Improving the EU's global economic competitiveness

Introduction

The Chair commented that improving Europe's competitiveness has long been a challenge. Since 2010, the euro area's economic growth underperformed its global competitors, particularly the US. In the last 15 years, potential growth in the euro area has been on average 1pps lower than in the US. The discussion focused first on the causes of Europe's weakness in competitiveness and then on how to address this weakness.

1. The economic gap between Europe and its main global competitors is widening

The European Union has been experiencing a structural shortfall relative to the United States and China since the mid-1990s due to structural weaknesses. This is also the result of economic policy choices.

1.1 Facts and Figures

1.1.1 Europe has fallen behind economically for more than 15 years

An official noted that Europe is massively underperforming on growth. There is a significant gap with the US in terms of GDP per capita, and emerging Asian countries are also increasingly challenging the EU in regard of competitiveness. In the period since the global financial crisis, the US economy on average has grown by 1.7 percent in real terms, meanwhile the European Union has lagged behind with a growth rate of 1.1 percent. This difference in growth rates has contributed to a shift in positions: while the European economy was larger than the US economy in 2008, but the US economy is currently 50% larger than the EU economy.

A policy-maker commented that, while the EU's overall performance as measured by trade indicators and price and cost competitiveness has been relatively stable over the past years, indicators on productivity and innovation suggest weaknesses. The slowdown in labour productivity since the 2000s has been more pronounced in the EU, with substantial heterogeneity across Member States. Sluggish investment dynamics, lower research and development spending and a lack of diffusion of new technologies are driving these differences. Additional challenges include access to finance, the regulatory framework, public administration, and investments in infrastructure and education.

An industry representative commented that there appeared to be general agreement that Europe is losing competitiveness compared to the US and China. There are very few European champions in the global top 20 companies by market cap. The US equity markets are the largest in the world and continue to be among the deepest, most liquid and most efficient, representing 42.9% of the $106 trillion global equity market cap in 2023. Discussion around competitiveness since the financial crisis has focused too much on regulation, supervision and stability and too little on growth. Europe has disadvantages, such as a lack of self-sufficiency in energy, but also has significant advantages, such as its savings and good, educated people. Despite having the preconditions for growth, growth is not happening.

1.1.2 Per capita incomes in all advanced EU economies are lower than in the US

An official noted that per capita GDP growth over the last 10 years in Europe is similar to that in the US. The European growth rate of output produced per hour is slightly higher than that of the US, but it would still take 80 years to catch up with U.S. income levels. Indeed, per capita income levels in the EU are on average around one-third lower than in the US after correcting for price and exchange rate changes that do not reflect changes in living standards. This difference is not only driven by less-rich European countries. With the exception of Luxembourg and Ireland, per capita incomes in all advanced EU economies are lower than in the US. This gap is driven by shortfalls in capital stocks, choices in working fewer hours, retiring earlier and lower productivity. Also, Europe is aging faster than the US. In this context, growth per capita matters more than growth per hour worked.

1.1.3 Convergence as an engine of growth has also been stuttering within Europe

An official commented that the larger income differences within the EU compared to the US should drive faster EU growth, given the growth opportunities that lower-income countries offer. The poorest US state has a per capita income level of around 80% of the US average. In the EU, there are eight countries with income levels below 80% of the EU average. However, growth in the EU's lower income countries has been insufficient to make progress on income convergence. The growth slowdown between the early and late 2010s in central and eastern European economies suggests that its convergence to average euro area living standards will not be achieved until after 2100.

1.2 The main reasons for this worrying gap

This gap is due to structural factors and different economic policy choices.

1.2.1 Less favourable demographics and lower labour and capital productivity in Europe

The Chair noted that only one-third of the difference in growth between the eurozone and the United States since

2010 can be explained by less favourable demographics in Europe, while two-thirds is due to lower labour and capital productivity. The productivity gap between Europe and the US has been widening because of differences in technological progress, market efficiency and institutional framework. Europe's underinvestment in innovation constrains technological progress, while market failures and excessive administrative burden prevent the economy from achieving its full potential. An International Monetary Fund (IMF) forecast states that Europe is expected to grow 0.9% this year, the US 2.1% and China 4.6%. There is a concern that current weaknesses are being driven by underlying factors that will affect Europe in the long term.

An industry representative commented that the US is largely self sufficient in energy. More work on this is required in Europe. The US labour market is historically more flexible than the more fragmented labour markets in Europe, with the exception of the UK and Ireland. Another difference is demographics. The US has grown its population 0.4% since 2000 while Europe has shrunk 0.1% and China has shrunk 0.2%. In terms of common public goods, there are opportunities to grow in defence, health and energy.

An official remarked that the medium-term economic outlook is concerning. Europe will need to address the old headwinds, such as demographics, the investment gap in eastern European countries and the slowing down of convergence and productivity. In addition, there are new headwinds, such as the Russian invasion of Ukraine and geo-fragmentation.

1.2.2 Europe depends on the United States for energy, technology, capital markets and the military

An official highlighted that the growth difference between Europe and the US is driven by four main areas: energy, technology, capital markets and the military. In the first two fields, Europe has significant competitive disadvantages compared to the US, while in the latter ones it depends on the US. Europe imports 62.5% of its energy need from abroad, while the US is a net exporter. The seven biggest tech firms in the world are US-based companies, while there are only two European companies in the top 20. European countries rely on US capital markets for large IPOs or acquisition financing, because Europe does not have a deep capital market. The military dependence on the US is self-evident. Strategic independence and autonomy will not be possible if there is a heavy reliance on the US in these four sectors.

An industry representative noted that, unlike Europe, the United States has bet on growth in the technology space. This area is largely underdeveloped in Europe and has huge upside potential for the future. The banking union and the capital markets union (CMU) are necessary for growth. Liberalisation of the broader services sector, not just banking, must also be considered.

1.2.3 Consequently, Europe has been hit harder than its economic rivals by the war in Ukraine

An industry representative commented that the EU has experienced a perfect storm. There is war in Ukraine. Global demand has been affected. Household consumption in the EU has moved sideways since the pandemic, while US consumption has increased. Capex, with the exception of Italy and perhaps eastern Europe, has decreased within the European Union. Economists are concerned about a potential scenario where growth and inflation are both at 1%.

1.2.4 Overly dispersed and complex regulations, high energy costs and the absence of dynamic and efficient capital markets help to explain Europe's lack of competitiveness compared to the US in particular

An industry representative stressed that industrial companies globally will be the drivers of growth. These companies like stability and have stated that the regulatory environment in Europe is too complex. For these companies, not only the absolute cost but also the volatility of the cost of energy is important. Companies need to be confident of long-term returns when investing. The current energy policy of Europe is unclear. Concerns around this lack of visibility are increasing and affecting clients' willingness to invest in Europe. Europe has a huge competitive advantage in the energy transition as it was ahead of the curve in terms of innovation. This competitive advantage must not be lost due to complexity, lack of stability, fragmentation and lack of pragmatism.

The US Inflation Reduction Act (IRA) is simple, long term and pragmatic. One big strength of the US is that it brings stability. There are similar issues with regard to the capital markets. The US capital market is not only bigger, more profound and has more depth and liquidity, but also offers a wider range of solutions. The leveraged finance market and the high-yield bond markets, for instance, have very few opportunities in Europe compared to the US.

The Chair (Rolf Strauch) agreed that risk culture needs to be nurtured.

1.2.5 The European approach to regulation treats the financial sector as more of a part of the broader social policy agenda, such as looking at double materiality assessments under CSRD or bonus caps

An industry representative commented that the European policy objectives regarding a net zero transition have led to a number of additional measures and requirements for European banks, such as the Corporate Sustainability Reporting Directive (CSRD) and Pillar 3 disclosures. These are more focused on advancing the policy objective than on the international competitiveness of European banks. Not having these requirements is a competitive advantage for other jurisdictions. Whether the ideal European bank is a social utility providing community service and financing for political objectives or a streamlined interface providing access to competitive international financial market pricing for consumers and companies should be considered.

When decisions are taken in Europe to suspend dividends without respect to capital strength or the strength of the sector, or when windfall taxes are taken due to the normalisation of interest rate levels, this creates a lot of bank sector investor uncertainty. This leads to a European policy and regulatory risk premia being assessed on European banks. The extent that the financial sector is viewed as an extension of the public sector in Europe reduces the attractiveness of the sector to international investors.

1.2.6 The lack of cohesion in the single market

An industry representative remarked that, since the beginning of the 1990s, small changes have been made in specific areas to resolve short-term problems. However, there has been very little structural reform. An excess of regulation can stifle creativity. There is no growth without taking risks. For example, the lack of venture capital is unsurprising and partly due to restrictions in the Markets in Financial Instruments Directive (MiFID). This has resulted in stability but no growth. Implementation time should be reduced at the EU level. The IMF expects growth of barely 1% in the next five to six years. This must be addressed urgently by freeing up the capacities of the private sector. The public sector is in too much debt, has no capacity and the savings are exported to the US.

The Chair summarised that a number of reasons why Europe is falling behind have been outlined, including demographics, lack of investment and productivity linked to technology. The energy market is relevant in terms of cross-competitiveness, but also in terms of volatility and risk culture. The single market is incomplete. However, there are also strengths.

2. The solutions to Europe's lack of economic competitiveness have been identified. All that remains is to implement them

The good news is that Europe has the tools to respond to these economic competitiveness challenges. Structural reforms and the single market are the places to start. Establishing a single market will include work on CMU, the banking union, harmonisation of taxes and subsidies and harmonising of bankruptcies. This will make it possible to operate across Europe at scale.

2.1 Europe has real strengths

2.1.1 The European Union's capacity to provide public goods is encouraging

A policy-maker noted that Vincent van Peteghem has alluded to the fact that there has been a natural shift towards cooperation between the private and the public sector. This started with the Juncker plan and evolved further with NextGenerationEU, which made public goods, such as health or defence, available through the provision of private goods. This was achieved by means of joint public procurement for private goods, vaccines or weapons, with the ultimate aim being public health or defence. The ability of the European Union to provide public goods rapidly when needed in response to crises, in spite of all its challenges, is very positive.

2.1.2 Europe's key advantage is that it has been leading on the green agenda

An industry representative stated that Europe's key advantage is that it has been leading on the green agenda. However, the US is catching up very quickly. Higher capital requirements for banks means less ability to lend and further capital requirements should not be included in any new rules. Non-banks are equally as important as banks, because non-banks help banks to provide the means to accelerate growth. Acceleration of the CMU is crucial.

An official pointed out that there are three main considerations with respect to European competitiveness: sustainability, inclusion and growth. If addressed, these three factors can result in a prosperous and green future for Europe. The factors could either reinforce or undermine each other. Europe is performing well on sustainability and inclusion.

2.1.3 The pricing model used by the EU via the Emission Trading Scheme is an efficient instrument to address the climate transition

A policy-maker underlined that there has been frequent comparison of Europe to the US. The European Emissions Trading System has delivered very well and provides very good incentives. It has been agreed that this will be enlarged and its scope broadened, which will be much more efficient. In contrast, continuation of the very expensive subsidies programmes in the US would raise real questions about the public finances and the stability of public finances in the US.

2.1.4 Reforms in Europe have become a central element of economic policy

A policy-maker commented that the perception of the word 'reforms' has changed dramatically in recent years. Instead of a euphemism for mass unemployment, layoffs and closure of companies, reforms in Europe have become a central element of economic policy. The NextGenerationEU agreement was possible not because of the investment it contains but because of the reforms. Ursula von der Leyen has commented that reforms are the engine of growth and investment is the fuel.

An official reported that world growth has been upgraded by 0.2% for the current year, driven by the US upgrade of 0.6% and China upgrade of 0.4%. There is little spillover for Europe from this external demand, with Europe being downgraded by 0.2%. However, there are some positive indications for the euro area. First, the disinflation effort works, with monetary policy and the unwinding of supply shocks playing a key role here. Second, labour markets remain strong. Real incomes are expected to increase in the current year, which will lead to higher private consumption. Easing of financial conditions as the disinflation effort gets traction will increase investment and produce stronger domestic demand. This means that the immediate outlook is reasonably good, facilitating fiscal consolidation.

2.2 Structural reforms must be implemented without further delay

2.2.1 Identifying what needs to be done at European and member state level

A policy-maker commented that it is crucial to consider what aspects are the responsibility of member states and what needs to be done at the European level. Spending on R&D in the EU is behind that in the US. Urgent action must be taken to close this gap through a combination of additional public funding, leveraging of private investment in these areas and improving incentives. Regulations for private companies in these areas must also be considered to ensure that the incentives to invest are present. Europe must attract talent and reverse the trend seen in recent Programme for International Student Assessment (PISA) results in many member states.

A policy-maker remarked that countries are unable to address major emergencies alone. A Eurobarometer revealed that the number one thing that people want from the European Union is help in case of an unexpected event. What public administration can do is limited. It is too easy to put all the blame for this on the public administration. There have been 20 years of disengagement and a lack of investment. A recommendation of the high-level report on cohesion is to invest in the capacity of the public administration as if it were a physical asset. The more trust that there is between the countries and Europe, the more it will be possible to do things at the European level.

2.2.2 Reducing the weight of the state in the economy and recalibrating the size and complexity of the EU regulatory framework

An industry representative commented that the state in Europe represents over 50% of the GDP. This could be a root cause of low growth. The oversized state is regulating everything and crowding out the private sector and creativity. Despite 15 years of discussion there has been no progress on CMU and securitisation. Defence, border control and energy are all problems that must be addressed by the European Commission. With a 1.3% budget compared to the GDP, the European Commission will struggle to address these issues. To start growth, capacity in the private sector must be increased and advances made on the single market.

The Chair noted the suggestion that that the national governments are possibly too big at 50%, but also that the European level has too little money. If it is not possible to increase the envelope, resolving this will require a redistribution between the national and European levels.

A policy-maker remarked that, in the next five years, 30% of public administration staff will retire, so a change will be needed. However, the approach should not be 'Throw it away' but instead 'Organise the change.'

An industry representative stated that some regulations will also need to be reviewed if we want to foster investments in companies´ equity or more venture capital, for example the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR).. Furthermore, the European Central Bank has consistently been against leveraged finance. The risk weighting in these cases is so high that it is essentially forbidden. Regulation should be considered in the context of the results of the regulation. MiFID should be reviewed.

He also highlighted that although the single rulebook is of fundamental importance, the most common regulatory tool is directives and national rules play a key role. Different regulatory frameworks are the main barrier to European consolidation. This leads to a lack of potential synergies that could be achieved in a bank merger.

2.2.3 The success of structural reforms depends on their coherence, transparency and the quality and efficiency of national administrations

A policy-maker commented that an essential element for successful reforms is coherence, which the EU is very good at. The EU has been promoting the Green Deal and emphasising the importance of the green transition over the past five years. The response to the war in Ukraine, REPowerEU, is very green, because the two biggest elements are saving and a move to renewables. This coherence is very much appreciated by the market. Transparency is also important. For example, the transparency of the curve of the Next Generation EU bonds is crucial.

Public administration is one of the most important factors in making a country or a region competitive. In the past 10 to 15 years, public administration has suffered from a great deal of disinvestment, so there is a big gap between the demands placed on it and the resources that is has. Often, problems in public administration in Europe are due to ability and capacity, not political resistance. This is important because most crises now are supply-side shocks. A demand-side shock can often be resolved with money. However, public administration is needed to resolve a supply-side shock.

2.3 Completing the single market is the right response

An official pointed out that the big advantages in the US are a large single market and lots of flexibility in labour and product markets. The answer to economic resilience in Europe is the single market. The IMF has estimated that a reform package that reduces within-EU barriers by 10% could permanently lift real incomes by more than 7%. Such reforms include completing the banking and CMUs, for example, through greater harmonisation of national rules on taxes and subsidies, improving insolvency regimes, and reducing administrative burdens. IMF research shows that closing the gap between involuntary and desired working hours alone would increase EU labour supply by about 1.3%.

A policy-maker stated that, in order for the single market to fulfil its full potential, progress must be made on energy union, banking union and CMU. Proposals have been made on how to finance a smart industrial policy at the European level in order to minimise fragmentations in the single market.

2.3.1 Energy independence is urgently needed and requires more strategic thinking

An official noted that demography would be the focus of the upcoming Hungarian Presidency. In addition, energy independence is urgently needed. A third priority is to improve competitiveness. Energy prices in Europe are more affordable than they have been, but still very high. Next Generation EU and the Recovery and Resilience Facility (RRF) is a step towards the solution of this issue, but it does not fully cover the related financing needs. Furthermore, the pace of implementation leaves a lot to be desired. The facility amounts to approximately €650 billion euros, but only 35% has been disbursed so far, although we are past the halfway point to the 2026 deadline. The Commission's evaluation of the progress on the RRF has stated that it is 20% behind schedule. Faster progress must also be made on the CMU.

An industry representative commented that there is a need for more strategic thinking. When the US makes a decision about shale gas, it takes everything into consideration, including environmental issues, the competitiveness of its industry and security of supply. This collective approach that should be taken on every topic. For example, when considering a specific bank regulation, the banks' role is to explain what the consequences for them, the market and investments will be. The private sector's role is to state what it can do and cannot do. Risk-taking between the private and public sectors should be optimised to leverage public funds and raise as much private money as possible. CSRD requires corporates in Europe to provide a level of information that their competitors do not need to provide, putting them at an asymmetrical competitive disadvantage. There will be consequences for this in terms of innovation.

2.3.2 Completing the Banking and Capital Markets Unions

A policy-maker remarked that it is hoped that both the Letta report and the Draghi report will contribute to completing CMU. Many things, such as single issuance of bonds, will not be possible if the capital markets are not large and liquid enough.

An industry representative emphasised that banks are ready to take the risk as long as they are able to match the risk. Optimal risk matching within the balance sheet requires securitisation, a CMU, a European Deposit Insurance Scheme (EDIS) and the same bankruptcy laws all across the European Union. To have a single market of retail financial services, depositors must feel that they are equally protected in all countries across Europe. These points have been made numerous times over the last 15 years.

An industry representative commented that the policy focus on the securitisation markets has the potential to be transformative. One reason why the US banking sector has been such a powerful engine for the US economy is that it is able to recycle risk and financial resources, rather than relying on warehousing traditional credit products on balance sheet. Financial market participation increases with securitisation. Banks are better able to use their financial resources and there is greater availability of credit into the real economy. The American securitisation market is more than 10 times the size of the European one. The originate to distribute model enables a great deal of investment without the constraints placed by the size of bank balance sheets. When policy and regulatory matters are being considered, there should be a very disciplined approach towards the cost-benefit analysis and bank shareholders must be considered as stakeholders. Banks price risk, financially transform it and then distribute it. It is a concern when banks are warehousing risk, because that suggests that there are no other willing buyers. The focus should be on making investments financially attractive to end investors.

The Chair noted there are good reasons for the regulatory burden and banks have been safer in the current crisis than in previous crises, but some adjustment may be necessary. Whether banks would be able and willing to take the risk of financing the green transition or whether another approach would be needed must be considered.

2.4 NextGenerationEU and the revised Stability and Growth Pact: models for the future?

A policy-maker commented that the RRF can be a model for the way ahead. Political agreement has also been reached in the trialogues on the reform of the fiscal rules in Europe. Member states are coming out of the succession of recent crises with an increased level of debt. There is now a balanced package in place that ensures that debt levels can be reduced over the medium term in an economically realistic way. The package is country specific and based on debt sustainability aspects. The new fiscal rules also include incentives for investment and reforms, including for expenditure for the increased needs for defence and security in Europe. It is hoped that the final formal agreement will be complete by April and that the new rules can be implemented in spring.

An official noted that with regard to climate, energy security and common public goods, a central fiscal capacity is needed. The most efficient way to progress on this in the near future would be a climate and energy security fund at the EU level. Next Generation EU was a breakthrough instrument, partly because it connects the requirement of national structural reforms with investment. It is positive that the element of structural reform is included in the new fiscal framework. Completion of the single market will increase living standards and help close the gap toward the US. This is money on the table; let's take it.

The Chair summarised the suggested reasons for the relative competitive weakness in Europe: demographics, investment, productivity, technology, energy and the cost of geoeconomic fragmentation. Europe's resilience is underpinned by its strengths, such as knowledge and creativity. Labour markets are working better than in the past. There are also advantages around sustainability and inclusion. The focus should not only be on growth but also on how this growth is achieved. There is a great deal of work for the next Commission to do. Focus should be on making the single market work and allowing for risk taking in order to unleash financing.