Flash Economics

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Is market financing a barrier to innovation?

The United States, where companies are mainly financed on the financial markets, is often contrasted with Europe (where companies are mainly financed through intermediaries, in particular banks).

One argument often heard is that market financing is not conducive to innovation, and therefore to growth, because financial market participants have short time horizons.

This argument is totally unconvincing for several reasons:

- It is contradicted by the comparative economic performance of the United States and Europe;
- Equity investors often have a long time horizon; for example, they know how to wait many years for a recently created company to generate a profit;
- Intermediated financing creates a long-term, customer-based relationship between lenders and borrowers; the existence of this relationship can have unfavourable consequences: while it prevents bankruptcies, it perpetuates the economic structures inherited from the past, and runs counter to creative destruction.

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The difference between corporate financing in the United States and in Europe

In the United States, companies are mainly financed by the markets (equities, bonds), while in the euro zone, companies are mainly financed by bank credit. Chart 1 compares stock market capitalisations in the United States and the euro zone, Chart 2 compares outstanding non-financial corporate bonds, and Chart 3 compares bank credit.

Chart 1
Market capitalisation

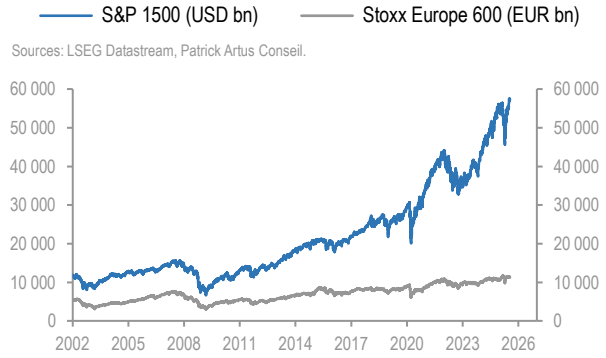


Chart 2
Outstanding bonds issued by non-financial corporations

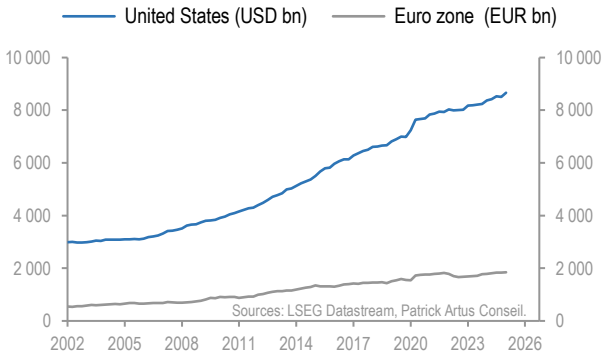
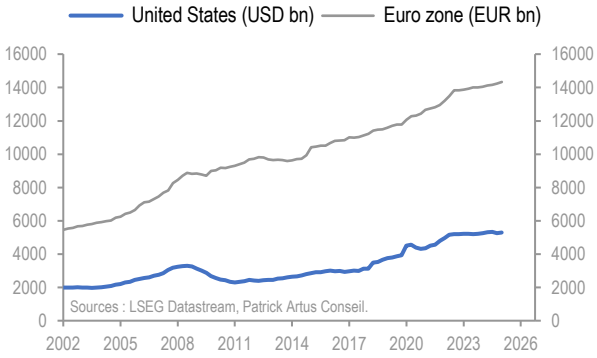


Chart 3
Outstanding credit of non-financial corporations



So we have mainly disintermediated corporate financing in the United States, and intermediated corporate financing in Europe.

An often-heard argument: disintermediated corporate financing (i.e. market financing) is detrimental to growth

The idea put forward by those who support this argument is that financial market participants have short time horizons.

Market financing would therefore focus on the short-term profitability of investments, which would lead to insufficient R&D, and therefore to weaker growth than if companies were financed through intermediaries.

But this argument is not convincing, for several reasons.

It is difficult to believe that financing companies on the financial markets reduces innovation and growth

The idea that financing companies on the financial markets reduces innovation and growth is contradicted by observation of the facts and reflection.

1- Business innovation efforts and growth performance are much higher in the United States than in Europe

Chart 4 shows business R&D expenditure as a percentage of GDP, while Chart 5 shows the level of labour productivity.

Chart 4
Corporate R&D spending (as % of nominal GDP)

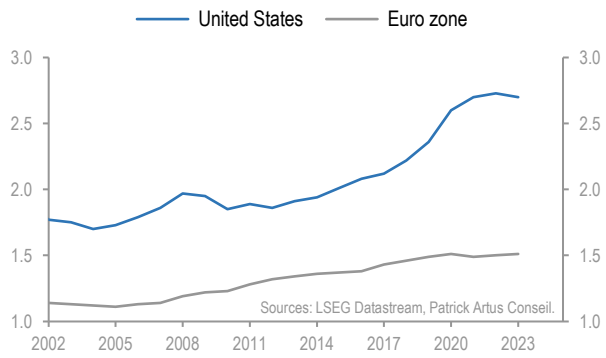
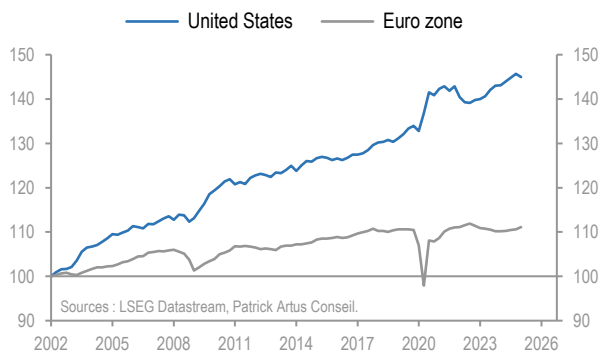


Chart 5
Productivity per head (2002.Q1 = 100)



One can observe that the United States (where companies are mainly financed by the markets) has much higher levels of corporate R&D spending and labour productivity growth than the Euro zone (where companies are mainly financed by banks).

2- Equity investors can be patient investors

Equity investors can wait many years for the companies in which they invest to generate profits. The example of Amazon is clear on this point (**Charts 6/7**).

Chart 6
Amazon: Stock market index (15.05.1997 = 100)

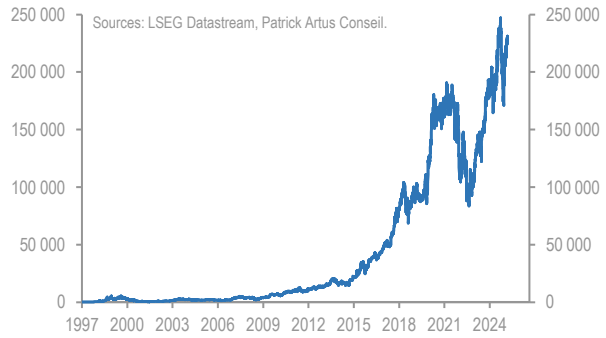
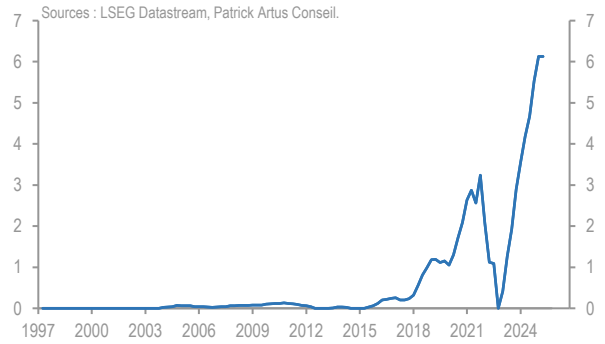


Chart 7
Amazon: Earnings per Share (USD)



Amazon was floated on 15 May 1997, did not make a profit for the full year until 2003 and has not been structurally profitable until 2015. Yet Amazon's share price took off in 1997-1999, and again from 2007 onwards.

3- The argument that bank credit financing creates a long-term relationship between the lender (the bank) and the borrower (the company) should be taken with caution

It is often argued that intermediated financing of companies (bank financing) creates a long-term relationship between the lender (bank) and the borrower (company), This is favourable because the lender has a great deal of information about the borrower and does not stop financing the company when the economic or financial situation is difficult, which is the case if the financing is disintermediated (done on the financial markets).

But this long-term relationship between lender and borrower, which characterises intermediated (bank) financing, can have serious disadvantages: it avoids bankruptcies and keeps alive companies that would normally disappear; it perpetuates the economic structures inherited from the past; it opposes the creative destruction that characterises financing on the financial markets.

One can see, for example, that in Germany, or in the euro zone as a whole, where companies are mainly financed by banks, the weight of traditional industry (automotive, steel, aluminium, chemicals, fertilisers, etc..) has remained much greater than in the United States (**Chart 8**), while the weight of the technology sector has remained low (**Chart 9**).

Chart 8
Real value added in manufacturing
(as % of real GDP)

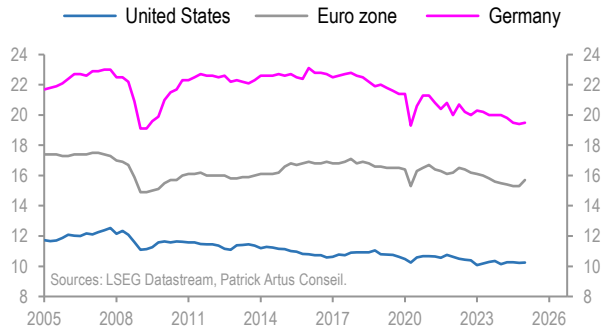
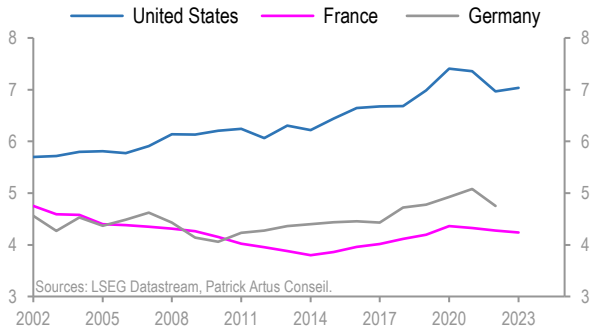


Chart 9
Gross value added of the ICT sector
(as % of nominal GDP)



Summary: the argument in favour of intermediated financing (by banks) of companies is probably wrong

Many economists defend the idea that financing companies on the financial markets is unfavourable because financial market participants have short-term time horizons.

We think this argument is wrong. In fact :

- American companies (financed on the markets) are clearly more innovative than European companies (financed by banks);
- We have also seen that investors in equity markets can be patient investors, able to wait a long time for the companies in which they invest to become profitable;
- Finally, it appears that intermediated financing (by banks) of companies, if it does indeed lead to a long-term customer relationship between lenders and borrowers, keeps alive companies that should have disappeared and prevents 'creative destruction', as the comparison between the United States and the euro zone (or Germany) clearly shows.

It should be borne in mind that moving to market financing in Europe would also mean changing the rules of the labour market. A high degree of flexibility in employment is needed to compensate for the fact that market financing can be interrupted in times of crisis.

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