Europe's saplings need financial fertiliser

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After recent financial turmoil, it would be tempting for European policymakers to rein in the scope of financial innovation – tempting, but misguided. On the contrary, the current focus on financial stability must go hand in hand with a renewed policy impetus to improve the European financial system's ability to foster enterprise growth.

A look at the world's largest companies offers both comfort and concern. On the face of it, Europe holds its ground well. Its share of the FT Global 500's market value has increased over the past five years and now reaches 32 per cent, while the US share has plummeted from 57 per cent to 38 per cent. But, in contrast with the US and most other economies, Europe's champions are ageing giants. Only 12 out of the 154 European companies in the ranking were created after 1950. Among US companies, those born after 1950 number 51 out of 174. Europe has a prosperous stock of established large companies, but does a dismal job of grooming new ones.

One reason is that Europe lacks the high-powered innovation ecosystems that generate the Microsofts, Genentechs and Googles of this world. But among US companies now worth more than $20bn and born in the past half-century, high-technology companies remain a minority. Apart from a few energy companies, most of the rest are service innovators: the likes of FedEx, Carnival Cruises, Las Vegas Sands, retailers such as Wal-Mart or Home Depot, media outfits and financial services companies. Technological innovation, while crucial, is not the only factor driving the continuous emergence of new giants in the US. Others are the size of its domestic market, especially for services, where Europe remains fragmented; the flexibility of its labour market; and the higher cultural and social status of entrepreneurs.

But an additional factor is often overlooked: the American finance industry offers more support for the growth of emerging companies than its European counterpart. Economic research in the past 20 years has firmly established that financial development is not only a consequence, but also a cause, of economic growth. Efficient financial systems enable the allocation of capital to businesses and entrepreneurs with the highest growth potential.

Europe's recent financial development has been impressive but remains unbalanced. The continent's large companies can now rely on deep, liquid and efficient capital markets. But every available indicator suggests that emerging enterprises benefit from a wider range of appropriate financing solutions in the US than in Europe.

Private equity comes first to mind. Beyond it, many credit offerings, such as high-yield bonds, mezzanine loans and other subordinated debt instruments are well suited to high-growth service businesses that can pledge no tangible assets as collateral. The markets for these financial products remain comparatively underdeveloped in Europe, especially outside the UK and Nordic countries.

Moreover, corporate finance for mid-sized businesses is a proximity business: it must reach the companies where they are and it requires the intensive use of local information. The concentration of a very efficient finance industry in a few places cannot be a substitute for widespread financial development.

This important factor in economic growth remains a blind spot of policy. The European Union's much-heralded Lisbon strategy for growth and jobs has 24 "integrated guidelines", but none specifically touches the financial system. The reasons may be found in the political economy of Europe's post-war economies, when capital scarcity was the norm and the financial sector was managed under tight state control.

A new impetus is needed to make Europe's financial system more supportive of emerging enterprises. The times for direct provision of financing by governments, through co-investment or public guarantees, are largely gone. Instead, policy initiatives should focus on creating a level playing field with the right incentives for market players. Much could be achieved with a mix of assertive competition policy, less prescriptive securities regulation in markets reserved for professional investors, a Europe-wide effort to simplify and harmonise insolvency procedures, the elimination of tax distortions between financial instruments and an evolution of prudential rules to encourage investment in emerging companies. Many levers are at national level, but a concerted effort by the EU's member states would maximise the chances of success.

In the current turmoil, policymakers must keep their eye on the ball. Europe's priority remains higher long-term growth and that means entrepreneurial new companies. The financial crisis will inevitably result in a rash of initiatives and regulations: in their discussion, all should remember that what Europe needs is more private equity for growth and expansion, more venture capital, a liquid market for high-yield bonds and more sophisticated and competitive corporate finance offerings.

Policy responses to the perils of instability should not put a heavy lid on those financial innovations that are necessary to improve Europe's growth potential. From an economic and political point of view, Europe's financial system must be improved so that more young sprouts can grow and challenge Europe's tall old corporate trees.

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