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McKinsey Global Institute

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

Executive summary

Challenges and opportunities

Per capita GDP is
24% lower in the EU-15 than in the United States

Productivity in 2009 is
15% lower in the EU-15 than in the United States

70% of Europe's 1995–2005 productivity growth gap with the United States is from local services

Europeans work on average
5 weeks less than do people in the United States

Labour market participation by 55- to 64-year-olds is
37% in Italy

28% of 2009 world GDP came from the EU-27

In 1995–2005, manufacturing drove **37%** of productivity growth in the EU-15

>100% of 1995–2005 net job growth in the EU-15 came from services

24 million net new jobs were created in the EU-15 in 1995–2008

Labour market participation by 55- to 64-year-olds is **74%** in Sweden

Executive summary

Many of Europe's political, financial, and academic leaders are still engaged in intense efforts to tackle the aftershocks of the global financial crisis amid fears that a double-dip recession may be in prospect. But while short-term pressures are forcing policy makers to focus their energies on fire fighting, there is a pressing need to turn attention to the task of generating sustainable long-term growth.

The challenges Europe faces are serious—more so for some economies than for others. Economic growth remains fragile in many parts of the region, but, given high debt and deficit levels, there is little remaining scope to stimulate growth from public funds. Unfortunately, the threat to growth is not likely to dissipate in the short term or even the medium term. Several factors are set to bear down on European GDP growth for years to come. Adding more strain to this picture are significant imbalances in unit labour costs and current account balances that have been allowed to develop because of a lack of coordination and a policy vacuum, at least in parts of Europe, on structural reform.

In this paper, the McKinsey Global Institute (MGI), McKinsey & Company's economics and business research arm, examines Europe's growth challenge and the building blocks of an effective pro-growth structural reform agenda.[1] The task ahead will be significantly more complex because of the significant divergence in performance among Europe's constituent economies and their different starting points on the road to renewal.

By the end of this year, government debt levels are expected to stand significantly above the 60 per cent of GDP defined as sustainable by the European Union (EU) in 11 of the EU-15 countries (the exceptions being Denmark, Finland, Luxembourg, and Sweden); in the case of Greece, debt is projected to reach an estimated 125 per cent by the end of 2010. The option of further direct pump priming of growth through the public purse would seem to have been closed off, at least for most major European countries. Indeed, many governments have announced, or are planning, sweeping cuts to scale back their deficits in the short and medium terms. This unfolding era of public austerity will coincide with a period of significant deleveraging by households in some major countries and some parts of the corporate sector such as commercial real estate. Taking

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1 In this paper, we focus on the European Union 15 (EU-15). The EU-15 represented 88 per cent of EU-27 GDP in purchasing power parity (PPP) terms in 2009 and 98 per cent of the eurozone. The EU-15 includes three economies that are outside the eurozone—the United Kingdom, Denmark, and Sweden—that account for 20 per cent of EU-15 GDP. We excluded the 12 more recent EU member states, which still have a period of catching up ahead of them. In aggregate, these 12 states had per capita GDP of PPP $19,000 in 2009, compared with $35,000 in the EU-15, and productivity of $24 per hour, compared with $49. These states have had significantly higher compound annual growth rates of per capita GDP and productivity in the decade from 1998 to 2008 compared with the EU-15 (4.6 versus 1.7 per cent per capita GDP growth; 4.5 versus 1.3 per cent productivity growth). Many of the structural recommendations may still hold true also for the entire EU-27.

history as our guide, this process will weigh on Europe's GDP growth for some considerable time.

Intensifying these headwinds against growth, ageing will cause a drag on per capita GDP growth as the labour force shrinks over the next 20 years; MGI estimates the annual drag at 0.4 per cent. Even while ageing bears down on growth, it will also place further demands on the public purse. According to European Commission estimates, ageing will require additional government expenditure equivalent to as much as 3 per cent of GDP by 2035.[2]

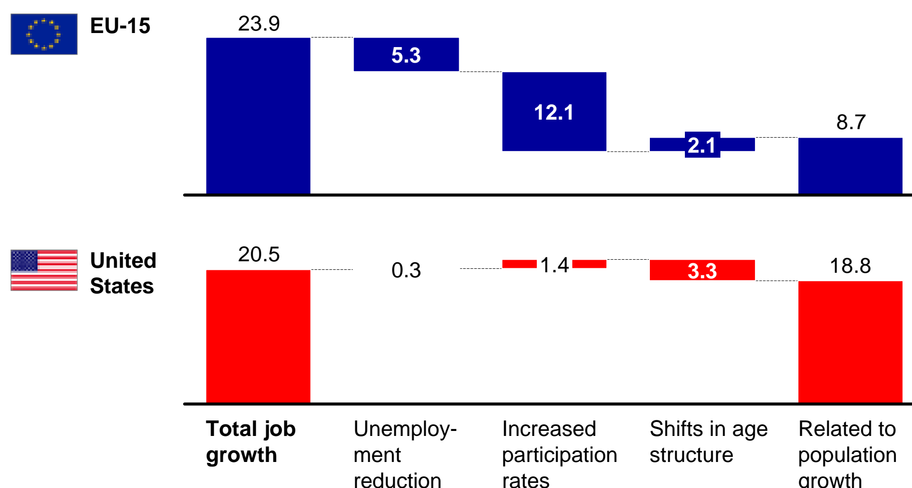
Conventional wisdom argues that Europe is a laggard in structural reform, politically unable or unwilling to change its "social model" and hobbled by perennially high unemployment. But this view misses some important developments. In the ten years prior to the crisis, Europe's per capita GDP growth matched that of the United States. This achievement was due importantly to the fact that Europe had been undertaking major reform to its labour markets that helped cut unemployment and boost participation by six percentage points in 20 years. Contrary to popular perceptions of Europe's poor record on job creation, 24 million new jobs were created between 1995 and 2008, more than in the United States over the same period despite slower population growth (Exhibit 1).

Exhibit 1

Europe has already successfully created many new jobs above population growth in the past decade

Additional jobs, 1995–2008

Million



Note: Numbers may not sum due to rounding.

SOURCE: The Conference Board; International Monetary Fund; Eurostat; McKinsey Global Institute analysis

Europe can take some comfort from these advances. However, after decades of catching up, the productivity gap against the United States has widened since the mid-1990s (Exhibit 2). Given many simultaneous pressures bearing down on Europe's growth, MGI finds that it will need to accelerate productivity growth by around 30 per cent over historic levels (or increase labour input beyond projections) just to maintain past GDP growth levels. Productivity growth would

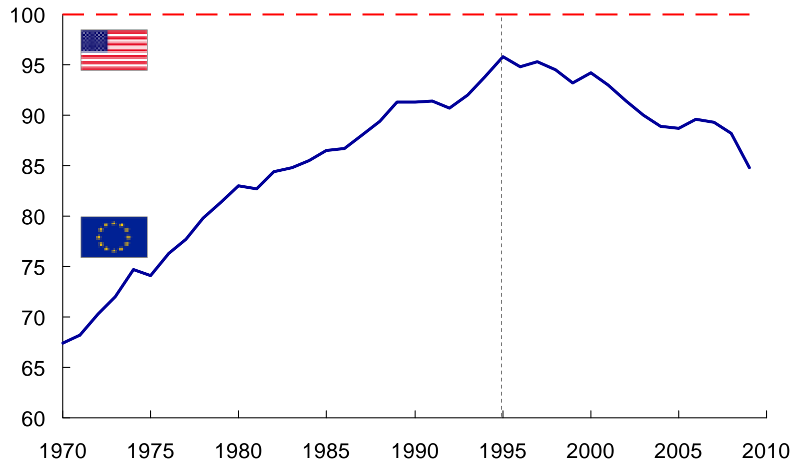
2 *2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2008–2060)*, European Commission, 2009.

have to grow by an even greater margin if Europe is to close the 24 per cent per capita GDP gap with the United States that prevails today—equivalent to $11,250 per capita, or $4.5 trillion in overall GDP.

Exhibit 2

Europe's labour productivity stopped catching up with US labour productivity in the mid-1990s

Labour productivity,[1] indexed to the United States



1 Expressed in $ at 2009 purchasing power parities (PPP) using the Elteto-Koves-Szulc (EKS) method for deriving transitive multilateral purchasing power parities.

SOURCE: The Conference Board; International Monetary Fund; OECD; McKinsey Global Institute analysis

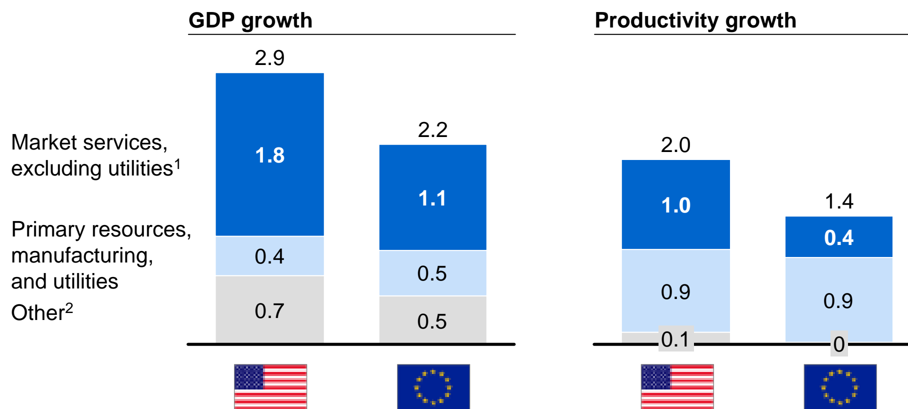
A major cause of the gap in both absolute productivity and productivity growth is Europe's relative weakness in service sectors (Exhibit 3).

Exhibit 3

Services sectors are the source of the GDP and productivity growth gap between the EU-15 and the United States

Sector contribution to 1995–2005 GDP and productivity growth

Compound annual growth rate, %



1 Construction; transport; retail; wholesale; hotels and restaurants; professional and financial services; computer and related activities; research and development; legal; technical and advertising services; renting of machinery and equipment; other community; social and personal services; and private households with employed persons.

2 Education, health and other public goods, real estate, and mix effect.

Note: Numbers may not sum due to rounding.

SOURCE: EU KLEMS; McKinsey Global Institute analysis

While European manufacturing and utilities have performed in line with the United States and contributed an important 60 per cent of overall productivity growth, service sectors have accounted for all of net job growth, as they have in all high-income economies. However, Europe's value-added and productivity growth severely lag behind these measures in the United States. Local services, including retail, wholesale, hotels and restaurants, private and other community services, and rental, accounted for five out of a total seven percentage points of productivity growth difference with the United States. Reforms to stimulate service sectors across the broad range of European economies would boost economic growth and employment, and they need to be a priority for economic policy makers.

Another challenge for Europe remains its relatively inflexible labour market. Despite important progress over the past ten years, further structural reforms are required. To illustrate, senior participation in the labour market—the participation of older workers aged 55 to 64—stands at 51 per cent, compared with 65 per cent in the United States; unemployment has averaged 2.5 percentage points higher; and a higher share of women, on average, tend to work part time, rather than full time. In addition, Europeans exercise a societal choice in favour of more free time—absences from work due to longer vacations and other paid leave total five weeks more per year than in the United States (Exhibit 4).

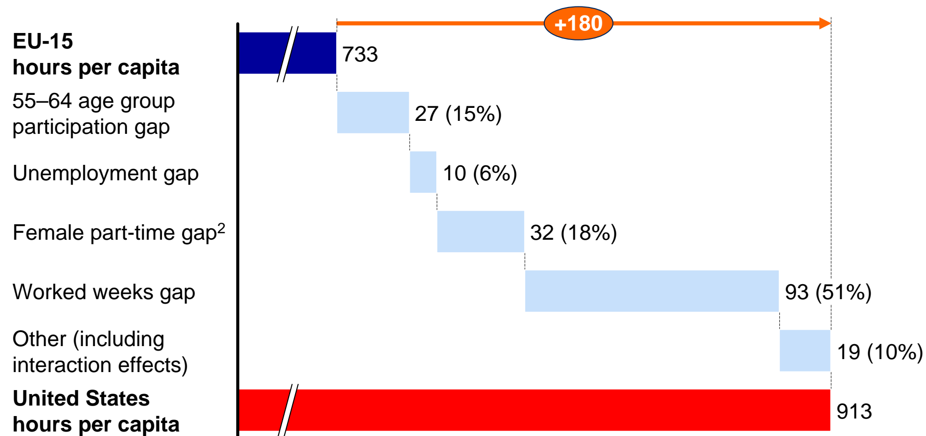
Exhibit 4

Europe's labour utilisation is much lower than in the United States

ESTIMATES

Decomposition of hours worked per capita gap between the United States and the EU-15

Annual hours per capita,[1] 2008



1 Standardised hours used for cross-country comparison. Official hours adjusted using the adjustment factors in OECD *Going for Growth*, 2008; using official hours, the gap would be around 60 hours smaller (overall and in terms of worked weeks).
2 Assuming female part-time incidence aligned to US level and keeping current average weekly hours in part-time/full-time jobs.
Note: Numbers may not sum due to rounding.

SOURCE: OECD; Eurostat; McKinsey Global Institute analysis

In today's environment of inhibited growth and constrained public finances, we believe that Europe has little option but to address structural barriers to growth that many individual economies have allowed to remain in place for too long. We think Europe has sufficient competitive strengths on which to build to emerge from the current crisis on a path of higher and more sustainable growth—provided that it embarks on bold reforms in three areas in parallel:

- **Further reforming labour markets in four areas**: (1) boosting participation among older workers as spearheaded by Nordic countries as well as the Netherlands; (2) reducing structural unemployment through reforms as implemented in Denmark or the United Kingdom; (3) reducing unemployment among young workers through successful policies such as those implemented in the Netherlands; and (4) balancing the mix of part-time and full-time work for women as one way to increase the average number of hours worked.

- **Unlocking the full growth potential of service sectors in four ways:** (1) further opening up competition in service sectors that remain constrained by a high level of regulation (e.g., professional services) and monopolistic structures (e.g., network industries); (2) boosting productivity by continuing smart regulation of product, land, and labour markets and supporting greater operational efficiency and professionalism in sectors such as retail, land transport, and construction; (3) unlocking growth by setting the direction and providing crucial enablers such as standards, education, and infrastructure in, for instance, business services, tourism, and telecommunications; and (4) ensuring European scale across national borders.

- **Aligning policies to growth and innovation**: capturing opportunities in growth and innovation particularly in high-tech and manufacturing in areas such as exports to expanding emerging markets, clean technology, or longer-term technological innovation (e.g., biosciences and nanotechnology) by (1) re-prioritising funds and allocating them in innovative and competitive ways to support R&D and innovation; (2) developing larger-scale clusters; (3) improving the link between academia and business; and (4) fostering a more entrepreneurial mind-set.

In each of these areas, Europe has some weaknesses to overcome—weaknesses that should not be seen as a cause for pessimism but as untapped opportunities for growth. In each case, the most effective reform will draw on proven best practices that some European countries have already implemented and that have delivered success. None of the measures we discuss relies on importing politically unrealistic proposals from outside Europe. Rather, the aim is to apply European best practices to spur European growth.

European leaders should act boldly—and soon. If they take the crisis as an opportunity to embark on far-reaching reforms across the continent, just as Sweden did in the 1990s, they can lead European economies back to a sustainable path of growth and renewal.

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