

MCKINSEY GLOBAL INSTITUTE

A WINDOW OF OPPORTUNITY FOR EUROPE

JUNE 2015

HIGHLIGHTS



Platform for renewal

Europe has many strengths, and citizens are willing to make trade-offs for growth



Boosting competitiveness

Eleven growth drivers to reform the European economy



Stimulating demand

Approaches to support reform with investment within Eurozone governance



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MGI is led by three McKinsey & Company directors: Richard Dobbs, James Manyika, and Jonathan Woetzel. Michael Chui, Susan Lund, and Jaana Remes serve as MGI partners. Project teams are led by the MGI partners and a group of senior fellows, and include consultants from McKinsey & Company’s offices around the world. These teams draw on McKinsey & Company’s global network of partners and industry and management experts. In addition, leading economists, including Nobel laureates, act as research advisers.

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A WINDOW OF OPPORTUNITY FOR EUROPE

JUNE 2015



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PREFACE

Seven years on from the global recession, the European economic recovery remains sluggish, and talk persists of countries exiting the Eurozone. Yet Europe has fundamental strengths on which to build. The question is how to use those strengths as a platform for a return to robust growth.

In this report, the McKinsey Global Institute (MGI), which has studied productivity and growth in 30 industries in more than 20 countries over the past 25 years, has examined European growth from three angles. First, the research looked at the supply side and productivity of the European economy, discussing 11 competitiveness growth drivers that together would constitute a sweeping programme of structural reform. Second, MGI has drawn on previous analysis on debt and deleveraging to examine the current shortage of aggregate demand in Europe and to highlight various options for stimulating investment and job creation. Third, MGI conducted a survey and conjoint analysis of 16,000 Europeans in eight countries during August 2014 to ascertain their aspirations and priorities.

This research was led by Eric Labaye, a director of McKinsey and chairman of MGI based in Paris; Sven Smit, a McKinsey director based in Amsterdam; Eckart Windhagen, a McKinsey director based in Frankfurt; Richard Dobbs, a director of McKinsey and MGI based in London; and Jan Mischke, an MGI senior fellow based in Zurich. Matt Stone led the project team. The team comprised Paraic Behan, Josef Ekman, Asher Ellerman, Sebastian Farquhar, Alec Guzov, Jakob Hensing, Anna Orthofer, Juliane Parys, Björn Saß, Anne-Marie Schoonbeek, Nigel Smith, Charlotte van Dixhoorn, and Ollie Wilson. We would like to acknowledge the helpful support and input of MGI colleagues Jonathan Ablett, Timothy Beacom, Ivo Eman, Lucia Fiorito, Jan Grabowiecki, Karen Jones, Priyanka Kamra, Krzysztof Kwiatkowski, Arshiya Nagi, Aditi Ramdorai, Vivien Singer, and Amber Yang.

We are grateful to the academic advisers who helped shape this research and provided challenge and insights and guidance: Martin N. Baily, Bernard L. Schwartz Chair in Economic Policy Development and senior fellow and director of the Business and Public Policy Initiative at the Brookings Institution; Richard N. Cooper, Maurits C. Boas Professor of International Economics at Harvard University; Howard Davies, chairman of Phoenix Group; Hans-Helmut Kotz, visiting professor of economics at Harvard University and senior fellow at the Center for Financial Studies; and Lord Adair Turner, senior fellow at the Institute for New Economic Thinking.

In addition to MGI's advisers, we benefitted hugely from insights and feedback provided by Bruno Bezard, general director, French Treasury; Laurence Boone, special advisor for International, European Economic and Financial affairs, French Presidency; Michael Bosnjak of the GESIS – Leibniz Institute for the Social Sciences, associate professor at the Free University of Bozen-Bolzano; Horace “Woody” Brock, president of Strategic Economic Decisions; Marco Buti, director-general for economic and financial affairs at the European Commission; Raffaele della Croce, lead manager, Long-Term Investment Project, at the OECD; Ian Davis, chairman of Rolls-Royce Group PLC; Klaus Günter Deutsch, head of the department of research, industrial and economic policy, Bundesverband Deutscher Industrie e.V.; José Manuel González-Páramo, member of the Board of Directors, BBVA; Yoram Gutgeld, member of the chamber of deputies and economic advisor to the prime minister, Italy; Thomas Heilmann, Senator for Justice and Consumer Protection, Berlin; Kalin Anev Janse, secretary general of the European Stability Mechanism; Ton Kuijlen, emeritus professor of methodology at Tilburg University; Pascal Lamy, president emeritus of the Jacques Delors Institute and former director general of the World Trade

Organisation; Jean Hervé Lorenzi, founder and chairman of the Cercle des économistes; Catherine L. Mann, OECD chief economist and head of the economics department; Giles Merritt, founder and secretary-general of Friends of Europe; Rudolf Minsch, chief economist of Economiesuisse; Peter Mooslechner, executive director, Oesterreichische Nationalbank; Ewald Nowotny, governor, Oesterreichische Nationalbank; Jean Pisany-Ferry, commissioner general for Policy Planning, Office of the French Prime Minister; Baudouin Regout, policy officer, secretariat general, European Commission; André Sapir, senior fellow at Bruegel; Gerhard Schwarz, director of Avenir Suisse; Jean Tirole, chairman of the Toulouse School of Economics and a Nobel laureate in economics; Claire Waysand, chief of staff for the Minister of Finance and Budget, France; Axel Weber, chairman, UBS; and Thomas Wieser, chair of the Eurogroup Working Group of the European Council.

We also had the great honour of testing and refining our thinking in further confidential discussions with many policy makers and officials affiliated with governments and central banks throughout Europe and with European institutions. We thank them all deeply for their time.

We would like to thank many McKinsey colleagues for their input and industry expertise, including Konrad Bauer, Cornelius Baur, Alejandro Beltran de Miguel, Kalle Bengtsson, Kirsten Best-Werbunat, Beril Beten, Marco Bianchini, Daniel Boniecki, Bogdan Buleandra, Christian Casal, Adam Chrzanowski, Miklos Dietz, Catarina Eklöf-Sohlström, Nicklas Garemo, Anna Granskog, Philipp Härle, Antony Hawkins, Matthias Heuser, Vivian Hunt, Alain Imbert, Andrew Jordan, Stijn Kooij, Peter Lambert, Sebastien Leger, Frank Mattern, Jean-Christophe Mieszala, Jorge Omeñaca, Jakob Österberg, Occo Roelofsen, Matt Rogers, Jimmy Sarakatsannis, Luuk Speksnijder, Leonardo Totaro, Thomas Vahlenkamp, Cornelius Walter, Peter de Wit, and Louise Young.

MGI's operations team provided crucial support for this research. We would like to thank MGI senior editor Janet Bush; Matt Cooke, Rebeca Robboy, Vanessa Gotthainer, Rachel Grant, Damaris O'Hanlon, and Vanessa Ratcliffe in external communications and media relations; Julie Philpot, editorial production manager; Marisa Carder, graphics specialist; and Deadra Henderson, manager of personnel and administration.

We are grateful for all of the input we have received, but the final report is ours and any errors are our own. This report contributes to MGI's mission to help business and policy leaders understand the forces transforming the global economy, identify strategic locations, and prepare for the next wave of long-term growth. As with all MGI research, this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution, although it has benefitted from the input and collaborations that we have mentioned. We welcome your emailed comments on the research at MGI@mckinsey.com.

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IN BRIEF

A WINDOW OF OPPORTUNITY FOR EUROPE

Europe's growth since the start of the financial crisis has been sluggish, and the continent faces some difficult long-term challenges on demographics and debt levels. But new MGI research finds that, thanks to a convergence of low oil prices, a favourable exchange rate, and quantitative easing (QE), Europe has a window of opportunity to undertake ambitious reforms, stimulate job creation and investment, and unlock new economic dynamism.¹

- It may be tempting for some observers to write off Europe. That would be a mistake. The continent has a foundation of strength on which to take action. It remains a world leader on key indicators of social and economic progress. And respondents polled in an MGI survey and conjoint analysis of 16,000 Europeans in eight countries had high aspirations and expressed willingness to make tough trade-offs to achieve them.
- Three areas of reform with 11 growth drivers—many of which policy makers already implement in some form—can help deliver on European aspirations. They entail investing for the future (for example, nurturing innovation and reducing the energy burden), boosting productivity (for example, competitive and integrated markets in services and digital and more openness to trade), and mobilising the workforce (for example, increasing grey and female labour-force participation and enhancing labour-market flexibility).
- Three-quarters of the impact of growth drivers can be obtained at the national level. Best practice on every key dimension of the economy can be found somewhere in Europe. The challenge is to emulate that best practice and adopt it more widely.
- Scope for structural reform is limited while investment and job creation are weak. Corporations are piling up cash despite low interest rates, households have cut investment since the bubble, and governments have adopted austerity policies. While every sector is acting rationally, collectively they are causing weak demand that means output is still 15 percent below pre-crisis trends.
- Europe has several options for reigniting investment and job creation despite its complex institutional setup. Measures to unlock financing and quantitative easing can help but are insufficient on their own. Fiscal stimulus is not easy to implement at scale in Europe. New ideas need to be explored, including accounting for public investment as assets depreciate rather than during capital formation, and carefully adjusting taxation and wage structures.
- By scaling up and speeding up reform mostly at the national level and stimulating investment and job creation at the European level in lockstep, Europe could close its output gap, return to a sustained growth rate of 2 to 3 percent over the next ten years, unleash investment of €250 billion to €550 billion a year, and create more than 20 million new jobs. This requires trust and the right governance structures that avoid moral hazard, bundle tight package deals, or lift investment programmes to the European level.

¹ We define Europe in this report as the EU-28 plus Norway and Switzerland.

A window of opportunity for Europe

€2.2 trillion a year needed to meet European aspirations by 2025

Europeans seen willing to make trade-offs—e.g., more working hours and/or less social protection—for higher incomes and better education, health care, security, and living environment



Increasing competitiveness

Implementing European best practice in three key areas can deliver growth aspirations

75% can be achieved by national governments

Act within current governance structure where possible (e.g., QE)



Test potential for a post-Maastricht governance system to enable bolder action



Look at new solutions like balance sheet accounting and unleashing household spend



Reigniting investment and job creation

Action needed to kick-start growth

15% BELOW

Europe's output is well below its pre-crisis trend

Growth potential

If Europe undertakes reform on the supply side AND boosts investment and job creation—moving beyond crisis management and establishing the vision, trust, and governance to act at speed and scale—**2–3% sustained GDP growth** is possible

2–3% growth



A WINDOW OF OPPORTUNITY FOR EUROPE

Seven years on from the global financial crisis, Europe's recovery has been sluggish. The stability of the Eurozone remains a concern, with uncertainty swirling around Greece and its potential exit from the currency union. Indeed, it may be tempting for some to write off Europe, with its complex institutional setup, unfavourable demographics, and high social commitments and debt burdens.

Survey respondents in 8 countries are willing to work **0.5-2.7** more hours per week for higher incomes and better public services

In this report, the McKinsey Global Institute, the business and economics research arm of McKinsey & Company, shows that writing off Europe would be a mistake. The continent has a solid platform for renewal. It has made progress in narrowing imbalances in its economies' current accounts and unit labour costs. It is home to several of the world's most competitive economies. And Europeans want more. According to a new MGI survey and conjoint analysis of 16,000 Europeans in eight countries during August 2014, a majority of survey respondents seek further improvements in their incomes and priority areas including health care, education, security, and the living environment equivalent to 15 percent of GDP even if they require trade-offs such as working 1.8 hours more per week or reducing social protection.¹

Indeed, several recent developments suggest that Europe has a window of opportunity in the short term to accelerate reform and stimulate job creation and investment. The developments we analysed include the sudden and largely unexpected drop in oil prices, a favourable euro exchange rate, the announcement by the European Central Bank (ECB) of a quantitative easing programme, and an improving business climate. All of these together point to economic growth being stronger in 2015. Now is the time to act. The next few years will determine whether Europe continues moving forward or falls back (for our definition of Europe, see Box 1, "Defining Europe").

Europe has a window of opportunity in the short term to accelerate reform and stimulate job creation and investment ... the next few years will determine whether Europe continues moving forward or falls back.

¹ The survey covered 2,000 respondents in each of eight countries: France, Germany, Italy, Poland, Romania, Spain, Sweden, and the United Kingdom.

Box 1. Defining Europe

Unless otherwise noted, throughout this report MGI defines Europe as the 28 countries of the European Union (EU) plus Norway and Switzerland. We sometimes refer to this set of countries as “Europe-30”. On occasion we will use “Europe” as shorthand for Europe-30 or a substantial subset of the countries if the availability of data makes it impossible to address the entire sample. Where our analysis specifically addresses the member states of the EU or the countries of the Eurozone, this is noted. The European micro-states of Andorra, Liechtenstein, Monaco, San Marino, and Vatican City are not included in our analysis. Some may question whether Europe is a useful unit of analysis given that its individual countries and peoples often face varying societal and economic challenges that can make generalising difficult. However, the idea of Europe has been with us since at least the Roman Empire. Today, the EU has bound together individual societies in myriad cultural, social, and economic ways; the advent of monetary union has created even deeper economic integration among its members. In short, what happens in Hungary, Italy, and Sweden has implications for Germany, Portugal, and Romania. The success of national economies and societies is of continent-wide interest.

Still, we acknowledge differences within Europe (Exhibit 1). While Europe’s heterogeneity is sometimes a source of strain, we would argue that it can be a source of strength, offering an opportunity for countries to learn from leading practices successfully adopted by others on the continent. Indeed, the benefits of economic integration are greater when economies are very different from one another. Consider, for instance, the expansion of German manufacturers’ supply chains into Central and Eastern Europe or the nearly 270,000 students who studied in a country other than their home country in 2012 and 2013 through the EU’s Erasmus (European Community Action Scheme for the Mobility of University Students) exchange programme.

To reflect differences within Europe, we occasionally talk about groups of countries that have a higher degree of commonality than can be found in the Europe-30 alone:

- **Nordics:** Denmark, Finland, Norway, and Sweden.
- **Continental Europe:** Austria, Belgium, France, Germany, Luxembourg, the Netherlands, and Switzerland.
- **United Kingdom and Ireland.**
- **Southern Europe:** Cyprus, Greece, Italy, Malta, Portugal, and Spain.
- **Baltics:** Estonia, Latvia, and Lithuania.
- **Central and Eastern Europe:** Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia.

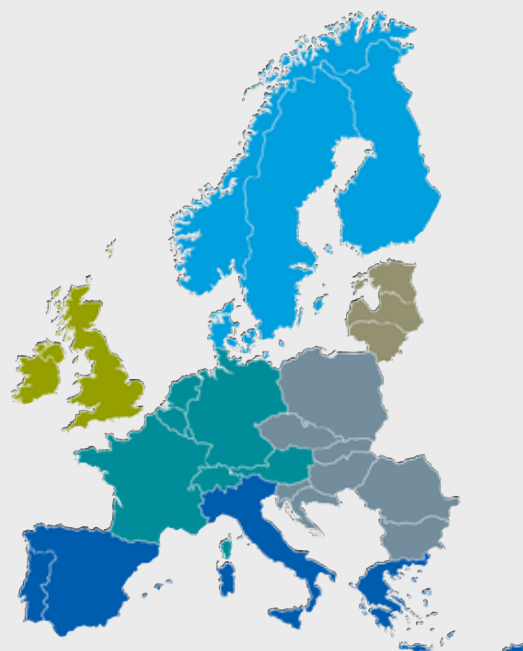
Box 1. Defining Europe (continued)

Exhibit 1

Europe is characterised by a high degree of heterogeneity

Selected economic data by region

Region	Per capita GDP, 4Q13 \$ thousand, purchasing power parity	Output gap % of GDP	Employed share of working-age population, 4Q13 % aged 15–64
 Nordics	42.0	-2.1	73
 Continental Europe	37.7	-1.5	70
 United Kingdom and Ireland	34.4	-0.8	71
 Southern Europe	28.0	-5.4	55
 Baltics	14.6	0.7	65
 Central and Eastern Europe	19.5	-1.4	61
Europe-30	31.3	-2.4	64



SOURCE: Eurostat; IMF; McKinsey Global Institute analysis

Sustainable growth and prosperity will likely be attained only when far-reaching structural reforms implemented mostly at the national level are carried out in concert with stimulation of investment and job creation enabled at the European level. They are mutually reinforcing, amplify each other's impact, and are very likely to return Europe to sustained GDP growth of the 2 to 3 percent a year that can meet the aspirations of its population. This would, in effect, add the equivalent of the Austrian economy to growth annually compared with post-crisis growth rates. Europe would then have an opportunity to unleash investment of €250 billion to €550 billion a year in innovation, education, infrastructure, and energy and, by closing its output gap and mobilising its workforce, create more than 20 million new jobs.

20m

new jobs possible
with reform plus
investment and job
stimulation

MGI has studied growth, productivity, and competitiveness in 30 industries in more than 20 countries over the past quarter of a century. Drawing on that body of work, this report explores three areas of structural reform, identifying 11 competitiveness-enhancing growth drivers and detailed initiatives underneath, quantifying their potential impact, and mapping the current performance of European countries against them. At least one country on the continent has already acted on each growth driver that this report discusses. The challenge is to adopt those solutions more broadly. Three-quarters of the potential impact lies within the power of national governments.

All of these drivers come at a cost either in terms of investment to make change happen, or in terms of disruptions to some groups in society. No programme of structural reform is likely to succeed without simultaneous action to reignite investment and job creation at the European level. Drawing on MGI analysis of debt and deleveraging to understand the shortage of aggregate demand, the research highlights the specific constraints on households, corporations, and the public sector, and assesses the potential impact and institutional feasibility of various ways that Europe could stimulate investment and job creation.² While the standard prescription of fiscal spending and QE may not easily apply in Europe, there are ways to unlock investment and job creation even in the current complex European institutional setup. These options include a change in public-accounting rules to account for investments as they depreciate and a careful adjustment of taxation and wage structures. Europe can take encouragement from the fact that much has already been achieved to stabilise the economy and fortify the Eurozone against future shocks.

Touching on the political challenges of implementation, the report finds that there are ways to overcome the stalemate. Europe has taken many of the right steps in response to the crisis, but often not at the speed and scale required. Many of the growth drivers described could face significant political resistance or become mired in complex decision making. At the national level, reform is difficult while budgets are tight and the rate of job creation too low to absorb restructuring losses. At the European level, supporting investment and job creation raises concerns of moral hazard, trust, and viable governance structures. Potential solutions can include tightly knit package deals combining reform and stimulus packages, building on those measures that we identified as not requiring any loosening of the Fiscal Compact or mutual debt guarantees, or elevating investment programmes to the European level. Only a coordinated effort at all levels can elevate Europe's economy and society to renewed dynamism.

Not all options described in this report will be met with unanimous approval. Some of the ideas discussed involve trade-offs beyond economics and would require a new consensus. The analysis offers a sense of the pathways to a new deal for Europe rather than a precise route. It is our hope that this effort sparks an invigorated discussion across the continent on the most effective and viable path to reform.

² *Debt and (not much) deleveraging*, McKinsey Global Institute, February 2015.

Europe has a platform for ambitious renewal

Europe has had a sluggish recovery and now faces debt problems as well as a challenging level of social commitments given its demographic burden. But it also has a foundation of strength, has made progress in rebalancing its constituent economies, and has a window of opportunity of growth likely being stronger in 2015 (see Box 2, “The Eurozone has built new institutions and rebalanced since the crisis, but more progress and flexibility are needed”). Moreover, European citizens aspire to further economic and social progress in Europe even if achieving this entails tough trade-offs on their part.

Europe's recovery has been sluggish, and the continent faces strong economic headwinds

Although recent trends have led to a cautious return to a degree of optimism about Europe's economic prospects, the fact remains that the continent's recovery has been sluggish and that considerable challenges clearly lie ahead. Per capita GDP in terms of purchasing power parity has only just returned to its pre-crisis peak for the continent as a whole, and the longer-term growth performance of Europe has been declining; projections suggest that long-term growth in GDP may continue to decline by around 10 percent (Exhibit 2).

Exhibit 2

At historical productivity-growth rates, GDP and per capita GDP growth are set to slow in Europe

Employment, productivity, and growth

Medium UN population scenario; compound annual growth rate (CAGR), %; future 50 years assumes past productivity growth rates for next 50 years



1 Europe-4 comprises France, Germany, Italy, and the United Kingdom (the European G20 member states, which collectively account for around 60% of Europe-30 GDP).

NOTE: Numbers may not sum due to rounding.

SOURCE: The Conference Board Total Economy Database; United Nations Population Division; ILO; McKinsey Global Institute analysis

Box 2. The Eurozone has built new institutions and rebalanced since the crisis, but more progress and flexibility are needed

The 2008 financial crisis exposed underlying strains in the Eurozone. Current-account imbalances that had swelled in the ten-year period prior to 2008 proved unsustainable in an environment of heightened volatility and perceived risk. Governments retrenched—putting even more pressure on growth—to preserve credibility with creditors, including official creditors in bailout programmes. Without recourse to currency devaluation and with only limited fiscal transfers and labour mobility within the Eurozone, many countries were forced to resort to “internal devaluation”—pushing down wages and therefore unit labour costs to restore competitiveness. As a result, current-account balances, on average, have moved towards surplus, initially driven by a collapse in imports followed by export growth (Exhibit 3). In Spain, for example, imports fell by 17 percent in 2009; since then, exports have grown by about a third while imports have remained static. However, this process has been accompanied by very high unemployment and outright deflation in some instances, which has, in effect, increased the overall debt burden in real terms. Moreover, countries with surpluses have not yet reduced their current-account imbalances.

While ECB President Mario Draghi’s July 2012 pledge to “do whatever it takes” to preserve the stability of the Eurozone went a long way towards calming market nerves, gradual changes are under way that could make the Eurozone more resilient in the face of future crises, although progress remains uneven:

- **Flexible wages and prices.** Eight countries have experienced nominal wage deflation in at least two years since 2008. Partly as a result, some economies—notably Greece, Ireland, Spain, and Portugal—have made significant progress in returning their unit labour costs to the same position relative to Germany that prevailed in the early 2000s.
- **Labour mobility.** Migration between EU countries increased from 0.2 percent of the population in 2003 to 0.35 percent in 2012, though this remains far below annual migration between US states (2.2 percent), Swiss cantons (1.7 percent), and German Länder (1.4 percent) in 2012.
- **Fiscal transfers.** Intra-EU transfers amount to 1.6 percent of European GDP, far below the intra-US transfers of 8.4 percent of US GDP. To date, these transfers do not act as automatic stabilisers in the case of economic turbulence in one part of Europe—and they are handled at the EU level, not the Eurozone level.
- **Integrated capital markets and risk sharing.** The banking union goes some way towards severing the link between unstable banks and national government finances, and a capital markets union has been proposed. But retail banking remains fragmented.
- **Institutional foundation and policy coordination.** European policy makers have put in place a number of new institutions to improve the resilience of the single-currency area. For instance, the European Stability Mechanism was established to provide emergency liquidity support to governments. The Fiscal Compact and European Semester were introduced to improve the coordination of economic and fiscal policy while controlling for moral hazard. New monetary instruments of the ECB (such as QE, ABS purchasing, and Targeted Longer-Term Refinancing Operations) have been introduced.

Overall, certain European countries were relatively proactive in terms of structural reform in the wake of the financial crisis, and in response to the pressures brought about by the Eurozone debt crisis. Although reform has been relatively active in countries such as Ireland, Portugal and Spain, nevertheless its momentum has been declining in recent years.¹ This suggests the need for a renewed focus throughout Europe, especially given the uncertainty surrounding Greece in the aftermath of the 2015 election.

¹ *Economic policy reforms 2015: Going for growth*, Organisation for Economic Co-operation and Development (OECD), 2015.

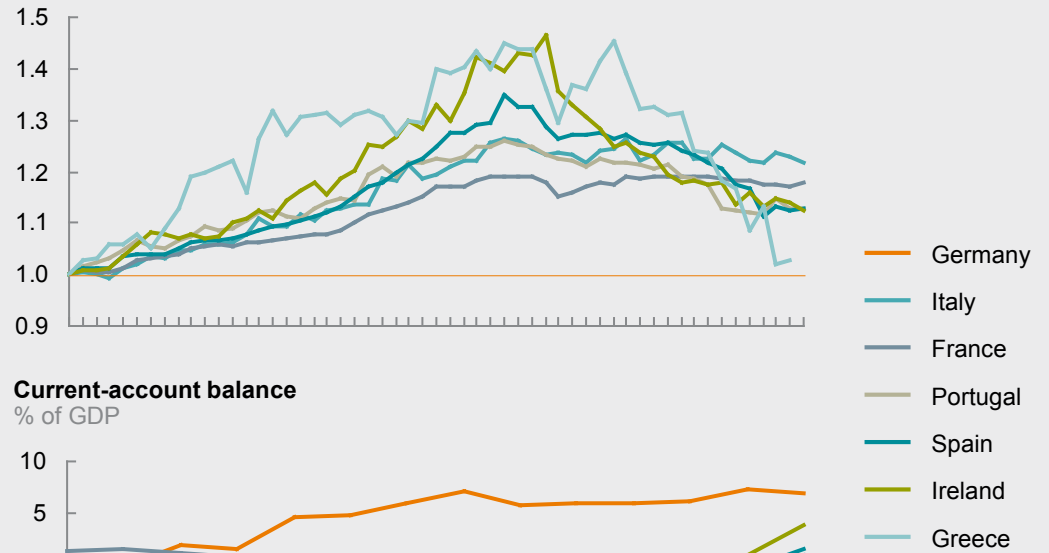
Box 2. The Eurozone has built new institutions and rebalanced since the crisis, but more progress and flexibility are needed (continued)

Exhibit 3

The Eurozone has made progress on rebalancing and convergence

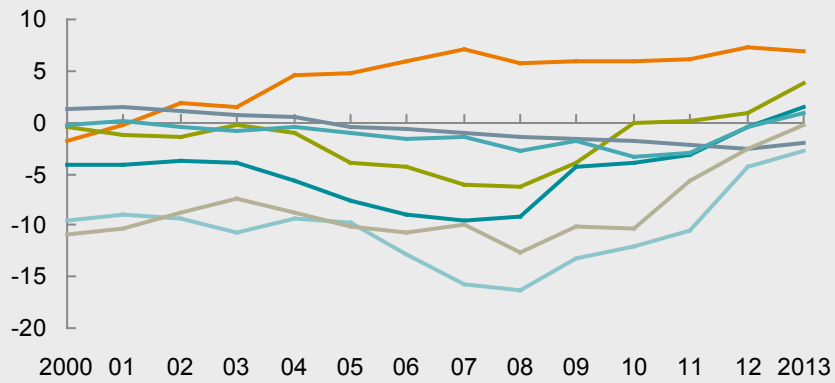
Unit labour cost relative to Germany

Index: 1 = 1Q00



Current-account balance

% of GDP



SOURCE: Eurostat; McKinsey Global Institute analysis

In some countries, including Germany, the decline in the rate of GDP growth may be particularly significant because of a large expected shrinkage in the employed working-age population. In the nearer term, the likelihood of relatively strong 2015 growth is due to a number of factors boosting demand that may prove short-lived. Some economists have warned that Europe could be headed towards a deflationary spiral similar to the one Japan suffered in the 1990s.

Europe's working-age population to shrink by

42M

to 2050

Longer term, there is apprehension that ageing will further sap the European economy's strength and put even more pressure on governments' finances unless countries manage to turn longer healthy lives into longer economically active lives. The prime working-age population in Europe, conventionally defined as aged 15 to 64, is set to shrink by 4 percent, or 14 million people, in the period to 2030, and by 12 percent, or 42 million people, to 2050 (there are a few exceptions to this broad trend, such as the United Kingdom). Given this trend, even the modest 1.5 percent European Commission forecast for GDP growth to 2025 requires significant increases in labour participation.

Given current primary fiscal balances, interest rates, and projected real GDP growth, the ratio of government debt to GDP will continue to grow from already high levels in many European countries, including Belgium, Finland, France, Italy, the Netherlands, Portugal, Spain, and the United Kingdom. This is a source of concern since high debt levels have historically been a drag on growth and increased the risk of financial crises that can spark another set of deep economic recessions.³

But Europe has a foundation of strengths

Europe still has much to celebrate. Its countries include world leaders on key social and economic measures. Think of Germany's trade competitiveness, the United Kingdom's strength in services, France's world-class transport infrastructure, Portugal's record on bringing women into the workforce, Poland's resilience throughout the crisis, Estonia's adoption of digital technologies in the public sector, and Denmark's energy efficiency.

The sudden and largely unexpected drop in oil prices, a favourable euro exchange rate, QE, and an improving business climate all suggest that 2015 is likely to be a strong year for growth and a window of opportunity for an ambitious programme of renewal.

Europe generates

25%

of global GDP

And Europe has solid fundamental strengths. It is one of the world's largest economies, generating 25 percent of global GDP—larger than the United States and close to the size of the North American Free Trade Agreement area. Europe is home to a huge, highly integrated domestic market of 500 million inhabitants. European economies are well connected to global flows: half of the 20 most competitive economies in the world are European, according to the World Economic Forum. Despite the difficult economic environment, many companies continue to thrive and compete on a global scale—142 Fortune 500 companies are headquartered in the region, compared with 128 in the United States. And European economies remain world leaders on six dimensions of social and economic progress and perform well on indicators of economic health (Exhibit 4). Furthermore, some European economies have made progress in the past few years on crucial structural policies needed to underpin future growth.⁴ This gives cause for optimism that such efforts can—as they must—continue at an accelerated pace.

³ *Debt and (not much) deleveraging*, McKinsey Global Institute, February 2015.

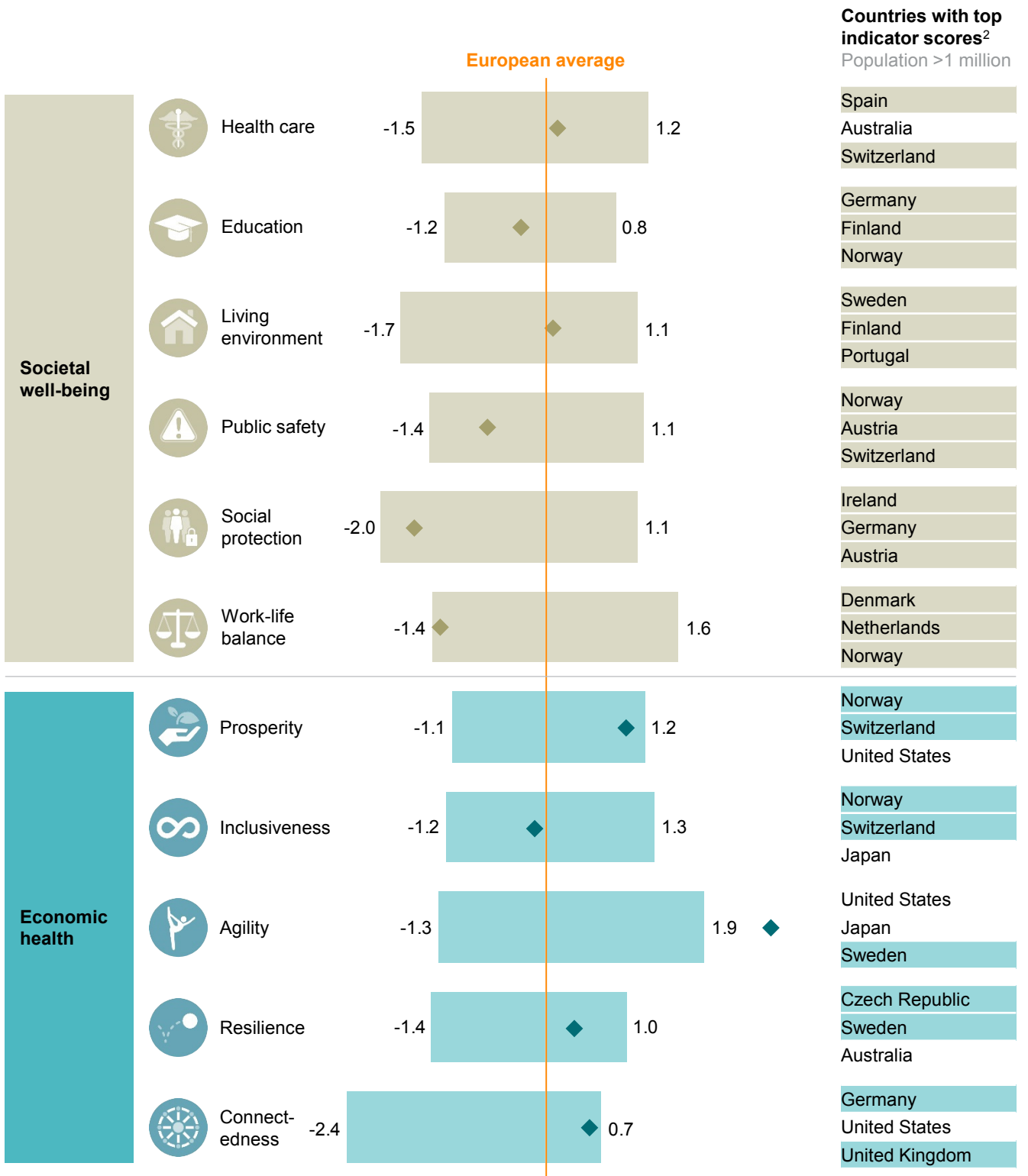
⁴ *Economic policy reforms 2015: Going for growth*, OECD, 2015.

Exhibit 4

European countries remain world leaders on key dimensions of social and economic progress

Performance on attributes relative to Europe-30 average
Composite indicators; ranges of country-level z-scores¹

■ Europe-30 ◆ United States



1 Measurement of the number of standard deviations away from the mean. The selection of subindicators and metrics, of course, influences country scores; not all countries have rankings for all metrics.

2 Comparison among Europe-30 countries, Australia, Canada, Japan, South Korea, and the United States.

SOURCE: Eurostat; Organisation for Economic Co-operation and Development (OECD); United Nations Educational, Scientific and Cultural Organization (UNESCO); United Nations Office on Drugs and Crime (UNODC); World Bank; World Economic Forum (WEF); World Health Organization (WHO); Central Intelligence Agency (CIA); national statistical offices; McKinsey Global Institute analysis

If Europe pushes forward on reform, it could sustain GDP growth that is well above current forecasts. The European Commission forecast 1.5 percent annual GDP growth to 2025 at the time of writing. By way of contrast, in a scenario in which all countries were to close the gap with the region's top-quartile performers on productivity and mobilising the labour force, the growth rate could be 2.1 percent a year—or more if Europe adopts the kind of growth-enhancing reforms we discuss in this report.

European economies remain world leaders on social and economic progress and perform well on indicators of economic health.

Europeans say they would make tough trade-offs to achieve their high aspirations

Europeans in general enjoy an enviable quality of life even in comparison with citizens of other high-income countries and regions. The aspects of life that they care most about are health care, education, the living environment, public safety, social protection, and work-life balance.⁵ At least one European country exemplifies best practice in each of these areas. But the picture varies enormously within the continent, and Europeans say they want more and are not content merely to preserve the social progress Europe has achieved thus far.

In an MGI survey and conjoint analysis of 16,000 Europeans in eight countries, respondents were asked to choose between sets of conjoint scenarios that trade off a desire to have more or less of different attributes of societal aspirations. The attributes are health care, education, the living environment, social protection, public safety, buying power, working hours, and productivity (here represented by personal factors such as the willingness to work faster or under more pressure, or training oneself). A model ensures that scenarios are economically balanced: improvements in one attribute have to come at the expense of other attributes or a willingness to work longer or more productively. People are rarely asked about their aspirations in a way that allows quantified real-world variables to be employed so as to show a “true” cost. Full details of the survey methodology are available in the appendix (see the Detailed Analysis paper that accompanies this report).

€2.2T
a year to 2025
needed to meet
European
aspirations

Respondents said they want additional investment in education, health care, public safety, and the living environment in the period to 2025, and, at the same time, want to increase their disposable income (Exhibit 5). MGI estimates that achieving what respondents say they want would cost an estimated €2.2 trillion a year by 2025, or the equivalent of 15 percent of Europe's GDP. Collectively, respondents said that they would be prepared to make trade-offs to generate this amount. This preparedness is expressed as a willingness to work longer—1.8 additional weekly hours per worker on average (0.5 hours to 2.7 hours depending on the country)—and more productively, as well as a willingness to accept some reallocation of resources away from social-protection programmes.

The survey results show a common willingness to make such trade-offs independent of respondents' current employment status and across countries, demographic segments, age groups, levels of income, and educational attainment—and not just among those individuals who are currently deprived of work opportunities because of the difficult economic environment. In their most preferred scenario, 84 percent of respondents were willing to compromise on their working hours and productivity in exchange for improvements in other priorities. Reducing the resources devoted to social protection garnered support from 58 percent of respondents.

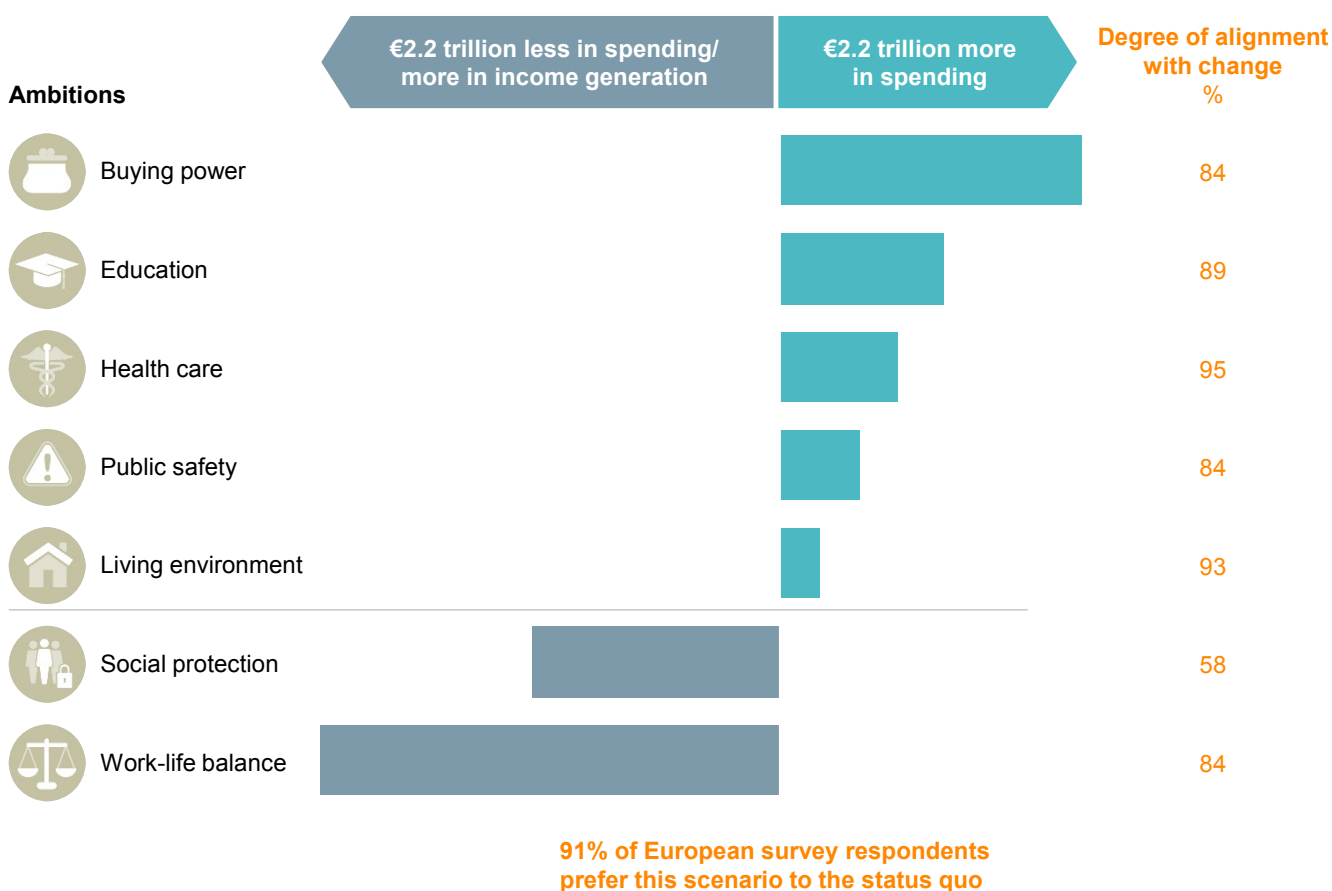
⁵ *Better Life Index*, OECD, 2014.

The precise nature of the trade-offs varies from country to country and among different groups of individuals. For instance, Polish survey respondents would prefer to generate additional output mainly through significant productivity improvements of almost 12 percent and to increase their working hours by only a relatively modest 1.1 weekly hours per worker. In contrast, French respondents would be willing to work as much as 2.0 more weekly hours per worker while slightly decreasing productivity and reducing spending on social protection. Spanish respondents would opt to work 2.7 hours more per week if it meant increasing social protection.

Exhibit 5

European survey respondents have high aspirations—and are willing to make tough trade-offs to achieve them

Preferred trade-off of European respondents in 8 countries¹
 Additional spending and income generation (15% of Europe-30 GDP)



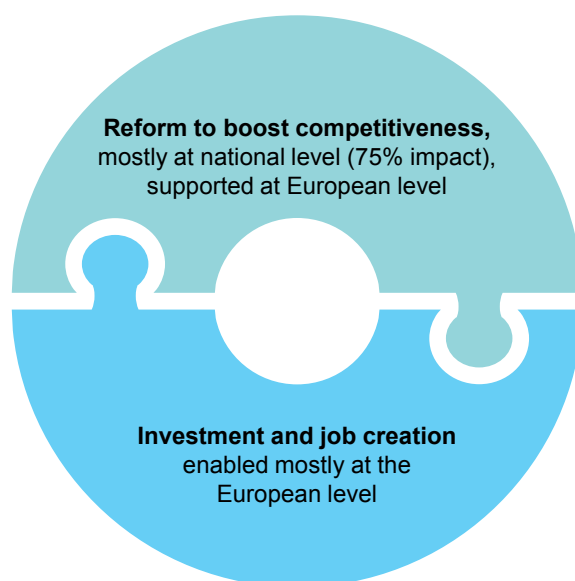
¹ Calculated based on Europe-30 2013 GDP and GDP-weighted conjoint scores for the eight surveyed countries.

SOURCE: MGI European Aspirations Conjoint Survey, August 2014; McKinsey Global Institute analysis

To deliver on citizens' aspirations in a smarter way than having them work longer or harder, European leaders must collaboratively develop a comprehensive programme of reform largely at the national level—together with investment and job creation enabled by pan-European action. Only this combination, pursued in lockstep, will overcome inertia and get Europe's growth engine motoring again (Exhibit 6).

Exhibit 6

Europe will need to work in tandem on reform and support for job creation and investment



SOURCE: McKinsey Global Institute analysis

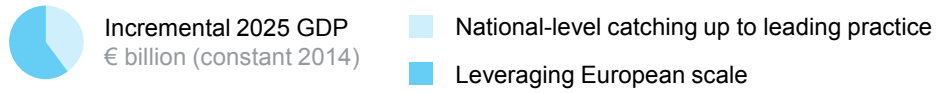
Reform—three-quarters achievable at the national level—can deliver on growth

Three broad structural reform efforts—investing for the future, boosting productivity, and mobilising the workforce—composed of 11 growth drivers could enhance the competitiveness of the European economy and offer a menu of options that policy makers should continue to examine and develop (Exhibit 7). Collectively, they could help the region attain an annual GDP-growth rate of 2 to 3 percent and sustain it to 2025 even as the factors boosting growth in 2015 ebb away (Exhibit 8). This would be more than enough to meet in full the aspirations voiced in the survey. Most of the impact from the growth drivers comes from productivity increases, and only one-quarter comes from increased labour-force participation rates and immigration. It will, of course, require significant effort not only to recover more quickly from the crisis, but also to move beyond the 1.7 percent potential trend growth rate derived from the average long-term productivity growth rate of leading nations of 1.4 percent a year, forecast growth in the working population of 9 million, and an increase in participation of 5.0 and 7.5 percentage points among women aged between 25 and 54 and men and women in the 55 to 74 age bracket, respectively.

Most of the impact from the growth drivers comes from productivity increases, and only one-quarter comes from increased labour-force participation rates and immigration.

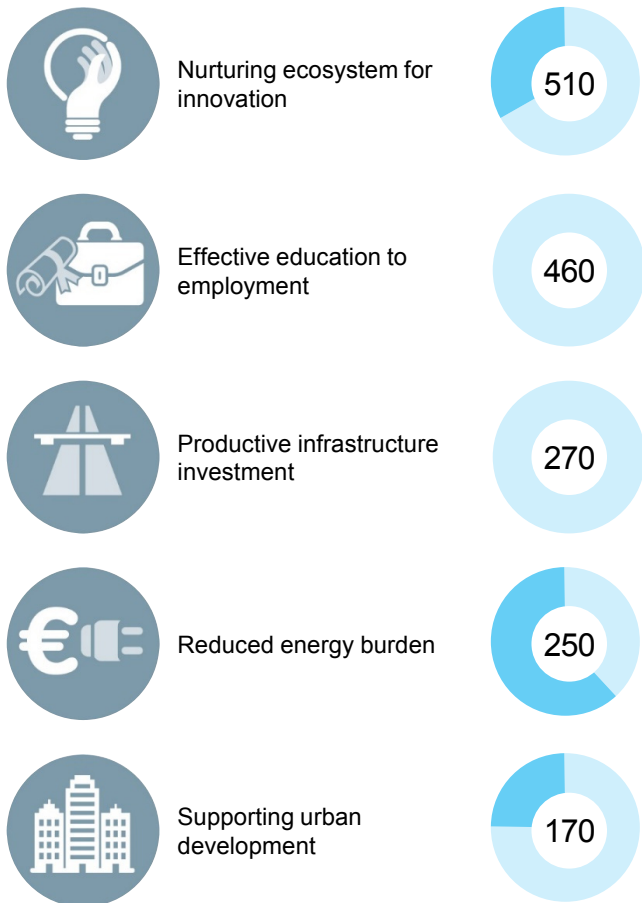
Exhibit 7

Eleven growth drivers—about three-quarters achievable at the national level—can deliver on European aspirations

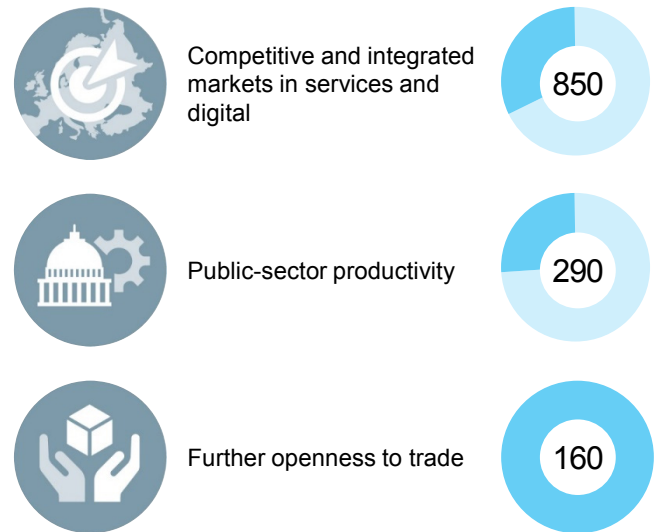


Enabler
Changing incentive structures and taxation

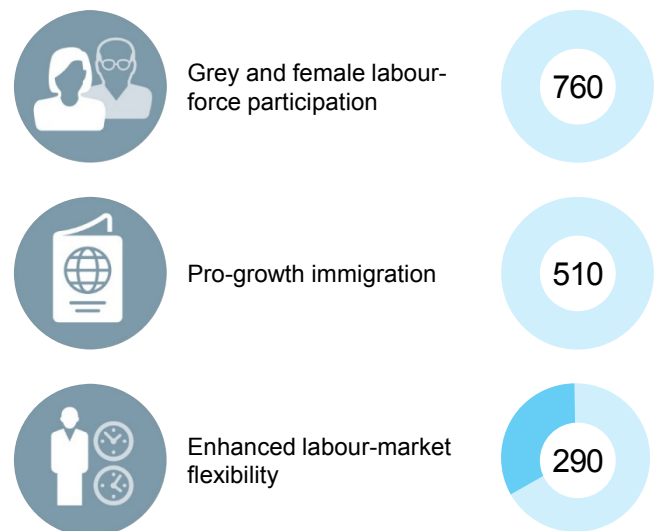
Investing for the future



Boosting productivity



Mobilising the workforce



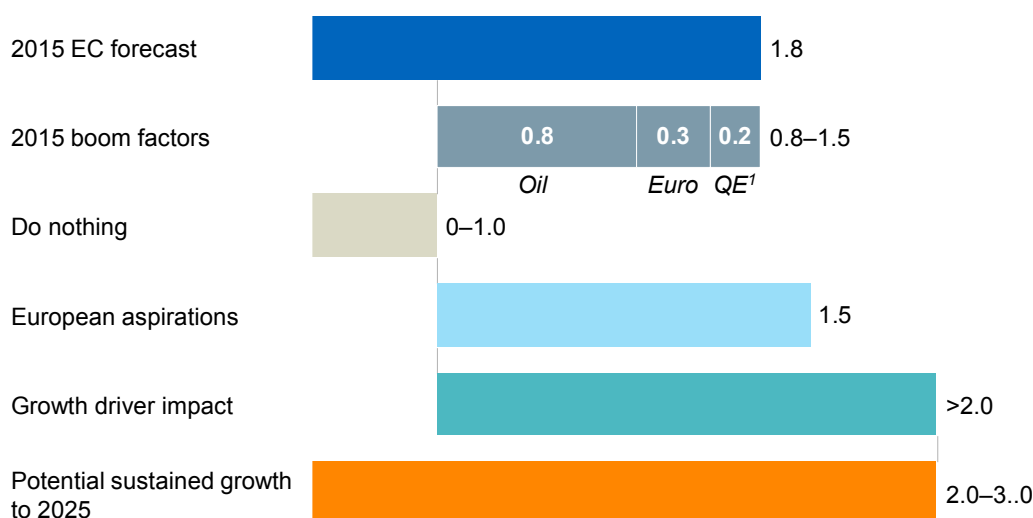
SOURCE: McKinsey Global Institute analysis

Exhibit 8

The growth drivers could deliver sustainable growth of 2 to 3 percent even when oil and currency effects ebb away

Potential GDP growth for Europe-30 (estimates)

%



1 Projected impact of QE from central bank remittances. Much of the “Euro” impact also relates to QE; impact of QE estimated at up to a maximum of 0.2% of GDP; assumes a GDP weighted bond rate of between 1.3 and 2.2%.
NOTE: Numbers may not sum due to rounding.

SOURCE: IMF; European Commission; McKinsey Global Institute analysis

3/4

of impact of competitiveness drivers from national level

It is notable that three-quarters of the impact from the growth drivers can be delivered at the national level without the need for complex Europe-wide agreement and alignment. According to a scorecard we developed to assess the performance of countries on the growth drivers, some European countries are typically already leading on each of them (Exhibit 9).⁶ The challenge is not to reinvent the wheel, but to spread and accelerate the adoption of leading practices that already exist in the region. Of course, not all countries will be able to attain top performance in all dimensions. Instead, policy makers must determine where to prioritise effort based on each country’s gap to the leading practices and comparative advantage.

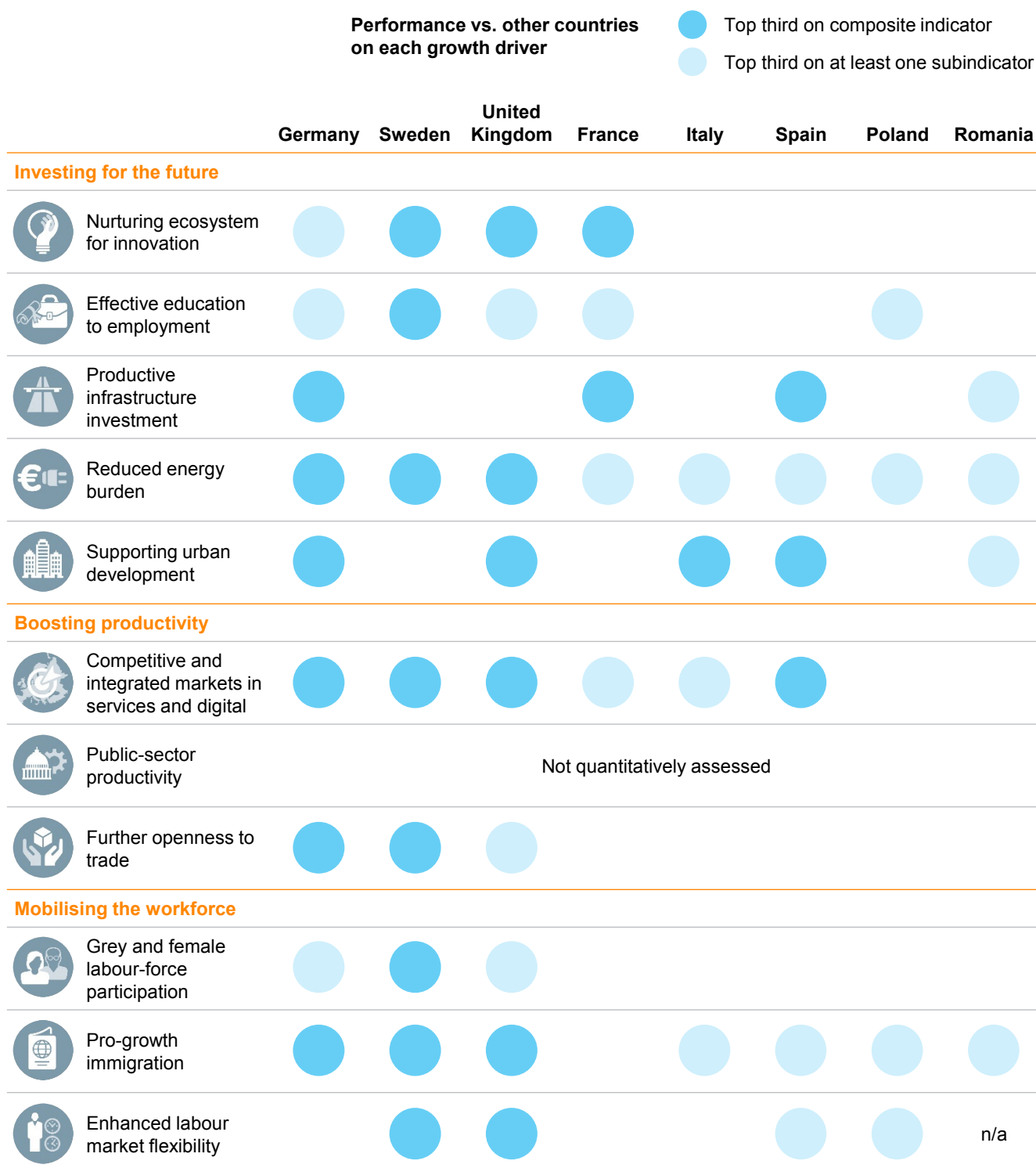
The other one-quarter of the collective impact of these growth drivers will require some involvement from the EU and coordinated action at the supranational level, doubling down and expanding on ongoing initiatives. For instance, the EU can spur innovation in sectors with significant economies of scale by setting Europe-wide standards for disruptive technologies and open data. It also can accelerate progress in interconnecting gas and electricity networks across Europe’s internal borders. The EU is also responsible for Single Market legislation and external trade agreements, and it can consolidate some public procurement at the European level to boost efficiency of spending.

Europe can look to existing initiatives and efforts as inspiration for pushing ahead with additional structural reform. Much has already been achieved, such as the establishment of the European Semester, a programme that helps align reform policies, exchanging best practice, and creates peer-pressure for countries to reform and accelerate progress.

⁶ For more detail on the indicators we use in the scorecard, please see the appendix in the Detailed Analysis paper that accompanies this report.

Exhibit 9

European economies need wider adoption of best practice that already exists on the continent



NOTE: All countries assessed as long as at least two out of three or four subindicators available; limited data availability particularly for Bulgaria, Croatia, Cyprus, Latvia, Malta, Norway, Romania, Slovakia, and Switzerland.

SOURCE: McKinsey Global Institute analysis




Each growth driver is underpinned by concrete initiatives that are already working on the ground in Europe. For example, the Netherlands is a model performer on openness to trade thanks in part to its excellent trade logistics infrastructure. The United Kingdom is a leader on increasing the participation of grey workers in the labour force by phasing

out the statutory retirement age. For some initiatives, significant pan-European action will be required for successful implementation, but most could be enacted by national governments alone and therefore put in place more rapidly (Exhibits 10–12).

Exhibit 10

The 11 growth drivers are underpinned by concrete initiatives, many of which have already been pioneered within Europe

Orange text: Initiatives likely to require a high degree of European cooperation





Growth driver	European top performer by country type	Initiatives	Example countries where initiatives have been implemented
 <p>Nurturing ecosystem for innovation</p>	<ul style="list-style-type: none"> Large, higher income Small, higher income Lower income <ul style="list-style-type: none"> Netherlands Switzerland Portugal 	<ul style="list-style-type: none"> Deepen the Single Market, and set Europe-wide standards and regulations for transformational technologies (e.g., autonomous vehicles) 	<ul style="list-style-type: none"> United Kingdom
		<ul style="list-style-type: none"> Gear public-procurement spending, including defence spending, towards supporting innovation 	<ul style="list-style-type: none"> Belgium Austria
		<ul style="list-style-type: none"> Unblock barriers to entrepreneurship and accept “creative disruption” across sectors (e.g., UK start-up visas, seed-investment schemes) 	<ul style="list-style-type: none"> United Kingdom
		<ul style="list-style-type: none"> Support digitisation of government and the economy 	
		<ul style="list-style-type: none"> Establish standards and platforms for open data in the private as well as the public sector 	<ul style="list-style-type: none"> United Kingdom
 <p>Effective education to employment</p>	<ul style="list-style-type: none"> Netherlands Finland Slovenia 	<ul style="list-style-type: none"> Establish dedicated schemes for matching youth to employment, and increase transparency about labour-market and career choices 	<ul style="list-style-type: none"> United Kingdom Finland
		<ul style="list-style-type: none"> Develop a flexible dual-apprenticeship model 	<ul style="list-style-type: none"> Germany Austria Switzerland
		<ul style="list-style-type: none"> Revamp the selection and training process for teachers 	<ul style="list-style-type: none"> Finland
		<ul style="list-style-type: none"> Proactively measure school performance on a defined set of metrics and intervene with targeted programs where outcome shortfalls are identified 	<ul style="list-style-type: none"> United Kingdom
		<ul style="list-style-type: none"> Stimulate dialogue between employers and educational providers 	<ul style="list-style-type: none"> European Union
 <p>Productive infrastructure investment</p>	<ul style="list-style-type: none"> France Austria Czech Republic 	<ul style="list-style-type: none"> Increase spending in countries currently underinvesting, explore alternative funding options outside the tax budget, and increase productivity of spend where overinvestment occurred 	
		<ul style="list-style-type: none"> Conduct comprehensive infrastructure-productivity assessments 	
		<ul style="list-style-type: none"> Take an integrated view of infrastructure project selection, streamline delivery of infrastructure projects, and improve utilisation of existing infrastructure through pricing and technology use 	<ul style="list-style-type: none"> Finland Sweden

SOURCE: McKinsey Global Institute analysis

Exhibit 11

The 11 growth drivers are underpinned by concrete initiatives, many of which have already been pioneered within Europe (continued)

Orange text: Initiatives likely to require a high degree of European cooperation



Growth driver	European top performer by country type	Initiatives	Example countries where initiatives have been implemented
	<ul style="list-style-type: none"> ▪ Large, higher income ▪ Small, higher income ▪ Lower income 		
 Reduced energy burden	<ul style="list-style-type: none"> ▪ United Kingdom ▪ Sweden ▪ Slovenia 	<ul style="list-style-type: none"> ▪ Use targets, standards, and fiscal policy to incentivise investment in energy productivity (e.g., energy-efficiency targets for buildings, carbon taxes, etc.) 	<ul style="list-style-type: none"> ▪ Denmark
			<ul style="list-style-type: none"> ▪ Accelerate towards a single European energy market (e.g., cross-border gas and electricity interconnectors, non-discriminatory infrastructure access) ▪ Launch a cost-effective pan-European unconventional resource strategy (e.g., support schemes for renewable energy, exploration of shale gas, alternative energy storage)
 Supporting urban development	<ul style="list-style-type: none"> ▪ Netherlands ▪ Belgium ▪ Greece 	<ul style="list-style-type: none"> ▪ Enable urban redevelopment and expansion, supported by regulatory changes and property value capture 	
			<ul style="list-style-type: none"> ▪ Develop affordable housing ▪ Remove barriers to rural-urban migration (e.g., reduction of rural-urban subsidies) and improve cities' attractiveness for talent
 Competitive and integrated markets in services and digital	<ul style="list-style-type: none"> ▪ Netherlands ▪ Ireland ▪ Hungary 	<ul style="list-style-type: none"> ▪ Fully implement the EU Services Directive, remove remaining barriers to cross-border services provision (especially in heavily regulated professions), and smartly regulate product and land markets 	<ul style="list-style-type: none"> ▪ United Kingdom ▪ Ireland ▪ Sweden
			<ul style="list-style-type: none"> ▪ Ensure that directives on cross-border transport infrastructure are enforced and competition enhanced ▪ Deepen Single Market in digital through investing in information and communications technology (ICT) infrastructure and enhanced consumer and intellectual-property protection
 Public-sector productivity	Not assessed	<ul style="list-style-type: none"> ▪ Create conditions for competition in public services where possible, including through the judicious use of outsourcing, and establish a "customer attitude" 	<ul style="list-style-type: none"> ▪ Netherlands ▪ Austria
			<ul style="list-style-type: none"> ▪ Tightly review government efficiency and productivity and establish an independent organization that can implement internal change ▪ Launch a productivity-measurement programme and publish results that establish accountability ▪ Implement joint purchasing and pooling of resources (e.g., in defence procurement)

SOURCE: McKinsey Global Institute analysis

Exhibit 12

The 11 growth drivers are underpinned by concrete initiatives, many of which have already been pioneered within Europe (continued)

Orange text: Initiatives likely to require a high degree of European cooperation

Growth driver	European top performer by country type	Initiatives	Example countries where initiatives have been implemented
 Further openness to trade	<ul style="list-style-type: none"> ▪ Large, higher income ▪ Small, higher income ▪ Lower income 	<ul style="list-style-type: none"> ▪ Agree on robust trade agreements with the growth engines of the next decade: China, India, and the United States 	
		<ul style="list-style-type: none"> ▪ Expand and improve the trade logistics ecosystem (e.g., efficient infrastructure, customs procedures, and quality of support services) 	<ul style="list-style-type: none"> ▪ Germany ▪ Netherlands
		<ul style="list-style-type: none"> ▪ Establish exporter support networks in destination countries 	<ul style="list-style-type: none"> ▪ Germany
		<ul style="list-style-type: none"> ▪ Offset the adverse effects from trade through adequate investments and policies 	
 Grey and female labour-force participation	<ul style="list-style-type: none"> ▪ Spain ▪ Norway ▪ Estonia 	<ul style="list-style-type: none"> ▪ Stop incentivising individuals to not work (e.g., abolishment of statutory retirement age) 	<ul style="list-style-type: none"> ▪ United Kingdom
		<ul style="list-style-type: none"> ▪ Provide more support and flexibility to workers (e.g., child-care systems) 	<ul style="list-style-type: none"> ▪ Sweden ▪ Norway ▪ Denmark
		<ul style="list-style-type: none"> ▪ Reduce (perceived) barriers to employment (e.g., harmonisation of maternity and paternity leave, protective legislation) 	<ul style="list-style-type: none"> ▪ Sweden
		<ul style="list-style-type: none"> ▪ Offer lifelong learning to everyone 	<ul style="list-style-type: none"> ▪ Germany
 Pro-growth immigration	<ul style="list-style-type: none"> ▪ United Kingdom ▪ Ireland ▪ Estonia 	<ul style="list-style-type: none"> ▪ Introduce open and transparent immigration systems contingent on employment 	<ul style="list-style-type: none"> ▪ Sweden
		<ul style="list-style-type: none"> ▪ Attract immigrants by: <ul style="list-style-type: none"> – Implementing shortage lists that ease entry 	<ul style="list-style-type: none"> ▪ Sweden ▪ Denmark ▪ Germany
		<ul style="list-style-type: none"> – Establishing European welcome centres abroad 	<ul style="list-style-type: none"> ▪ United Kingdom
		<ul style="list-style-type: none"> – Creating a pan-European immigration portal (e.g., a single European online visa application) 	
		<ul style="list-style-type: none"> ▪ Increase education and integration opportunities (e.g., expansion of European Blue Card system, language courses) 	<ul style="list-style-type: none"> ▪ European Union ▪ Netherlands ▪ Germany
 Enhanced labour-market flexibility	<ul style="list-style-type: none"> ▪ United Kingdom ▪ Norway ▪ Hungary 	<ul style="list-style-type: none"> ▪ Reduce employment protection, wage rigidity, and labour taxes to incentivise hiring, particularly for younger workers 	<ul style="list-style-type: none"> ▪ Spain
		<ul style="list-style-type: none"> ▪ Adopt more assertive active labour-market policies at the expense of passive unemployment benefits (e.g., training, matching of job-seekers and vacancies) 	<ul style="list-style-type: none"> ▪ Germany ▪ Denmark
		<ul style="list-style-type: none"> ▪ Intensify efforts to make the single labour market work 	<ul style="list-style-type: none"> ▪ Germany ▪ Spain

SOURCE: McKinsey Global Institute analysis

Investing for the future

There are opportunities to prepare for the future and accelerate growth in five areas of reform and investment:

Europe spends only
2%
of GDP on R&D,
just ahead of China

■ **Nurturing ecosystem for innovation.** Europe is home to some of the most innovative countries and companies in the world but spends only 2 percent of GDP on research and development (R&D), just ahead of China, at 1.9 percent. In particular, Europe's private-sector R&D spending—at just 1.3 percent of GDP—lags behind that of South Korea (2.7 percent), Japan (2.6 percent), the United States (1.8 percent), and other countries. Analysing company-level R&D spending, we find that Europe's gap is concentrated solely in electronics, software, and Internet services. One of the more tangible ways Europe can encourage innovation is by using government procurement. This approach has a successful track record. One example is the way procurement by the US Department of Defense spurred the development of semiconductors. European governments spend more than 5 percent of GDP on procurement, compared with only 0.7 percent on public R&D and 0.1 percent on subsidies for private-sector R&D. Governments could also deepen the Single Market, set Europe-wide standards and regulations for transformational technologies such as autonomous vehicles and open data, unblock barriers to entrepreneurship, and accept “creative disruption”. Additionally, governments could support large-scale step-up of public co-financing of risk capital for new ventures, as France is attempting to do. This could help close the innovation gap with the United States, whose tech companies have dominated many of the coming disruptive technologies and explain the entire R&D spending gap between Europe and the United States.

74%
of educators say
they prepare
students for
work; only
35%
of employers agree

■ **Effective education to employment.** Educational attainment and examination scores vary widely within Europe. Youth unemployment has soared, hitting hardest those without a tertiary or vocational education. More needs to be done to prepare young people for the jobs companies need to fill. A McKinsey Center for Government survey found that 74 percent of educators say they are adequately preparing graduates for the workforce, but only 35 percent of employers and 38 percent of students agree.⁷ Some European countries have already defined leading practices in improving pathways from education to employment through increased transparency about what skills are needed and jobs are available, dual-apprenticeship models, improved selection and training of teachers, measurement and evaluation of schools, and putting in place forums to facilitate dialogue between employers and educators. European leaders could also encourage leading technology and industrial companies to co-create courses, curriculums, or “digital universities” to better prepare entrants into the labour market for the skills they will need in the future.

⁷ McKinsey surveyed 5,300 young people, 2,600 employers, and 700 education providers from eight EU countries (France, Germany, Greece, Italy, Portugal, Spain, Sweden, and the United Kingdom). See *Education to employment: Getting Europe's youth into work*, McKinsey Center for Government, January 2014.

Europe infrastructure spending is **0.3-0.9%** less than needed to support growth

- **Productive infrastructure investment.** Based on MGI's international database of infrastructure investment and our methodology for addressing need, we estimate that European investment in transport, power, water, and telecommunications infrastructure over the past decade has been 0.3 to 0.9 percent of GDP lower than needed to support the growth rates to which Europeans aspire.⁸ Public investment has on average declined since the crisis. Investment levels and the quality of infrastructure vary widely within Europe. Adjusted for income levels and growth rates, countries including Portugal and Spain have particularly good infrastructure but have also invested more than needed to support growth. France and Germany combine high quality with relatively low and declining investment rates. The United Kingdom has subpar quality and below-expected investment, while Italy scores low on quality despite high expenditure. The rate of investment needs to be optimised—which in most cases implies an increase—and alternative funding options outside the tax budget should be explored. But there is also at least as large an opportunity to spend more productively. MGI research has shown that countries could save as much as 40 percent on their infrastructure bills if they applied global best practice on project selection, delivery, asset management, governance, and finance. Even neighbouring European countries score very differently on these dimensions, suggesting ample opportunity to learn from one another.

- **Reduced energy burden.** Electricity and natural gas prices for European households increased by 70 and 160 percent, respectively, from 2004 to 2013 and are now around double those of the United States. While development of new supply sources is vital in the longer term, McKinsey analysis suggests that shale gas is likely to meet only a small proportion of European gas demand by 2030—and at a higher cost than in the United States. Energy prices are critical for energy-intensive industries such as metals, paper, and minerals, and the chemicals industry has already shifted a significant volume of investment from Europe to the United States. But it should also be noted that such sectors generate a relatively small share of European output and often can be traded only regionally, mitigating global cost pressure. Higher energy prices may even aid a shift towards higher value-added industries that are less energy-intensive. The broad imperative is therefore to use energy more productively and efficiently. Today, there is huge variation in the energy intensity of the household, transport, industry, and service sectors across Europe. Laggards can be five times as energy-intensive as leaders. There are European examples of success in promoting energy efficiency. Denmark did so through a concrete and coherent regulatory framework of energy-intensity standards. In parallel, Europe should lower energy costs by fully integrating electricity and gas networks and markets and by establishing a pan-European framework for increasing the supply of new energy sources, including renewables and unconventional hydrocarbons.

Only **61%** of Europe's population lives in a city

- **Supporting urban development.** Urban living is more productive than rural living, but only 61 percent of Europe's population lives in a city, compared with 65 percent in Canada, 81 percent in the United States, and 87 percent in South Korea. Within Europe, there is a difference of 30 percentage points between the most urbanised region (Continental Europe) and the least urbanised (Central and Eastern Europe).⁹ The urbanisation rate in the latter has been static for decades as urbanites have moved to more competitive cities such as London. While citizens should be free to choose where they want to live, and megacities (with populations of ten million or more) face particular challenges, there are barriers to rural-to-urban migration that should be removed. These include high levels of support per capita in rural areas through the Common Agricultural Policy and national transfer schemes, high housing costs in cities, and low satisfaction with urban infrastructure. Europe can more broadly apply funding approaches such as

⁸ For details of our methodology, see *Infrastructure productivity: How to save \$1 trillion a year*, McKinsey Global Institute and McKinsey Infrastructure Practice, January 2013.

⁹ MGI Cityscope database.

property-value capture, as Spain has done, to support urban redevelopment, including affordable housing and infrastructure expansion. Cities that are experiencing significant emigration need to up their game in competing for talent at the European and even global levels.

Boosting productivity

Three drivers could have a particularly strong positive impact on productivity growth:

250
collective-
management
organisations in
Europe for digital
content

- **Competitive and integrated markets in services and digital.** Accelerating productivity growth in the services sector could close much of Europe's productivity-growth gap with the United States. Streamlining product-market regulation in retail, construction, hospitality, and other largely non-tradable sectors is a key avenue for growth. The potential for regulatory simplification is considerable in countries such as the Czech Republic, which requires licenses—restricting market entry, reducing supply, and raising prices—for 395 professions compared with only 45 professions in Estonia. An equally important lever for enhancing competitiveness and productivity is further integrating markets through Europe's Single Market legislation. The EU legally established the Single Market in 1993, but the European Commission estimates that only 40 to 50 percent of the potential impact of the Services Directive has been realised because of poor implementation and enforcement of the rules. We find that in many cases, countries with the most infringements against the Services Directive between 2002 and 2012 also achieved the least productivity growth in services. In transport, there is scope to push the concept of a single European sky (coordinated air traffic management) and to increase cross-border connectivity and competition in rail as well as road haulage. Europe would benefit from an integrated pan-European digital market. Today, Europe's telecoms and digital infrastructure remains fragmented, with high price variations. There are 250 collective-management organisations in Europe for digital content, many with national monopolies in specific sectors. Further integration, including data and consumer protection rules, is needed.
- **Public-sector productivity.** The public sector in Europe accounts for 26 percent of the continent's GDP, with public transfers representing an additional 22 percent of GDP. The high GDP share of public spending appears increasingly problematic as Europe ages, and boosting the productivity of the public sector is therefore paramount. It is hard to measure the output and productivity of the public sector, but one UK measure suggests that productivity was static between 2000 and 2009 while private-sector productivity increased at 1.4 percent a year. Governments could improve public-sector productivity by redoubling efforts to improve its measurement, creating competitive conditions in the provision of services where possible (including through the judicious use of outsourcing), and increasing transparency and tracking performance to reinforce accountability internally and vis-à-vis citizens. Joint purchasing and pooling of resources at the European level—in defence, for instance—could also substantially reduce costs. Public-sector leaders should also embrace new technologies and trends that have the potential to improve productivity and effectiveness further, such as implementing big and open data systems as a part of e-government efforts.
- **Further openness to trade.** Europe is the world's largest exporting region. Excluding intra-European trade flows, the EU's share in global flows in goods and commercial services was 13 percent in 2012, higher than the share of China, Japan, or the United States. Continental Europe drives the EU's impressive overall trade performance. While trade profiles across European regions vary, the continent has a particularly strong showing in knowledge-intensive manufacturing and services. The rising prominence of emerging markets in global trade is a formidable opportunity for European businesses to grow and for consumers to access less expensive labour-intensive goods and services. Europe could agree to robust trade agreements with the expected growth engines of

Europe's public
sector accounts for

26%
of GDP

China, India, and the United States. It also could further expand an already efficient trade logistics ecosystem, and set up trade support networks similar to Germany's chambers of commerce in export destination countries, while offsetting any adverse effects from trade.

Mobilising the workforce

Ageing can erode the available labour pool, and therefore three drivers designed to mobilise workers will grow in importance:

Only
35%
of 55–74 age
group economically
active in 2013

- **Grey and female labour-force participation.** Participation in the European labour force by women aged 25 to 54 has increased from less than 50 percent four decades ago to 79 percent today, higher than the 74 percent in the United States. But there is scope for some countries to do more. Female participation in Italy and Greece is lower than the European average. Germany and the Netherlands have high participation rates, but women in these countries tend to work far fewer hours than men. Social support through harmonised maternity and paternity leave, child-care provision, and equal treatment in the tax system can boost female participation. There is also an opportunity to boost participation among older, or “grey”, workers in Europe as a whole. In 2013, only 35 percent of those aged 55 to 74 were economically active. Life expectancy has increased by more than nine years since 1970, but the average effective male retirement age has fallen by six years over the same period. Approaches to boost grey participation include the removal of incentives not to work by, for instance, eliminating the statutory retirement age as the United Kingdom has done, and the expansion of lifelong learning and retraining opportunities.
- **Pro-growth immigration.** Immigration can be a contentious political issue, but viewing policy on immigration—particularly from outside Europe—through a pro-growth lens can have significant economic benefits. Such immigration can drive growth by expanding the workforce, increase demand and investment as more people need housing or local services, contribute to more sustainable debt levels as debt is carried on more shoulders, and reduce some of the pressure from ageing because immigrants tend to be younger and within prime working ages.¹⁰ In countries where immigrants tend to be lower skilled, however, unemployment rates can be more than twice as high among immigrants as among natives. If Europe boosted its net extra-European migration rate from 2.6 people per 1,000 inhabitants per year to 4.9 people, it could compensate for the projected 11 million drop in the working-age population, as conventionally defined, to 2025. Within Europe, Belgium, Norway, and Sweden already have comparably high levels of net migration from outside Europe. To achieve higher immigration of people with needed skills across Europe, countries could introduce open and transparent immigration systems contingent on employment (as Sweden has done), use shortage lists (as Germany does), set up welcome centres abroad to attract skilled immigrants, and create a pan-European immigration portal, while enhancing education and integration of newcomers.
- **Enhanced labour-market flexibility.** The share of people of working age employed in Europe was 64 percent in 2013, below the average of Organisation for Economic Co-operation and Development (OECD) advanced economies. Forty-three percent of young Europeans aged 15 to 24 are on temporary contracts. Labour mobility among European countries is only one-fourth to one-sixth of the mobility between, for instance, German Länder or between US states. Yet a number of European economies have successfully reformed their labour markets over the past decade and, as a result, reduced

¹⁰ In the long term, only keeping people economically active for longer can sustainably stabilise dependency rates; life expectancy and the number of old people will continue to grow, but countries may not want to expand their populations indefinitely and at increasing rates.

unemployment or increased the employed share of people of working age in other ways. Initiatives to drive impact might include a reduction in employment protection, where it seems excessive, as well as in labour taxes to incentivise hiring, particularly in the case of younger workers (Spain used both levers in its labour-market reform), adopting more assertive active labour-market policies at the expense of passive benefits (as in Denmark's "flexicurity" model), or making wage-bargaining mechanisms more flexible. Europe should also intensify efforts to make the single labour market work in reality.

In aggregate, the growth drivers would boost Europe's competitiveness in light of future trends and developments. In a world where global competition and the pace of innovation are accelerating, Europe must take advantage of the opportunities offered by the growth drivers to stay ahead. Nurturing an ecosystem for innovation, creating a single digital market, and ensuring effective education-to-employment pathways will all help Europe to ride the wave of new technologies such as next-generation genomics, advanced materials, and Industry 4.0. Europe can overcome such challenges as a shrinking workforce, the obesity epidemic, and spiralling health-care costs by focusing on grey and female labour-force participation, taking a pro-growth view of immigration policy, and boosting public-sector productivity. Resource (including energy) scarcity, climate change, and new geopolitical risks can be addressed in part by investing in a pan-European energy strategy, productive infrastructure, and further openness to trade, and by improving the competitiveness of the continent's cities.

In a world where global competition and the pace of innovation are accelerating, Europe must take advantage of the opportunities offered by the growth drivers to stay ahead.

Europe can reignite investment and job creation in several ways

A programme of structural reform based on the 11 growth drivers would profoundly change the way the European economy works, creating a platform for higher competitiveness and productivity in the long term. However, such a programme would require substantial investment as well as stronger investment and job creation as the economy rebalances. But investment and job creation across all domestic sectors of the economy remain weak. Many proposals for how to unleash investment and job creation have been floated, though discussions have narrowly focused on the traditional prescription of fiscal stimulus, which is difficult in the European institutional setup, and QE, which has its limits as a source of stimulation because liquidity has been largely restored and demand for credit remains anaemic despite the fact that interest rates are still ultra-low. Now is the time for Europe to consider all feasible options.

Europe can take encouragement from the fact that much has already been achieved—or proposed—to stabilise the economy and fortify the Eurozone against future shocks. The ECB has introduced new monetary instruments including QE, purchases of asset-backed securities, and the Targeted Longer-Term Refinancing Operations (TLTRO) programme for small and medium-sized enterprises (SMEs). The European Banking Union centralises banking regulation and supervision. The European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) have supported countries with challenging debt situations while pushing for structural reforms. The capital markets union initiative aims to reduce dependency on bank funding and foster growth through increased risk sharing and equity investments. In addition, the European Fund for Strategic Investments—also

known as the “Juncker Plan”—was created with the aim to provide additional funding of, fully leveraged, about €315 billion for infrastructure, energy, and job creation.

Successful reform requires productive investment and demand for jobs—and vice versa—but a gap in demand persists across all sectors of the domestic economy

Growth
drivers need
**1.7-
3.7%**
extra spending

The competitiveness growth drivers cannot be put into practice in an environment of retrenchment and depressed investment and job creation. We estimate that the growth drivers that invest for the future require additional spending of between 1.7 percent and 3.7 percent of European GDP for higher infrastructure investments, more R&D, better education, and quality affordable housing in growing cities. The growth drivers that relate to boosting productivity involve difficult transitions as economies rebalance and companies and public organisations restructure. Such transitions are difficult even in benign phases of an economic cycle and are all but politically impossible when those who may lose their jobs in the process will have trouble finding another one. The third type of growth driver—those that mobilise the workforce—will also be difficult while slack persists in the economy and unemployment remains stubbornly high.

We should note that some of the featured reforms could trigger private investment and therefore stimulate investment and job creation. For instance, greater immigration may require investment in housing and create opportunities for retailers and other local service firms. Progress on building a single market in energy or telecoms and clarity on regulation in those sectors can unleash investment in infrastructure.

Depressed demand in Europe has resulted in an output gap that the European Commission, the International Monetary Fund (IMF), and the OECD estimate is between 2.4 percent and 2.7 percent of GDP compared with current potential output. Output is still 15 percent below where it would have been if pre-crisis trends had continued. While different economic schools of thought try to describe the situation, and the neoclassical view would negate the need for action, our analysis suggests that without measures to shore up investment and job creation, a strong recovery seems difficult at best and Europe’s debt problem will only worsen.

In an often turbulent global economy, Europe thus far has relied solely on exports to drive the recovery. Net exports have performed strongly since the crisis, and the current-account balance has improved by about three percentage points of GDP since 2008. However, questions linger over how much more improvement there will be in the context of a fragile global economy.

While each sector is acting rationally, the collective result is insufficient investment and job creation.

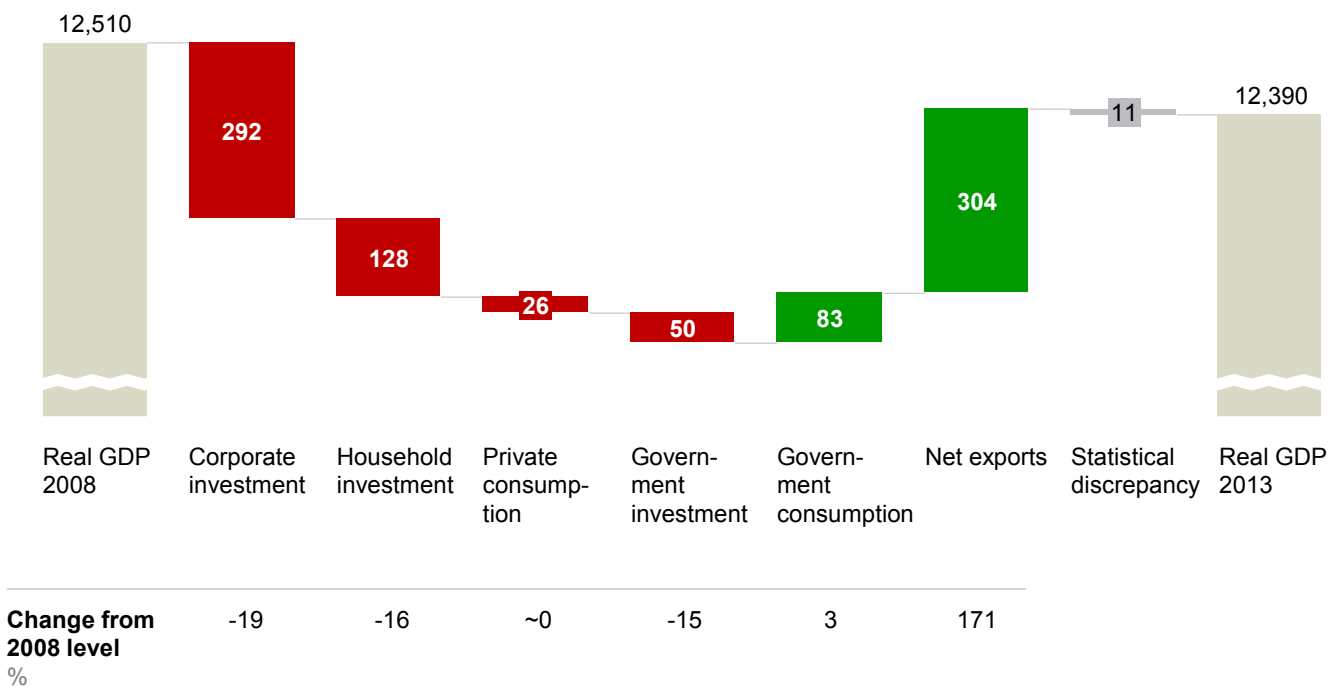
Other sources of demand remain anaemic. Households are attempting to deleverage, companies are piling up cash because they perceive the macroeconomic outlook to be so uncertain, and the public sector is engaged in austerity programmes to keep debt levels under control. While each sector is acting rationally, the collective result is insufficient investment and job creation (Exhibit 13).

Exhibit 13

Europe has thus far relied solely on exports to drive its recovery despite a weak global economy

Europe-30 change in real GDP, 2008–13

€ billion, chain-linked volumes, reference year 2005 (at 2005 exchange rates)



1 No split of investment (gross capital formation) by source in Eurostat; government/household/corporate split from European Commission AMECO database applied to Eurostat total investment figures.
NOTE: Numbers may not sum due to rounding.

SOURCE: Eurostat; AMECO database; McKinsey Global Institute analysis

Households have been trying to repair their balance sheets but have made very little progress. By the first quarter of 2014, after nearly 20 quarters of deleveraging, household debt was at virtually the same level as during the 2008 Lehman Brothers crisis. Savings rates have stabilised at around 11 percent of GDP, while the rate of household investment as a proportion of disposable income has declined by more than one-quarter since its pre-crisis peak. Private consumption has been stagnant for five years.

67%
of business leaders cite weak demand as primary barrier to investment

Corporations are stockpiling record amounts of cash because they are not confident about the demand outlook. Corporate deleveraging is ongoing. Non-financial corporate debt as a share of GDP has fallen six percentage points since its peak but is still 16 points above 2005 levels. Annual corporate investment is €290 billion lower than it was on average before the crisis. Excess cash holdings have increased by 60 percent since the crisis, to nearly €800 billion for Europe’s 500 largest companies. While there are some pockets of financing constraints—between 20 percent and 30 percent of small and medium-sized enterprises in southern Eurozone countries cite finance as a key constraint—67 percent of business leaders interviewed by the Association for Financial Markets in Europe cite the weak demand outlook as the primary barrier to investment. Historically, corporate investment has tended to follow recoveries rather than lead them (Exhibit 14).

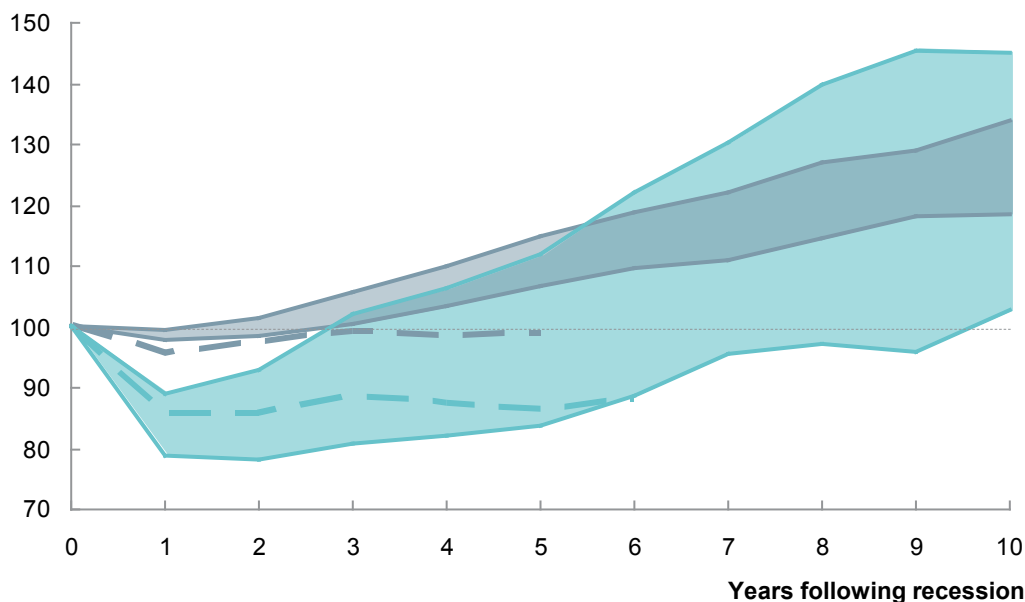
Exhibit 14

Private investment typically recovers with a lag compared with the overall economy

Private investment and GDP indexed to 100 in the year prior to each recession identified¹

— — Current crisis ■ GDP middle quartiles ■ Private investment middle quartiles

Index: 100 = peak real GDP prior to recession



¹ Episodes in which private investment fell at least 10% from GDP peak to GDP trough, excluding 17 episodes when private investment fell by less than 10%. All values in year zero are equal to 100 since private investment is indexed to 100 in that year.

NOTE: Data for 2014 not yet available for real GDP.

SOURCE: *Investing in growth: Europe's next challenge*, McKinsey Global Institute, December 2012; McKinsey Global Institute analysis

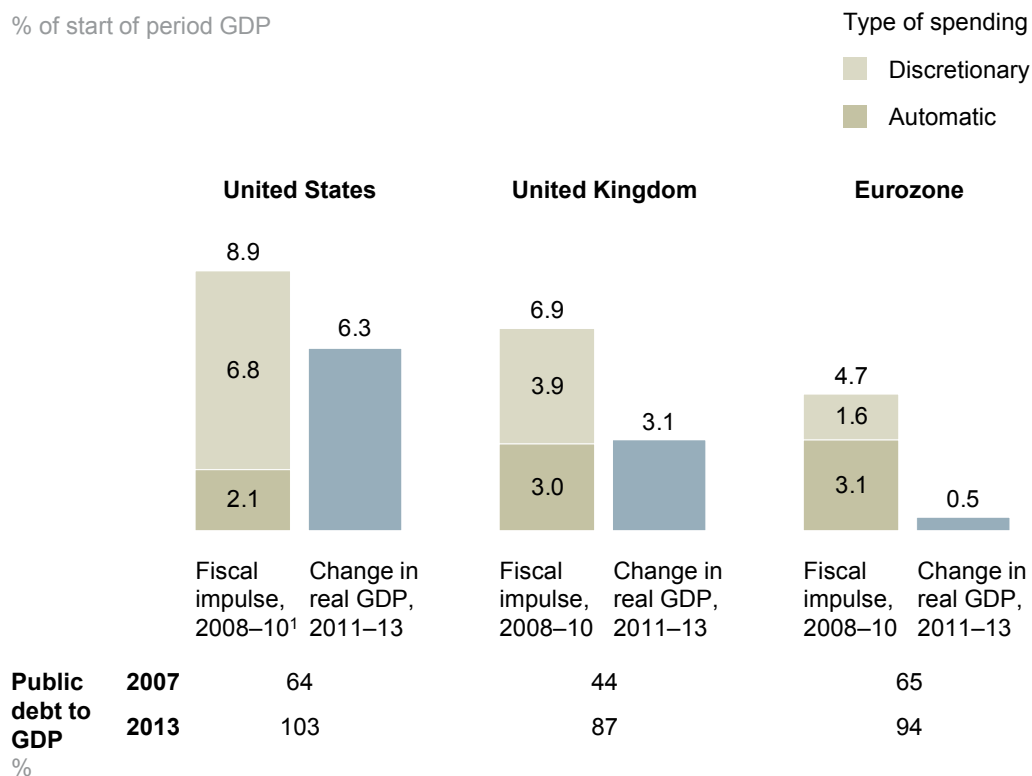
4.7%
of GDP, European
fiscal stimulus
2008–10

The public sector has embarked on austerity policies to keep debt levels under control. Gross sovereign debt levels remain very high in some economies—near or above 100 percent in all Southern European economies except Malta.¹¹ In the Eurozone, the stimulus that came from accommodative fiscal policy peaked during the immediate crisis period of 2008 to 2010 with a cumulative expansion of 4.7 percent of GDP. Between 2011 and 2013, government spending contracted by more than 3 percent of GDP in aggregate, and the fiscal stance shifted towards spending on past obligations rather than future investment. The stimulus undertaken by the United States (and the United Kingdom) took a different course. The United States expanded its deficit more decisively, by close to nine percentage points of GDP between 2008 and 2010—nearly three-quarters of which was discretionary spending rather than automatic stabilisers—and cut back much more sharply afterwards. In fact, many economists argue that this scaling back of spending due to sequestration was too sharp. Even using conservative estimates of multipliers during recessions and during an upswing, this goes some way towards explaining difference in growth between Europe and the United States (Exhibit 15). From 2007 to 2013, the cumulative general government deficit in the United States was more than 30 percentage points of GDP higher than in the Eurozone, but levels of public debt to GDP increased by only ten percentage points more than those in the Eurozone as growth and inflation were higher.

¹¹ We use gross public debt as the most widely used measure, but we recognise that it is only a weak indicator of debt sustainability unless looked at in conjunction with hidden liabilities such as pensions, public assets, and the ability to generate a primary surplus.

Exhibit 15

The Eurozone gave a comparatively small fiscal stimulus after the crisis and experienced a slow recovery



¹ Fiscal impulse is defined as the negative change in the fiscal balance; general government spending.
NOTE: Numbers may not sum due to rounding.

SOURCE: Eurostat; AMECO; IMF; FRED; McKinsey Global Institute analysis

Not only was fiscal policy more aggressive and better timed in the United States, but so were monetary policy and the clean-up of banks because in order to progress the latter, Europe first had to build new institutions and reach multilateral agreements. This can partly explain why demand has been slower to recover in Europe than in the United States.

Of course, Europe is not a monolith, and the demand situation varies widely. Among the largest economies, Germany did not experience a housing bubble and is arguably operating at capacity. Spain and the United Kingdom have experienced a sharp end to previous credit bubbles; in both economies, household and corporate debt ballooned before the crisis. Now, as they deleverage, their investment is sharply down. While the United Kingdom has restored growth and largely closed its output gap, Spain still faces a gap of at least 5 percent of GDP. In France and Italy, investment held steadier after a more moderate increase in debt from lower starting levels. Both countries embarked on a major fiscal contraction after the crisis to get high debt and deficit levels back under control, although deficits remain above pre-crisis levels. The divergence between countries now largely reflects imbalances in the Eurozone that built up prior to the crisis.

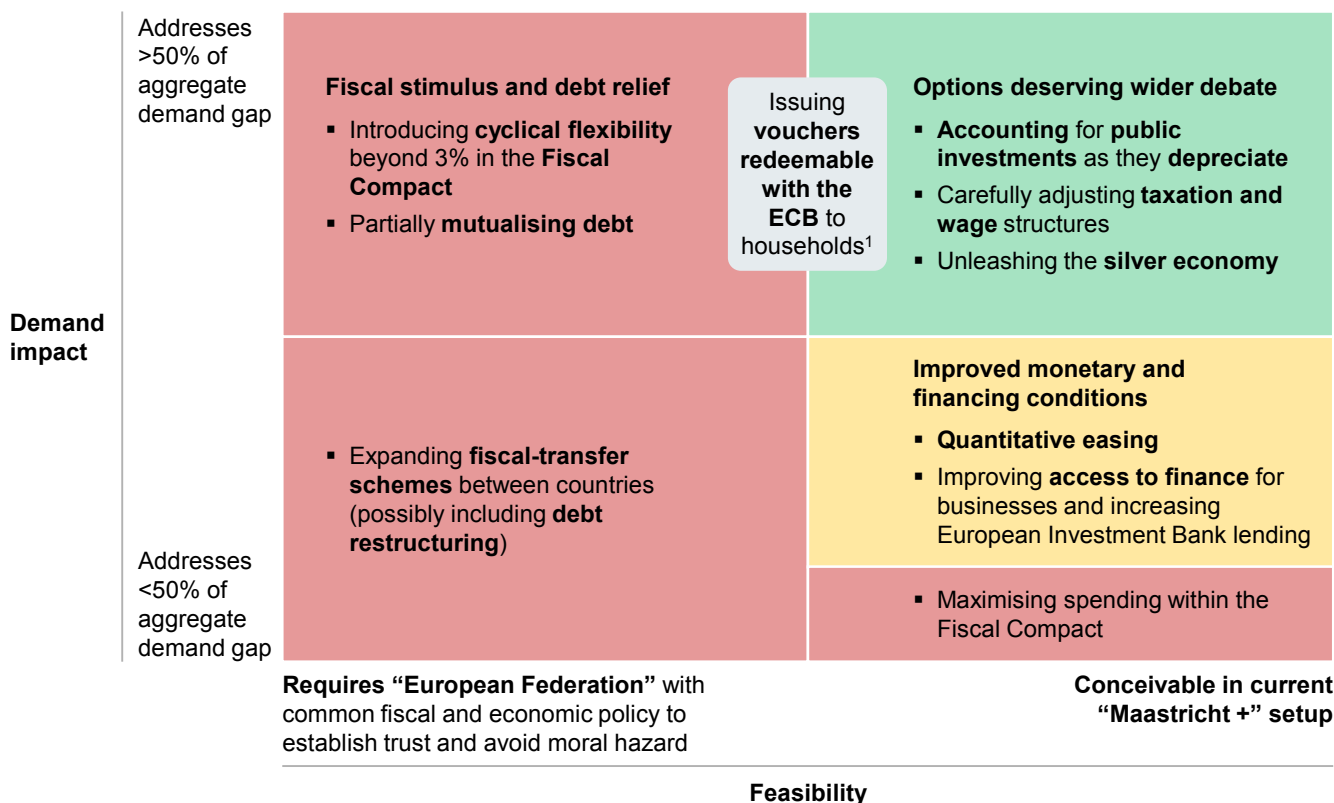
In the Eurozone, the traditional prescription of fiscal stimulus and debt relief cannot be easily replicated

Europe has a menu of options at its disposal for shoring up demand from corporations, the public sector, and households (Exhibit 16). All options for stimulating investment and job creation entail risk and may have possibly unintended, often distributional, consequences that require careful consideration. Nevertheless, relying solely on a further increase in net exports as the way to close Europe’s demand gap is also risky—at best.

Exhibit 16

A menu of investment and job creation options can complement structural reform even outside a federal setup

Prerequisites for all options: Progress on competitiveness and growth drivers and structural reform



1 Debate persists over whether this option would constitute hidden fiscal policy.

NOTE: There is a neoclassical school of thought that argues that structural reform is enough; however, our analyses clearly indicate a structural weakness in demand across all sectors of the economy in line with the balance sheet recession or liquidity trap school of thought.

SOURCE: McKinsey Global Institute analysis

Independent fiscal regimes in a currency union require either stringent rules to control deficits or credible no-bailout commitments to avoid requiring some countries to pay the bill for high deficits in another country. While the Maastricht treaty contains both elements, the crisis demonstrated that neither was strong enough. Government leaders took bold action and agreed on the Fiscal Compact. While this compact has been criticised for compounding the shortage in aggregate demand, it was a step towards a stronger long-term Eurozone framework and helped enable bolder central-bank action.

Given this institutional setup, the traditional prescription of fiscal stimulus cannot be easily replicated in Europe. Its impact would be either too small without further measures or politically unviable without moving to an integrated economic and fiscal policy in Europe:

- **Maximising spending within the Fiscal Compact** would allow around €50 billion of additional annual fiscal expenditure, almost €40 billion of which would come from the German government. However, Germany does not have a significant output gap, and the impact of that spending on Southern European economies facing the largest shortages in demand is unclear given that their exports to Germany account for only 2.4 percent of Southern European GDP.
- **Introducing cyclical flexibility within the Fiscal Compact** would help but is hardly conceivable in the current Eurozone setup. Throughout the recession, incremental government spending, also known as the fiscal impulse, in Europe has been substantially below that of the United States. This may explain at least part of the difference in real GDP growth between the two regions. If Europe implemented a one-time fiscal impulse of 2.2 percent of GDP, the impact on the size of the output gap would be dramatic. A rough estimate suggests a maximum impact in the order of €440 billion including fiscal multipliers. A government that is willing to rewrite the rules when it is convenient, even for a short time, might be expected by markets to do so again. As such, a change to fiscal rules to allow more spending for only a short time might be treated by the markets similarly to how they would treat a long-term change. This would effectively require Europe to mutualise the debt of the more indebted and currently economically weaker nations and move to a more federal setup to avoid the moral hazard associated with that.
- **Partially mutualising debt** to support further borrowing in the economies facing the most challenging conditions would require strong governance and significantly greater economic and fiscal integration to avoid moral hazard. But if such integration were to develop, it would yield tangible benefits. Estimates of the cost of borrowing for common-issuance European bonds range between 10 and 60 basis points higher than the German rate, but lower than the average rate across Europe. Based on 2013 borrowing rates and taking the interest rate on ten-year government bonds as representative, this would have saved governments between €6.4 billion and €8.5 billion every year over the life of the bonds issued that year alone—although some (such as Germany) would have had to pay more. Additionally, other proposals that could be viable outside of a federal setup exist, such as debt redemption funds, or mutualising debt only up to 60 percent of GDP.
- **Expanding fiscal transfer schemes between countries** to close the output gap has been rightly ruled out unless the Eurozone turns into a full federation. As it stands, the mean absolute contribution of EU member states is 1.6 percent of European GDP. The rate at which transfers flow from economically stronger to weaker countries is about one-fifth the level in the United States, where transfers between states are equivalent to 8.4 percent of US GDP. Such transfers act more counter-cyclically than they do in Europe. It is notable that Europe lacks EU-wide unemployment insurance, EU-wide defence spending, and European-level tax income.

€40B-
60B

potential effect
from pan-European
unemployment
scheme

A pan-European unemployment scheme could stimulate investment and job creation by €40 billion to €60 billion a year via the higher demand multipliers in countries with high output gaps compared with those operating at capacity. Almost ten times that effect would be conceivable if transfers were increased to US levels. Extraordinary one-off transfers, such as sovereign debt restructuring in exchange for reforms, could also be explored in a European federation.

Improved monetary and financing conditions will help but may prove insufficient on their own

The evidence suggests that accommodative monetary policy—traditional or non-traditional—is beneficial to the European economy during a period of stagnation, but that, by itself, cannot fully resolve Europe’s shortage of investment and job creation. Low inflation keeps real interest rates fairly high, and companies continue to hold cash despite ultra-low nominal rates as they rarely adjust their hurdle rates and the macroeconomic outlook remains fragile.

- **QE**, the purchase of securities in the open market against central-bank reserves, has several transmission channels to the real economy—many of which seem more muted in the Eurozone than in the United States. First and foremost, QE can resolve a liquidity crisis, but liquidity in Europe has largely been restored, and credit is constrained only in pockets of the economy. Second, QE can enable higher fiscal spending. Indeed, it does enable some flexibility via the central bank’s profit remittances back to governments on those securities held by the ECB, but beyond that, despite record-low interest rates, Eurozone governments are cutting expenditure and borrowing to move towards compliance with the Fiscal Compact. Third, QE may support household spending by lowering interest expenditure and shoring up asset prices. But with Europeans’ affinity for bank deposits, higher asset prices would affect those in the population with the lowest propensity to spend, and lower interest rates would also be reflected in bank deposit rates, potentially dampening spending in Germany, France, and other countries where liquid asset holdings exceed household debt. Fourth, in the corporate sector, interest rate reductions do not seem to be an important factor in corporate investment decisions as hurdle rates are rarely adjusted and the demand outlook remains weak. Finally, QE may help lower the exchange rate of the euro and support net exports; at the time of writing, there are signs that this is happening. But in the absence of complementary fiscal measures, the jury is out on the effect of the QE programme announced by the ECB in January 2015. And keeping long-term interest rates low can have devastating effects on pension funds and life insurance companies, as well as significant distributional consequences.
- **Improved access to financing for companies** could have a significant impact, but it is unlikely to be on the scale needed to close the aggregate demand gap. We estimate that such improved access could add between €6 billion and €23 billion to demand if all SMEs were able to access financing with the same ease as those in Germany. Tools might include a faster clean-up of bank balance sheets, completing a banking union and launching a capital markets union, freeing up bank capital for lending via securitisation, preferential regulatory treatment of SME lending, and developing non-bank sources of funding, such as venture capital and private placements. In this vein, the capital markets union proposed by the EU in February 2015 also aims to harmonise regulations and legislation governing securities, taxation, and insolvency and investor protection. Particularly for Southern European companies that face the most difficult financing challenges, as well as for financial stability more broadly, implementation of the EU banking union and a move towards a capital markets union would be helpful.

Increased lending by the European Investment Bank (EIB), enabled by government capital contributions outside the Fiscal Compact or through ECB purchases of EIB debt, could help to advance infrastructure and other projects that are facing capital constraints. The effects will be contingent, however, on finding ways to structure additional projects that become economically viable through reduced cost of capital.

New options should be debated to widen the range of potential solutions

The debate on measures to stimulate investment and job creation—focused on QE and the appropriate degree of retrenchment in countries' budget deficits—has become stale. New ideas that open up new possibilities deserve more debate:

Public investment collapsed to

0.2%
of GDP

European household net assets are

135%
of GDP

- **Accounting for public investments as they depreciate**, rather than during capital formation, is one option worth exploring. Public net investment collapsed to a mere 0.2 percent of GDP in 2013, while real public consumption has increased since the crisis. A change in public-accounting standards could change the bias against investment and unlock up to €140 billion a year in productive spending while increasing the pressure to contain public consumption. Governments would need to take a balance sheet approach to accounting—as private-sector corporations do—that treats investment as assets and accounts for depreciation of these assets only over time for the annual deficit. As with the private sector, there would need to be impairment tests for these assets to contain unproductive spending.
- **Carefully adjusting taxation and wage structures** has the potential to redirect resources to households with the greatest pent-up demand. The marginal propensity of higher-net-worth households to consume is only about one-third that of lower-wealth households, and capital income is less likely to be spent than labour income. But the labour share of national income has declined, and wealth concentration has increased. Options include the reduction of labour tax wedges, favourable wage rounds in the Eurozone “core” countries, and judicious land, property, wealth, and capital-gains taxation. For all the current discussion about the high levels of household debt and slow deleveraging, the fact remains that the value of European households' net financial assets is approximately 135 percent of GDP.

As a first approximation, MGI estimates that a redistribution equivalent to 1 percent of GDP could trigger additional spending of around €200 billion. Policy design and great care are critical: a poorly conceived measure could indeed harm growth by promoting capital flight or a decline in investment.

- **Unleashing the “silver” economy** is another opportunity. In the Eurozone, those aged 55 and older make up only around 45 percent of households but hold almost 60 percent of household wealth. They typically have stronger balance sheets than younger generations, having saved at an increasing rate throughout their prime working years and having benefited from favourable asset-price developments in the decades prior to the crisis. Encouraging increased spending of this demographic's accumulated wealth could be a significant lever for boosting investment and job creation, as could incentives for wealth transfer to younger generations. As an example, Japan, which has one of the oldest populations in the world, has recently changed its taxation policies to incentivize the transfer of accumulated savings from seniors to their descendants, and increased inheritance taxes to increase the redistribution of wealth.

Unlocking just 1 percent of the silver age group's saved wealth as new consumption could offer a stimulus to the European economy of approximately 0.3 to 0.6 percent of GDP. With its excellent health-care system, its innumerable and highly developed tourism destinations, and strong cultural heritage, Europe is well placed to take advantage of the silver economy.

Crediting households with
€5,000
each could close the output gap

- **Issuing vouchers to households redeemable with the ECB** could stimulate incremental spending, accelerate household deleveraging, and raise inflation closer to the ECB's target level of 2 percent. The central bank would effectively credit households with a certain amount of money through time-limited spending vouchers, redeemable with the central bank. This would be the equivalent of printing money but would ensure that the newly minted money was used for spending in the near term. An equitable distribution of vouchers across the Eurozone would avoid the need for lengthy discussions about redistribution between countries, moral hazard, or implicit liabilities. MGI's first-order estimate is that crediting citizens with around €650 billion, or around €5,000 per Eurozone household, through such an approach could close the demand gap in Europe.

This idea is bold and is likely to have considerable impact, but it is also a risky concept. Possibly the largest potential risk is a backlash from the financial markets and an erosion of citizens' trust in the common currency. While people are concerned about the inflationary effects of such an approach, escaping deflation and restoring an inflation rate close to the ECB's mandate would be the explicit goal of the policy. As such, it may also be within the ECB's mandate, although this position could be challenged and the initiative regarded as a hidden form of fiscal policy. The target inflation rate could be kept under control because directly crediting households minimises the money multiplier effect, and the balance sheet expansion for a given increase in aggregate demand would likely be smaller than is the case with QE. Some commentators are concerned about setting a precedent for future calls on the ECB to print money repeatedly. However, as long as its independence is assured, the central bank could print money only if the other monetary-policy tools at its disposal failed to satisfy its mandate.

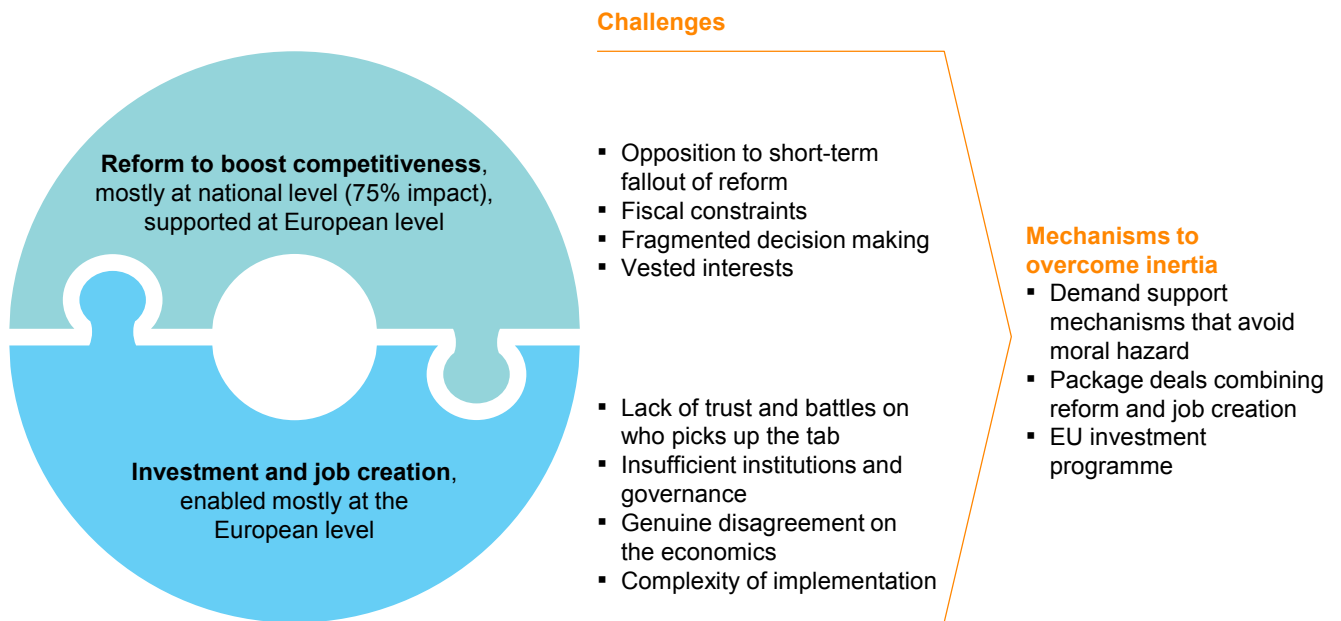
Europe can overcome barriers to action and develop a positive narrative

Europe has significant challenges to overcome. On the structural side, there will be opposition to the short-term effects of reform, significant fiscal constraints, and the ever-present issues of fragmented decision making and strong vested interests. For stimulating investment and job creation, huge issues of trust and questions of governance must be worked through, along with genuine disagreement over the right economic path. But these challenges can be overcome if Europe's leaders take the opportunity to build on popular sentiment and work towards packaged deals that combine reform and job creation, leverage existing EU investment programmes, and strengthen key institutions to avoid moral hazard (Exhibit 17).

The stakes are high. We broadly see four possible futures for Europe, and only if the stalemate of reform vs. stimulus can be overcome is greater prosperity highly probable (Exhibit 18). A programme of investment and job creation without any structural reform could all too easily prove a "shot in the arm", resulting in a boost to growth in the short term but possibly precipitating another financial crisis as capital markets take fright at the sustainability of some countries' debt burdens. Meanwhile, structural reform without any investment and job creation support is likely to prove deflationary and politically risky, with high unemployment, increasing political instability, and even, potentially, the break-up of the Eurozone. Only moving in lockstep on national-level reform and reigniting investment and job creation (enabled at the European level) can lead Europe out of the current gridlock and return the continent to a sustained growth rate of 2 to 3 percent a year.

Exhibit 17

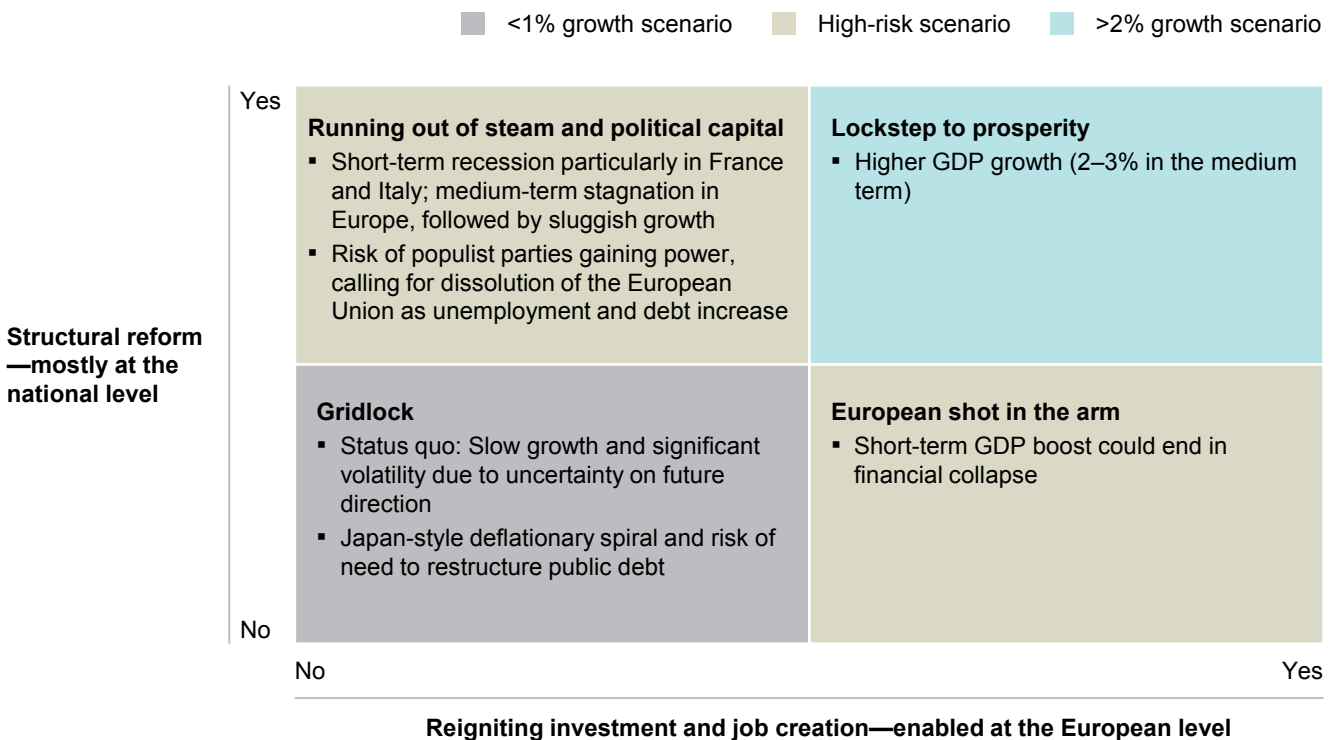
Europe will need to work in tandem on reform and support for investment and job creation



SOURCE: McKinsey Global Institute analysis

Exhibit 18

MGI has identified four potential scenarios for Europe—only reform, investment, and job creation combined will deliver prosperity



SOURCE: McKinsey Global Institute analysis

It is understandable that people living in areas that have felt relatively less economic pressure feel a weaker imperative to act beyond a broad sense of solidarity and that these people regard the burden of resuming growth as lying squarely on the shoulders of more affected regions. But the reality is that all European countries have specific needs for reform (Exhibit 19). All European economies have been through periods of both strength and weakness.

The economic future of the continent depends on whether it moves forward on broad-ranging reform on the supply side, backed by decisive action on investment and job creation. The question is whether—and how—Europe now moves forward on this sweeping agenda. This analysis suggests several powerful sources of optimism.

Exhibit 19

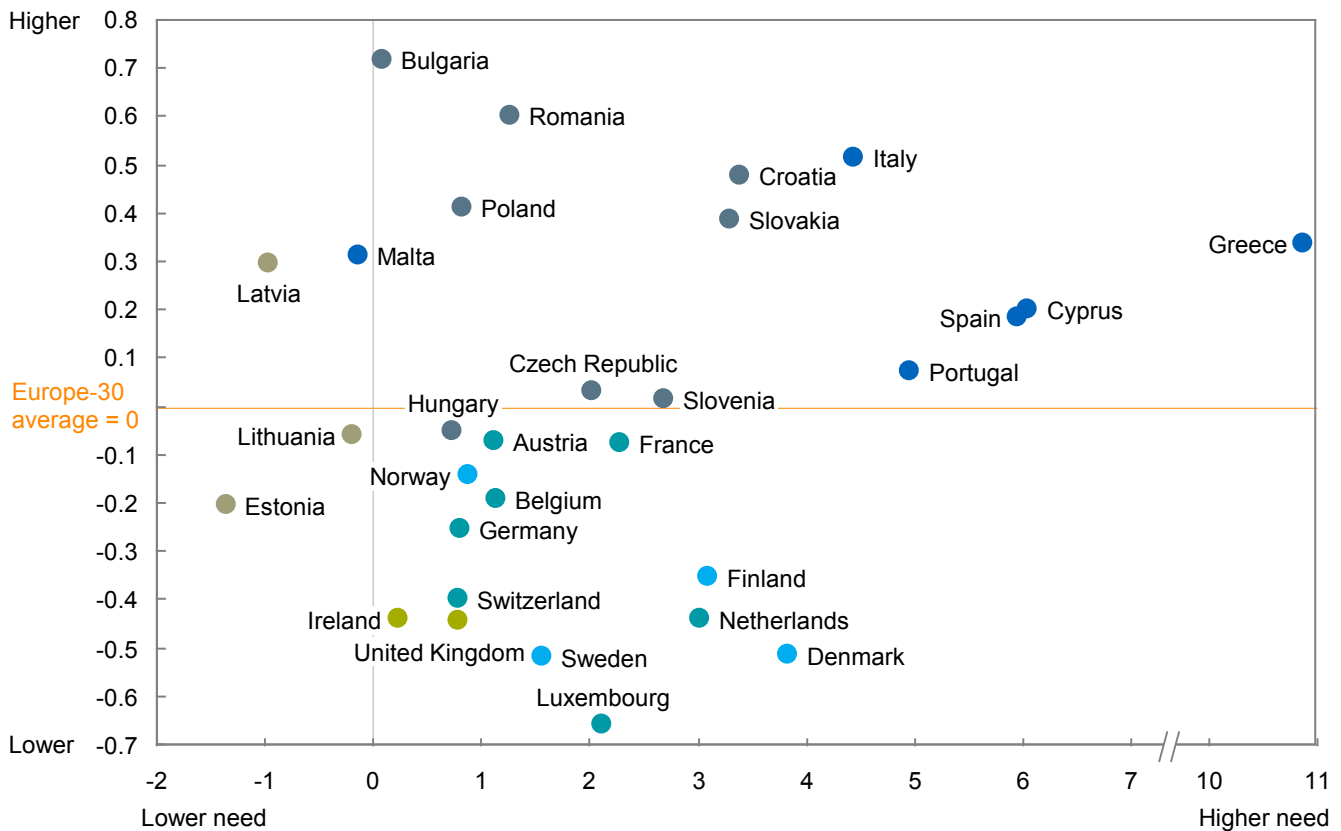
Each country has different relative priorities for structural reform and investment and job creation measures

Relative importance of structural reforms and demand-side measures

- Nordics
- Continental Europe
- United Kingdom and Ireland
- Southern Europe
- Baltics
- Central and Eastern Europe

Need for structural reform

Inverse average country z-score for competitiveness growth drivers



Need for investment and job creation
Output gap (inverse) as % of GDP¹

¹ Positive values indicate an economy running below potential.

SOURCE: European Commission; McKinsey Global Institute analysis

Opposition to structural reform can largely be tackled at the national level alongside European action to boost investment and job creation

There are many institutional and political barriers to implementing competitiveness reforms that political leaders need to tackle. Some of them, like immigration, are unpopular; some, like infrastructure, require considerable time to reap the rewards; and others are subject to disagreement among experts, like the nuance on how best to improve outcomes. Flexible labour markets or openness to trade face resistance from groups with vested interests. Budget limitations stand in the way of improved education. However, Europe's recent history shows that, by building appetite for change, demonstrable commitment from governments, and the careful management of interest groups, reform at the national level is possible and has proved transformative.

The fact that three-quarters of the competitiveness growth drivers discussed in this report can be implemented by national governments is an important key to unlocking change—and best practice already exists across Europe. Nevertheless, meaningful progress on accelerating reform will require visionary political leadership and, importantly, as we have stressed, simultaneous consensus and action at the European level to shore up investment and job creation.

There are ways to unlock European action on investment and job creation despite governance, moral hazard, and distributional issues

Agreeing to measures to stimulate investment and job creation at the European level is difficult—as we know from the fact that debate on the best path forward has been going on for six years. Most of the barriers relate to governance and a lack of trust among European partners and a fear of creating moral hazard. However, most of these issues can be overcome within Europe's—specifically the Eurozone's—current institutional framework. Without moving to a full federal system of economic and fiscal governance, there is scope to use levers that don't cause moral hazard and to design “package” deals in which national-level supply-side reform is coupled with European action on investment and job creation. It is in the interests of all to move forward given the strong economic ties that bind all parts of Europe together.

Measures to stimulate investment and job creation face many tangible barriers. Many measures, including debt restructuring and transfer payments, have explicit distributional consequences. In some cases, there is genuine disagreement about the economics and the most effective path ahead. Examples where there is disagreement include the capacity of economies to raise more public debt and whether crisis economies are sufficiently small and open to export their way out of recession. There are formidable institutional barriers, too. National leaders and sometimes their parliaments and even the constitutional courts of the 28 EU member states need to agree on the path ahead. The ECB has a mandate to control Eurozone inflation but not to target employment as the US Federal Reserve does. In the long term, Eurozone economies, in particular, need to address even more fundamental questions about the institutional design of economic and fiscal governance.

In the absence of a move towards greater fiscal and economic integration, designing stimulus packages in a way that minimises moral hazard has to be an important part of the mix. Changes in national accounting rules, or adjustment of taxation structures, could be as viable as elevating large-scale investment programmes to the European level. Ideally, the types of investments selected would be large scale, and in the interest of all Europeans, such as in developing pan-European energy grids and production facilities, upgrading the continent's security and defence capabilities, or creating multinational R&D and education programmes.

Crafting package deals of measures designed to boost competitiveness and stimulate investment and job creation may serve as a viable approach, too. We have already seen agreements that combine action on the supply side—a commitment to detailed reform—with financial support for those economies that were bailed out by the ECB, the European Commission, and the IMF. There could now be scope for other economies, including large ones that have not been subject to such bailout conditions, to make a commitment to comprehensive reform in exchange for decisive action at the European level to reignite investment and job creation beyond bare-minimum credit programmes. This could be coupled with multiple topic-focused pairings of reform and investment, such as an energy union that combined energy investment with reform of national regulation like market access and competition barriers. For such package deals to be successful, it is imperative that European leaders work towards restoring trust between individual states. Today, a lack of trust that countries will spend wisely and follow through with difficult reform, rather than later seeking a bailout from their peers, is a barrier to action.

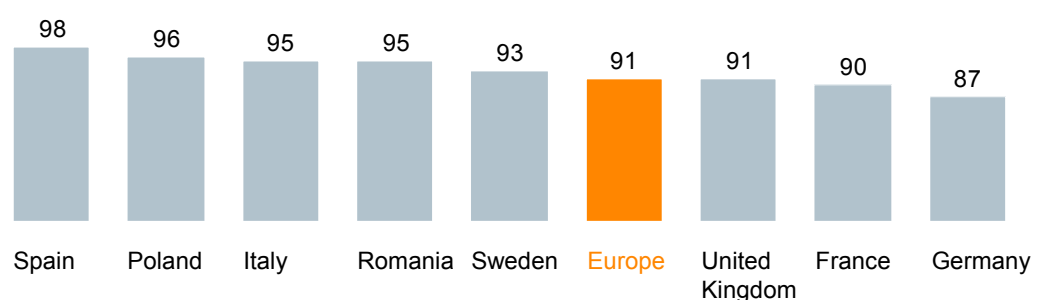
Europeans seem willing to play their part in their region's economic renaissance

Many decision makers may fear that reform will not find favour with voters. But the evidence suggests that perceptions of electoral risk from voters who do not support the case for reform are not always justified. First, research suggests that the probability of being re-elected is approximately the same for a reforming government as for a government that does not embark on reforms.¹² Second, the results of the MGI survey suggest that Europeans actually want decisive action in favour of growth as long as they are assured that they reap the rewards. The vast majority of opinion in the survey did not opt for the status quo but for a combination of improved health care, living environment, buying power, education, and public safety even if it required significant trade-offs. Support for this combination is remarkably consistent across countries, ranging from 87 percent support in Germany to as high as 98 percent support in Spain (Exhibit 20).

Exhibit 20

Appetite for change in Europe may be greater than often believed

Share of respondents who prefer the average scenario over the status quo
% (weighted)



SOURCE: MGI European Aspirations Conjoint Survey, August 2014; McKinsey Global Institute analysis

¹² Marco Buti, Alessandro Turrini, and Paul van den Noord, *Reform and be re-elected: Evidence from the post-crisis period*, Vox, Centre for Economic Policy Research, July 2014.



There is a genuine opportunity for real change and a positive narrative, building on Europe's undoubted strengths and the aspirations of its citizens, and seizing the current window of opportunity created by the confluence of a number of positive trends observed in 2015. Now is the time for Europe's leaders to shift the focus from crisis management towards framing a broad programme of national-level structural reform and investment and job creation enabled at the European level that can put Europe's economy on a healthier footing for the long term.



Engländer
Schweizer
Dänemark



Dänemark



England



Schweden

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June 2015
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