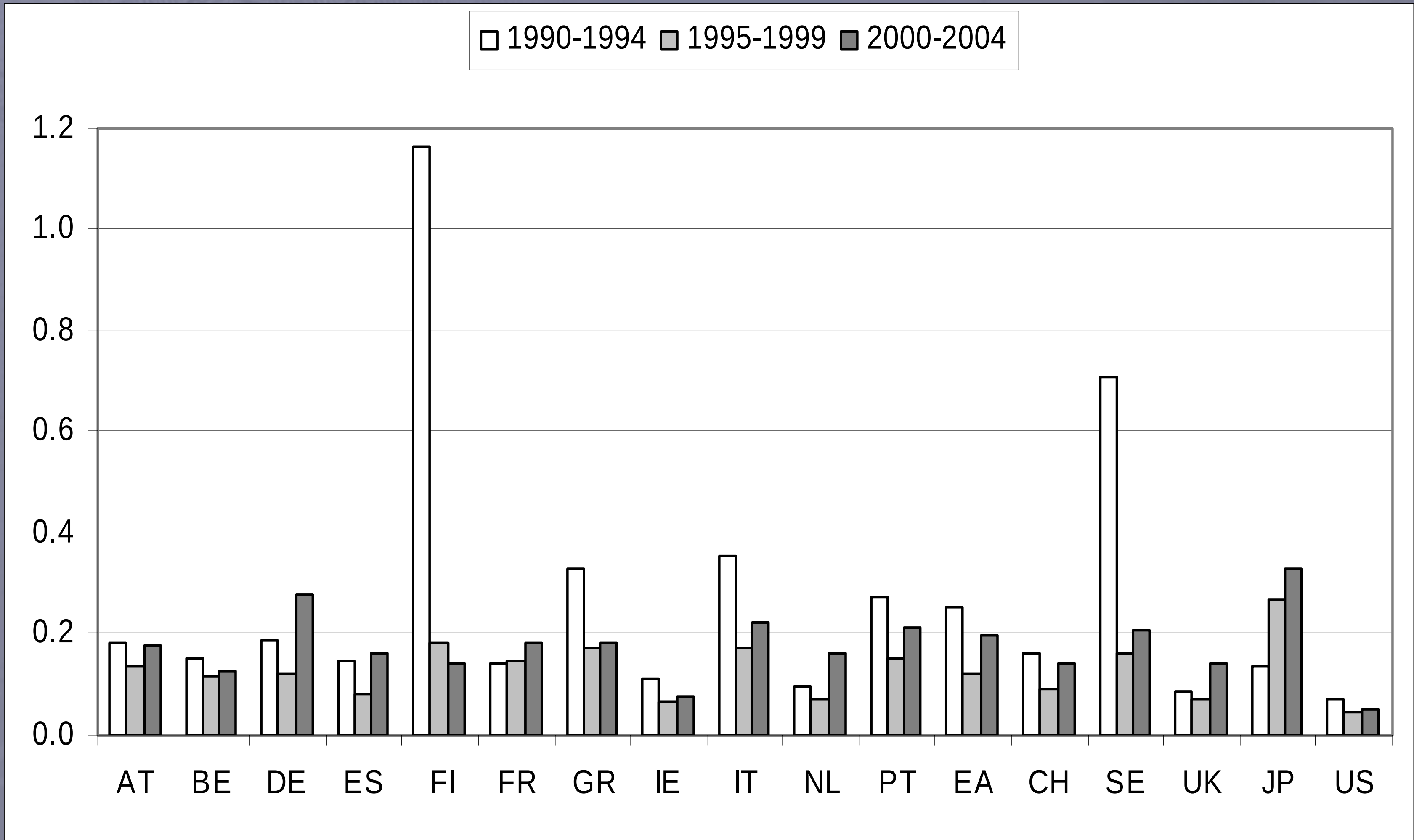
(% of GDP, by country of collateral)
US* includes also issuance by governmental agencies (Freddie Mac, Fannie Mae, etc)
Data for JP missing.

Venture capital financing (early investment stage)



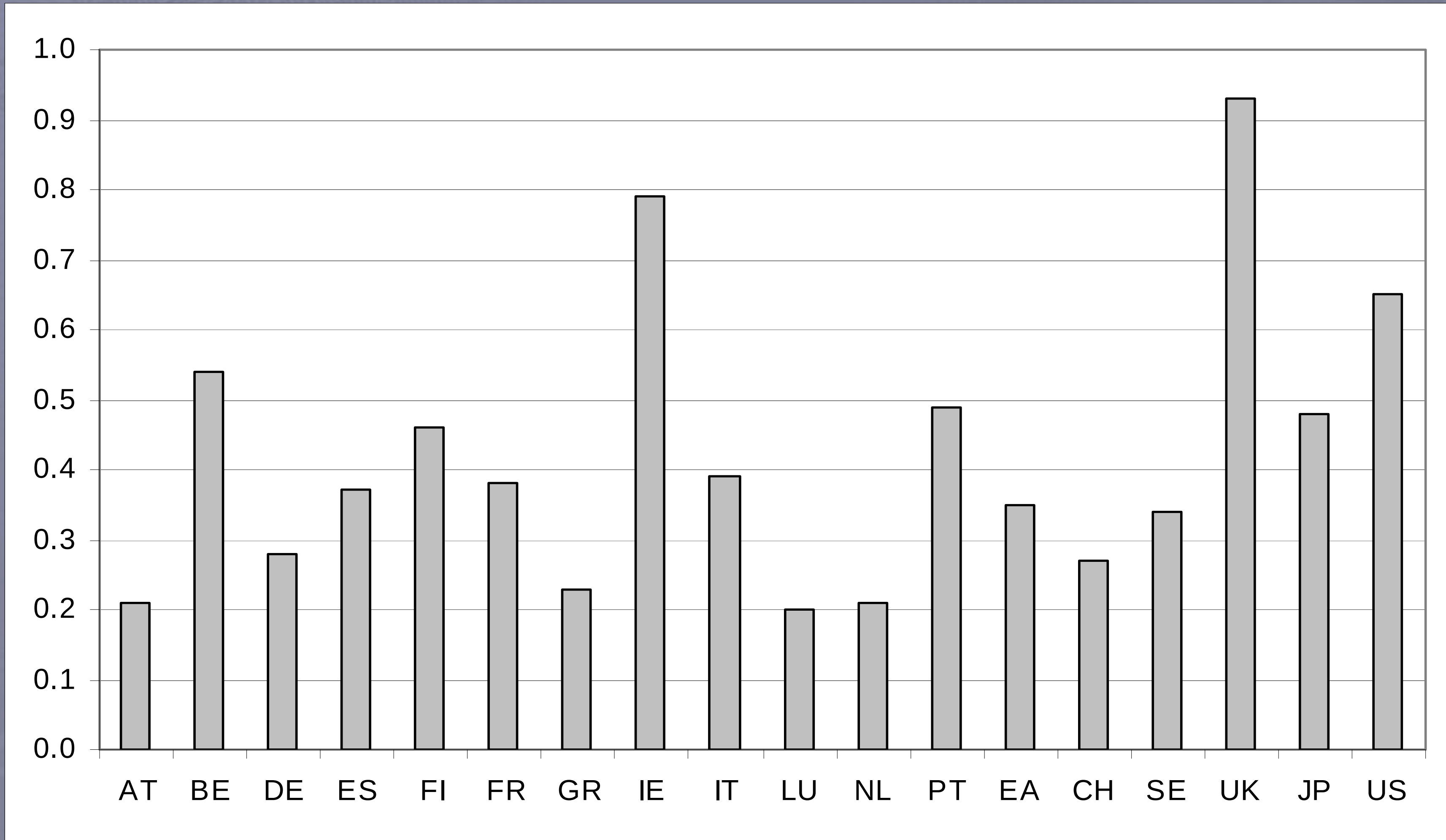
(% of GDP, by country of management). Data for LU, JP missing.

Dispersion of analysts' earnings forecasts



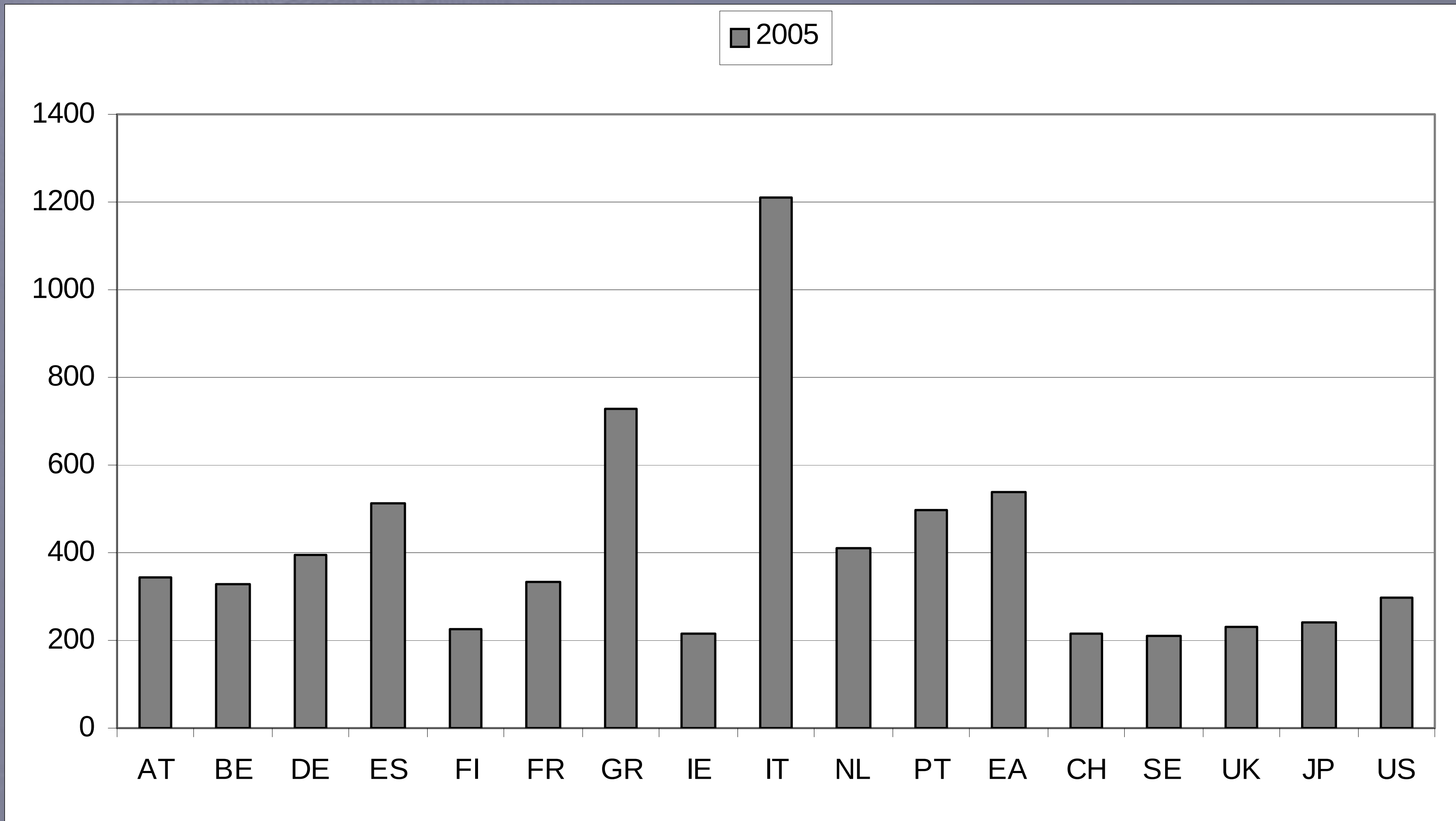
(standard deviation of EPS forecast/level of forecast)

Enforcement of shareholder rights against SD



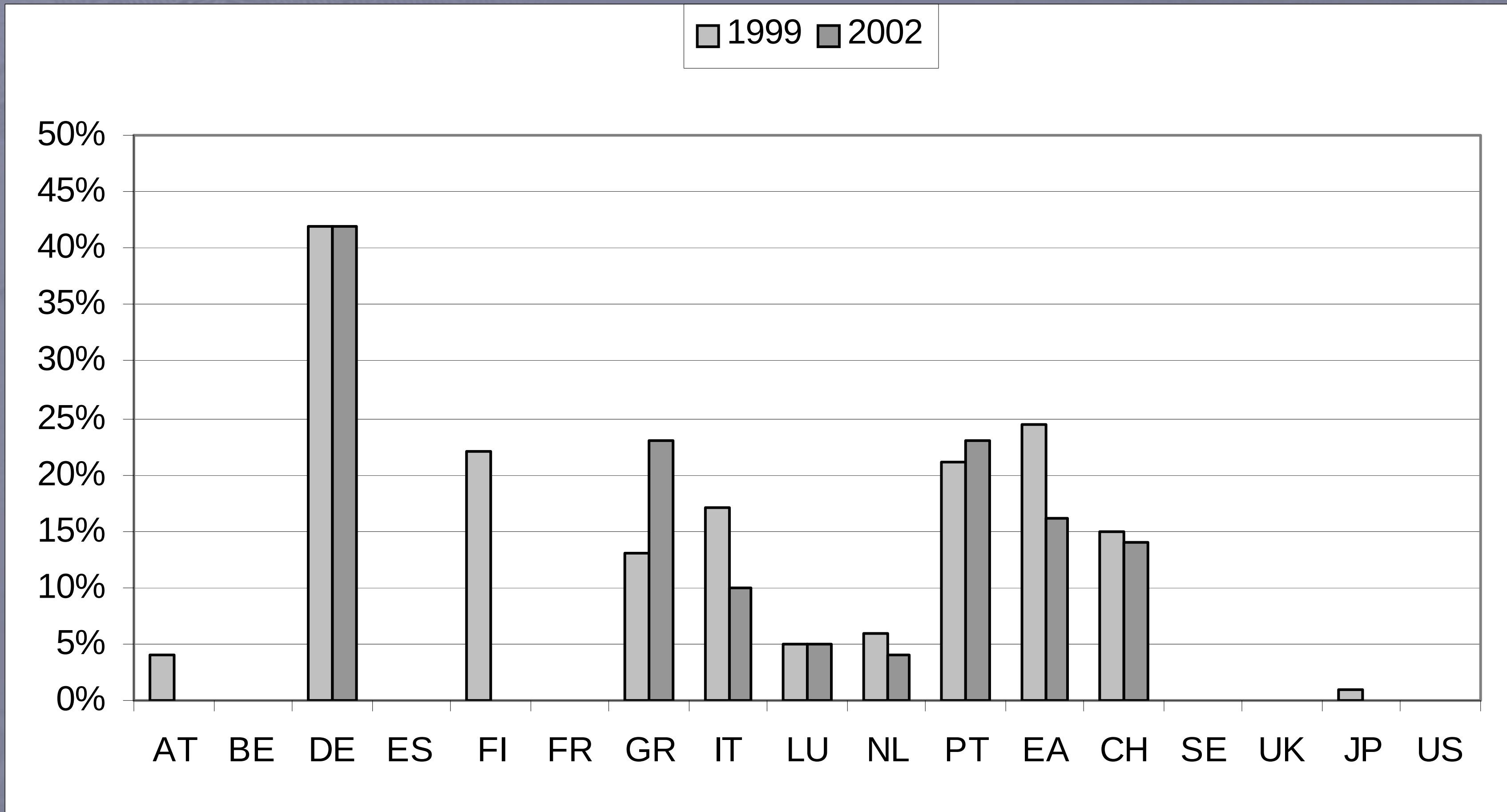
(Anti-self dealing index, Djankov et al. 2006)

Speed of legal system in solving financial conflicts



(days, duration of enforcement, Djankov et al. 2003
latest update World Bank), data for LU missing

State ownership of banks



(% of total assets, World Bank). Data for BE, FR missing for 1999, for IE in 1999 and 2002.

Conclusions I

- Paper presents
  - A framework for evaluating the performance of a developed financial system
  - Derives 8 groups of relevant dimensions of a financial system
  - Presents 41 indicators of performance across those dimensions (target about 50 indicators)
- Needs to be selective among and go beyond the variables highlighted in the finance and growth literature, which are mostly derived from developing and emerging country data
- Research advice for many European countries needs to focus on industrial economies with developed financial systems (except new member states)

Conclusions 2

- Important to note that a comprehensive view on the financial system needs to go much beyond financial integration, which still tends to be the main focus of European policies
- Results
  - Fair amount of heterogeneity across countries and across indicators for given countries (need to look at many indicators)
  - Finland, the Netherlands and Sweden are doing well by a larger number of indicators
  - Greece, Italy and Portugal have room for further development
    - They show however a number of positive trends
  - France and Germany offer an intermediate picture
  - UK and a bit less the US perform very well across many indicators
- Room for structural reforms in the European financial sector
- High potential for promoting productivity and growth

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The end