



Financing Europe's Fast Movers

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Questions and answers for media

What problem does this policy brief address?

New firms started in Europe grow less briskly than firms in the US and emerging markets. One reason is the relative underdevelopment of financial services adapted to emerging firms in Europe. Corporate finance is crucial for the emergence of new companies, but the role of the financial system in fostering innovation and growth is often overlooked in the debate about structural reform in Europe. None of the Lisbon strategy's 24 current 'integrated guidelines for growth and jobs' (2005-08) specifically focuses on finance. This policy brief argues that it is high time for Europeans to recognise the link between finance and growth, and more specifically the financial needs of emerging companies.

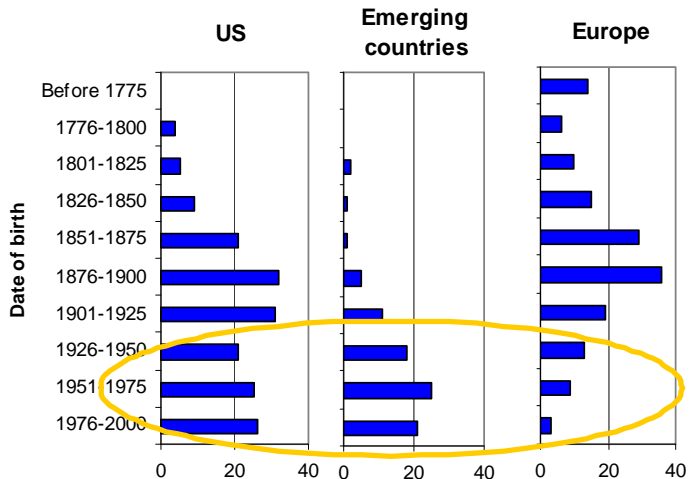
Why is the financial system important for growth?

Access to finance is essential for a company to grow and develop. In a knowledge economy where companies rely less on physical investment, traditional bank loans are insufficient. While Europe has a world-class financial system for established companies, new instruments adapted to emerging firms remain underdeveloped in most EU countries.

How does the growth of European companies compare to the rest of the world?

The growth of companies differs significantly between Europe, the US and emerging markets. Europe's corporate landscape is dominated by older, established companies. Few large companies have emerged in Europe since the second world war. Of the world's 500 largest companies only three were started in Europe after 1975, compared with 23 in the US and 21 in emerging markets. Many new firms are created in Europe, but after creation they tend to grow less briskly than in other economies. As OECD research has illustrated, among those firms that survive in the years following their creation, the pace of growth is much quicker in the United States. While in Europe the largest companies are likely to stay long at the top of their world, in the US they are vigorously challenged by new entrants, and by their own shareholders who often force them to divest non-core activities or to split into separate entities.

Figure 1
'Population Pyramids' of FT Global 500 Listed Companies, 2007



Does the financial system in Europe hamper growth?

Today's emerging firms need new financial solutions, with financing which is typically less senior than debt backed by physical assets. The US financial system has evolved quickly to provide such new corporate finance solutions. More research is needed to prove how much of the difference in the growth of emerging firms between the US and Europe is due to differences in financial systems, rather than other factors (such as barriers to entry and imperfect competition in markets for goods and services, as well as labour market constraints that discourage hiring in a risky environment). However, there is no contradiction between recognising the undeniable impact of non-financial factors and emphasising the importance of adequate corporate finance. The academic literature in the last 10 years has established a solid causal link between an economy's financial development and its growth potential.

What policy initiatives can be taken to improve the financial system in order to foster corporate growth in Europe?

The authors suggests that the orientation of the financial system towards growth, with an ability to offer optimal financial solutions to emerging firms, should be elevated to a top-level priority of financial policy in the European Union and its member states, alongside the existing policy objectives of financial integration and stability. The policy brief outlines options for a substantial reform programme that would encompass legislative and regulatory areas which have a major impact on corporate finance, such as:



- **Competition among intermediaries**

Non-banking entities should be allowed to compete with banks on a wide range of services. More corporate finance offerings by a wider variety of service providers would foster innovation

- **Securities regulation**

The prospects for a European market for shares traded by professional investors, with limited transaction costs which make it accessible by relatively small firms, would gain from appropriate regulatory initiatives. Also, securitisation has acquired a bad reputation since the start of the subprime crisis but it remains a unique technique to better allocate capital and enlarge the pool of investors for a given category of assets. Cross-border regulatory harmonisation would enable a much more dynamic European market for securitised corporate debt.

- **Insolvency legislation**

Previous EU initiatives on insolvency rules have focused on solving jurisdictional conflicts and more recently on trying to diminish the 'stigma of failure' attached to unsuccessful entrepreneurs. But it is even more important to clearly define rights and processes in insolvency situations, so that investors can more easily provide subordinated rather than senior debt when it is conducive to company development.

- **Tax**

Policies should be reformed in order to remove current distortions, especially between equity and debt. Tax framework should provide a level playing field between different financing options, as well as a simple and predictable framework.

- **Prudential rules**

European countries should continue working on the removal of prudential regulations that unduly hamper equity (including private equity) investment by institutional investors such as pension funds and insurance companies, thus completing the already significant improvement made in this area over the past few years.

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