

MCKINSEY GLOBAL INSTITUTE

REBUILDING TRUST IN EUROPE: THREE PATHWAYS

BRIEFING NOTE

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Europe is bouncing back after a “lost” decade. Business and citizen optimism has returned, and Eurozone GDP in 2017 expanded at its fastest pace since the 2008 financial crisis. This changing mood creates an opportunity for European political and business leaders to take the action needed to ensure that growth and well-being are sustained in the long term, and that trust in Europe’s institutions is strengthened.

Rebuilding trust is critical: even in a time of economic recovery, divergent forces linger, anti-globalisation sentiment is gaining ground in a number of countries, and distrust of politicians and political institutions is rife. Business leaders tell us that they favour “more Europe” but worry about the fragility of Europe at large, and in particular the Eurozone. These doubts manifest themselves just as Europe wrestles with a wave of migration, and is facing challenges both from technology-driven changes to the nature of work, and from demographic forces, which will be a drag on growth. While many proposals and reform agendas exist to address these issues—and much has been achieved already—political divisions have prevented Europe from delivering bolder solutions more quickly.

This briefing note focuses on three pathways where Europe could take tangible action to begin restoring trust and credibility while sustaining economic momentum. These pathways are restoring economic dynamism and investment for inclusive growth; capturing the benefits of globalisation while addressing the backlash against trade and migration; and

embracing automation and AI to drive long-term competitiveness while addressing challenges from the future of work. This is just a start. To rebuild trust more fully, Europe will need to further strengthen governance, transparency, and citizen participation, and build an inspiring forward-looking narrative.

This note draws on recent research by the McKinsey Global Institute, including analytical reports, surveys of citizens and business leaders across Europe, submissions to an “Opportunity for Europe” essay competition, and a recent collaboration with the World Economic Forum to generate ideas among senior policy makers.

1. Restoring economic dynamism and investment for inclusive growth

A decade after the global financial crisis, the European economy is gathering momentum, but uncertainty is holding back investment and confidence in economic advancement remains elusive for many.

Europe’s economy is stronger than sometimes portrayed. For much of the past 60 years, the EU followed a growth trajectory similar to that of the United States, and the gap between the United States and the EU is narrower for various indicators of welfare than it is for GDP. Gender equality in society in the EU is the highest in the world, although it can further improve in the workplace. The EU as a whole scores strongly across a range of social indicators, from the quality of health care and education, to environmental protection, public safety, social protection, and work-life balance. Its trajectory diverged from that of the United States



when GDP growth in the EU fell back in a double-dip recession in 2012-13, but the euro crisis that accompanied it has since stabilised and per-capita GDP is back to pre-2008 levels. Unemployment in the EU-28 has fallen below 8 percent, its lowest level since 2008–09.

Recapturing economic momentum will require a strengthening of business confidence and investment.

Business investment is still below pre-crisis levels, at 12.4 percent of GDP in 2016. Business leaders we surveyed told us that lingering uncertainty and weak demand, which is hampering growth and productivity, are holding back investment. This has real consequences: our analysis shows that if investment of all forms in Europe were to return to pre-crisis levels (as a portion of GDP) by 2020, overall European GDP could receive a boost of €1 trillion in 2030. Underinvestment in critical areas such as transportation, new digital ecosystems, and power grids can erode future growth potential and productivity, which has slowed sharply in Europe post-crisis compared with a decade earlier. In France, Germany, and Sweden, for instance, annual labour productivity growth has slowed from a 1985-2005 average of some 2 percent to less than 1 percent in 2010-2016, while it is close to zero in the United Kingdom. Weak capital deepening is one of the primary drivers.

Large cash holdings are one manifestation of the lingering business uncertainty: EU gross corporate savings exceeded €2 trillion in 2016, almost €500 billion euros more than in 2009. Of the more than 2,000 C-suite business executives we surveyed across France, Germany, Italy, Poland, Spain and the United Kingdom, 37 percent told us that their cash position had increased by more than 3 percent. Fuelling the reluctance to spend are concerns other than a lack of investment opportunities: just over half of the respondents to a separate McKinsey Quarterly survey said they saw more investment opportunities than they could fund. All this comes at a time when the return on cash is poor because of historically low interest rates. Companies hoarding cash say they are evenly split between “saving for future investment” and “building reserves for potential future crises.”

The survey also highlighted a lack of confidence in the future of the Eurozone. Most of those we polled told us that the EU has had a positive impact on their business, with 60 percent saying they want “more Europe,” including more centralised authority and spending. However, one in three

expected the Eurozone to break up or shrink, and 16 percent even expected the EU itself to disband.

The stabilisation of the Eurozone relied heavily on intervention by the European Central Bank; the consolidated balance sheet of the Eurosystem at the end of 2016 was €3.7 trillion, or 1.8 times higher than in 2008. While sovereign debt has fallen back in some countries, notably Germany, in countries such as Greece, Italy, and Portugal it still exceeds 100 percent of GDP.

Concern about rising income inequality and lack of advancement is fuelling a lack of trust.

Disposable income for the bottom decile has grown more slowly than income for the middle and upper deciles across much of continental Europe over the past decade. However, European societies continue to be more equal than the United States, as measured by Gini coefficients and other metrics. Recession and slow recovery following the 2008 financial crisis alongside longer-term demographic and labour market changes combined to halt advancement of market incomes—both wages and capital—between 2005 and 2014 for as many as two-thirds of households in advanced economies. Taxes and transfers prevented this income stagnation from feeding through to disposal income in some but not all countries: in Italy, disposable income fell for households across the income distribution between 2005 and 2014. All this has contributed to a feeling among many Europeans of “losing out” at a time when some middle-income jobs are under pressure and low-paying temporary employment contracts are on the rise in many European countries.

Several concrete measures could be taken to address these issues of lingering fragility:

- **Structural reform** along 11 growth drivers—focused around investing for the future, boosting productivity, and mobilising the workforce— which could raise Europe’s GDP by 2 to 3 percent annually. About 75 percent of these measures could be enacted by national governments, with the remaining 25 percent at a pan-European level, as identified in MGI’s 2015 Window of opportunity for Europe report;
- **Rekindling both public and private investment**, especially in Southern Europe, which may require concerted action across sectors. One policy choice could be to change public accounting systems to account for public investment as assets depreciate,

rather than during capital formation. Such a shift could be combined with a more flexible approach to fiscal deficit targets, as suggested by one submission in our 2016 essay prize contest, to give governments greater flexibility to borrow funds in order to invest in growth-enhancing opportunities;

- **Addressing lingering debt issues.** This will require Europe to strengthen the banking union, clean up weak bank balance sheets, address persistent issues of non-performing loans, and deal with excess sovereign debt. One of the essay prize winners proposed the extreme option of cancelling public debt, although politically that may be impossible to achieve;
- **Providing a clear pathway for the future of the Eurozone.** European businesses require both regulatory certainty and a credible plan for the future of the Eurozone, to enable future investment. Proposals by French President Emmanuel Macron and European Commission President Jean-Claude Juncker have put the issue high on the European political agenda. Greater transparency can also help on this front.

2. Capturing the benefits of globalisation, while addressing the backlash against trade and migration

Europe has been at the heart of many of the interconnections that have been forged over the past three decades, amid a sharp increase in flows of goods, finance, people, and data. Today, however, the continent faces a popular backlash against trade and migration—two of globalisation’s core features. Those disenchanted by globalisation are among the most suspicious of European and national institutions, polls show. For policy makers and business leaders, the complex challenge ahead is how to capture the benefits of continued growth in these flows while mitigating negative consequences.

Europe’s interconnected economies are strongly affected by global flows. Global trade in goods and services has surged since the 1980s, growing at double the pace of global GDP between 1986 and 2008, as global value chains in manufacturing have woven countries and companies closer together. Our research shows that global flows of goods, services, finance, people, and data combined have raised world GDP by at least 10 percent, adding almost \$8 trillion of GDP. The financial crisis in 2008 reduced imports

of goods and led to a sharp pullback in financial flows, especially in Europe: among Eurozone banks total foreign loans and other claims have fallen by \$7.3 trillion, or 45 percent, since 2007. In 2007, two-thirds of the balance sheet assets at German banks were foreign and just one-third were domestic, whereas today that proportion has been reversed. As in the United States, the banking crisis in Europe in 2008 involving government rescues contributed to the anti-globalisation sentiment.

Even as growth in traditional trade and financial flows has slowed or dried up, a new frontier has opened in the form of digital flows—where Europe needs to resolve barriers. Use of cross-border bandwidth globally has grown 45 times since 2005. Virtually every type of cross-border transaction now has a digital component, and about 12 percent of the global goods trade is conducted via international e-commerce, with much of it driven by platforms such as Alibaba and Amazon. Europe as a whole is well placed to capture the benefits of these flows because its national economies are highly interconnected; in MGI’s Connectedness Index, six European countries rank in the top ten globally. But many barriers still impede the free flow of cross-border data within the European economy; only 15 percent of EU consumers buy online from another EU country, for example, whereas nearly 44 percent do so domestically, according to the European Commission. The Commission has also identified numerous national restrictions to the location of data storage or processing.

Rise of protectionist policies. The backlash against globalisation was sparked in part by concern that “unfair” competition in trade of both goods and services may be killing jobs and depressing incomes. This has helped foment protectionist policies, not just in Europe but globally; since 2009, G20 countries have introduced roughly 1,600 trade protectionist measures, according to the World Trade Organisation. Unfair trade, along with migration, was a key argument in favour of the pro-Brexit vote in the United Kingdom.

Businesses are concerned about this backlash against globalisation. Our survey of European C-suite executives highlighted their optimism about business prospects from digitisation and the rise of emerging economies, with those seeing these trends as positive for their business outweighing those who saw them as a negative by margins

of four to one and three to one, respectively. However, the rise in populism, pressures against globalisation, and geopolitical disruption are viewed negatively as main factors running counter to increased investment. European leaders will thus need to manage pessimism around globalisation—including managing the real impact it can have on workers—to enable growth and, in turn, encourage lasting trust.

Migration as a central concern in Europe.

Europeans have been especially vocal about their concerns around migration, and they worry about its implications for safety, security, social cohesion, and jobs and wages. Asked about the main challenges facing the EU, most Europeans mentioned immigration (39 percent) and terrorism (38 percent) in a recent Eurobarometer survey.

Close to three million people applied for asylum in Europe between 2015 and October 2017, and they are distributed extremely unequally. Germany alone has taken in more than 40 percent of these migrants. Integration has been a particular challenge. The unemployment rate among refugees in Germany, for example, was over 50 percent in 2016, at a time when Germany has a shortage of some types of workers.

Addressing such issues will be essential to heading them off. Options could include:

- **Accelerating growth and working to make it inclusive.** Driving overall growth can ensure that everyone is better off, and reduce backlash against globalisation, but on its own may not be enough. Welfare, regulatory, and training programs will need to be adapted to ensure that nobody is left behind. One of the winners in our prize essay contest suggested a variety of ways to compensate losers, for example by distributing GDP-indexed shares to workers affected by foreign competition from trade deals.
- **Managing the flow of migrants and asylum seekers.** As a baseline to rebuilding public confidence, Europe needs to be able to demonstrate to its citizens that it has control over who is entering its borders, and that flows will be managed fairly. Our collaboration with the World Economic Forum brought forth many ideas to manage the flow of migrants and asylum seekers, including expanding digital identity programs, building financial transfer mechanisms to support border countries, and improving repatriation mechanisms.

- **Improving long-term integration outcomes.**

European governments could optimise integration pathways for asylum seekers, providing different elements of integration support in a sequence that reflects different groups' needs. This could accelerate sociocultural and labour force integration.

3. Embracing automation and AI to drive long-term competitiveness, while addressing challenges from the future of work

Automation technologies including artificial intelligence (AI) will increasingly disrupt businesses and the workplace over the next ten to 15 years. They will bring benefits in the form of increased productivity and corporate performance, for those companies that successfully adopt these tools. But they will also bring considerable transition challenges, as humans work ever more closely with machines, and in some cases, are replaced by them.

Concerns about automation's impact add to the climate of mistrust.

In the European public debate over automation, the fear that “robots could take our jobs” is a recurring theme that adds to the climate of mistrust and fear. Our research suggests that historically there has been enough work to offset the portion of existing jobs displaced by technology, although not all sectors are affected equally and wages can be affected for some time. The same could be true with future digitisation and automation, if the process runs smoothly. However, more than 40 percent of Europeans report that they are either over or under-skilled for their jobs, according to the OECD. Such a mismatch may already affect productivity and job growth, and is likely to increase: millions of people will need to change occupational categories in order to find work in the new economy, and millions more will need to acquire higher cognitive and creative skills. In several European countries including Germany, as many as one-third of the workforce may need to change occupational categories by 2030, according to our research. This represents a massive training and retraining challenge for policy makers and business alike.

Our research has found that the activities most susceptible to automation account for roughly half of the activities that people do and that they exist in every sector. For Europe's five largest economies—France, Germany, Italy, Spain, and the United Kingdom—we estimate that about \$1.9 trillion in wages and 62 million workers are associated

with technically automatable activities. The actual impact on work will largely depend on the rate of adoption of automation technologies and the rate at which economies grow and create demand for new work. To illustrate, we estimate that 24 percent of full-time equivalent hours in Germany could be automated by 2030, assuming that adoption falls in the middle of our expected range, although the displacement could be as much as 47 percent if automation is very rapid. Wages are the primary means of building a disposable income for the middle class, and Europe must therefore ensure that the benefits of automation outweigh the risk of job losses and income loss including from wage suppression in order to maintain citizen trust in the new economy.

Seeking to slow (or halt) automation adoption is not a good option. European economies need the productivity boost that automation can bring, especially those whose working-age population is declining. In Germany, for example, ageing will represent a drag of 0.6 percentage point per year on per capita GDP growth to 2030, but early adoption of automation could more than offset that, with an annual boost of 2.4 percentage points. Companies across sectors from agriculture and health care to media and pharmaceuticals have already started to use the new digital and AI-powered tools to identify fraudulent transactions, personalise financial products, diagnose diseases, optimise purchasing, scheduling, and pricing in real time, and carry out predictive maintenance in manufacturing, among other uses. Doing so has let them capture immense productivity and performance benefits, and the benefits are expected to increase over time.

Europe is falling behind the United States and Asia in capturing the potential value at stake. Europe has digital startups and considerable innovation, but, unlike the United States and China, it has been largely unable to consistently translate that into global digital platforms. Investment in AI is already dominated by digital companies such as Amazon, Baidu, and Google, with Europe lacking the scale of such companies to make notable inroads. European companies including ABB, Bosch, BMW, and Siemens are investing in AI, even if they are not digital natives, but overall Europe is behind in external AI investment. European external AI investment totalled just \$1.1 billion to \$1.7 billion in 2016, compared with \$1.5 billion to \$2.5 billion in Asia and \$5 to \$8 billion in North America, based on venture capital and private equity investment

in AI companies, and M&A by corporations. Europe's investment in R&D more broadly was just 2 percent of GDP in 2014, well behind South Korea (4.2 percent), Japan (3.4 percent), and the United States (2.8 percent).

This is a challenge for Europe's economies, as AI seems to be an even more disruptive force than early digital technologies were for companies and countries. In our research, we find that early AI adopters experience positive momentum and profit growth, and can concentrate market share at the expense of slower adopters. Incumbent companies are at risk of losing out to new players, unless they digitally reinvent themselves with new business models and portfolios of activities. For now, only a fraction of European incumbent companies has taken this road of digital reinvention. European companies are also cautious about integrating AI technologies in their operations. A recent MGI survey found that just one tenth to one fifth of companies in European countries that were aware of AI had adopted it at scale.

European economies, particularly those with low economic growth, will have no choice but to grow and innovate in order for their industries to remain relevant and to create new work activities and occupations. Policy makers will need to address critical challenges from the transitions that will accompany automation adoption, while ensuring that progress happens at pace. The risk is that automation will exacerbate the growth of income inequality and the lack of income advancement. To capture the benefits of automation while avoiding its downside, policy makers and business leaders in Europe have a range of options. They include:

- **Embracing AI and automation quickly for the productivity benefits that they bring when worker transitions are successful.** If technology absorption is limited, global competition will further dampen the chance of prosperity. We recently estimated that small, open Northern European economies could see an additional 1.2 percentage points of GDP growth to 2030, with the same or better levels of employment, with automation diffusion. The trade-off between productivity and employment is actually less than it might seem at first, since the GDP bounce that productivity brings at an aggregate level will raise consumption and hence labour demand overall, as it has always done in the past, even if

some individuals, sectors, and regions struggle in the transition.

- **Completing the European digital single market and investing in critical digital assets, technologies, and ecosystems.** Free movement of data could become a new pillar of European integration. Europe needs to develop an environment that enables the digital economy to grow, which means encouraging innovative research, ensuring access to growth capital, addressing privacy and security issues, and building demand for key new technologies. Public procurement could be directed at digital innovations and research support, along the lines of the US Defense Advanced Research Projects Agency.
- **Transforming education and training.** This will require coordination between parents, educators, governments, employers, and employees, with a focus on enabling lifelong learning, especially for individuals with skills that can be easily automated. One idea proposed by the World Economic Forum initiative is for a “universal right to learn” that would give adult citizens tokens, paid for by businesses, that can be redeemed for skills training. Sweden already has “job-security councils,” run by the private sector, which provide displaced workers with a comprehensive suite of income support, training, and coaching.
- **Improving labour market dynamics and enabling more diverse forms of work.** Greater mobility and better matching of talent with opportunity are needed across Europe to increase fluidity; our research shows that rapid reemployment will be critical to ensure that unemployment does not rise in a time of automation. Digital platforms can improve job-matching and create myriad opportunities for individuals to earn income outside of traditional employment contracts. Labour institutions should evolve to reflect more independent work, for example, by ensuring portable benefits. Germany’s federal labour agency, for one, is piloting innovative online and offline counselling services directed at students, the unemployed, but also employees in jobs which are massively impacted by digitisation.
- **Rethinking transition and income support.** The European welfare state dating to the days of Bismarck will need to adapt to become more resilient. If automation does result in a

significant reduction in employment, greater pressure on wages in some strata of the population, or both, then some ideas such as conditional transfers, adapted social safety nets, different forms of taxation, and even universal basic income may need to be considered and tested, as Finland and the Netherlands are currently doing.

Tangible improvements on areas of citizen concern are essential, but more will be needed to strengthen trust and increase legitimacy and participation

Trust is an intangible but critical feature of modern democratic societies; it is easy to lose and hard to regain. Addressing the issues we have sketched out in this note with concrete steps could help restore a sense that Europe’s leaders are taking action on key areas of citizen concern. But more is needed at a time when many Europeans are asking fundamental questions about the continent’s democratic legitimacy and relevance. Citizens and businesses alike are concerned about Europe’s ability to deliver on its commitments. For example, while the business leaders we surveyed in 2017 were largely positive about the European Commission’s policy priorities, just 28 percent thought EU institutions were very effective at making and managing policy. They were not much more confident in their home governments.

Addressing Europe’s credibility gap is beyond the scope of this briefing note. It would require real evolution of EU and national governance, likely along with new funding. All of this is being discussed at the highest levels, particularly following the May 2017 French elections. Citizen engagement would also be needed, to foster a true sense of belonging. As one of our essay prize winners put it, a “technocratic reform masterplan, imposed from the top without concerns for design, distribution, and democracy” will not regenerate political enthusiasm and trust. As Europe works to enhance the fundamentals of its democratic legitimacy, policy makers could address elements of citizen and business concerns about governance in several tangible ways. They include:

- **Delivering government services—from trash collection to tax collection—more efficiently and effectively.** Digitisation of government services can play an important role, as the example of Sweden’s tax agency shows. It embarked on a wide-scale digitisation effort in 2006, with new e-filing processes for income statements and VAT returns. Within six

years, citizens' trust in the agency increased to 83 percent from 68 percent. Denmark has achieved significant improvement in healthcare outcomes while controlling costs, by taking a long-term, data-driven approach to health care system reform. Its average healthy life expectancy increased from 69.6 years in 2008 to 71.4 years in 2015, while spending per person was flat from 2009 to 2015.

- **Being transparent about decision-making, particularly at the European level, and strengthening citizen engagement.**

Europe will need to find ways to enhance the democratic process and become more responsive to citizen concerns. New digital tools can help: for example, open data platforms can create new mechanisms for government accountability. Estonia has offered internet voting since 2005, and now 30 percent of citizens take advantage of it. Some European countries are experimenting with publishing elected officials' expense reports; other countries publish detailed records of public spending. Virtual townhalls and crowd-sourcing of ideas could also help governments raise otherwise unheard citizen concerns and preferences.

- **Developing a new vision and narrative for European integration.** While trust and confidence cannot be regained without tangible improvement to the issues citizens care about, Europeans are more likely to rally around a revamped European Union if they are able to identify themselves with its rationale. A recurring theme of our 2016 essay prize was the need for a clearer and more compelling narrative, one updated for the 21st century, when the savage wars of the 20th century that drove the EU's creation in 1957 have faded into history. This will need to be more than a shallow PR campaign. To grow, strengthen, become more resilient—and remain a key actor on the global stage—Europe will need to address legitimate concerns and reenchant its people.

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