

Press Release

18 October 2010

Beyond austerity: A path to economic growth and renewal in Europe

Europe faces multiple, simultaneous pressures on GDP growth - at a time when scope to stimulate growth from public funds is limited by high debt and deficit levels. The threat to growth is unlikely to dissipate in the short or even medium term and significant imbalances in unit labor costs and current account positions between European economies intensify the strain. Switzerland shows good performance compared to its European neighbors.

In this challenging context, Europe has little choice but to pursue structural reform to boost growth. *Beyond austerity: A path to economic growth and renewal in Europe*, a new report by the McKinsey Global Institute (MGI), McKinsey's business and economics research arm, finds that Europe needs to accelerate productivity growth by around 30 percent over historic levels, or opt to work more, just to maintain past GDP growth levels. Productivity growth would have to increase by an even greater margin if Europe is to close the 24 percent per capita GDP gap with the United States that prevails today—equivalent to \$11,250 per capita, or \$4.5 trillion in overall GDP.¹

¹ The report focuses on the European Union 15 (EU-15). The EU-15 represented 88 per cent of EU-27 GDP in purchasing power parity (PPP) terms in 2009 and 98 per cent of the eurozone. The EU-15 includes three economies that are outside the eurozone—the United Kingdom, Denmark, and Sweden—that account for 20 per cent of EU-15 GDP. Many of the structural recommendations may still hold true also for the entire EU-27.

“Individual countries in Europe have already driven through important reforms, and this is cause for optimism. If others emulate their initiative, using today’s pressures as a spur to structural reform, the continent can achieve a healthy rate of sustained long-term GDP expansion,” says Charles Roxburgh, the London-based director of MGI. “Europe can pull this off in a European way, applying best practices that have already been proven to work in the region.”

Europe has made progress on reform, notably in labour markets, the report notes. In the ten years prior to the crisis, Europe’s per capita GDP growth matched that of the United States. This was due importantly to the fact that Europe had been undertaking major reform to its labor markets that helped cut unemployment and boost participation by six percentage points in 20 years. Contrary to popular perceptions of Europe’s poor record on job creation, 24 million new jobs were created between 1995 and 2008, more than in the United States over the same period, despite slower population growth.

MGI finds that if Europe as a whole could reach European best practice on labor market participation, its overall participation rate would rise 9 percent—without reducing vacation or absence times or changing the number of hours worked per week. Boosting service sector productivity to European best practice could add around 20 percent to the region’s overall productivity.

Switzerland shows good performance

While Switzerland was not directly covered in the EU-15-focused report, the country is deeply linked to the European economy. In terms of the reform agenda laid out, Switzerland shows very good performance already in the labour market. Unemployment in 2009 stood at 4.2 percent, one of the lowest in Europe. The employment rate of older workers was a very high 68 percent. And Switzerland also scores well on innovation metrics like triadic patents per capita, outperforming Germany in 2007 by about 50 percent.

European structural reform going forward

The report sets out a comprehensive agenda for European structural reform on the basis of analysis of existing best

practice within the region, proposing reforms in three areas in parallel:

1. Further reforming labor markets in four areas:

- Boosting participation among older workers as spearheaded by Nordic countries and the Netherlands
- Reducing structural unemployment through reforms as implemented in Denmark or the United Kingdom
- Reducing unemployment among young workers through successful policies such as those implemented in the Netherlands
- Balancing the mix of part-time and full-time work for women as one way to increase the average number of hours worked.

Senior participation in the European labor market today—the participation of older workers aged 55 to 64—stands at 51 percent compared with 65 percent in the United States. Unemployment has averaged 2.5 percentage points higher, and a higher share of women, on average, tend to work part time, rather than full time. Europeans’ preference for more leisure time is one reason for the gap in per capita GDP between Europe and the United States—Europeans work on average five weeks less than their American counterparts.

2. Unlocking the full growth potential of service sectors in four ways:

- Further opening up competition in those service sectors that remain constrained by a high level of regulation, such as professional services, and monopolistic structures such as network industries
- Boosting productivity by continuing deregulation of product, land, and labor markets, and supporting greater operational efficiency and professionalism in sectors such as retail, land transport, or construction
- Unlocking growth by setting the direction and providing crucial enablers like standards, education, and infrastructure in, for instance, business services, tourism, and telecoms
- Ensuring European scale across national borders.

The cause of the widening productivity gap between Europe and the United States is Europe’s under-performing service

sectors. Local services such as retailing alone account for two-thirds of the productivity shortfall.

- 3. Aligning policies to growth and renewal:** Capturing opportunities in growth and innovation areas such as expanding emerging markets, cleantech, or longer-term technological innovation, including biosciences and nanotechnology by
- Re-prioritizing funds and allocating them in innovative and competitive ways to support R&D and innovation
 - Developing clusters
 - Improving the link between academia and business
 - Developing a more entrepreneurial mindset.

The McKinsey Global Institute (MGI), founded in 1990, is McKinsey & Company's economics research arm. MGI's mission is to help business and government leaders develop a deeper understanding of the evolution of the global economy and provide a fact-base that contributes to decision making on critical management and policy issues.

The full report can be downloaded at www.mckinsey.com/mgi.

For more information, please contact:
McKinsey & Company, Inc. Switzerland
Pilar Wolfsteller
External Communications
Tel. : +41 44 876 8781
Mobile : +41 79 477 87 81
pilar_wolfsteller@mckinsey.com