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Financial Services Reform: Why Productivity Matters

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As the federal Department of Finance finalizes its long awaited "white paper" on plans for financial services legislative renewal, the rest of us ought to spare a thought for the government's languishing "productivity agenda." Could the white paper set the stage for action on productivity in Finance Minister Jim Flaherty's own bailiwick? It should, because smartly delivered financial intermediation is extraordinarily important to our economy and a vital policy goal.

Growing productivity, or the value of output per hour of work, is key to rising wages and living standards; hence the past decade's languid productivity performance partly explains slow growth in Canadians' incomes and household spending.[1] While Canada's persistently strong labour market is good news, growth in real output per hour has been slow compared to other developed countries, with our performance over the years 2000 to 2004 putting us at 24th of 29 OECD countries. Both total output and Canadian incomes have increased at a resolutely middling pace (Table 1).[2]

Against that lackluster backdrop, the 2005 figures provide a few surprises, including an unpleasant one from the financial services sector. Some sectors are looking strong on the productivity front — manufacturing recorded its sixth consecutive quarter of labour productivity growth running above 4 percent. However, the broad financial services sector showed a surprisingly weak result, with its fifth consecutive quarter of declining labour productivity (Figure 1).[3] If financial sector productivity had kept pace with the rest of the economy in 2005, the headline growth rate would have been about 0.2 percentage points higher on

1 Calculations based on Statistics Canada data released May 23, 2006, show that median individual income rose by an inflation-adjusted average of 0.7 percent annually from 2000 to 2004.

2 Cyclical factors, such as the long down-and-up swing in the price of commodities versus manufactures, have a powerful influence on the market value of Canadian output and hence incomes, a fact that ought not to be forgotten when examining productivity data.

3 The gap seems not to be a transient phenomenon: labour productivity in manufacturing has grown by more than 25 percent since 1997; the gain was less than 10 percent for financial services broadly defined.

Table 1: *Table 1: Comparing Growth Rates in Labour Productivity, Total Output and Individual Consumption, 2000–2004*

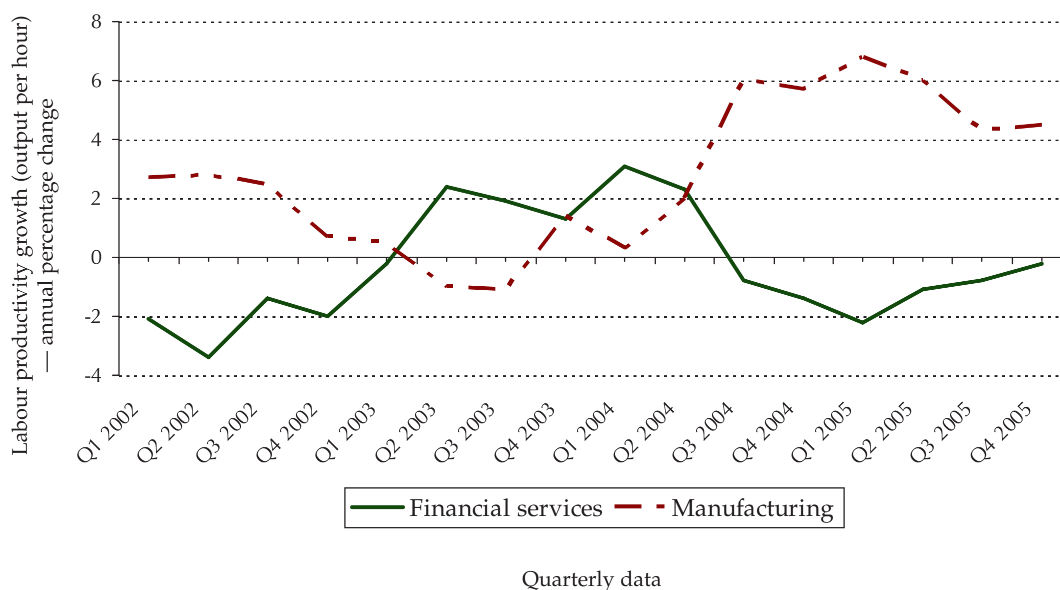
	OECD Country Ranking by Growth Rate			Compound Annual Growth Rate (%)		
	Labour Productivity (all industries)	Output Per Capita	Individual Consumption	Labour Productivity (all industries)	Output Per Capita	Individual Consumption
	Real Output (GDP) Per Hour Worked	*Real GDP Per Year Per Head*	*Real Final Consumption Spending Per Head*	*Real Output (GDP) Per Hour Worked*	*Real GDP Per Year Per Head*	*RealFinal Consumption Spending Per Head*
Slovak Republic	1	1	4	5.3	4.7	3.3
Hungary	2	2	1	4.6	4.3	6.8
Czech Republic	3	6	3	4.5	3.2	3.6
Korea	4	4	13	4.3	4.0	2.2
Poland	5	7	10	4.3	2.9	2.7
Iceland	6	13	20	4.0	1.9	1.1
Greece	7	3	2	3.7	4.1	3.7
Ireland	8	5	7	3.5	3.6	2.8
United States	9	18	16	2.8	1.3	1.9
Sweden	10	14	21	2.5	1.8	1.0
Norway	11	16	6	2.4	1.4	2.8
United Kingdom	12	11	9	2.1	2.1	2.7
Finland	13	12	12	2.1	2.1	2.5
Australia	14	9	8	2.0	2.1	2.7
Japan	15	22	23	2.0	0.8	0.8
France	16	20	17	1.8	1.0	1.7
Belgium	17	19	22	1.4	1.1	1.0
Germany	18	24	26	1.3	0.6	0.4
Denmark	19	23	18	1.3	0.6	1.6
Spain	20	15	14	1.3	1.6	2.0
Austria	21	21	25	1.2	0.9	0.4
New Zealand	22	8	5	1.1	2.6	3.2
Switzerland	23	28	27	1.1	-0.2	0.4
Canada	24	17	15	1.0	1.4	2.0
Luxembourg	25	10	11	0.9	2.1	2.6
Mexico	26	26	19	0.4	0.2	1.1
Italy	27	25	29	0.2	0.3	0.2
Netherlands	28	27	28	0.0	0.2	0.3
Portugal	29	29	24	-0.2	-0.2	0.6

Sources: OECD Productivity Database, www.oecd.org/statistics/productivity; author's calculations.

the year, an important long-run difference in the world of productivity measurement.

A smartly performing financial services sector is vital to the economy: effective financial intermediation is central to managing the commercial transactions that steer the flow of today's savings into current investment in houses, plant and equipment, and converting that physical investment into future income. This enables Canadian workers, consumers, savers, retirees, and businesses to convert their effort, ideas and planning into productive investment

Figure 1: *Financial Services Lag Manufacturing in Labour Productivity Growth*



Sources: Statistics Canada, CANSIM Table 383-0012; author's calculations.

for the future. In short, a well-developed financial sector is no small thing: it is a key indicator on the yardstick of economic maturity.

So is Canada's financial marketplace as efficient and effective as it could be? Unlike manufacturing, much of the sector operates behind protective barriers that dampen competitive forces and may sustain uncompetitive cost structures.[4] Laws limit foreign ownership in banking and require large banks' shares to be widely held, preventing cross-border or cross-pillar acquisitions of domestic firms; they inhibit scale-building domestic mergers; and they limit competition among the sectors' parts. Federal and provincial financial regulations impose stiff compliance costs within business subsectors. These are serious issues, some portending a future wherein stasis is the prettiest prospect — and stasis is not the same thing as effectiveness or stability.

Questions about Banking

Start with deposit-taking and consumer and commercial lending. Canada's largest chartered banks dominate these businesses, and many Canadians resent their size and power. Yet the banks say they are hobbled, too small to be as efficient and competitive as they could be, especially in the international banking marketplace. Indeed, only one of them ranks among the world's 50 largest banking companies by assets when, for example, three Dutch firms do, as do four from Belgium.

4 Foreign entry in bank lending markets is remarkably low in Canada, and regulatory barriers to entry are remarkably high, as compared with other OECD countries (OECD 2006, chapter 5).

Meanwhile, Canada's domestic banks face increasingly intense competition from nontraditional entrants, such as ING Direct, and competition from well-capitalized, non-bank lenders, for example GE Capital Solutions.[5] Perhaps merged domestic firms would become more competitive than now, and could better serve their consumers and businesses.

Canada's financial services legislation reserves to the Finance Minister the right to decide which bank mergers might proceed — after regulatory and competition policy hoops have been cleared. This raises the question of whether consumers' interests are well served if politicians determine which financial companies may combine with others, and if political risk inhibits companies from proposing and defending mergers on their economic merits.

Clarity in rules and public decision-making systems, isolated at least in principle from party politics, is a standard approach to resolving fraught issues like these. The federal white paper should therefore emphasize the importance of reducing the influence of politics over policy, so that the regulatory framework supports efficient financial services delivery.[6]

Questions about Health and Life Insurance

Barriers to competition put brakes on the market forces that might otherwise drive productivity growth, and on this front Canada's health and life insurers have questions to answer. These are strong, well-run companies that have gone through a period of rapid mergers and acquisitions at home and abroad. In the domestic marketplace, however, insurers are protective of their distribution channels — mainly brokers — leading them to claim that consumer choice is better served when banks are forbidden from competing directly with insurers to supply similar insurance products.[7]

While the insurers' claim attracts some sympathy, it is not easy to accept as a matter of logic. Under current regulations, for example, federally chartered banks may not place pamphlets in-branch to advertise affiliates' insurance products, a seemingly absurd situation. The insurers' claim is helped, however, if banks' apparent market power and massive access to data are perceived to be continuing threats to fair treatment for consumers.[8] The insurers' claims would be further sustained if banks sought to distribute insurance products under market-conduct rules different from those that insurers face when selling similar products.

A sound legislative and regulatory framework for ensuring consumers' fair treatment by their bankers, however, is already in place. Hence the banks' job is to satisfy Canadians that their data privacy would be properly respected, as required

5 See Bond (2004), who argues that alternative financial services channels would provide robust competition for merged banking firms. Chant (2001) outlined a framework for mutual recognition of prudential regulators, which would permit foreign companies to compete more readily in the domestic marketplace – the existence of such competition being key to the acceptance of large bank mergers.

6 Dobson (1999) offers an excellent survey of these issues.

7 The consumer interest argument is explored in detail in Horstmann, et al. (1996) and in Mathewson and Quigley (1998).

8 The extent to which concentration and market power is an issue is addressed in Mintz and Pesando (1996).

under privacy law, and that they would receive competent advice — if the banks were fully free to compete in marketing insurance to their borrowers and depositors. And, given that insurance marketing is a global business, Canada's banks need to demonstrate that their competitive spur to efficient, competitive service delivery is a strong enough prospect to allay consumers' lingering worries over their market strength. These are doable tasks, and federal legislation ought to facilitate their pursuit.

Questions about Securities Markets

Canada's balkanized securities regulation is all but unique in the developed world, and perhaps uniquely expensive to sustain and comply with. Provinces must explain why they cannot agree on a better plan. Securities issuers, for their part, with Sarbanes-Oxley and Enron still in the daily headlines, must demonstrate how partial self-regulation will in future guard against what it previously did not. Neither regulatory stasis nor uncertainty over the quality of corporate disclosure helps to steer workers' savings to their most productive opportunities — which is what efficient financial intermediation is all about.

Looking for Answers

The May 2 federal budget promised a white paper on renewing financial services legislation before the end of spring. Ideally, the white paper would clarify the government's plans for handling bank merger proposals; reducing political influence within the process will make proposals for productivity-enhancing realignments a brighter prospect. The federal plan would also leave the door open to regulatory change regarding insurance distribution; closing out competition before it began would make little sense. While securities regulation is not an issue the white paper will address directly, the federal government could use the occasion to offer provinces tangible rewards for partially ceding their oversight role in securities issuance, as part of a program intended to produce a better functioning economic union.

Given a minority Parliament, — and the fact that this not a field on which any party wants to go down fighting — the white paper is likely to be a tepid, timid, and tentative document. Yet Canadians should have high expectations of their public and private institutions. The Department of Finance could signal its willingness to turn words about productivity into legislative action in its own back yard. A focus on building the financial sector's competitiveness and efficiency in serving the public marketplace will keep the reform process on track — and help the economy at large better its performance.

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