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EUROPEAN BUSINESS: OVERCOMING UNCERTAINTY, STRENGTHENING RECOVERY

MAY 2017



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MGI research combines the disciplines of economics and management, employing the analytical tools of economics with the insights of business leaders. Our “micro-to-macro” methodology examines microeconomic industry trends to better understand the broad macroeconomic forces affecting business strategy and public policy. MGI's in-depth reports have covered more than 20 countries and 30 industries. Current research focuses on six themes: productivity and growth, natural resources, labour markets, the evolution of global financial markets, the economic impact of technology and innovation, and urbanisation.

Recent reports have assessed the economic benefits of tackling gender inequality, a new era of global competition, Chinese innovation, and digital globalisation. MGI is led by four McKinsey & Company senior partners: Jacques Bughin, James Manyika, Jonathan Woetzel, and Frank Mattern, MGI's chairman. Michael Chui, Susan Lund, Anu Madgavkar, Sree Ramaswamy, 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 offices around the world. These teams draw on McKinsey's global network of partners and industry and management experts. Input is provided by the MGI Council, which coleads projects and provides guidance; members are Andres Cadena, Sandrine Devillard, Richard Dobbs, Katy George, Rajat Gupta, Eric Hazan, Eric Labaye, Acha Leke, Scott Nyquist, Gary Pinkus, Oliver Tonby, and Eckart Windhagen. In addition, leading economists, including Nobel laureates, act as research advisers.

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EUROPEAN BUSINESS: OVERCOMING UNCERTAINTY, STRENGTHENING RECOVERY

MAY 2017



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PREFACE

The European Union (EU) celebrates its 60th anniversary this year, just as the economic recovery is finally gaining strength after a difficult decade. The EU has much that is positive to look back on and, with a population of more than 500 million and combined GDP of \$15 trillion, it remains a key global force. However, significant challenges are looming—not just external ones, in the form of major global trends such as ageing and digitisation, but also internal ones. The EU, created with the idea of forging “ever closer union” along with peace and prosperity, has to address forces of divergence, including the rise of populism in countries including France, Poland, and Spain, and the vote by Britain in 2016 to leave the EU altogether.

How Europe evolves will depend fundamentally on the interaction between the economic climate and the EU’s effectiveness in improving it. Recent research, our own and by others, suggests that most EU citizens continue to embrace the EU, even as they call for change.[†] A prize essay contest we sponsored in 2016 sought to crowdsource ideas on how economic reforms could be implemented in the EU in a way that would be acceptable to policy makers and the public alike, and many submissions suggested that a new narrative for the EU and ways to bridge the gulf between ordinary citizens and EU institutions would be needed.[‡]

Missing from the research above has been the opinion of private-sector business leaders. They help generate the majority of European GDP and are the main channel for employing and paying workers, creating the means for consumption. This report provides their crucial perspective on the EU economy, its policies, and its institutions. It is based on a survey of 2,000 C-suite executives in six European Union countries, in which we asked them about the outlook for their companies, their view of the major global trends, and their expectations and hopes for the future of Europe itself. The picture that emerges is one of a recovering economy and European business leaders largely supportive of the EU. However, their main concerns are linked to economic and global trends, fuelling uncertainty and nervousness. The EU has a role to play in clarifying its unity and by creating more effective institutions, so that it can better withstand the challenges to come.

The research was led by Jacques Bughin, a director of the McKinsey Global Institute and McKinsey senior partner based in Brussels, and Jan Mischke, MGI senior fellow based in Zurich. McKinsey senior partners Eric Labaye, Frank Mattern, Sven Smit, and Eckart Windhagen guided and contributed to the research. Kate Bragg headed the research team, which comprised Sarah Forman, Krzysztof Kwiatkowski, Kimberley Moran, and Aditi Ramdorai.

[†] See Catherine de Vries and Isabell Hoffmann, *Supportive but wary: How Europeans feel about the EU 60 years after the Treaty of Rome*, Bertelsmann Stiftung, January 2017. Our recent research on Europe includes *Rome redux: New priorities for the European Union at 60*, McKinsey Global Institute, March 2017; *Europe’s new refugees: A roadmap for better integration outcomes*, McKinsey Global Institute, December 2016; *Digital Europe: Pushing the frontier, capturing the benefits*, McKinsey Global Institute, June 2016; and *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

[‡] *An opportunity for Europe? The McKinsey Global Institute 2016 Europe Essay Prize: Key themes and winning entries*, McKinsey Global Institute, October 2016.

A number of our McKinsey colleagues provided valuable advice and analytical support: Jonathan Ablett, Tera Allas, Ivo Eman, Peter Fuller, Brett Jacobs, Sree Ramaswamy, Yvonne Staack, Tilman Tacke, and Soyoko Umeno. This report was edited and produced by MGI senior editor Peter Gumbel, editorial production manager Julie Philpot, senior graphic designers Marisa Carder and Margo Shimasaki, and data visualization editor Richard Johnson. Matt Cooke, MGI director of external communications, managed communications.

We would like to thank our academic advisers for their invaluable insights and guidance: Martin Baily, Bernard L. Schwartz Chair in Economic Policy Development and senior fellow and director of the Initiative on Business and Public Policy at the Brookings Institution, and Hans-Helmut Kotz, visiting professor of economics at Harvard University and senior fellow at the Center for Financial Studies.

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 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. While we are grateful for all the input we have received, the report is ours, including any errors. We welcome your comments on this research at MGI@mckinsey.com.

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May 2017



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The euro has been adopted by 19 EU countries since its introduction in 1999
© Manuel Breva Colmeiro/Moment/Getty Images

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IN BRIEF

EUROPEAN BUSINESS: OVERCOMING UNCERTAINTY, STRENGTHENING RECOVERY

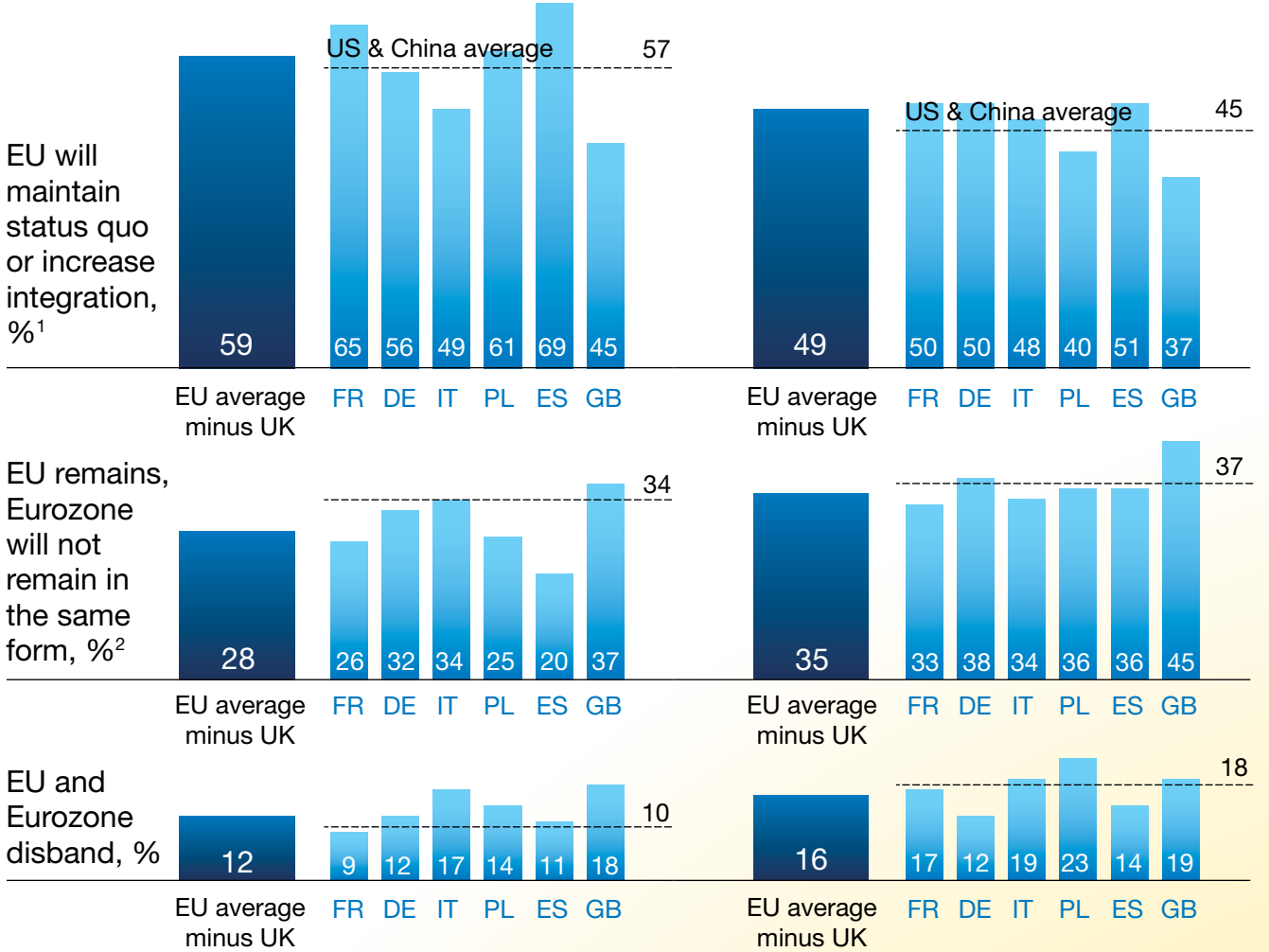
The European economy is on the road to recovery and business confidence has picked up after one of the toughest decades in the postwar era. While companies around Europe are more optimistic about the outlook, the majority remains nervous, perceiving some global trends as headwinds to their business and concerned about risks to the European Union (EU) itself. A survey of 2,000 C-suite executives we conducted in France, Germany, Italy, Poland, Spain, and the United Kingdom highlights their desire for “more Europe” in the form of more integrated policies across the EU, but also their divergent opinions on the trends and pressures on the EU they expect in the future.

- European businesses are more optimistic than economists’ forecasts and are expecting EU GDP growth of 2 percent annually over the next five years. They also expect average revenue growth of 2.1 percent in the coming year. About one in five companies predicts revenue growth above 5 percent, while about one-third of firms expect revenues to stagnate or decline in the year ahead. Larger, internationally focused companies are most likely to expect future revenue growth. US and Chinese firms we surveyed project even higher EU GDP growth than their European competitors on average, of almost 3 percent and 2.3 percent respectively.
- Businesses see opportunities to invest, even as they amass cash to insure against a range of risks and uncertainties. Gross corporate savings rose to almost €2 trillion in 2015, and firms are divided between those that say they are saving to fund future investment (48 percent) and those building reserves for future crises (47 percent). Uncertainty rather than weak demand, lack of opportunities, or access to finance is cited as the main barrier to investment.
- Most company leaders surveyed are positive about the effect of digitisation and the rise of emerging economies on their businesses, but more negative about other global trends. A positive view of digitisation, where the EU currently trails the United States, correlates with a more optimistic outlook for investment, while concerns about income inequality, rising populism, and antiglobalisation sentiment correlate negatively.
- Just over half the companies surveyed think the EU has had a beneficial effect on their business, and the most successful companies are the most positive. Smaller, less globalised companies tend to question the benefits of Europe and are less eager to invest in the future. Businesses generally are supportive of the EU Commission’s policy priorities, but are less positive about the way they have been executed.
- Eighty-five percent of surveyed companies say they think the EU will remain intact, and just under half anticipate that the status quo will prevail or that greater integration will take place. However, 51 percent expect the Eurozone to shrink or disband in the years ahead. After Britain’s decision to leave the EU, one in three respondents said a decision by any other countries to follow suit would be negative for their business.
- Reducing uncertainty should be high on the European agenda; restored productive investment could boost the EU’s GDP by as much as €1 trillion. The EU will need to address lingering areas of fragility, including remaining financial risk, the direction of the Eurozone and, where possible, geopolitical concerns such as migration and populism. One way to bolster confidence in the EU would be to develop a new narrative showing that the forces in favour of cooperation are stronger than those opposing it.

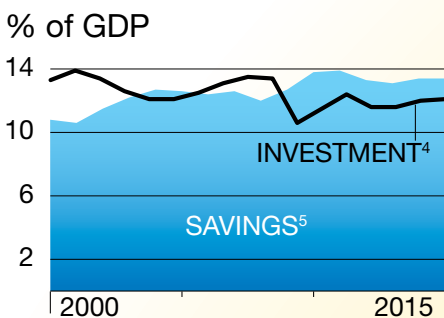
European business between hopes and fears

Q: Which of these scenarios is most beneficial for your business?

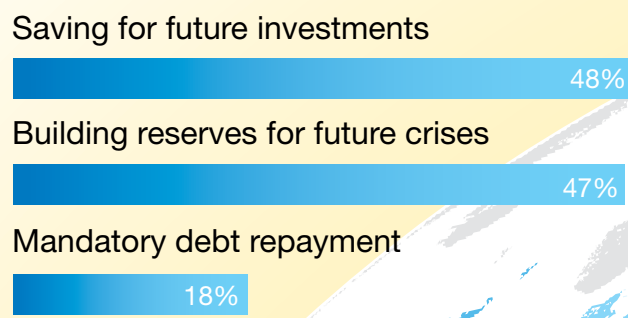
Q: Which of these scenarios is most likely to occur?



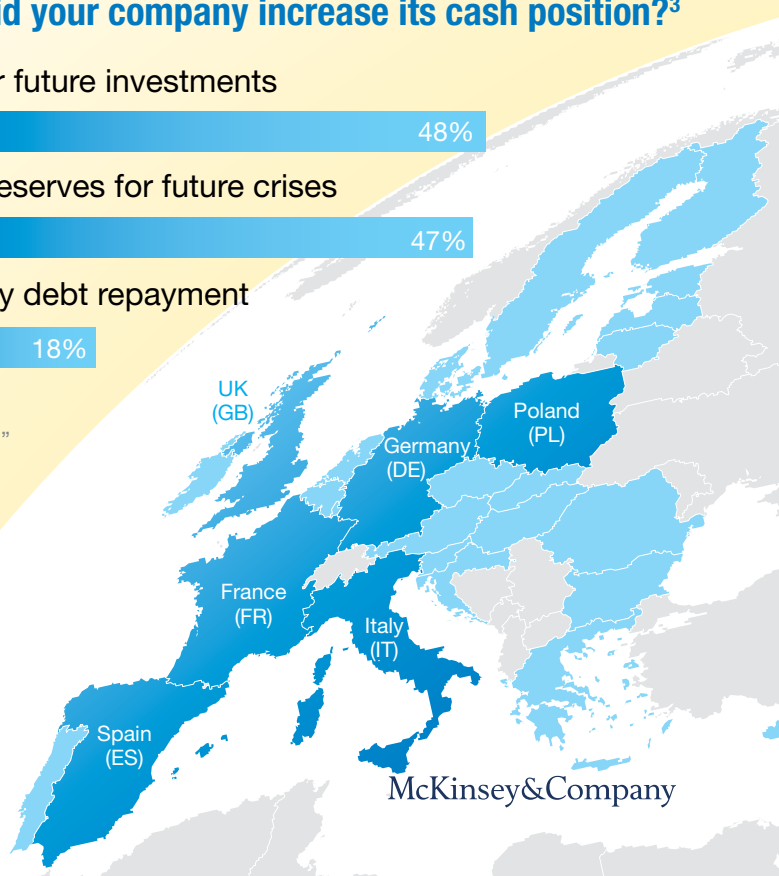
Cash position of EU firms



Q: Why did your company increase its cash position?³



1 Includes all responses with “EU and Eurozone remain intact with current responsibilities” or “EU responsibilities expansion” as top choice.
 2 Includes all responses with “Eurozone breaks up, EU intact” or “Eurozone shrinks, EU intact” as top choice.
 3 Asked only of companies that indicated cash position had increased; companies were allowed to choose up to two responses.
 4 Gross capital formation.
 5 Gross corporate savings.
 SOURCE: AMECO; McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis





La Défense business district in Paris
© EschCollection/Photonica/Getty Images

EXECUTIVE SUMMARY

The European economy is on the road to recovery after one of the toughest decades in the postwar era, marked by the 2007–09 financial crisis and the double-dip recession in 2012–13. The stronger outlook is cheering the European business community: a survey of 2,000 C-suite executives we conducted in France, Germany, Italy, Poland, Spain, and the United Kingdom shows that executives are on the whole more optimistic about the overall EU economy and about their own business outlook. However, the brighter mood is tempered by concerns over lingering risks and areas of fragility, including worries about another financial crisis, the rise of populism and antiglobalisation sentiment, and the future shape and role of the European Union itself, all of which are weighing on companies' investment behaviour.

2%

Expected annual GDP growth over the next five years

A FRAGILE RECOVERY

Our survey suggests that European businesses are expecting EU GDP growth of 2 percent annually over the next five years, higher than the 1.7 percent forecast by some economists for 2018. They are also more upbeat about their own business prospects: overall, the companies we surveyed expect weighted average revenue growth of 2.1 percent in the coming year, considerably higher than 1.5 percent annual forecast by economists and 1.6 percent average annual rise seen in the past three years.¹ About one in five companies is predicting revenue growth above 5 percent, while about one-third of firms expect stagnant or declining revenues in the year ahead. Larger, internationally focused companies are more likely to expect strong revenue growth. Survey respondents also expect to raise headcount over the next three years by an average of 2.4 percent cumulatively, triple the 0.8 percent forecast for employment growth (Exhibit E1).²

As part of our survey, we also polled US and Chinese companies that operate or invest in Europe for their views of the GDP outlook for Europe. They were even more upbeat than European companies, with US companies expecting growth of almost 3 percent, and Chinese firms anticipating growth of 2.3 percent.³

COMPANIES AMASS CASH EVEN AS INVESTMENT OPPORTUNITIES RETURN

How much of this restored optimism is mood, and how far does it extend into business decisions? Business investment patterns provide some revealing indications. Investment was one of the biggest casualties of the past decade, with corporate investment falling by €200 billion between 2007 and 2009. While business investment has crept back to 2007 levels in absolute terms, investment as a share of GDP remains at historic lows, most notably in southern Europe.⁴

€200B

Decline in investment from 2007–09 in Europe

Business investment tends to follow demand and demand expectations.⁵ Indeed, those European respondents to a *McKinsey Quarterly* survey who have increased their investment budget predominantly cite increasing demand expectations (43 percent) and increasing demand (40 percent) as the key reasons for doing so.⁶ And in line with the downturn and recovery of the economy, a large majority of businesses believe they have been investing at the right level.

¹ IHS Global Insights database.

² IHS Global Economy database.

³ A full list of survey questions and more detailed analysis of the results can be found in the technical appendix.

⁴ European Commission macroeconomic database (AMECO).

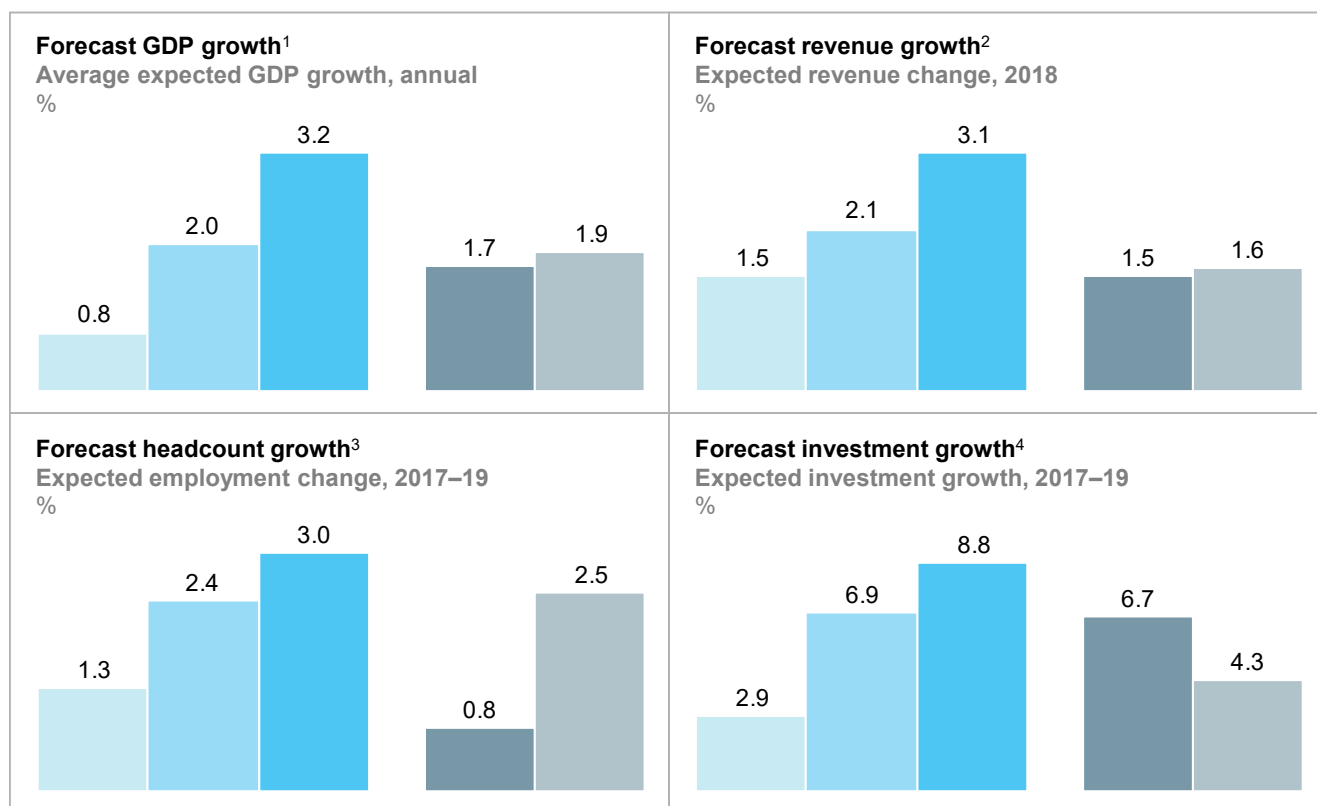
⁵ See *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

⁶ *McKinsey Quarterly* survey, March 2017.

Exhibit E1

European businesses are more optimistic than industry forecasts across four indicators (after weighting to more fully represent the business community within the six member states)

Survey sample ■ Low end of range ■ Midpoint of range ■ High end of range **For comparison** ■ Economic forecast ■ Historical performance



1 Forecast is IHS forecast GDP growth for EU-28 (2018). Historical performance is Eurostat historical real GDP growth for EU-28 (2016).
 2 Forecast is IHS forecast real GVA growth for average of 6 countries' total economies (2018). Historical performance is IHS historical real GVA growth for the average of 6 countries' total economies (2016).
 3 Forecast is the % change in employment for the total economy of the 6 countries (2017–19) from IHS. Historical performance is the % change in historical employment for the total economy for the 6 countries (2014–16) from IHS.
 4 Growth is the unweighted average of expected investment growth over 2017–19 across respondents as we do not have a breakdown of private investment by enterprise size to provide a total economy weighting. Forecast is the % change in investment in non-residential construction, metal products and machinery, and other investment from the European Commission's AMECO database. It estimates 3-year total growth based on the 2015 annual growth rate. The data for 2015 is the latest available for forecasting and assessing historical performance. Historical performance is the % change in investment in non-residential construction, metal products and machinery, and other investment from the European Commission's AMECO database over 2013–15. The data for 2015 is the latest available for forecasting and assessing historical performance.
 NOTE: Not to scale. GDP and revenue growth are response averages weighted by GVA contribution of different company size groups within each of the 6 countries. Forecast headcount growth is a response average based on share of employment for different company size groups within the 6 countries.

SOURCE: MGI Business Survey, 2017; IHS Global Economy database; IHS World Industry Service; European Commission SME Performance Review; Eurostat; AMECO database; McKinsey Global Institute analysis

Going forward, as the recovery continues, businesses in our survey see their investment rising by an average of 6.9 percent over the next three years cumulatively. Notably, as of today, almost 80 percent of European respondents to our global survey say they also have sufficient opportunities to invest or even more than they can fund.

Yet uncertainty appears to be holding investment back and leading to increases in cash flow positions instead. Forty percent of European respondents to our global survey say risk aversion is the key reason for not investing in all opportunities, and uncertainty about future relevance of investment (29 percent) and political uncertainty (17 percent) also feature highly. In our European survey, the top cited risks are the possibility of another financial crisis as well as European political trends such as the rise of populist parties.

Uncertainty appears to have shifted business preferences towards funding investment internally, and hoarding larger cash buffers. European companies continue to grow their cash: gross corporate savings rose to almost €2 trillion in 2015, €410 billion more than in 2009, turning companies into net lenders to the economy. Of the companies increasing their cash flow positions, 48 percent of our survey respondents say they are doing so in order to save for future investment, and 47 percent to equip them better for future crises. Forty percent of European respondents to the *McKinsey Quarterly* global survey who have not invested in all available opportunities cite risk aversion as a key reason not to do so; uncertainty about future relevance of investment (29 percent) and political uncertainty (17 percent) also feature highly. In our European survey, the top cited barriers to investment are regulatory burdens, regulatory uncertainty, and other concerns around possible risks.

GLOBAL TRENDS AND EUROPEAN CHALLENGES: BETWEEN OPTIMISM AND ANXIETY

In our survey we asked European business leaders for their perspective on global forces and trends potentially affecting business, from ageing to rising populism, and on their views of the European Union. For the trends, business leaders were eager to embrace digitisation and automation, with 55 percent of executives saying that advancing technologies will have a positive impact on their business. They also broadly welcomed the rise of emerging economies. However, between 35 and 40 percent of firms surveyed see rising populism, geopolitical disruption, and rising inequality as having a negative impact on their business. One-third also view any country beyond Britain leaving the EU as a negative for business, although one in four says the impact could be positive.

Most European businesses see benefits from EU membership and want “more Europe”

Fifty-four percent of European companies surveyed think the EU has had a positive impact on their business, and the better a company’s expected future revenue growth, the stronger the approval rating. The benefits of EU membership most cited by companies are maintaining peace and security, enabling ease of business, and providing free market access.

Some 57 percent of respondents said they have received benefits from the single market for goods and for services, while about 55 percent have seen benefits from the free movement of people that is enshrined in the single market, and from a unified currency. Asked about the challenges of EU membership, companies cited the loss of national sovereignty (19 percent) and complex and burdensome regulations and processes (13 percent).

The responses from British companies about the impact of the EU on their business were on the whole less favourable, although not significantly more negative than in the other countries we surveyed. For example, the 42 percent of UK business respondents saying the EU’s impact on their business had been “moderately positive” or “very positive”, was not far behind the 46 percent of Italian companies that felt the same way. Indeed, a slightly larger proportion of Italian firms said the EU’s effect had been negative (22 percent vs. 21 percent).

The results of our business survey are in line with views expressed by consumers: in one recent survey, some 70 percent of the German and Spanish public wanted more political and economic integration, as did 50 percent of French respondents, while less than half the Britons polled did.⁷

Across the six countries we surveyed, 60 percent of businesses say they want “more Europe”, including more centralised authority and spending—a proportion that rises to

55%

Share of executives who see technological change as positive for business

⁷ Catherine de Vries and Isabell Hoffmann, *Supportive but wary: How Europeans feel about the EU 60 years after the Treaty of Rome*, Bertelsmann Stiftung, January 2017.

65 percent when the replies from UK businesses are excluded.⁸ However, some of the policy desires contradict one another, and no one size fits all. Our survey also suggests that while many European businesses are supportive of EU Commission policy priorities, they have more mixed views about the way these policies have been executed.

European businesses see the EU remaining intact, but think the Eurozone could shrink or even disband

Some of the biggest uncertainties for European business are related to the future of the European Union itself. Now that the countdown for Britain's exit from the European Union has officially begun, at a time of economic and political divergence among the remaining 27 member states, what will be the future shape and direction of the EU itself? We presented companies with five possible scenarios and asked them which they thought were most likely to happen, and which they thought would be best for their businesses. The results highlight the gulf between hopes and expectations: nearly 85 percent of surveyed companies say they think the EU will remain intact, and just under half anticipate that the status quo will prevail or that greater integration will take place. However, just over half expect the Eurozone to shrink or disband in the years ahead.

The scenarios we suggested were:

- **Increased integration.** "EU responsibilities expansion: Both the EU and the Eurozone maintain their current structure, with core countries remaining in place (with only the UK leaving the EU). The EU gains new responsibilities and sets up new institutions such as common defence, external border protection, and partially common fiscal policy".
- **Maintaining the status quo.** "EU and Eurozone remain intact with current responsibilities: Both the EU and the Eurozone maintain their current structure and levels of responsibility, with core countries remaining in place (with only the UK leaving the EU)".
- **Eurozone shrinks.** "Eurozone shrinks, with the EU intact: Peripheral economies exit the Eurozone and return to their national currencies, while core countries retain the euro. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU)".
- **Eurozone breaks up.** "Eurozone break-up, with the EU intact: Core countries exit the Eurozone, and all countries return to their national currencies. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU)".
- **EU and Eurozone disband.** "EU and Eurozone erosion: Core countries exit both blocks, and both the EU and the Eurozone disband completely".

Exhibit E2 shows the results from business leaders when we asked them what they expect to happen. About one in three expects the Eurozone to break up or shrink, and 16 percent even expect the European Union to disband, along with the Eurozone. It also shows the survey results when we asked the business leaders what they thought would be best for their businesses. A larger proportion—almost 60 percent—want the EU and the Eurozone to integrate more closely or maintain the status quo, up from 49 percent who expect that to happen, while the share of those hoping the Eurozone will shrink or disband falls to 28 percent, and only 12 percent say they want the European Union itself to disband.

⁸ The questions about "more Europe" in our survey referred to more policies set and enforced at EU level; "less Europe" referred to more policies being set by individual member states. Follow-up questions then probed views on specific policies, including on trade, migration, and financial and monetary measures.

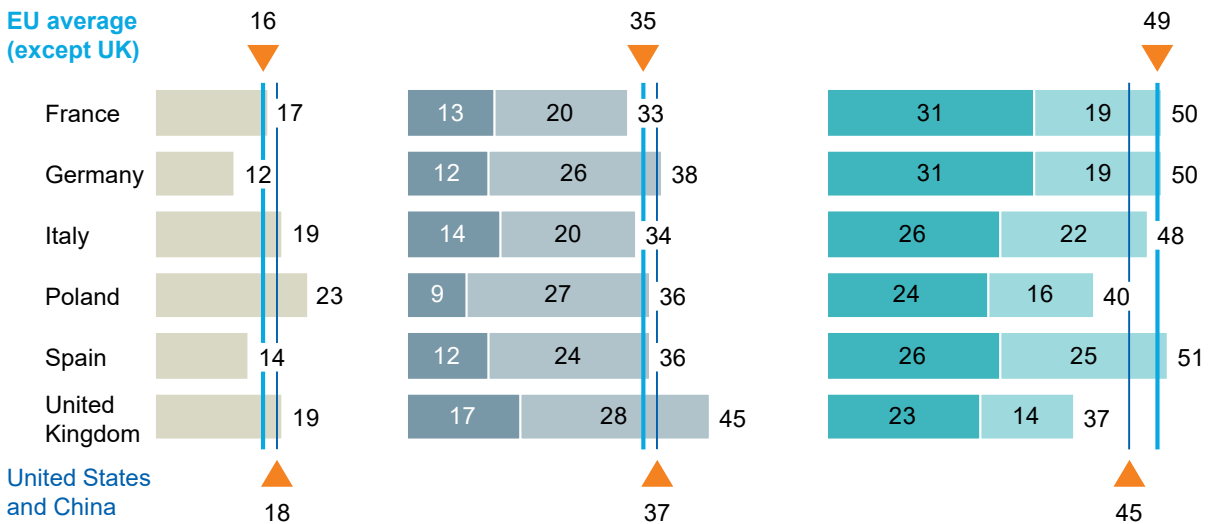
Exhibit E2

Respondents from all countries have split expectations for the future of the EU

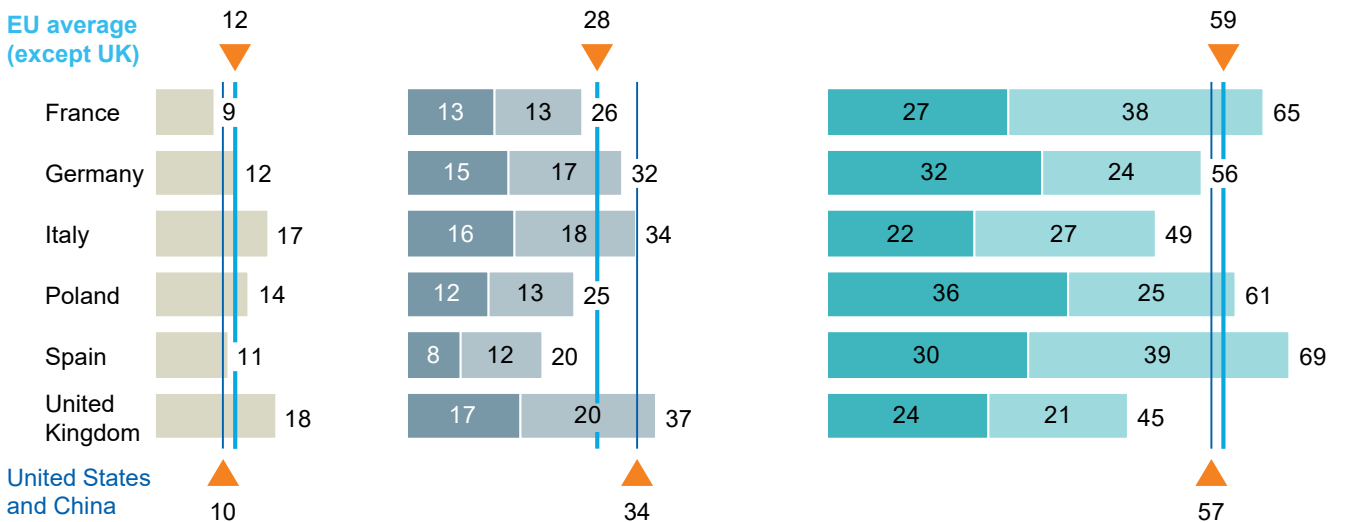
Expected and most beneficial scenarios for Europe
% of EU respondents

| Scenarios | EU and Eurozone will disband | EU remains as is, Eurozone will not remain in the same form | | EU will continue with status quo or move to increased integration | |
|-----------|------------------------------|---|-----------------------------|---|-----------------------|
| | | Eurozone breaks up, EU intact | Eurozone shrinks, EU intact | Status quo | Increased integration |

Q: The following are potential pathways for the future of the EU and the Eurozone. Please indicate which of these scenarios you think are most likely to occur.



Q: The following are potential pathways for the future of the EU and the Eurozone. Please indicate which of these scenarios you think are most beneficial for your business.



NOTE: All top-ranked scenarios. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

€1T

Potential boost to EU GDP from restoring investment to pre-crisis level

STRENGTHENING CONFIDENCE AND STABILITY

How can Europe further strengthen confidence within the business community and thereby boost investment? Our 2015 report on Europe's economic prospects provided detailed suggestions for ways to close the output gap, return to sustained 2 to 3 percent GDP growth, and create millions of jobs through a combination of national structural reforms and pan-European measures to stimulate demand.⁹ A subsequent prize essay contest we held in 2016 sought to crowdsource ways to implement reforms so that they would be palatable to European policy makers and the public alike.¹⁰ In our concluding section, we mainly take our cue from European businesses themselves, large and small, successful and struggling, across the six EU nations we surveyed, with a discussion of three paths forward: further stimulating recovery and investment; addressing key areas of fragility; and developing a new narrative for the EU.

Further stimulating recovery and investment

We used McKinsey & Company's Global Growth Model to test scenarios of what could happen to the European economy if investment were to return more strongly.¹¹ Our analysis found that EU GDP could rise by 5.7 percent in 2030, or the equivalent of an additional €1 trillion for the EU economy.¹² For context, that would be approximately equivalent to the combined GDP of the Czech Republic, Denmark, and Sweden.¹³

Our survey provided pointers on what policy options businesses would prioritise to achieve higher investment. Respondents are divided: more accommodative monetary and fiscal policy (23 percent) and additional economic stimulus (16 percent) were two of the top three most commonly cited ways to increase investment, while lower taxes and less spending by EU or national governments was the second most frequently cited (21 percent of respondents).

Some 80 percent of respondents also see a case for raising public investment—notably in energy and green investment, information and communications technology, and R&D—although the majority would not be prepared to pay higher taxes to finance those investment.

Addressing key areas of fragility

A number of key measures will need to be taken to address the lingering areas of fragility that are weighing on the corporate environment. They include:

- **Solidifying financial stability.** The EU has put in place the first phases of a banking union that include provisions for recapitalising struggling banks and “bail-ins” for those that are failing. However, the continued high level of non-performing loans in a few countries suggests more strenuous action may be needed to clean up bank balance sheets proactively—and restore investor confidence—be it at the national or at the European level. Difficult decisions will also be needed to defuse concerns about elevated sovereign debt levels.
- **Laying out and communicating a credible plan for the future of the Eurozone.** Given the significant proportion of business leaders who doubt the Eurozone's durability in its current form, EU and national government leaders will need to sketch out—and find the political consensus on—a plan that resolves the unstable equilibrium between

⁹ *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

¹⁰ *An opportunity for Europe? The McKinsey Global Institute 2016 Europe Essay Prize: Key themes and winning entries*, McKinsey Global Institute, October 2016.

¹¹ McKinsey's proprietary Global Growth Model is an advanced macroeconomic tool that provides growth and GDP outlooks for different economic scenarios. For details, see *Shifting tides: Global economic scenarios for 2015–25*, McKinsey & Company, September 2015.

¹² In 2010 prices, based on raising investment to pre-crisis levels by 2020.

¹³ AMECO.

monetary interdependence and fiscal and economic policy sovereignty, which has led to moral hazard and unaligned policy mixes.

- **Finding answers to global political challenges.** Most businesses see global trends as creating more risk and headwind than benefits. Political debate around migration and refugees and geopolitical tensions that are fuelling a rise of populism stand out as influencing businesses' perceptions about the EU and its benefits. Some of these issues are not within the control of EU institutions, especially without consensus among member governments, which has proved elusive on some key topics. Nonetheless, if the EU were to come up with solid pan-European answers to some of these issues, our research suggests that support from companies for "more Europe" and confidence in the EU could benefit.

A new narrative for Europe going forward

Successfully addressing these fragilities is no mean feat, and will require bold action by the EU and EU member states' elected leaders. Many individual steps have successfully been taken to "muddle through" and help overcome—for now—the worst financial and economic crisis in the EU's existence. But they have not put an end to uncertainty. The EU will need to demonstrate that the forces in favour of cooperation are stronger than those opposing it.

One way to move ahead and rally support for bolder moves forward would be to work on creating a new narrative for the European Union for the coming years. The EU's founding fathers did this convincingly in 1957 in the Treaty of Rome, outlining a clear and compelling vision of peace and prosperity and "ever closer union" (even if turning that union into practical steps proved highly complex already in the early years). The creation of the single market starting in the mid-1980s was another moment of reinvention, as was the momentous step towards establishing a single currency, which set off a decade of moves to bring about closer economic convergence. Today, the EU needs a new vision, one based on realism about the present, but also aspirations for the future.



For all the challenges it faces today, the EU is no stranger to adversity. Since its origins, it has had to tackle a seemingly endless succession of crises and threats to its integrity, from France's "empty chair" policy in the 1960s in a dispute with Germany over agriculture, to the global energy crisis in the 1970s, the complex restructuring of its coal and steel industries in the 1980s, and waves of currency turbulence in the 1990s before—and after—the creation of the euro. While the forces arrayed on the horizon, and increasingly in its midst, may seem formidable today, and are feeding some pessimism within the business community, resilience has been one of the EU's enduring strengths, and could prove invaluable again in today's turbulent world. But resilience needs a goal that can be articulated, and that can inspire a return to confidence. As our survey of European business indicates, that restoration of faith is needed.



A greenhouse in Almería, Spain

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1. A FRAGILE RECOVERY MARKED BY CAUTIOUS INVESTMENT

European companies and the European economy are finally on the road to recovery after one of the toughest decades in the postwar era. Economically, the 2007–09 financial crisis and the double-dip recession in 2012–13 that followed, on the heels of the European sovereign debt crisis, took a severe toll on GDP growth and on business confidence. Politically and socially, the period was marked by divergence and disgruntlement, culminating in the British vote in June 2016 to leave the European Union.

This economic “lost decade”, as some are calling it, may be over, as growth picks up and business sentiment improves.¹⁴ A survey we conducted of businesses in six European countries shows that expectations of economic growth and revenue are higher than economists’ forecasts and their performance in the past three years, and that many companies are looking to continue hiring. Yet the survey also highlights uneven distribution of the gains—with smaller companies, in particular, less upbeat about their prospects—and continued evidence of fragility and nervousness.

This is most evident in the outlook for investment, which is at a 20-year low in terms of its proportion of European GDP. Businesses grew cash during the decade, and have mixed feelings about ramping up their investment now that the economy is on the mend: firms tell us they are holding back in large part because of the risks and uncertainty that they see ahead. Overcoming this nervousness and restoring confidence will be key to ensuring that the European economic and business recovery is sustained.

THE EU IS EMERGING FROM A DIFFICULT DECADE THAT OBSCURED ITS LONGER-TERM ACHIEVEMENTS

The European Union has been a force for economic growth and social advancement for most of the past 60 years, but the past decade’s sluggish growth and political malaise have obscured its achievements over six decades.¹⁵ When the heads of government of Belgium, France, Germany, Italy, Luxembourg, and the Netherlands met in Rome in March 1957 to sign a treaty establishing the European Economic Community (the forerunner of today’s EU), they were explicit about their aims: to strengthen peace and liberty and “lay the foundations of an ever closer union among the peoples of Europe”, that would improve living and working conditions through common action to eliminate barriers that divide Europe.¹⁶ The EU’s GDP has grown more than sevenfold, to \$15 trillion, in the 60 years since.¹⁷ Until the financial crisis in 2007–08, its GDP per capita performance was broadly comparable with that of the United States. Since the financial crisis, however, Europe’s GDP per capita growth has been just half that of the United States, at 0.3 percent compared with 0.6 percent. The sovereign debt crisis in 2012–13 threw Europe into a double-dip recession that the United States managed to avoid (Exhibit 1).

7x

Growth in EU’s GDP since the 1957 Treaty of Rome

¹⁴ The idea of a “lost decade” has become a recurring theme among some economists and policy makers. See Claire Jones, “Spectre of ‘lost decade’ haunting Europe”, *Financial Times*, August 21, 2014; Szu Ping Chan and Peter Foster, “Mark Carney warns Britain is suffering first lost decade since 1860 as people across Europe lose trust in globalisation”, *Daily Telegraph*, December 5, 2016.

¹⁵ For a more detailed analysis of the EU’s achievements and future challenges, see *Rome redux: New priorities for the European Union at 60*, McKinsey Global Institute, March 2017.

¹⁶ The treaty’s full text is available at http://ec.europa.eu/archives/emu_history/documents/treaties/rometreaty2.pdf.

¹⁷ In constant 2015 dollars.

Exhibit 1

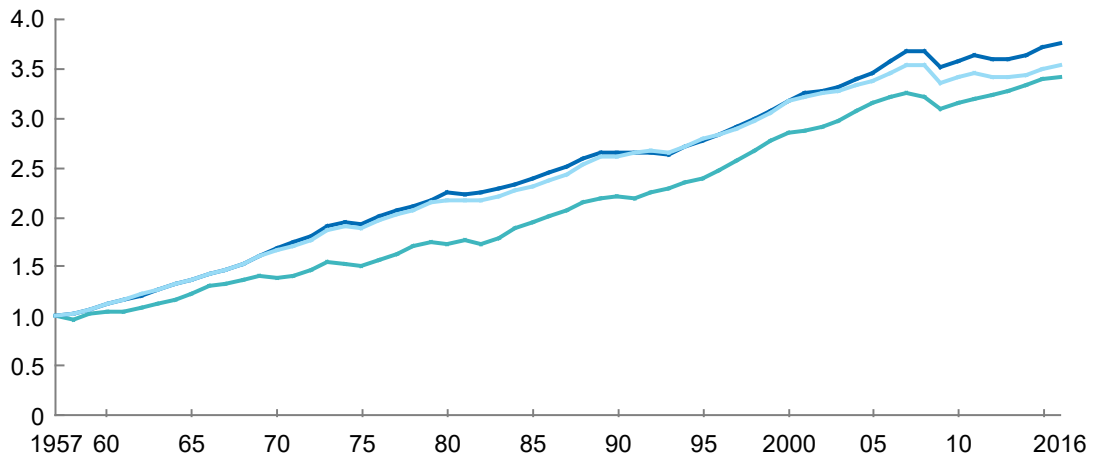
Europe's economy, in per capita terms, performed solidly compared with the United States until Europe's double-dip recession after 2008

GDP per capita, purchasing power parity adjusted¹

United States EU-28 EU-15

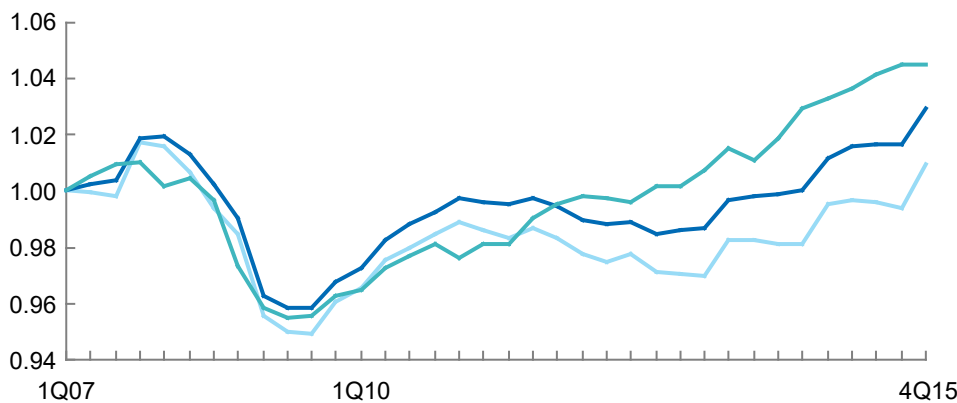
1957–2016

Index: 1.0 = 1957



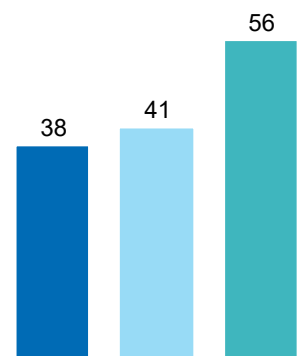
1Q07–4Q15

Index: 1.00 = 1Q07



2016

\$ thousand



1 Annual EKS GDP data from The Conference Board, converted to 2015 price level in US dollars using 2011 EKS purchasing power parity (PPP); European countries' per capita GDP weighted with respective year population.

SOURCE: The Conference Board; Eurostat; McKinsey Global Institute analysis

The EU has a significant gap with the United States in per capita GDP, but less so on a welfare basis.¹⁸ 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. Within that overall picture there is considerable variation among countries; Nordic member states and continental European countries tend to perform better than Southern Europe or the Eastern Europe nations that have joined the EU since 2004.

¹⁸ See Charles I. Jones and Peter J. Klenow, "Beyond GDP? Welfare across countries and time", *American Economic Review*, volume 106, number 9, September 2016.

The EU's single market has been a singular achievement but still has gaps

From a business perspective, one of the milestones of the past 60 years was the creation of the single market in 1986–92. The programme put a new emphasis on free movement of people, services, and capital and ushered in an extended period of liberalisation of network industries and services. This contributed to the interconnectedness of the EU and the ability of individual member states to leverage the large internal market. European businesses have benefited from the ensuing ease of cross-border business, as well as from harmonisation measures that aim to provide a clear and predictable legal framework. Economic estimates of the benefits of EU membership vary widely, but a 2014 report from the European Parliament estimated that GDP across all EU members is 5 percent higher as a result of the single market than it otherwise would be.¹⁹ The American Chamber of Commerce to the EU puts that figure at 1.7 percent, and estimates that economic integration brought about by the single market led to the creation of 3.6 million more jobs in the EU.²⁰

For all its achievements, the single market still has gaps that remain to be filled, however. Full harmonisation has yet to take place across a range of sectors and policy areas, including digital, capital markets, energy, and defence procurement, and considerable incremental efficiencies and savings could still be achieved. In digital, for instance, only 15 percent of all EU consumers buy online from another EU country, whereas nearly 44 percent do so domestically, and the EU has a significant deficit in digital trade with the United States.²¹ Our research finds that a completed digital single market could double the ratio of cross-border to national digital trade of goods and services, and boost cross-border flows beyond e-commerce, including Web and video applications. We estimate that the combined impact of these benefits amounts to €375 billion a year.²² For energy, the European Commission estimates that completing the internal energy market would provide between €16 billion and €40 billion of net economic benefits per year.²³ There is also more space to connect the public and defence sectors across the single market. Europe has been slower to consolidate defence industries than the United States, which revamped its defence sector in the 1990s. The result is that Europe has 17 battle tank systems in service compared with just one in the United States, and 29 types of frigate and destroyer compared with just four in the US Navy.²⁴ McKinsey has estimated that, in the long run, €11 billion of the €35 billion annual defence investment budget in EU countries—more than 30 percent—could potentially be saved through pooling of procurement.²⁵

The EU is at an inflection point, facing a growing backlash and increased divergence

The EU is at an inflection point. It faces a growing backlash against the free movement of goods and people that has underpinned its economic growth since the Treaty of Rome. In opinion surveys and elections, a growing proportion of Europeans are expressing scepticism or outright hostility to free trade and especially immigration; the British move to leave the EU was in part driven by that scepticism and is being closely watched as a possible precedent. At the same time, the EU is in a state of “unstable equilibrium”: national economies have integrated tightly including with open borders and, for Eurozone members, a common currency, yet political decision making for matters of common concern including fiscal and economic policy, security, and issues such as migration largely remains the

¹⁹ Zsolt Pataki, *The cost of non-Europe in the single market*, European Parliamentary Research Service, September 2014.

²⁰ *The EU single market: Impact on member states*, American Chamber of Commerce to the EU, February 2017.

²¹ *Why we need a Digital Single Market*, European Commission fact sheet, May 2015; *Digital Europe: Pushing the frontier, capturing the benefits*, McKinsey Global Institute, June 2016.

²² *Digital Europe: Pushing the frontier, capturing the benefits*, McKinsey Global Institute, June 2016.

²³ *Progress towards completing the Internal Energy Market*, European Commission, October 13, 2014.

²⁴ *Post-truth, post-West, post-order? Munich Security Report, 2017*, Munich Security Conference Foundation, 2017.

²⁵ Janosch Delcker, “EU could slash costs by pooling military spending: study”, Politico, February 6, 2017; *The future of European defence: Tackling the productivity challenge*, McKinsey & Company, May 2013.

purview of national governments. Some economists and financial market participants continue to believe that the euro in its current form is not sustainable.²⁶

The fault lines in today's Europe go beyond the fundamental question of pro- or anti-EU. Sixty years after the Treaty of Rome's pledge to lay the foundations of an ever closer union, the differences and divergences in Europe remain substantial, across economic, social, political, and cultural dimensions. While economies have on the whole begun to converge closer to Germany's, the EU's largest economy, they remain far apart and have moved further from one another since the 2007–08 crisis. Indeed, divergences among EU member states exist across a wide range of social and economic indicators, from energy intensity and housing quality to air quality and homicide rates. They are also demographic: while populations across most Southern and Eastern European cities are poised to decline because of demographic changes and emigration, cities in Scandinavian countries continue to grow.²⁷

EUROPEAN BUSINESS OPTIMISM IS FINALLY RETURNING, WITH SOME HIGH FLYERS LEADING THE PACK

While the broader EU context is challenging—and an ongoing concern for many business leaders—optimism is finally returning in many firms. Barometers of EU business sentiment had shown a steep drop from the 2007–08 financial crisis for all businesses, and the double-dip recession in 2012–13 was especially painful for small and medium-sized businesses, many of them in the service sector. The pickup in sentiment has been slower than in previous recovery periods, but the EU's Economic Sentiment Indicator rose sharply in the latter half of 2016 and stabilised at a high level in the first quarter of 2017, well above the long-term average (Exhibit 2).²⁸

In our survey, businesses are more upbeat and see a return to GDP growth of 2 percent, above economists' forecasts.

Exhibit 2

While business sentiment about the EU plummeted by over 40 percent in 2009 to reach its lowest point in the last decade, a recent steady increase has seen it almost return to pre-crisis levels



1 The Economic Sentiment Indicator (ESI) is a composite indicator compiled by the EU Commission and made up of five sectoral confidence indicators with different weights: industrial, services, consumer, construction, and retail trade.

SOURCE: European Commission Economic Sentiment Indicators; McKinsey Global Institute analysis

²⁶ See, for example, Joseph E. Stiglitz, *The euro: How a common currency threatens the future of Europe*, W. W. Norton & Co., 2016.

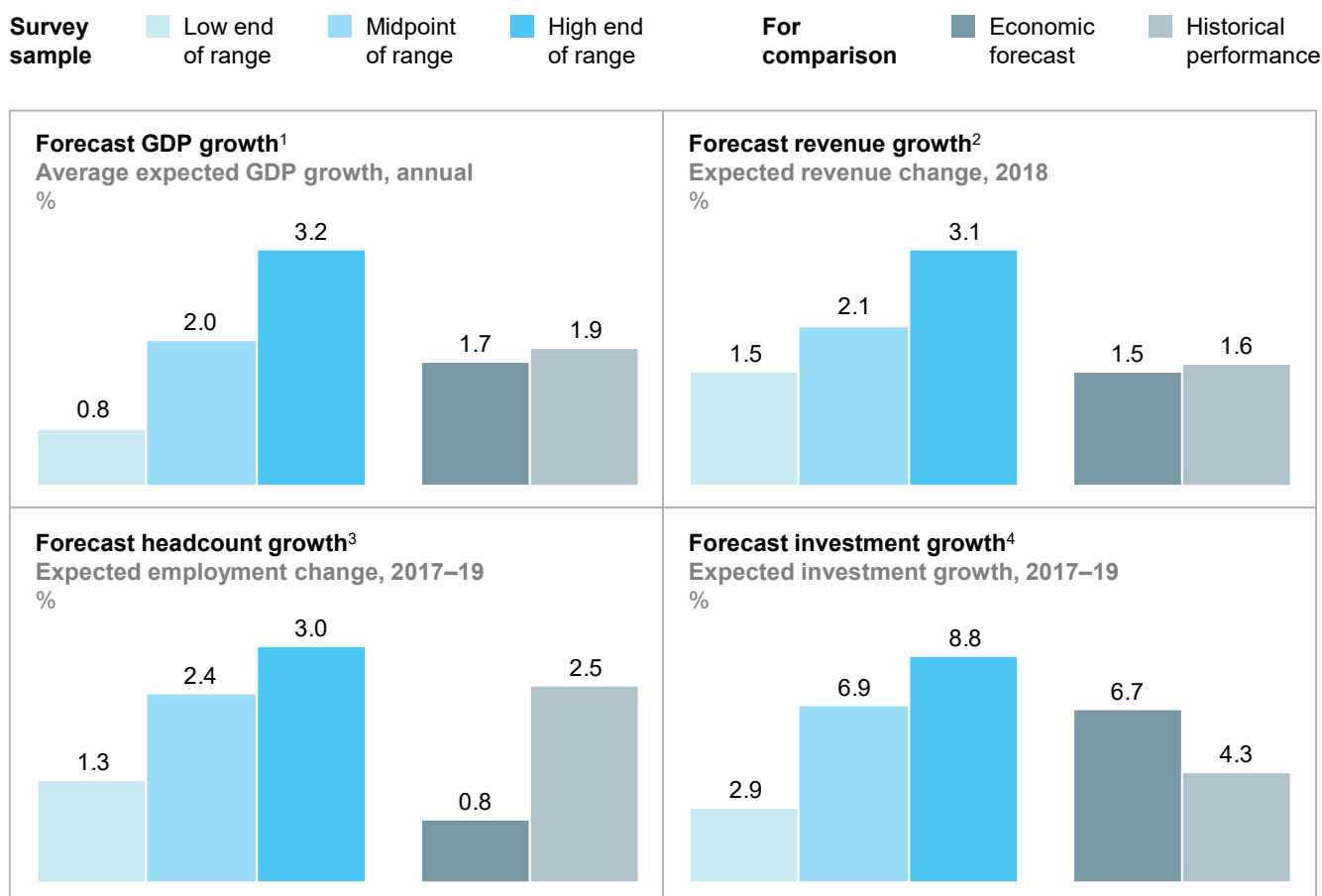
²⁷ For details, see *Rome redux: New priorities for the European Union at 60*, McKinsey Global Institute, March 2017.

²⁸ *Economic Sentiment Indicator*, European Commission.

A survey we conducted of about 2,000 business executives in six European countries confirms that returning optimism. For the EU economy as a whole, businesses are expecting an increase in GDP over the coming five years averaging 2 percent per year, higher than the 1.7 percent forecast by some economists for 2018, and above the average annual 1.9 percent rate of growth in 2016 (Exhibit 3).²⁹ (For details of how we conducted the survey and analysed the results, see Box 1, “Methodology of our survey of European business”.) A full list of survey questions and additional analysis of the results is available in an online appendix.³⁰

Exhibit 3

European businesses are more optimistic than industry forecasts across four indicators (after weighting to more fully represent the business community within the six member states)



1 Forecast is IHS forecast GDP growth for EU-28 (2018). Historical performance is Eurostat historical real GDP growth for EU-28 (2016).
 2 Forecast is IHS forecast real GVA growth for average of 6 countries' total economies (2018). Historical performance is IHS historical real GVA growth for the average of 6 countries' total economies (2016).
 3 Forecast is the % change in employment for the total economy of the 6 countries (2017–19) from IHS. Historical performance is the % change in historical employment for the total economy for the 6 countries (2014–16) from IHS.
 4 Growth is the unweighted average of expected investment growth over 2017–19 across respondents as we do not have a breakdown of private investment by enterprise size to provide a total economy weighting. Forecast is the % change in investment in non-residential construction, metal products and machinery, and other investment from the European Commission's AMECO database. It estimates 3-year total growth based on the 2015 annual growth rate. The data for 2015 is the latest available for forecasting and assessing historical performance. Historical performance is the % change in investment in non-residential construction, metal products and machinery, and other investment from the European Commission's AMECO database over 2013–15. The data for 2015 is the latest available for forecasting and assessing historical performance.
 NOTE: Not to scale. GDP and revenue growth are response averages weighted by GVA contribution of different company size groups within each of the 6 countries. Forecast headcount growth is a response average based on share of employment for different company size groups within the 6 countries.

SOURCE: MGI Business Survey, 2017; IHS Global Economy database; IHS World Industry Service; European Commission SME Performance Review; Eurostat; AMECO database; McKinsey Global Institute analysis

²⁹ IHS Global Insights database forecasts 1.7 percent GDP growth across all EU-28 countries in 2018. Eurostat recorded a 1.9 percent average GDP growth across all EU-28 countries in 2016.
³⁰ The detailed technical appendix is available at www.mckinsey.com/mgi.

Box 1. Methodology of our survey of European business

We surveyed about 2,000 C-suite business executives in six European countries—France, Germany, Italy, Poland, Spain, and the United Kingdom. These nations represent about 70 percent of EU employment and 65 percent of all EU businesses.¹ The online survey was run between February 17 and March 14, 2017.² We asked questions about corporate performance, the outlook for the economy, views on global trends that could affect them, and their sentiment about policies and the future of the Eurozone and the European Union.

Respondents are active in a representative range of sectors in services, manufacturing, and primary industries and infrastructure.³ These firms also cover a broad range of firm sizes, though larger firms are slightly overrepresented: small and medium-sized enterprises constituted 54 percent of the survey sample; they cover 67 percent of total employment in the EU (Exhibit 4). (Responses were limited to private-sector businesses, and excluded government services, education, and non-profits). To gain an external investor perspective for the survey, we sent a subset of questions to Chinese and US companies that have operations or are investing in Europe. Responses from just over 200 businesses from each of these two countries were collected.

As the survey sample demographics broadly mirrored the target population, results are generally presented as unweighted averages, unless specifically noted. However, as the slight overweighting of larger companies could represent a bias, we reweighted responses to four questions to more closely reflect the breakdown of small and medium-sized enterprises vs. large and extra-large businesses, based on their contribution to gross value added or to employment.⁴ The four questions focused on forecast GDP growth for the EU, future

revenue growth, forecast headcount growth, and historical revenue growth.

Given the large set of qualitative questions we asked, and the wide range of respondents in terms of different sectors, geographies, size, and market exposure, we are careful about showing average aggregates and use a number of statistical tests to help interpret the data. We use cluster analysis to identify five robust segments highlighting how companies see the future of Europe. We also used regression techniques to understand links between investment, employment growth, and revenue growth.

We further used Chi-square Automatic Interaction Detector (CHAID) analysis to determine which of our survey answers are most able to discriminate against selected dependent variables, and as a technique to uncover non-linear effects between companies' decisions and their perception of trends and of Europe. These analytical techniques deepened our understanding of the survey results and helped avoid a simplistic "one size fits all" view.

Where possible, we have sought to address concerns related to common method bias. All the data come from the same respondents and were obtained through a single questionnaire. Procedural choices, such as randomising the order of responses across respondents and guaranteeing the anonymity of the respondents, were also used. We have also run a Harman single factor test on the full survey as well on key subsets of questions like trends and perception around Europe.⁵ The results suggest there is unlikely to be systematic bias in the data.

See the technical appendix for a full list of survey questions and further analysis of the results.

¹ Eurostat, 2014. EU businesses in the non-financial business economy, excluding financial and insurance activities.

² The survey design and collection was done in cooperation with the UK-based firm Research Now, using survey architecture provided by Intellisurvey. Companies were tested on their ability to deliver and ensure high-quality answers in the time requested. Research Now provided panels of executive business leaders, who were compensated for their time. Respondents self-identified their position, industry, and company size. We used a professional translation firm to translate the survey from English into national languages, and to test semantic equivalence. The final panel had a distribution that approximately mirrored that of overall share of employment and provided enough results in each category to allow deep dives into individual categories (i.e., so that we could consider one industry at a time, or one company size group by country). During a post-processing period, responses with unreasonably short completion times, unintelligible free-text responses, signs of flatlining or inattention, and geographically inappropriate IP addresses were removed.

³ Where possible, we have reflected the European Commission's NACE 2 standards of classification for economic activities. For details see <http://ec.europa.eu/eurostat/documents/3859598/5902521/KS-RA-07-015-EN.PDF>.

⁴ GVA contribution distributions were used to reweight responses for GDP growth predictions for the EU, future revenue growth, and historical revenue growth. Forecast headcount growth was reweighted based on employment distributions.

⁵ Philip Podsakoff, Scott MacKenzie, Jeong-Yeon Lee, "Common method biases in behavioral research: A critical review of the literature and recommended remedies", *Journal of Applied Psychology*, volume 88, number 5, 2003.

Box 1. Methodology of our survey of European business (continued)

Exhibit 4

EU survey sample



¹ 6-country total.

NOTE: Not to scale. SMEs have fewer than 250 employees. Numbers may not sum due to rounding.

SOURCE: OECD, 2012; Eurostat, 2013; MGI Business Survey, 2017; McKinsey Global Institute analysis

The mood in companies is also more upbeat in respect to their own business prospects. Survey respondents said they expected weighted average revenue growth of 2.1 percent in the coming year, considerably higher than the 1.5 percent annual forecast for the six countries surveyed by economists and the 1.6 percent average annual rise seen in the past three years.³¹ Survey respondents expect to raise headcount over the next three years by an average of 2.4 percent cumulatively, triple the 0.8 percent industry forecast for employment growth in the six countries surveyed, although slightly lower than the 2.5 percent cumulative historical rate of the past three years.³² Our survey provides anecdotal evidence that rising employment and rising productivity are compatible (see Box 2, “Our survey shows business optimism about productivity and employment growth”).

³¹ IHS Global Insights, World Industry Service database.

³² IHS Global Economy database.

Box 2. Our survey shows business optimism about productivity and employment growth

One age-old question is whether there is a trade-off between productivity growth and employment growth. Prior MGI research has shown that if there is a trade-off at all, it is a temporary phenomenon, and that long-term productivity growth is achievable without job losses (at least at a high level although not necessarily at the local or sector level). In the United States, for example, more than two-thirds of the years since 1929 have seen positive gains in both productivity and employment.¹

Regression analysis we conducted on our European business survey findings provides anecdotal evidence to back up such findings. Across all survey questions tested, the core discriminating variable for expected growth in employment is expected growth in revenue productivity. Companies that expect to increase headcount also expect their revenue productivity to rise. This suggests that, in today’s business world, productivity and headcount are not seen as trade-offs.

For the 68 percent of respondents who expect productivity to improve, developing new products with higher customer value is the top-ranked method of achieving

productivity growth (18 percent of responses). This aligns with our initial findings: companies expect new products and services to generate enough increased revenue that they can run existing functions efficiently and increase hiring.

Technology is seen by some respondents as a key driver of productivity. Some 14 percent of respondents who expect productivity to increase state that this improvement will come from automating and redesigning processes, and 12 percent from digitising operations. However, rather than expecting to replace their workers with robots, these companies may expect automation, digitisation, and process redesign to help expand the effectiveness of their workers so that they can reach new markets and justify further growth in (human) employees.

These findings are also corroborated by the *McKinsey Quarterly* global survey, which suggests that if companies were to strongly raise investment, 55 percent of respondents said they would do so in order to develop new products or services, and 46 percent to increase sales, compared with 16 percent to increase automation.

¹ *Growth and renewal in the United States: Retooling America’s economic engine*, McKinsey Global Institute, February 2011.

Survey respondents were more or less in line with external forecasters on business investment. They expect this to rise by 6.9 percent on average over the next three years in aggregate, close to the 6.7 percent aggregate estimated by forecasts for these six countries.³³

As part of our survey, we also polled US and Chinese companies that operate or invest in Europe for their views of the GDP outlook for Europe. Their responses were more upbeat than those of European companies, with US companies expecting growth of almost 3 percent and Chinese firms anticipating growth of 2.3 percent.

The gains are not evenly distributed among companies, with about one in five “high flyers” and 46 percent “advancing”, while the remaining third are “left-behind”

Given the wide range of expectations and performance among the companies we surveyed, we identified three categories of companies, based on self-reported profitability and future revenue growth expectations. The categories are:

- **“High flyers”**. These are companies that were profitable in 2016 and predicted at least 5 percent revenue growth for the year ahead. They represent 19 percent of survey respondents.
- **“Advancing”** companies, which were profitable in 2016 and expected revenue growth for the following year. They constitute 46 percent of survey respondents.
- **“Left-behind”** companies, which are the remaining 35 percent. They were unprofitable last year and/or expect revenues to stay the same or decline next year.

We used this categorisation as a framework to analyse the survey results more generally and test correlations between indicators of performance such as past and expected headcount growth and past revenue growth. Overall, businesses that have done well historically are more likely to continue to forecast growth, while those that have been left-behind tend to see problems ahead. We also used this framework to analyse corporate views of trends, and attitudes to investment and the European Union, as we discuss later in this report.

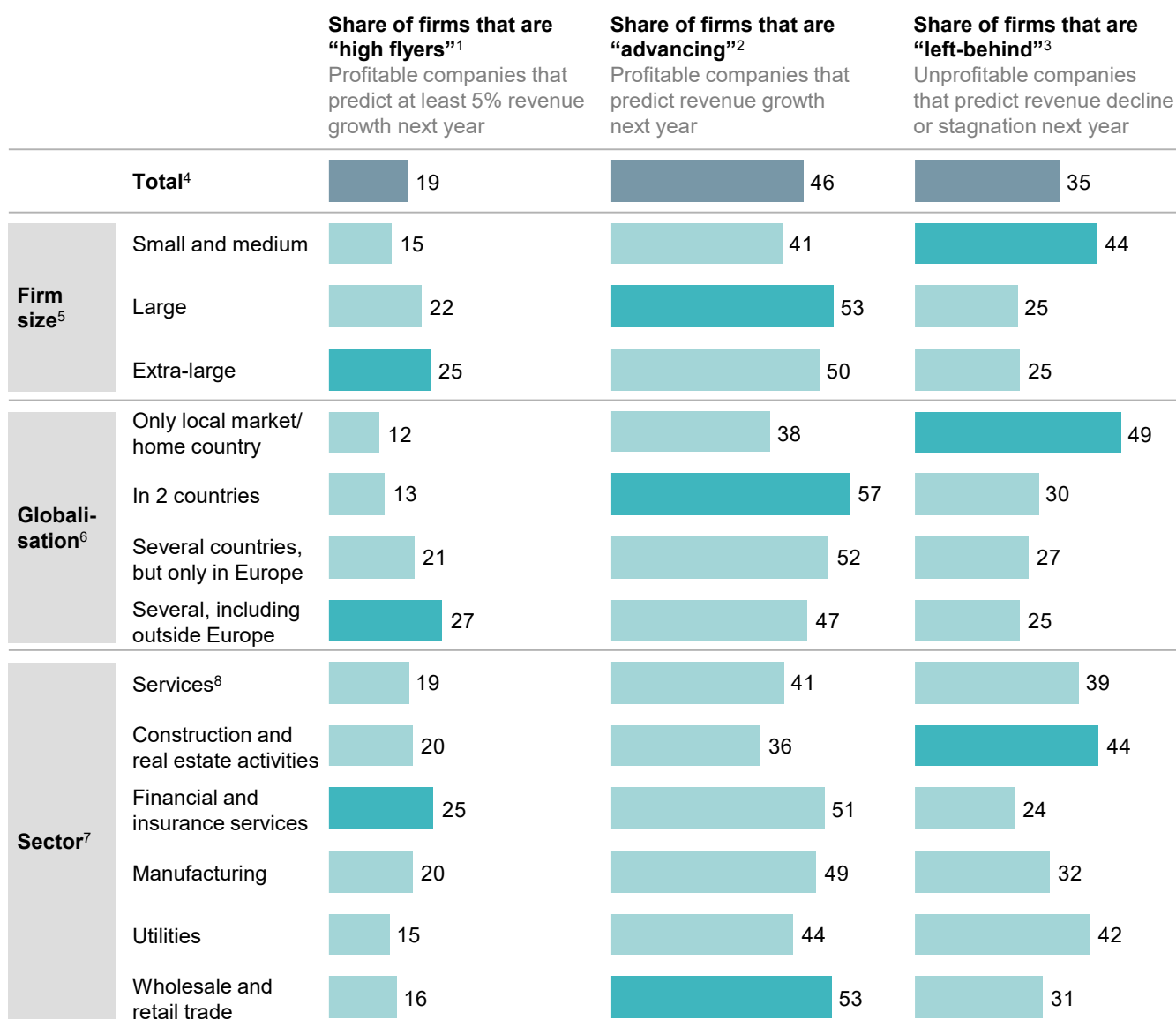
These categories are not monolithic: the companies within them are from different countries, of different sizes, and have varying degrees of internationalisation. Yet companies at the two extremes tend to be different on key dimensions. For example, the left-behind category is overrepresented by small companies that are focused on their domestic market, and they are also less likely to have increasing historic cash flows. Companies in the services sector are slightly more likely to be high flyers, particularly within financial and insurance services, while construction companies and utilities are more likely than other industries to be in the left-behind category (Exhibit 5). However, all of the countries surveyed were represented amongst the high flyer group; roughly one in five British, French, German, Polish, and Spanish companies are in the category, but only 11 percent of Italians are. Further, there are high flyers in every size group: 15 percent of small and medium-sized enterprises from our sample—and 12 percent of companies with only local operations—are high flyers.

³³ AMECO.

Exhibit 5

Large, global firms are more likely to have revenue growth expectations that make them “high flyers” or “advancing”

%



1 High flyer companies had the highest scores on a composite score based on company profitability and predicted revenue growth. They represent 19% of all EU companies surveyed.

2 Advancing companies had positive scores on a composite score based on company profitability and predicted revenue growth, in between high flyers and left-behind companies. They represent 46% of all EU companies surveyed.

3 Left-behind companies had the lowest scores on a composite score based on company profitability and predicted revenue growth. They represent 35% of all EU companies surveyed.

4 Total of all 6 EU country survey respondents.

5 Small and medium companies have <250 employees. Large companies have 250–1,000 employees. Extra-large firms have >1,000 employees.

6 Location of company operations.

7 Not all sectors are included.

8 Business, professional, scientific, and legal services.

NOTE: Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

65%

Share of “high flyers” increasing their cash flows by more than 3%

THE RECOVERY REMAINS FRAGILE: INVESTMENT IS RETURNING BUT REMAINS LOW, BUSINESSES ARE GROWING CASH TO HEDGE AGAINST CRISES, AND DEBT OVERHANGS REMAIN PARTIALLY UNRESOLVED

Investment was one of the biggest casualties of the past decade, with corporate investment falling by €200 billion between 2007 and 2009. While investment has crept back to 2007 levels in absolute terms, investment as a share of GDP remains at historical lows.³⁴ Further, in a sign of continued fragility and nervousness, European companies continue to grow their cash—and our survey suggests that the most successful companies are the biggest hoarders: 65 percent of our high flyers have increased their cash flows by more than 3 percent, and two-thirds of them—44 percent of the total—have increased cash flows by more than 10 percent over the past three years (Exhibit 6). Companies say they are doing so because of the risks they see ahead, and in order to invest going forward, while they believe they have been investing at appropriate levels already. One of the largest risks companies see is another financial crisis forming—and, indeed, debt overhang issues have not been fully resolved.

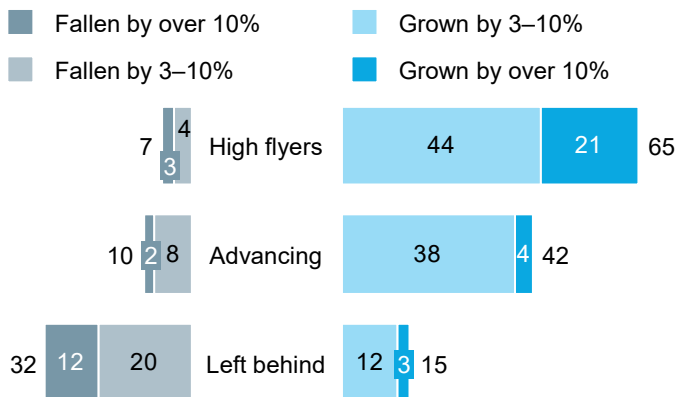
Exhibit 6

High flyers and advancing companies are more likely to predict high growth in investment and cash flow position, while those left-behind report the opposite

% of EU respondents

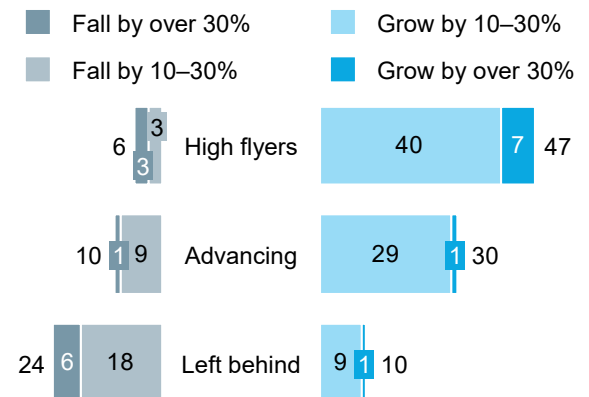
Historical change in cash flow position

Q: How has your company's cash position (operating cash flow minus short-term and long-term capital expenditures) changed, compared to three years ago?



Expected change in investment

Q: How do you expect your company's average annual investment in EU countries over the next 3 years to change, compared to last year?



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Corporate savings increased sharply over the past decade, and businesses continue to grow cash positions

Companies across Europe have effectively become net lenders rather than seeking credit since the crisis, when savings rose well above investment (Exhibit 7).

As of 2015 EU gross corporate savings totalled €1.97 trillion. This is €410 billion more than savings of €1.56 trillion in 2009.³⁵

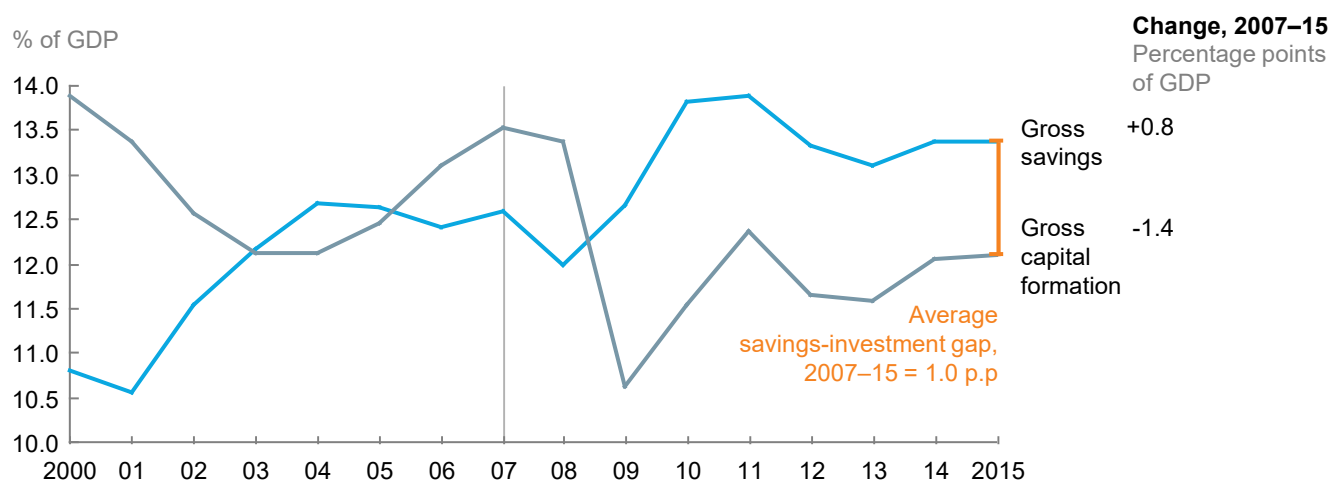
³⁴ AMECO.

³⁵ Ibid.

Exhibit 7

Corporate savings increased after the crisis and today still exceed investment

European Union gross corporate savings and gross capital formation, 2000–15



SOURCE: AMECO; McKinsey Global Institute analysis

Explanations for this cash buildup emerge from the responses to our survey: companies that have increased their cash flow position cited both saving for future investment (48 percent) and building reserves for future crises (47 percent) as primary reasons for increasing cash flow positions. While some deleveraging is taking place, the portion of companies identifying debt repayment (18 percent) or excessive debt levels (9 percent) as a reason for their cash hoarding are much smaller than for the other two explanations (Exhibit 8).³⁶ Companies with growing cash flow positions in all three of our categories—high flyers, advancing, and left-behind—gave relatively similar answers; even among high flyers, concern about future crises slightly outweighed saving for future investment.

Some of the differences are to be found at the national level. Italian and Spanish companies in our survey were the least likely to have grown their cash flow positions—only about one-third did—and in both countries a larger proportion of businesses said they were saving for future investment than building reserves for future crises. By contrast, about 40 percent of German and French companies grew their cash flow positions, and 56 percent of German companies said they were doing so to guard against future crises. In Poland, the caution about the future was almost as large.

National trends confirm that each country's corporate savings are rising. Gross corporate savings in Spain rose to €216 billion in 2015 from €117 billion in 2007, an 85 percent rise. In Germany, the growth was also substantial, rising 23 percent to €419 billion from €341 billion in the same period.³⁷

At the sectoral level, 46 percent of financial and insurance services companies grew their cash flow position, in a reflection of the increasing pressure to hold significant capital to shield against future crises, while less than 30 percent of construction and real estate companies did the same.

³⁶ Survey respondents could choose up to two responses, hence the totals do not add up to 100 percent. Further, this question was asked only of respondents who indicated that their company's cash position had increased.

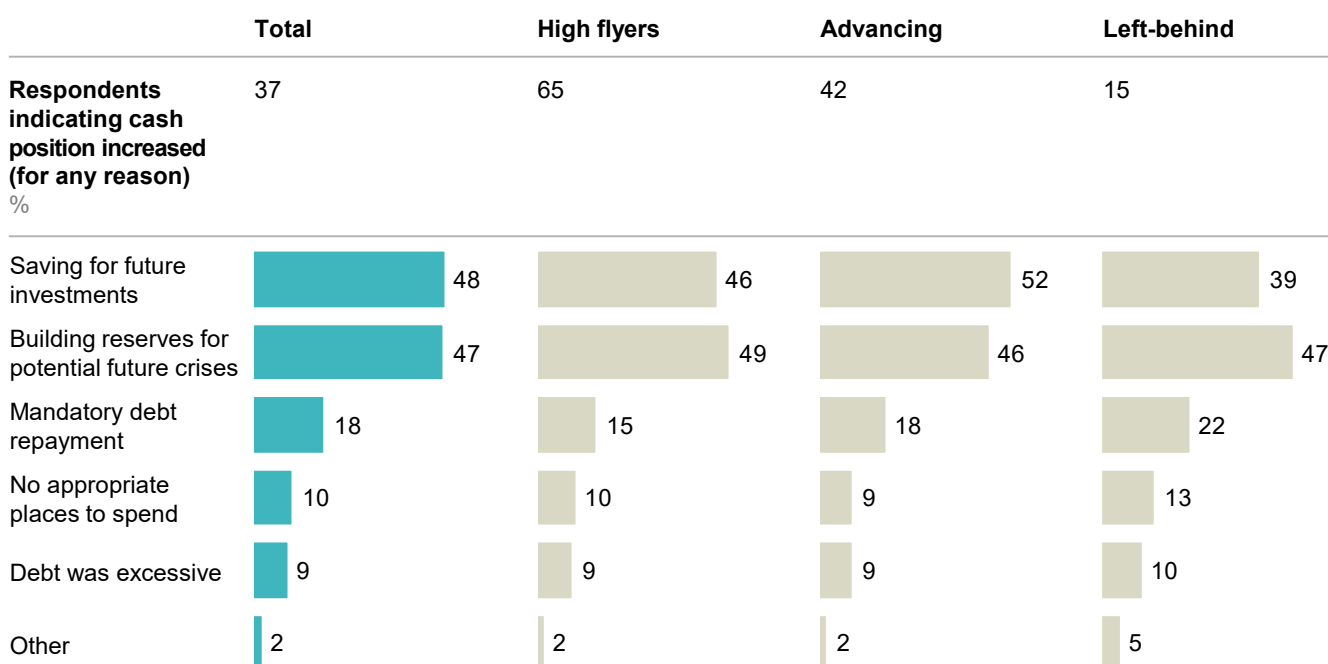
³⁷ AMECO.

Exhibit 8

Companies with varying levels of performance all cite similar reasons for increasing cash flow position

Q: Why did your company increase its cash position? (asked only of companies that indicated cash position had increased; companies were allowed to choose up to two responses)

% of EU respondents who increased cash position, by performance level



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Investment as a share of GDP is at a 20-year low, although corporate investment is recovering

Investment of all types has been the key missing element in Europe’s recovery since the financial crisis.³⁸ Overall, investment fell to 19.3 percent of GDP in 2013, the lowest in more than 20 years. Household investment remains weak, and public investment has been subdued in line with austerity policies that limited government deficits. Corporate investment also took a dive after 2007–08 and has recovered only relatively weakly. The contraction has mainly been in investment in real estate and structures. Other corporate investment has grown moderately in real terms but is still down in nominal terms relative to GDP because of price declines of investment goods (Exhibit 9).

The weak investment picture, including lackluster corporate spending, has held back growth and job creation in the European Union. Anemic investment weakens aggregate demand and depletes the economy of its productive capacity, which in turn further slows growth, income, and investment. Indeed, the investment picture in the United States and Europe has created concerns that the global economy is in a phase of “secular stagnation”.³⁹

³⁸ See *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

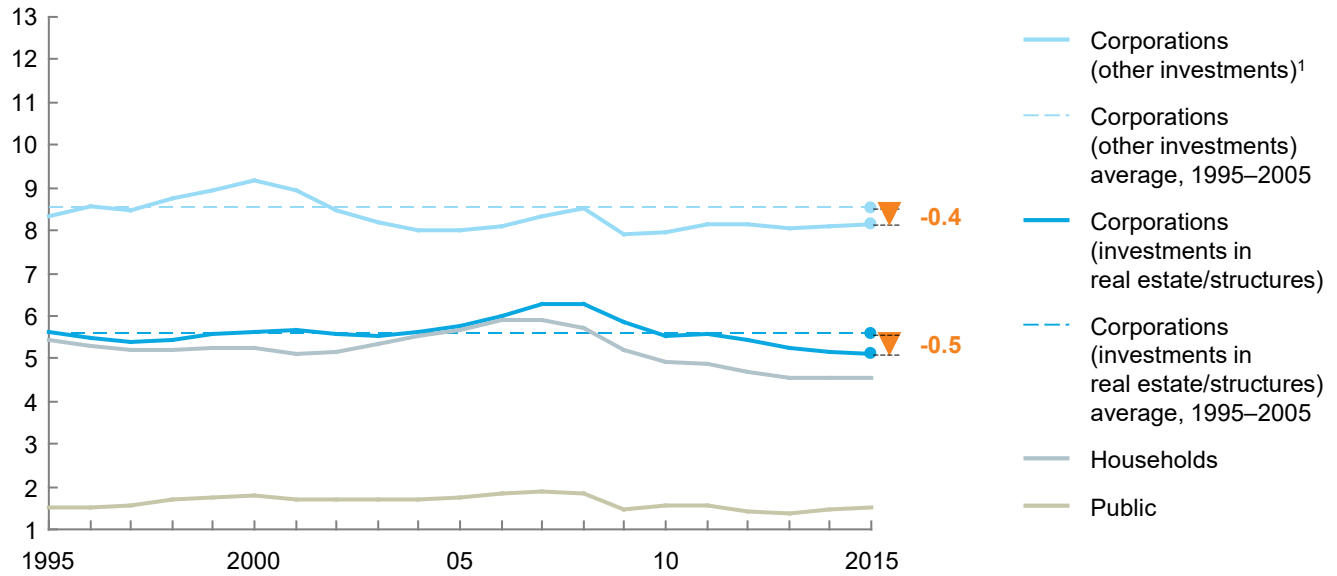
³⁹ See, for example, Lawrence H. Summers, “The age of secular stagnation: What it is and what to do about it”, *Foreign Affairs*, February 15, 2016, and *Secular stagnation and low investment: Breaking the vicious cycle*, McKinsey Global Institute discussion paper, April 2016.

Exhibit 9

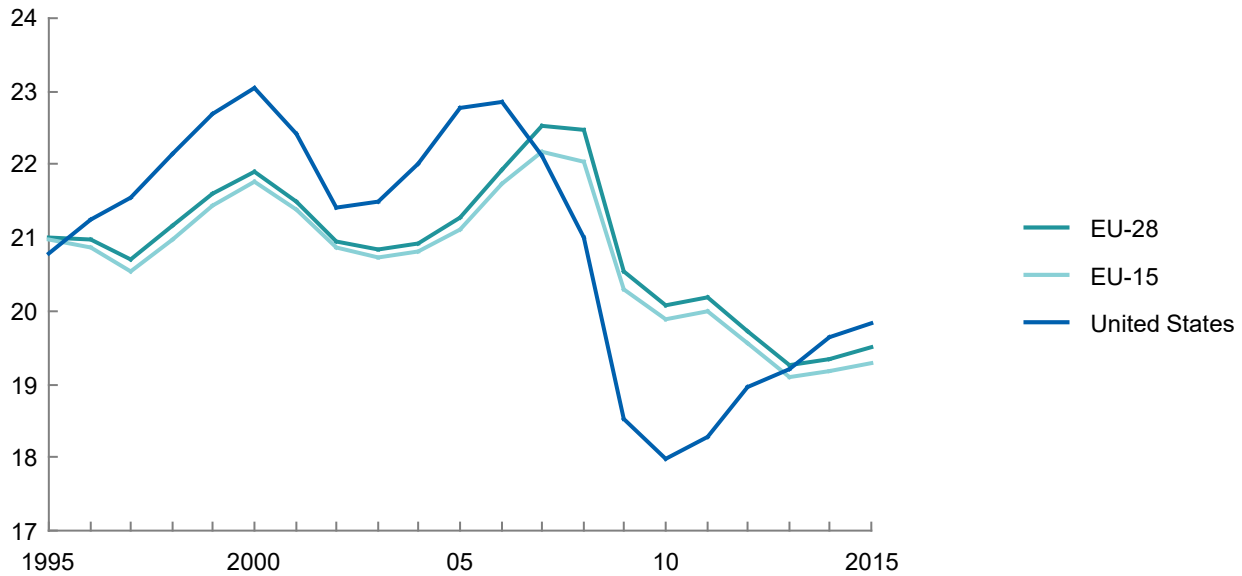
Overall investment in Europe has dropped, including in corporate investment

Gross fixed capital formation
% of GDP, current prices

Components



Country comparison



1 Includes all corporate investments excluding real estate and structures .
 NOTE: Not to scale.

SOURCE: AMECO; McKinsey Global Institute analysis

Companies say they are investing at appropriate levels, and a majority sees significantly more investment opportunities available than they can fund

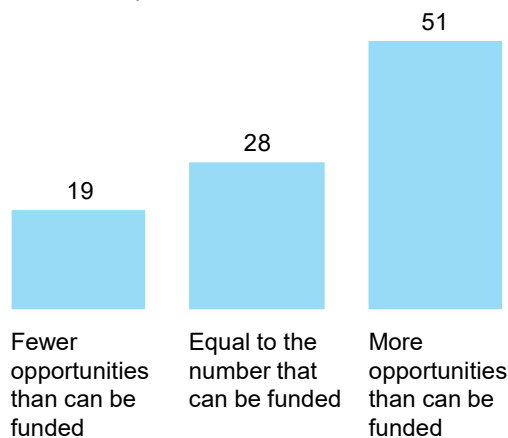
Our survey indicates that companies see many possible investment opportunities in Europe, and believe they have been investing at appropriate levels over the past three years. This basic attitude holds true for companies in all three of our categories including the high flyers, 72 percent of which say they are making the right amount of investment. Among the left-behind companies, 26 percent believe they have invested too little, but 22 percent think they have invested too much, which suggests weak investment strategies throughout (Exhibit 10). The sentiment that companies have invested appropriately is the common theme across all sectors and countries, although there are some national differences. More than one in four Italian and Polish companies think they may not have invested sufficiently, for example, while in France, Germany, Spain, and the United Kingdom, that proportion drops to less than one in five.

Exhibit 10

Businesses think their past investment levels have been appropriate even though they see many more investments than they could fund

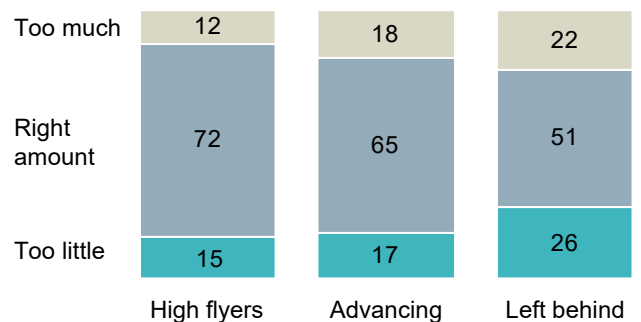
Q: How would you describe the current supply of attractive investment opportunities (i.e., investments with positive net present value) available to your company, relative to your company's current capacity to invest (i.e., its annual investment budget)?

McKinsey Quarterly global survey
% of EU respondents



Q: Do you feel your business has made the appropriate level of investment in Europe over the past 3 years?

MGI Business Survey, 2017
% of EU respondents by category



NOTE: Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; *McKinsey Quarterly* global survey (excludes "Don't Know", N = 443); McKinsey Global Institute analysis

In our global *McKinsey Quarterly* survey, we also asked companies about the investment opportunities they see relative to their capacity to invest.⁴⁰ Among the European respondents, more than half see more opportunity than they can fund, and only 19 percent experience a dearth of opportunities relative to their funding capacity.

Investment intentions over the next three years appear stronger. Overall, more than one in four respondents (26 percent, including the UK respondents) say they expect to increase investment in the next three years by at least 10 percent. Companies in our high flyer

⁴⁰ *McKinsey Quarterly* survey, March 2017 (excludes "Don't know", N = 443).

category are the most bullish, with 47 percent saying they plan investment increases, compared with 30 percent of advancing companies and just 10 percent of left-behind firms.

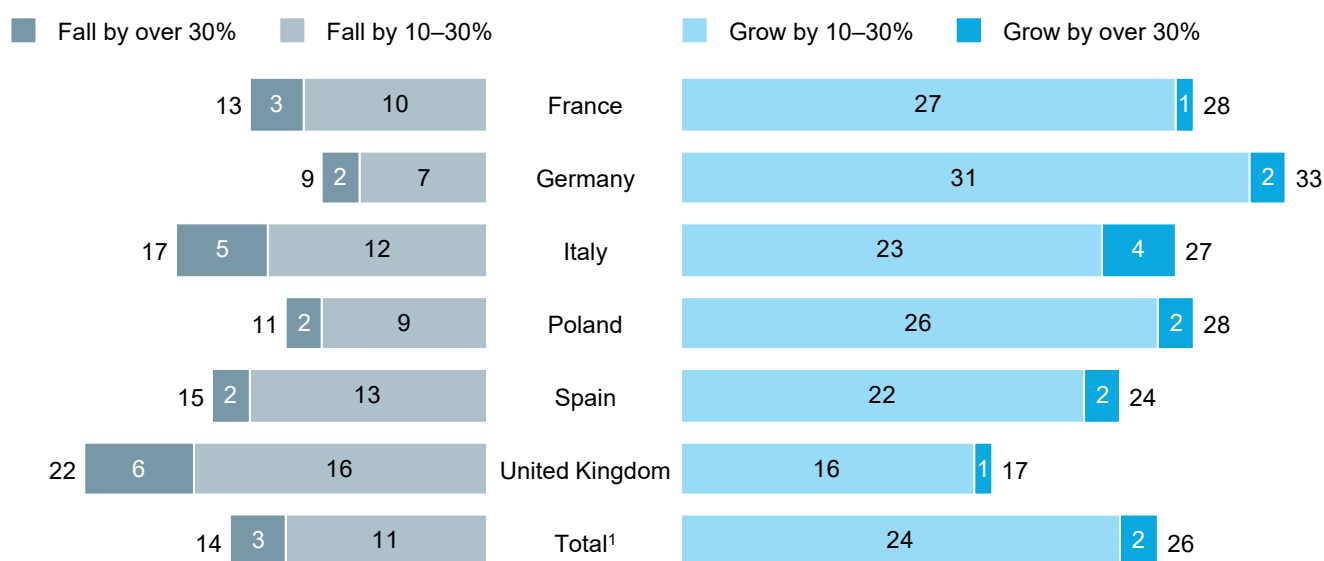
In Germany, 33 percent of businesses are planning to increase investment in the EU in the next three years, followed by France and Poland (28 percent), Italy (27 percent), and the UK (17 percent) (Exhibit 11). There are strong indications of future investment growth in the manufacturing sector, with 32 percent of companies surveyed expecting to invest more in the EU, according to our survey.

Exhibit 11

German companies are most likely to increase their investment in the EU, while British, Italian, and Spanish firms are more likely to decrease their investments over the next three years

Q: How do you expect your company's average annual investment in EU countries over the next three years to change, compared to last year?

% of EU respondents indicating each growth level



1. Total for all 6 EU country survey respondents.

NOTE: Numbers will not sum to 100, as “stay the same” responses are not shown. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Companies cite regulation and uncertainty as main barriers to investment, and see risks of another financial crisis or recession as well as from rising populism

As part of our survey we asked companies to cite the main barriers or obstacles to investing in the EU. We also asked them to identify the potential risks that are their biggest concerns to investing in Europe. Their answers give some clear indications of their state of mind.

Among the barriers to investment, the top-ranked answer amongst EU respondents was regulatory burdens (12 percent of respondents), followed by regulatory uncertainty (9 percent) and a more general uncertainty about the future environment (8 percent). This finding is also supported by the *McKinsey Quarterly* global survey; of those European companies seeing more opportunities than they can fund, 40 percent cited risk aversion as a key reason for not investing more, followed by insufficient internal funding (34 percent) and lack of management capacity (29 percent). Among those who did not see enough opportunities to invest, the top reasons were high hurdle rates and insufficient demand (32 percent each).

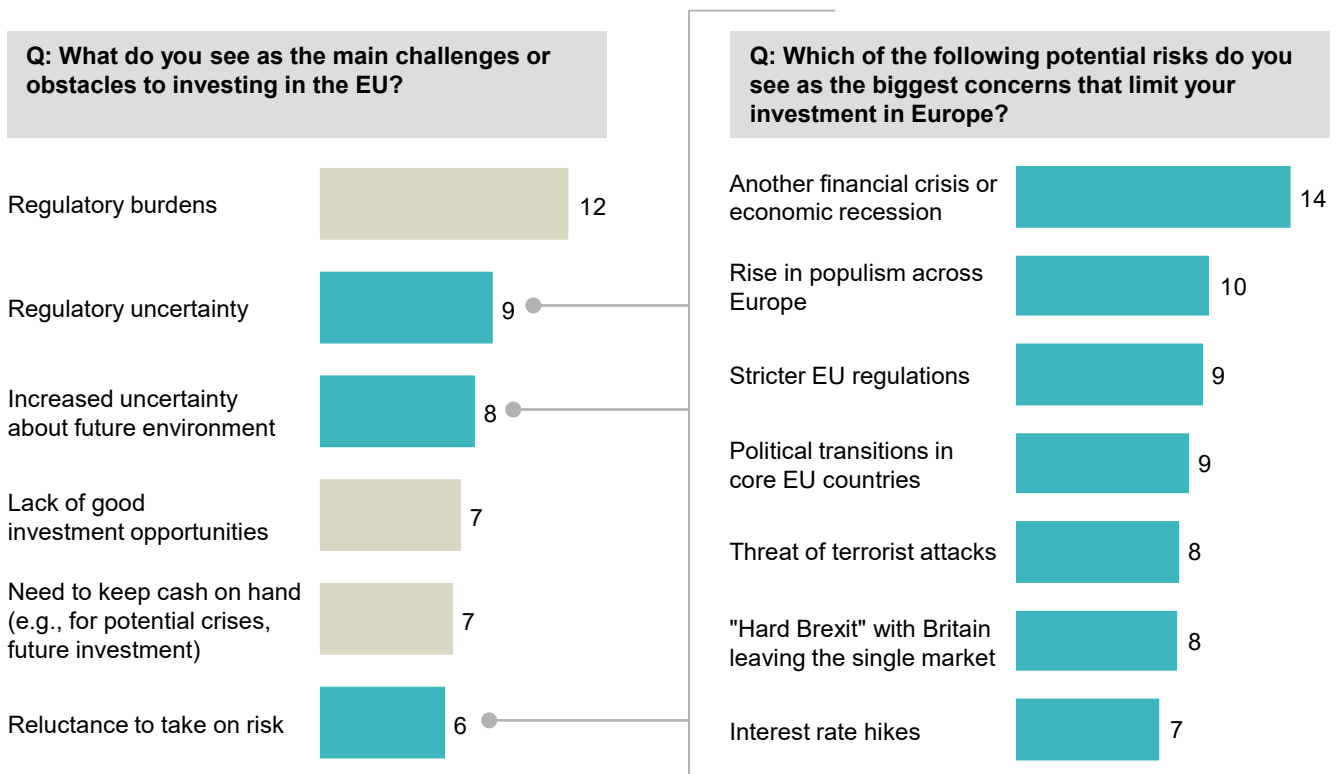
Of the risks limiting investment, another financial crisis or recession was seen as the most significant (14 percent), followed by a rise in populism (10 percent). By contrast, two issues that had been a preoccupation immediately after the financial crisis and during the sluggish recovery—financing difficulties and weak demand—were not cited as prevailing issues today (Exhibit 12). An analysis of the survey results shows that expected investment growth is most closely aligned not with perceived growth opportunities, but with historical cash flow positions (see Box 3. “Future investment plans and historical cash flow positions are intertwined”).

Exhibit 12

Companies surveyed cite regulatory burdens and various forms of geopolitical, regulatory, and financial risks as barriers to investment

Most frequently cited top-ranked barriers

% of EU respondents selecting each



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Regulatory burdens and uncertainty were consistently at the top of the list across our three categories of high flyers, advancing companies, and left-behind firms. They also were common across European countries and sectors, although there were some notable differences. For financial services firms, for example, regulatory burdens stood out as substantially greater than other barriers, whereas in construction, too little demand and expected returns below hurdle rate were also cited prominently.

Box 3. Future investment plans and historical cash flow positions are intertwined

One might expect that, of the investment questions we asked, predicted investment growth would most closely align with growth opportunities. Yet it turns out that historical change to cash flows is the strongest discriminator for future investment growth, only then followed by expected revenue productivity growth. This raises questions on why internal funding and cash buffers seem to be so important for investment decisions at a time when external financing is available at ultralow rates and has not been quoted as a major constraint.

The relationship between past cash flow position and expected investment exists in both directions, however, and it is difficult to identify whether one

causes the other. Of all of the themes tested in our survey, our CHAID analysis suggests that past revenue growth is the strongest discriminator of changes to past cash flows. This is in line with our findings that high flyers (93 percent of which have experienced past revenue growth) are more likely to have had stronger past cash flow growth. The next most important discriminator is expected investment, in line with future investment being a key reason for growing cash. Among high flyer companies, those with higher expected investment are more likely to have had historic growth in cash flows, and among the left-behind companies, those with lower expected investment are yet less likely to have grown their cash flow positions.

The most striking differences are to be found in the replies from the Chinese and US respondents. Regulatory burdens do not rank near the top of the list for either. For Chinese companies, the biggest obstacle to increased investment in the EU is increased uncertainty about the future environment (15 percent), followed by financial market pressure for short-term returns (13 percent) and expected return below target or payback period too long (12 percent). For US companies, regulatory uncertainty and the more general uncertainty about the future environment share the top ranking (each 9 percent), followed by reluctance to take on risk. Among the risks, however, Chinese and US firms shared the concerns of EU companies about another financial crisis being the most significant risk to investment. But the second most significant risk for them, indicating a more global outlook, is changes to trade deals affecting investment in the EU, including new US policies. For American companies, exchange rate volatility was the third largest risk.

Returns to capital have not fully recovered everywhere in Europe, but spreads against risk-free rates increased

The risk aversion highlighted in our survey may have led to missed opportunities. With interest rates falling to historically low levels after the crisis, spreads between interest rates and returns on invested capital widened. Even as returns on net capital stock have not fully returned to pre-crisis peaks for Europe as a whole, spreads to historic low interest rates have widened (Exhibit 13). A Bank of England survey of UK businesses highlighted that the average expected rate of return was 13 percent, above the 11 percent rates of return businesses achieved over the past five years. This is significantly higher than the cost of being able to raise bank debt over the past five years, of around 4 percent.⁴¹ Other surveys confirm that business investment is not particularly sensitive to interest rate changes.⁴²

Increasing spreads between targeted as well as realised return on investment on the one hand and falling risk-free rates and weighted average cost of capital on the other hand point to increased risk premium/perception. However they could also reflect changes in future expectations of growth, interest rates, or elevated spread thresholds to make best use of limited internal funding.

⁴¹ *Quarterly bulletin*, Bank of England, Q1 2017.

⁴² See, for example, Duke CFO Global Business Outlook, December 2015.

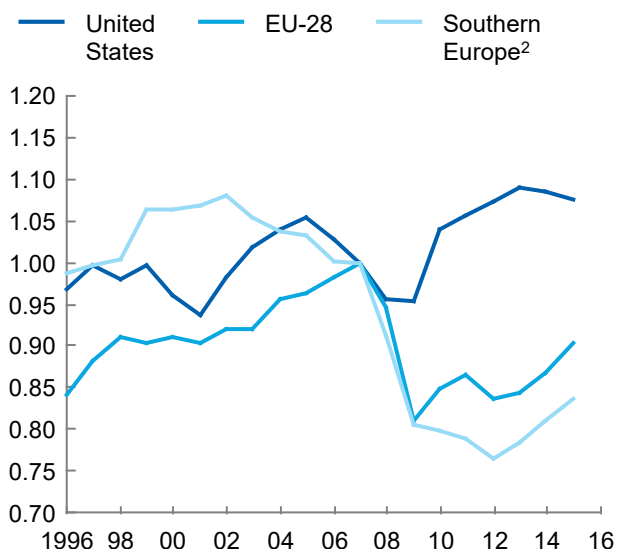
Exhibit 13

While returns in Europe have not fully recovered, the spread to interest rates has increased

Index: 1.00 = 2007

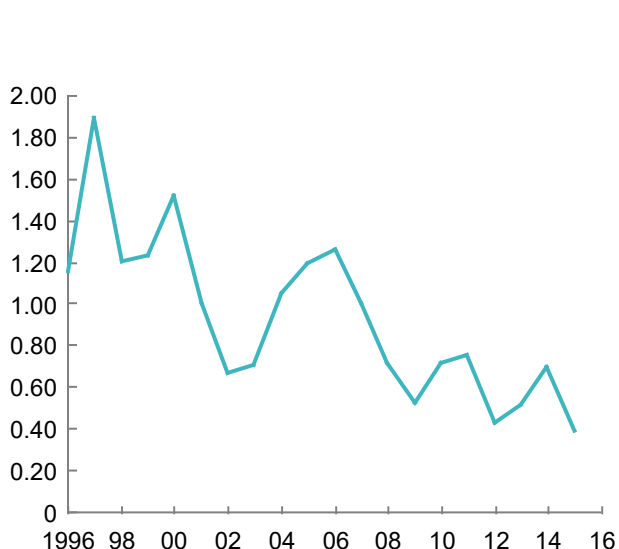
Real net returns on capital stock¹

Index: 1.00 = 2007



Real risk-free interest rate, Eurozone³

Index: 1.00 = 2007



- 1 Net returns (calculated as net domestic income less compensation of employees) divided by net capital stock (accumulated gross fixed capital formation less depreciation).
 - 2 Calculated as weighted average changes in country indices using nominal GDP in 2007 as a weight; includes Greece, Italy, Portugal, and Spain.
 - 3 Risk-free rate based on 10-year US government bond yields and inflation differentials.
- NOTE: Not to scale.

SOURCE: AMECO; US Department of the Treasury; IMF; Eurostat; McKinsey Global Institute analysis

At the same time, overcapacity in European business does not appear to be out of line with historical averages. If demand were to spike unexpectedly, about 60 percent of the European companies in the *McKinsey Quarterly* global survey said they could increase production by 6 to 15 percent without hiring new staff, and only 3 percent of respondents believed they were at full capacity utilisation for their employees. Overcapacity was not often cited as a concern in our survey, however, and indeed it would not be consistent with businesses seeing more opportunities than they can fund. Capacity utilisation metrics also seem back to largely normal levels: by the start of 2017, they had returned to 82 percent, about the same level as in 2002–06.⁴³

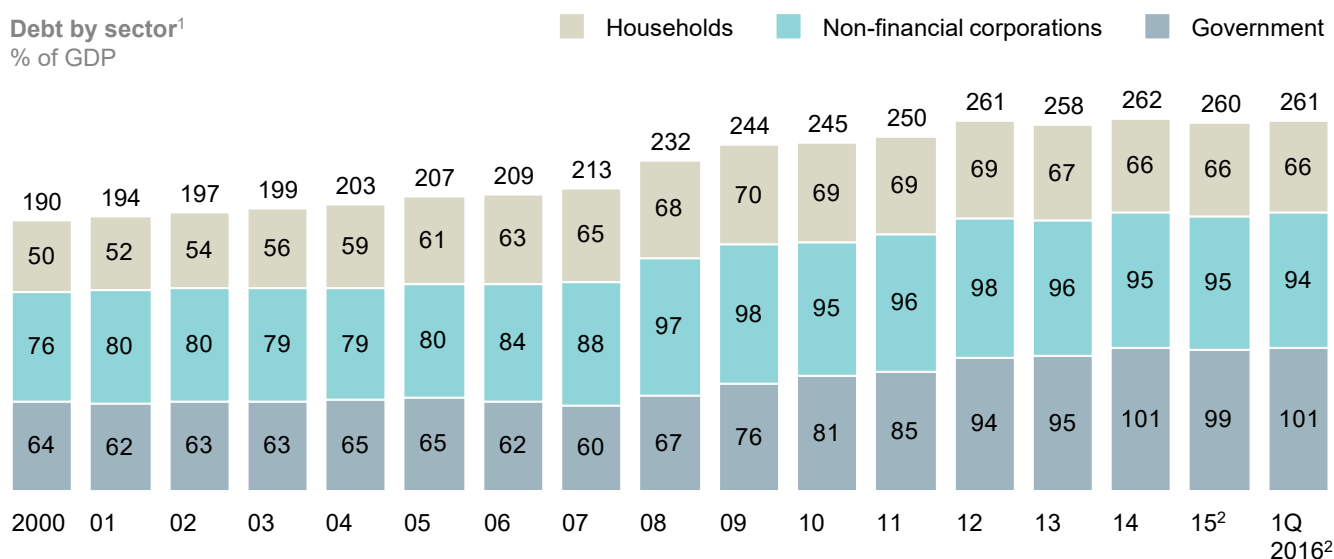
Europe's debt overhang remains unresolved

Debt reduction has been a frequent talking point in Europe, especially after the financial crisis and during the sovereign debt crisis. Overall debt in EU member states including that of households, non-financial corporations, government, and financial institutions grew sharply in 2007–08 and reached a peak of 388 percent of GDP in 2012. Since then it has remained relatively stable, but deleveraging has not yet begun in earnest. Government debt continued rising after 2012, and peaked at 101 percent of GDP in 2014 (Exhibit 14).⁴⁴

⁴³ Eurostat, 2017.
⁴⁴ *Debt and (not much) deleveraging*, McKinsey Global Institute, February 2015.

Exhibit 14

Debt in Europe has peaked relative to GDP, but deleveraging has not yet begun



1 Excludes debt of financial sector. Includes Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden, and the United Kingdom.

2 Data for Romania and Poland is for 4Q 2014.

NOTE: Values are for debt as of 4Q of each year. Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute analysis

In the financial sector, banks in Southern European economies in particular still face significantly high levels of bad loans: in Greece, more than one-third of total gross loans in 2015 were non-performing, while in Italy the proportion was almost 18 percent. In the EU overall, the proportion of non-performing loans, at 5.6 percent of total gross loans, is more than three times that of the United States or Japan.⁴⁵ In our survey, European companies expressed concern about the continued debt overhang, which some indicated was affecting their willingness to invest. Interestingly, debt was not considered the main obstacle to investment for Southern European countries. Italian businesses felt potential future crises and regulatory burdens were obstacles to investment, while Spanish firms were worried about regulatory burdens and uncertainty. Both countries had the fewest respondents signalling that they were not investing because of the need to pay back debt.

•••

Our survey of 2,000 business leaders across major European economies paints a picture of an EU economy that is finally recovering and appears more confident about the years ahead. Optimism about revenue and employment has returned, indicating that business is finally putting a “lost” decade behind it. Yet this recovery remains fragile, lacking the essential element of robust investment. Companies have held on to their cash, and half of them tell us they are doing so because they fear a new recession or future crises. What are the roots of this risk aversion, which is holding back economic growth? In the next chapter, we examine how European companies view global trends affecting their business, and their hopes, expectations, and fears about the European Union.

⁴⁵ *World development indicators*, World Bank, 2015.





Factory-floor automation at an automotive parts manufacturer
© Yoh4nn/E+/Getty Images

2. GLOBAL TRENDS AND EUROPEAN CHALLENGES: OPTIMISM OR ANXIETY?

Even as the long-awaited economic recovery arrives, European companies and the European economy face a number of challenges, both in the long term and more immediately. A number of immutable global forces will shape Europe's future in coming years. These include demographic change that is already starting to act as a drag on growth as European countries age; the rise of digitisation and automation, which could boost productivity and economic growth even as they reshape the workplace; and growing opportunities in emerging economies that come with challenges to competitiveness from emerging companies that are encroaching on turf long occupied by European incumbents. Other political and geopolitical trends include growing public disaffection with aspects of globalisation such as trade and immigration, amid a surge in migration and the ascendance of political populism in some countries.

While these developments play out on a global stage, some of the biggest uncertainties for European business are local. Now that the countdown for Britain's exit from the European Union has officially begun, what will be the future shape and direction of the EU itself, at a time of economic and political divergence among the remaining 27 member states? Companies see a range of possible scenarios—and what they want is not necessarily what they expect. Most firms surveyed say that their business has benefited from EU membership and that they want “more Europe”, including more centralised authority and spending. Most companies also tell us they want the EU to remain intact. However, just over half of them expect disruptive changes to the Eurozone in the years ahead.

The views of European business about the EU are often correlated with views about the broader trends. For example, companies worried about rising populism are most likely to believe the European Union should continue its integration efforts, whereas those negative about the impact of increased refugee populations on their business are more likely to give credence to potential EU breakup scenarios.

GLOBAL TRENDS INCLUDING AGEING, DIGITISATION, AND EMERGING ECONOMY GROWTH WILL CHALLENGE EUROPEAN ECONOMIES AND COMPANIES

The global economy is undergoing a dramatic transition as a result of four fundamental disruptive trends. Any one of these disruptions would probably rank among the largest economic forces the global economy has ever seen, including industrial revolutions in advanced economies. Together, they amplify one another, and are gaining strength, magnitude, and influence. The first trend is the shifting locus of economic activity and dynamism to emerging markets such as China, and to cities within those markets. The global urban population has been growing by an average of 65 million people a year over the past three decades, equivalent to adding ten times the combined population of Berlin, Brussels, and Paris.⁴⁶ Second is the acceleration in the scope, scale and economic impact of technology. Third is the changing demographic picture, as fertility falls and the world population greys. Finally, the world has become far more connected through cross-border flows of trade and through movements in capital, people, and information. Europe is particularly susceptible to some of these global forces and trends, which have helped stir political populism, including over an influx of refugees and migrants and rising inequality

65m

Average annual growth of global urban population over past three decades

⁴⁶ For details see Richard Dobbs, James Manyika, and Jonathan Woetzel, *No ordinary disruption: The four forces breaking all the trends*, PublicAffairs, May 2015.

that some blame on globalisation. This in turn is feeding some of the divergence and disgruntlement within the EU.

Demographic changes including lower fertility and ageing

A “demographic dividend” helping to fuel global growth in the past half-century has come to an end, and the working-age population is starting to decline in many countries, including in Germany and Italy, where the fertility rate has dropped sharply.⁴⁷ This is creating an economic growth gap in Europe and globally that needs to be filled by rising productivity if living standards are to be maintained. At historical productivity-growth rates, long-term global GDP growth would be 40 percent slower than its rate over the past 50 years. Yet productivity growth in the European Union has actually been weakening rather than strengthening. Government policy in many European countries risks exacerbating the effect of ageing. If maintained, policies such as low retirement ages will put an increasing burden on public finance and growth. Life expectancy has increased by more than nine years since 1970, but, over the same period, the male average effective retirement age for men has fallen by six years.⁴⁸

Some European countries are successfully dealing with the demographic challenges. For example, the United Kingdom has phased out a default retirement age, allowing people to work as long as they want. Germany has a jobs training programme that provides training and communications skills for people over 50, alongside internships and job counselling. Spain has raised its retirement age from 65 to 67.

These demographic shifts also have implications on Europe’s global influence, as populations in developing nations grow much more quickly. In 1900, Europe represented 25 percent of the world’s population. In 2015, it was just 6 percent, and by 2060 it will be only 4 percent.⁴⁹ As Europe’s economic and social influence gives way to other regions, European companies will need to change the way they seek talent, customers, and broader cultural influence.

Rapid technological advances including digitisation and automation

MGI research shows that companies with advanced digital capabilities in their assets, operations, and workforce outperform in terms of growth in revenue and market share. They improve their profit margins three times faster than the average and, more often than not, have been the fastest innovators and the disrupters in their sectors and in some cases beyond them. These are the digital leaders operating on the digital frontier.⁵⁰ But our research shows that Europe has ground to make up in digital: it is realising only 12 percent of its digital potential, compared with 18 percent in the United States (Exhibit 15). For now European nations rely heavily on digital imports from the United States. Despite some efforts, they have not created global technology companies to rival titans such as Amazon, Google, Facebook—or China’s Alibaba.

The next technological frontier—automation of knowledge work—is rapidly approaching, and it will have significant implications for European companies, as well as for economic growth and the future of work. About 46 percent of the work activities carried out in Europe’s five largest countries have the potential to be automated by adapting currently demonstrated technologies.⁵¹ Less than 5 percent of occupations could be fully automated by adapting currently demonstrated technologies, our research shows. However, a large number could

⁴⁷ *Global growth: Can productivity save the day in an aging world?* McKinsey Global Institute, January 2015.

⁴⁸ *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

⁴⁹ *White paper on the future of Europe: Reflections and scenarios for the EU27 by 2025*, European Commission, March 2017.

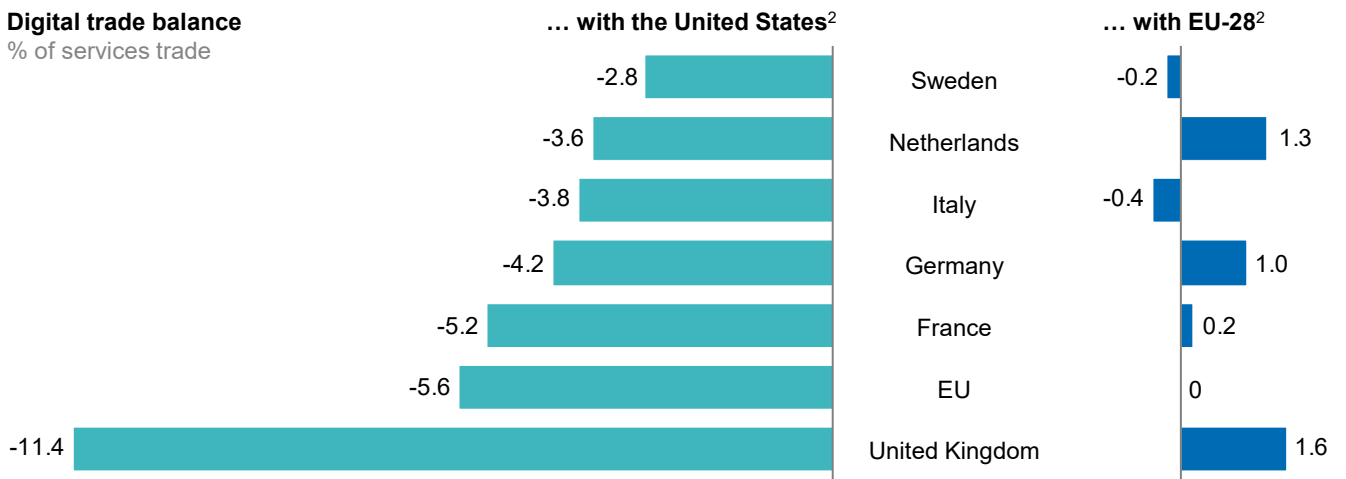
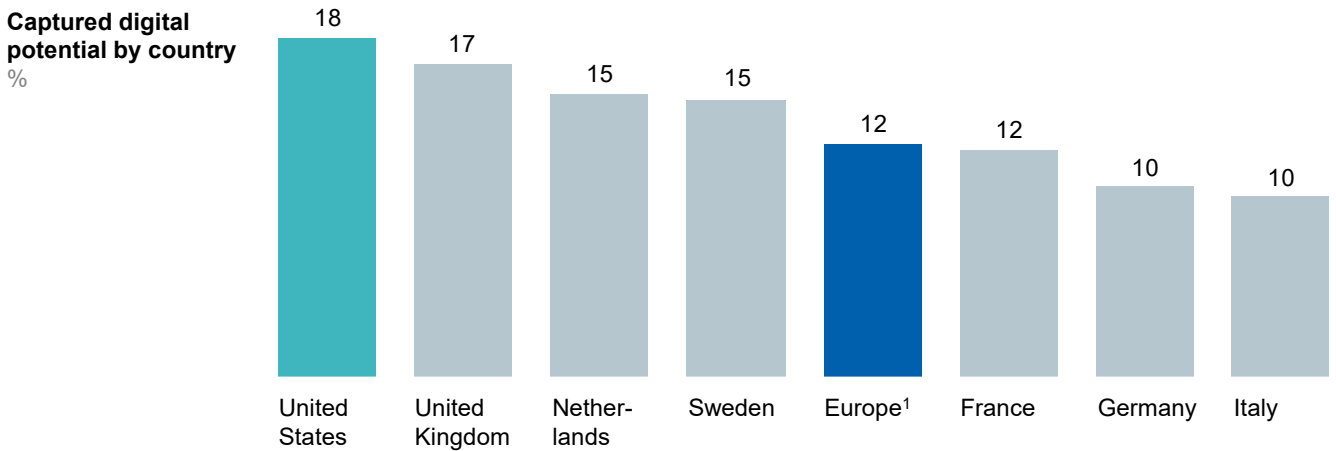
⁵⁰ *Digital Europe: Pushing the frontier, capturing the benefits*, McKinsey Global Institute, June 2016; *Digital America: A tale of the haves and have-mores*, McKinsey Global Institute, December 2015.

⁵¹ *A future that works: Automation, employment, and productivity*, McKinsey Global Institute, January 2017.

be partially automated; we estimate that about 60 percent of occupations have at least 30 percent of activities that are automatable.

Exhibit 15

Most European countries have not captured the full value of the digital economy, and rely on US digital imports



1 Europe is the weighted average of the six countries shown here. These six countries make up 60% of the population, and 72% of GDP, in the EU-28 grouping.

2 Trade within digital economy—examples include digital services commerce platforms; content services; and software services.

SOURCE: Eurostat; OECD; International Trade Centre; European Commission Joint Research Centre; CSIMarket; McKinsey Global Institute analysis

European business and government leaders have strong incentives to embrace automation technologies and become early adopters of them. Our research shows that the performance benefits for business from automation go far beyond labour substitution; they include the potential to increase throughput and scale, reduce errors, and improve quality and safety, among others. Relatively high wage levels in Europe will make the business case for automation more compelling for companies. Automation could also give a productivity boost to the global economy amounting to between 0.8 percent and 1.4 percent of GDP annually. This would be enough to ensure that most European Union nations maintain their current GDP per capita growth rates despite ageing. To reap these benefits, Europe will need to undertake significant catch-up efforts more broadly in technology, since delays in connectivity, big data use, and artificial intelligence can compound one another.⁵²

⁵² Ibid.

Global growth opportunities and heightened competition

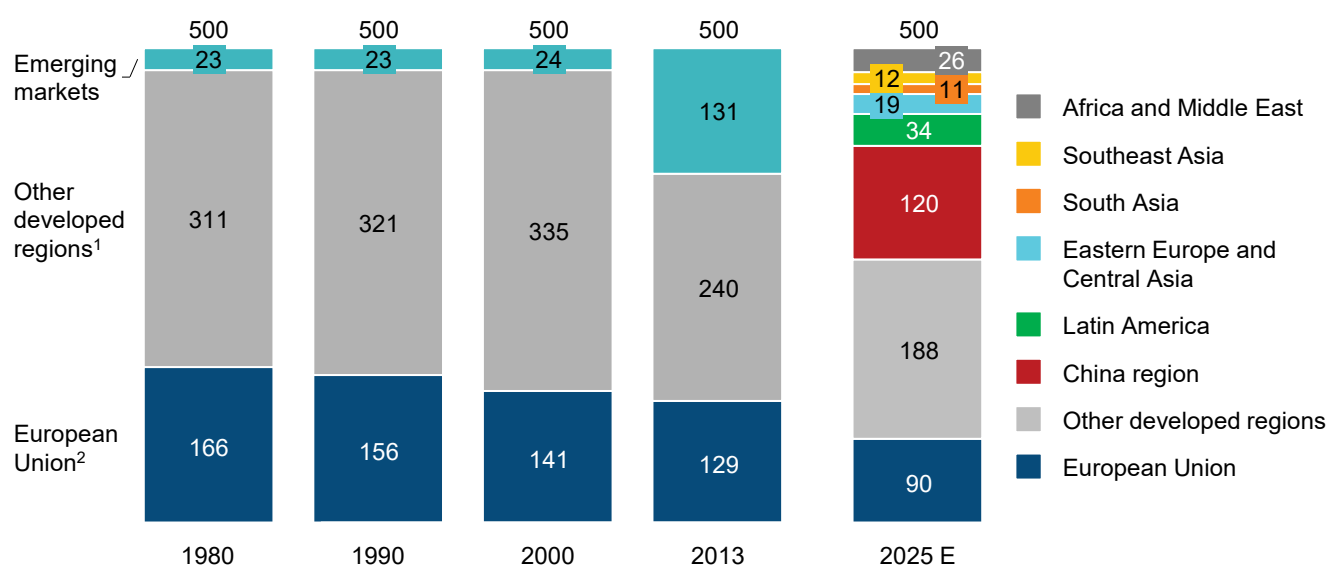
Flows of trade, services, capital, people, and data are essential indicators of globalisation, and have been closely associated with economic growth. Over the past three decades, Europe has been a leader in terms of its openness to trade flows, which in turn has been at the core of its competitiveness.⁵³ In our index of global connectedness, ten of the top 20 nations are in the EU. The EU also maintains a sizable trade surplus, of 3.4 percent of GDP in 2015, increasingly driven by knowledge-intensive goods and services.⁵⁴

Corporate Europe's ability to ride the wave of globalisation is increasingly challenged by companies in emerging economies. Of the largest global companies in the Fortune Global 500 ranking in 2016, 142 were European (126 of them were from the EU), compared with 134 from the United States. However, new competition from China and other emerging economies is already being felt and will likely affect future growth and earnings (Exhibit 16).⁵⁵ In the past decade, the 50 largest firms from emerging economies have doubled their share of revenue from overseas activity, from 19 percent to 40 percent. By contrast, the share of global revenues of EU firms has markedly declined, dropping from 36 percent in 1980 to 23 percent in 2013.⁵⁶ China today invests more in innovation as a share of GDP than the EU; Chinese research and development spending was just over 2 percent in 2015, while in the EU it was 1.95 percent. Both are behind the United States, where R&D spending amounts to almost 2.8 percent of GDP.⁵⁷ Similarly, Western European banks' stock of foreign claims declined in nominal terms by \$8.4 trillion, or more than 35 percent, between 2007 and 2015.⁵⁸

Exhibit 16

By 2025, European Union countries are predicted to represent 90 companies in the Fortune Global 500, down from 166 in 1980

Number of Fortune 500 companies by region



¹ Australia, Canada, Japan, South Korea, United States, and Western Europe excluding EU-28.

² Includes all current EU-28 countries, up to and including 2025.

SOURCE: Fortune Global 500; MGI CompanyScope; McKinsey Global Institute analysis

⁵³ *Digital globalization: The new era of global flows*, McKinsey Global Institute, March 2016.

⁵⁴ Eurostat, 2017.

⁵⁵ *Playing to win: The new global competition for corporate profits*, McKinsey Global Institute, September 2015.

⁵⁶ Ibid.

⁵⁷ *Gross domestic spending on R&D*, OECD, 2017.

⁵⁸ *Financial (de)globalization: The new dynamics of cross-border finance*, McKinsey Global Institute (forthcoming).

Political backlashes against globalisation and EU membership, and opposition to external migration and refugees

In opinion surveys and elections, a growing proportion of Europeans are expressing concern about—or outright hostility to—free global trade and especially immigration in its various forms. This sentiment is partially linked to measures of economic progress and anxiety about the future. MGI research shows that a majority of households in countries including France (63 percent), Italy (97 percent), and the United Kingdom (70 percent) experienced flat or declining market income from wages and capital in 2005–14. Many of those who felt they were not advancing and believed this was a persistent problem expressed sharply negative views about foreign trade and immigration.⁵⁹ An MGI survey of households in France and the United Kingdom shows that, among those pessimistic about their own and their children's incomes in the future, 57 percent think foreign labour is creating unfair competition, while 42 percent believe that trade leads to job losses at home.⁶⁰

The influx of more than two million refugees from Syria, Iraq, and other countries in 2015–16 has put further pressure on the EU and its member states. It is also proving a complex integration challenge. About 70 percent of the asylum seekers are male, and 30 percent are under the age of 18.⁶¹ In general, migrants to Western Europe tend to be low-skill; only about 26 percent of the more than 48 million migrants who lived in Western Europe in 2015 were high-skill, compared with 35 percent of migrants to North America.⁶² Further, unemployment rates for migrants are higher than they are for native-born workers in most Western European countries. Finding ways to better integrate and employ migrants has important implications; if better integration and other interventions were to cut the wage gap between immigrants and native-born workers from between 20 and 30 percent to between 5 and 10 percent, global economic output could increase annually by \$800 billion to \$1 trillion.⁶³

EUROPEAN BUSINESS IS OPTIMISTIC ABOUT DIGITISATION AND THE GROWTH OF EMERGING ECONOMIES, BUT NEGATIVE ABOUT OTHER GLOBAL TRENDS

49%

Share of survey respondents who say they expect the rise of emerging economies to have a positive impact on business

European businesses are eager to embrace digitisation and automation. Overall, 55 percent of companies we surveyed see these advancing technologies as having a positive impact on their business, against just 13 percent who have a negative view. Among the companies we categorise as high flyers, this proportion rises to 70 percent positive, and just 7 percent negative. But even for left-behind companies, the positives outweigh the negatives by more than 2:1. The upbeat perception holds regardless of the size of the company—49 percent of small and medium-sized enterprises see benefits, compared with 15 percent that do not. For the largest firms, that proportion rises to 64:9.

The rise of emerging economies is also broadly welcomed, with 49 percent of survey respondents saying they expect a positive impact on their business, compared with just 13 percent who see a negative effect. Once again, the high flyers are the most upbeat, with 64 percent seeing a positive impact. Global and exporting companies that are positive towards emerging economies are more likely to be more positive about all global trends. This reflects a clear interdependence of these trends, which we also see in relation to sentiment about the EU.

⁵⁹ *Poorer than their parents: Flat or falling incomes in advanced economies*, McKinsey Global Institute, July 2016.

⁶⁰ *Ibid.*

⁶¹ *Europe's new refugees: A road map for better integration outcomes*, McKinsey Global Institute, December 2016.

⁶² *People on the move: Global migration's impact and opportunity*, McKinsey Global Institute, December 2016.

⁶³ *Ibid.*

For the other global trends we asked about, the sentiment turns markedly more negative. Respondents are more balanced with respect to the expected impact of migration on their business. Just under one-third of survey respondents had a negative view of the impact of the ageing of the population, the pressures against globalisation, and an increase in refugees. Between 35 and 40 percent of firms surveyed see rising populism, geopolitical disruption, and rising inequality as having a negative impact on their business. One-third also view any countries beyond Britain leaving the EU as a negative for business, although more than one in four say the impact could be positive (Exhibit 17).

Exhibit 17

While EU businesses expect to benefit from digitisation and the rise of emerging economies, they perceive most global trends as negative

Q: The following are trends and changes that Europe is experiencing or predicted to experience in the coming years. What kind of impact do you think these trends and changes will have on your business over the next five years?

% of EU respondents in each category



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

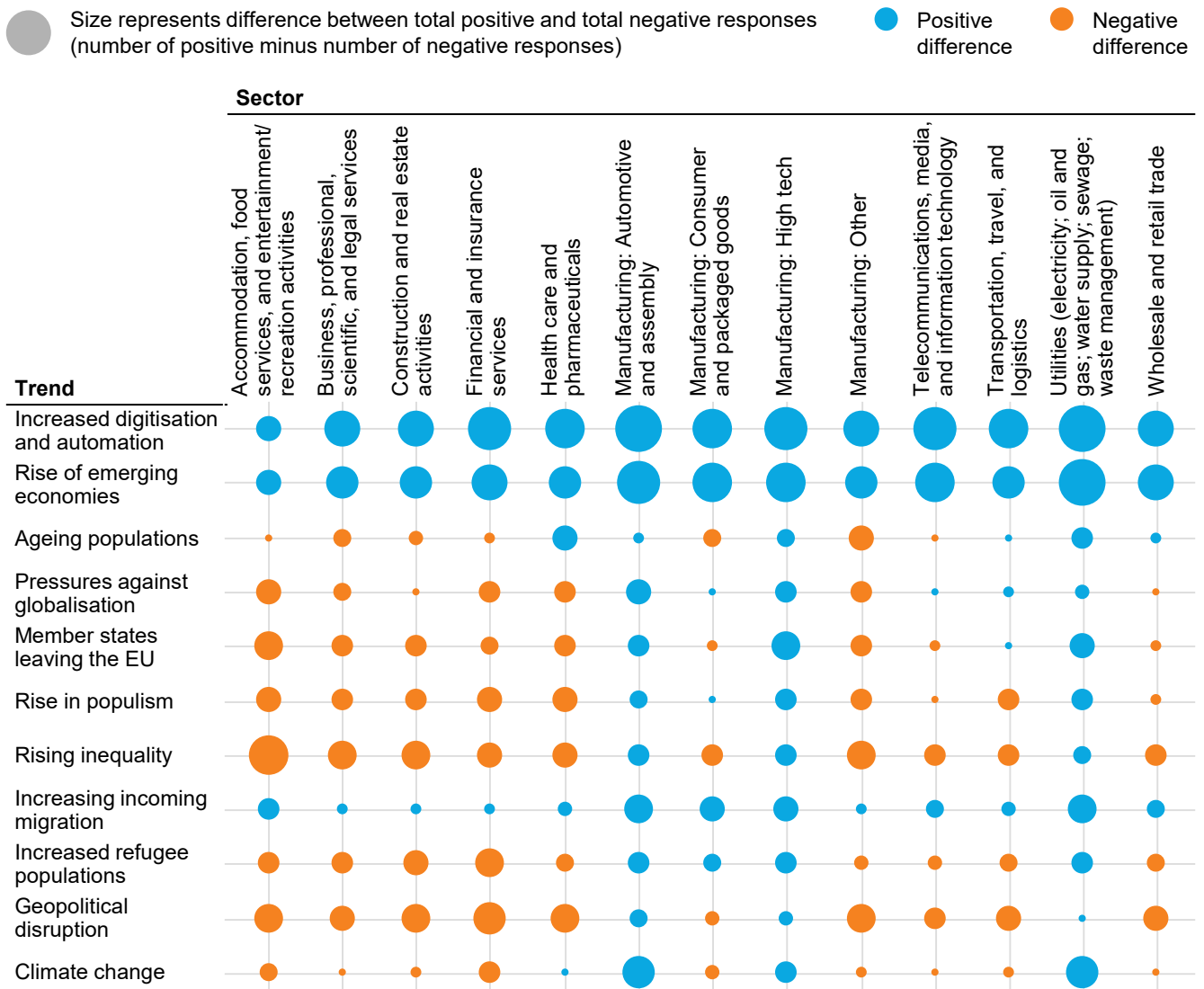
While there is some difference in the degree of negativity among high flyers, advancing, and left-behind companies, the overall direction is broadly similar. The left-behind group appears especially concerned about ageing, with 36 percent anticipating a negative impact. This could indicate that many of these businesses have an older workforce that may be more affected by the ageing trend, that they are concerned about the need to support a greying

population, that they do not expect to appeal to an ageing consumer base, or that they are concerned about the shrinking size of EU populations relative to the rest of the world.

Among sectors, there are some significant differences in positivity towards trends (Exhibit 18). The manufacturing sectors (automotive, consumer packaged goods, and high tech) are the most positive towards all trends, including member states leaving the EU and climate change, which other sectors appear to struggle with. Utilities are also positive, although with a considerably smaller survey sample these results are possibly not quite as indicative. Perhaps more surprisingly, there is a general negativity within several service sectors (accommodation, food services, and entertainment/recreation activities, business, professional, scientific, and legal services, construction and real estate activities, financial and insurance services, health care and pharmaceuticals) towards at least eight of the global trends. In particular, rising inequality is seen as a particularly negative trend for these sectors, along with geopolitical disruption.

Exhibit 18

Manufacturing and utilities companies are generally more positive towards global trends, while the service sectors are very negative



NOTE: Mining, agriculture, forestry, and fishing are not included because of small sample size.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Compared with their European counterparts, US and Chinese companies are more optimistic about the global forces, although Chinese respondents worry about the impact of populism and increasing refugee numbers. They are also substantially more negative about the effect of pressures from globalisation, geopolitical disruption, and rising inequality. Each trend in our survey was considered positive by most US firms, with 79 percent seeing digitisation as a boon, far higher than the 55 percent EU firm average, and above the 76 percent level of Chinese firms.

These trends are important for the economics of the business community as they correlate with future revenue expectations and investment for European business. Regression analysis found a significant impact of positivity towards trends on future investment levels particularly for the primary and manufacturing sectors. For the 15 percent across all sectors that are more optimistic about these trends (defined as being positive about eight or more trends), the effect against the average is roughly 1 point more growth in investment rate. CHAID analysis helped identify individual trends with significant impact. Digitisation acts as a positive trend for investment and revenue growth, ageing appears to put negative pressure on revenue growth, and antiglobalisation and inequality tend to depress investment. Helping businesses to better manage the risks associated with these trends can reap economic benefits.

MOST EUROPEAN BUSINESSES SEE BENEFITS FROM EU MEMBERSHIP AND WANT “MORE EUROPE”, BUT DO NOT RULE OUT CHANGES TO THE EUROZONE

Most companies we surveyed say the EU has had a positive impact on their business and say they want to see “more Europe” not less, favouring greater centralised authority and spending. However, our survey also highlights a gap between what business wants and perceptions of what might happen. When presented with a range of possible scenarios for the future, 84 percent of EU respondents (excluding the United Kingdom) picked ones in which the EU survives intact as the most likely. However, just over half think the Eurozone could change or even break apart while the EU stays in its current form.

More than half of European businesses in our survey say they have seen benefit from the EU

Fifty-three percent of European companies surveyed think the EU has had a positive impact on their business, and the better a company’s performance, the stronger the approval rating. Within our high flyer category, 67 percent see a beneficial outcome, with almost half of those saying the EU’s impact has been “very positive”. For companies in our advancing category, too, a clear majority (57 percent) says the EU’s effect on business has been positive. The left-behind companies are less enthusiastic, with 41 percent positive and 38 percent giving a “neutral” answer. Overall, 32 percent of the responses were neutral (Exhibit 19).

The ratings are broadly consistent across high-level sector groups, with more than 50 percent of businesses in most sectors giving a positive response, although there were differences among sectors. Manufacturing companies were the most positive about the impact of the EU on their business (57 percent positive responses), while health care and pharmaceutical firms (46 percent positive responses), and accommodation, food services, and recreation companies (42 percent) were among the most negative.⁶⁴ More significant differences can be found at the country level, and in relation to the size of the company. Spanish firms are easily the most enthusiastic about the benefits they have had from being in the European Union, with just over 70 percent giving a positive rating, ten times the proportion of firms giving a negative rating. The least positive reaction was in Britain, where only 42 percent of companies said EU membership had been positive, followed by Italian

⁶⁴ Mining and agriculture are not included in this sector analysis because of the small sample size.

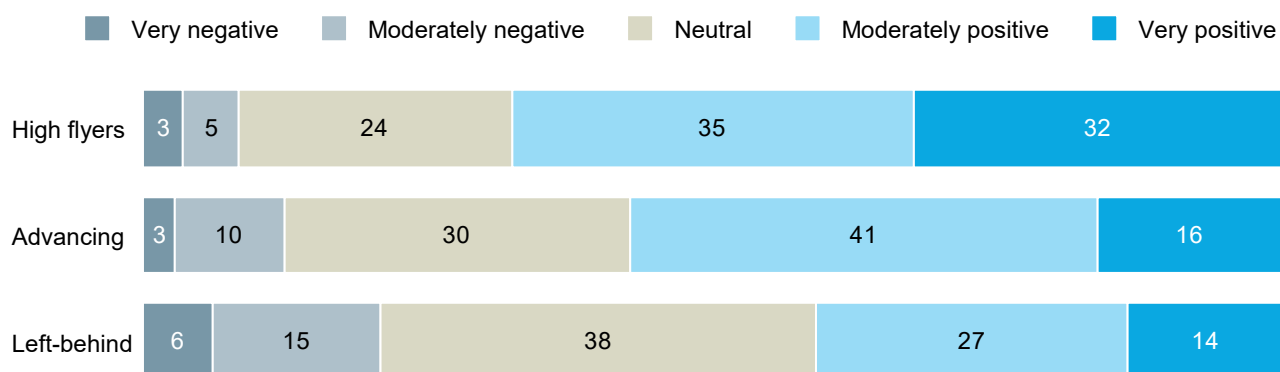
firms, at 46 percent (see Box 4, “UK firms tend to be more negative about the EU’s impact on their business, but not by a wide margin”).

Exhibit 19

More successful companies are much more positive about EU membership

Q: In general, how would you describe the impact of your country’s membership in the EU on your business?

% of EU respondents in each category



Average (%)

| Category | Very negative | Moderately negative | Neutral | Moderately positive | Very positive |
|-----------------------------|---------------|---------------------|---------|---------------------|---------------|
| All EU | 4 | 11 | 32 | 35 | 18 |
| EU excluding United Kingdom | 4 | 9 | 31 | 37 | 19 |

NOTE: UK respondents are included in the high flyer, advancing, and left-behind categories. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

The differences are also noteworthy between large and small companies; 60 percent of extra-large firms (more than 1,000 employees) report that EU membership has had a positive impact on their business, compared with just 37 percent of microenterprises (one to nine employees).

The benefits of EU membership most cited by companies are maintaining peace and security, enabling ease of business, and providing free market access. Some 57 percent of respondents said they have received benefits from the single markets for goods and services, while about 55 percent have seen benefits from the free movement of people that is enshrined in the single market, and from a unified currency. (Only four of the six countries where we did the polling are in the Eurozone, with Poland and the UK being the two with their own currencies). Very few companies (between 8 and 14 percent) say such initiatives have had a negative impact on their business. Asked about the challenges of EU memberships, companies cited the loss of national sovereignty (19 percent) and complex and burdensome regulations and processes (13 percent)—answers that are consistent with the concerns about regulatory burdens we discussed in the previous chapter (Exhibit 20).

The results of our business survey are in line with views expressed by consumers: in one recent survey, almost 70 percent of the Italian and Spanish public wanted more political and economic integration, as did 50 percent of German and Polish respondents, while less than half the Britons polled did.⁶⁵

⁶⁵ Catherine de Vries and Isabell Hoffmann, *Supportive but wary: How Europeans feel about the EU 60 years after the Treaty of Rome*, Bertelsmann Stiftung, January 2017.

Box 4. UK firms tend to be more negative about the EU's impact on their business, but not by a wide margin

While some British business groups including the Confederation of British Industry (CBI) warned about the economic costs of Brexit before the June 2016 referendum, they have since promised to “make a success” of UK withdrawal from the European Union.¹ Compared with businesses we surveyed in five other European countries, the responses from British companies about the impact of the EU on their business were on the whole less favourable, although not significantly more negative than in some other countries.

For example, the 42 percent of UK business respondents saying the EU's impact on their business had been “moderately positive” or “very positive”, was not far behind the 46 percent of Italian companies that felt the same way. Indeed, a slightly larger proportion of Italian firms said the EU's effect had been negative (22 percent vs. 21 percent). The positive UK responses were considerably lower than earlier polls of British business before the Brexit vote.²

When the UK responses are stripped out of our survey analysis, the overall pro-EU sentiment rises, but not significantly. Excluding British firms, 57 percent of EU businesses reported that membership was “moderately positive” or “very positive” for business, compared with 54 percent including the UK responses. The average share of respondents in our survey who deemed the EU's impact as “moderately negative” or “very negative” was 13 percent without UK companies and 15 percent with them (in the United Kingdom alone, 21 percent of companies held a negative view of the EU's impact).

At a sector level, however, bigger differences between UK and continental European businesses become evident. For example, financial services are considerably more positive about the EU once British companies are removed from the sample, rising to 61 percent from 54 percent, and negative responses in this sector fell to 10 percent from 16 percent. Overall, British firms are considerably less positive about the impact on business of a single currency (32 percent positive responses in the United Kingdom vs. 59 percent in the five other countries), and of the free movement of people (42 percent vs. 58 percent).

British companies were most out of sync with their European peers in answers to forward-looking questions about the future of the EU. Britain was the only one of the six surveyed countries where a majority of business leaders say they want “less Europe” (56 percent in the UK, compared with 35 percent in the five other EU countries). British firms are also more likely to anticipate a change or breakup of the EU or Eurozone (63 percent vs. 51 percent), and significantly less likely to expect the EU to integrate more closely or maintain the status quo (37 percent vs. 49 percent).

However, scepticism among British firms about EU institutions is widely shared by their continental European peers, our survey indicates. Just over 27 percent of UK companies surveyed believe EU institutions are effective at making and managing policy, almost exactly the same proportion as the average of companies in the five other countries.

¹ Szu Ping Chan, “Big business groups vow to make Brexit a success”, *Daily Telegraph*, December 31, 2016. For the CBI's pre-Brexit position, see Marion Dakers, “Brexit could cause £100bn short-term shock to the economy, warns the CBI”, *Daily Telegraph*, March 20, 2016.

² For example, in a CBI/YouGov survey in 2013 that reached mostly large businesses, 76 percent of CBI members said “the ability to buy and sell products inside EU markets without taxes and tariffs on trade flows” had positively affected their business, while only 1 percent said the impact had been negative. www.cbi.org.uk/news/8-out-of-10-firms-say-uk-must-stay-in-eu/yougov-cbi-eu-business-poll/

Exhibit 20

Businesses generally see free-market access, ease of doing business, and geopolitical stability as the prime benefits of EU membership, and loss of national sovereignty as the key challenge

Top 5

% of EU respondents choosing each option



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Excluding UK firms, 65 percent of European businesses surveyed say they want “more Europe”

Business leaders across Europe, with the exception of the United Kingdom, broadly support policies that would centralise more authority and spending at an EU level. Across the six countries we surveyed, 60 percent of businesses say they want “more Europe”—a proportion that rises to 65 percent when the replies from UK businesses are excluded (Exhibit 21). Companies we categorise as high flyers are even more enthusiastic, with the proportion rising to nearly 70 percent. But even firms in the left-behind category favour “more Europe”, 53 percent compared to 47 percent that say they want less Europe. Spain once again is easily the most enthusiastic nation, with 79 percent of companies saying they want “more Europe”. Manufacturing companies are similarly positive; 70 percent reported wanting “more Europe”, in contrast to only 55 percent of companies in primary industries and infrastructure services, and 57 percent in other services.

Across all sectors, the most important discriminator for whether or not a company wants more or less Europe is its perception of historical EU membership benefits. Being in favour of more Europe is almost 2.5 times more likely for a company that has benefited from Europe in the past. Manufacturing companies are more likely to be positive towards “more Europe”, while companies from the service sector, such as accommodation and food services or business services, tend to be much more negative about “more Europe”.

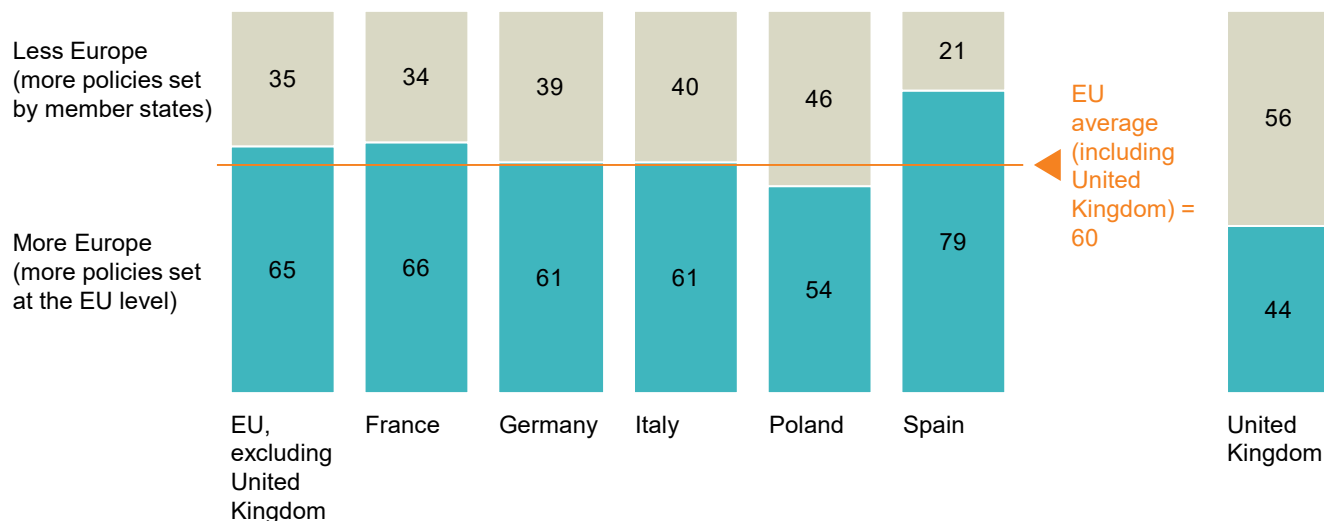
What do companies mean by “more Europe”? To gain a deeper understanding of their answers, follow-up questions sought their views on some specific policies. The outcome suggests that there is no clear single wish list for business (see Box 5, “Business does not have a one-size-fits-all wish list for more Europe”).

Exhibit 21

Far fewer UK companies report that they want “more Europe” than do other EU members

Q: If you had to choose, would you want “More Europe” or “Less Europe”?

% of EU respondents



NOTE: Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Box 5. Business does not have a one-size-fits-all wish list for “more Europe”

While a majority of businesses in our survey reported that they wanted “more Europe”, they do not all want more of the same things. We used cluster analysis as an analytical technique to identify five clusters of companies, based on shared preferences on what they value and want from the EU.

Each cluster is comparable in size (with 18 to 24 percent of all EU respondents in each), and includes survey responses that can be grouped into a distinctive “personality” for the cluster. They are distinguished by the benefits and drawbacks they see in EU membership, the priorities they have for EU institutions, and the policies they think could encourage growth and investment (Exhibit 22).

For example, respondents in the “security and stability” cluster (19 percent of respondents) generally see peace and security and freedom from government corruption as the primary benefits of EU membership, rather than any economic advantages. Conversely, businesses in the “financial volatility” cluster (24 percent of EU respondents) are more likely to see economic predictability and stability and access to goods, services, and markets as the

primary benefits of EU membership. While EU policies focused on strengthening the European position in world affairs might help to meet the first group’s needs, the second would generally push the EU to focus on stabilising disruptive economic trends and creating a better environment for economic growth.

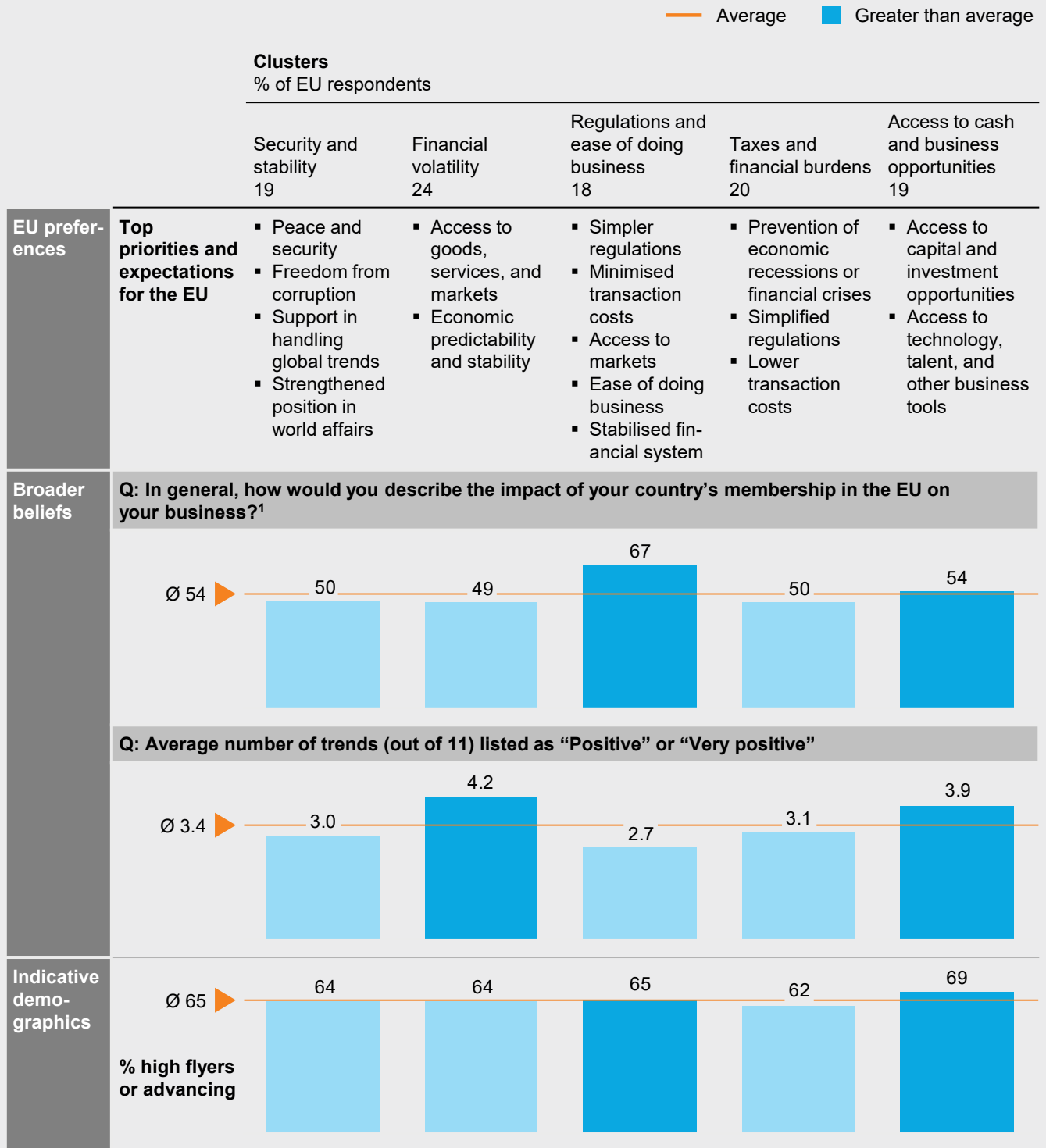
These clusters suggest that there is no “one size fits all” approach that can appeal to all EU businesses, but that some policy categories will appeal to a similar subset of companies.

Our clusters each contain businesses with a range of behaviours and demographics, but they skew towards particular groups. For example, small and medium-sized enterprises and companies with single-country operations are overrepresented in the “security and stability” cluster. EU policies that target particular clusters of companies based on their preferences and priorities for the EU may therefore be able to reach groups that EU institutions see as high priorities, such as rapidly growing businesses, or those that expect to be left-behind by global shifts.

Box 5. Business does not have a one-size-fits-all wish list for “more Europe” (continued)

Exhibit 22

There are five clusters of companies, each with specific beliefs and priorities for the EU



¹ % of respondents answering “Moderately positive” or “Very positive”.
NOTE: Not to scale. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

The policies that gained the most support were primarily related to centralising more authority and spending. Greater law enforcement powers were the top choice (62 percent support), followed by creation and enforcement of a common external EU border protection (59 percent), developing common energy and environmental policies (59 percent), and managing migration at an EU level (57 percent). As we will see later in this chapter, the depth of feeling among companies about migration issues can colour views on the EU more generally. The least support was given to the idea of bolstering an EU military force and setting consistent wealth distribution policies across borders, rather than having individual countries set their own rules for social security, unemployment insurance, and tax policy. However, even for these policies, the share of those in favour easily outnumbered those against, by at 2:1 (Exhibit 23).

Exhibit 23

Business leaders broadly support policies that would centralise more authority and spending at an EU level

Q: Please explain your level of support for the following current or potential EU-level policies and responsibilities.

% of EU respondents in each category



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

European businesses see the EU remaining intact but think the Eurozone could shrink or even disband

In the first chapter, we noted the EU's state of "unstable equilibrium" and growing divergences, which come on top of the political disaffection with the European Union that has grown over the past decade in a number of EU member states—and which came to a head in the UK referendum on EU membership in June 2016. The idea of "ever closer union" that was enshrined by the EU's founding fathers in the 1957 Treaty of Rome, along with the goals of peace and prosperity, is no longer seen by respondents as the only way forward, and in European capitals and countryside towns, a lively debate about future paths is taking place.⁶⁶ When the European Commission in March 2017 published its white paper marking the 60th anniversary of the Treaty of Rome, the idea of European member states working ever more closely together in the spirit of forging a closer union was only one of five future scenarios it sketched out.⁶⁷

While the Commission's scenarios do not include withdrawal from the EU by member states other than Britain, or the breakup of the union entirely, in our survey we gave business leaders a broader range of scenarios to choose from. That included scenarios that involve major disruption. We presented respondents with five scenarios and asked them which they thought most likely. Then we asked them which they thought would be best for their business. The scenarios were:

- **Increased integration.** "EU responsibilities expansion: Both the EU and the Eurozone maintain their current structure, with core countries remaining in place (with only the UK leaving the EU). The EU gains new responsibilities and sets up new institutions such as common defence, external border protection, and partially common fiscal policy".
- **Maintaining the status quo.** "EU and Eurozone remain intact with current responsibilities: Both the EU and the Eurozone maintain their current structure and levels of responsibility, with core countries remaining in place (with only the UK leaving the EU)".
- **Eurozone shrinks.** "Eurozone shrinks, with the EU intact: Peripheral economies exit the Eurozone and return to their national currencies, while core countries retain the euro. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU)".
- **Eurozone breaks up.** "Eurozone break-up, with the EU intact: Core countries exit the Eurozone, and all countries return to their national currencies. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU)".
- **EU and Eurozone disband.** "EU and Eurozone erosion: Core countries exit both blocks, and both the EU and the Eurozone disband completely".

The responses are highlighted in Exhibit 24. Opinion is quite divided about what will happen, with just under half the surveyed EU companies—excluding UK ones—anticipating that the EU will maintain the status quo or increase integration. More than one-third of companies anticipate that the EU will remain intact, but that the Eurozone will not remain in the same form, either shrinking or disbanding. And 16 percent see both the EU and the Eurozone disbanding.

⁶⁶ The treaty's full text is available at http://ec.europa.eu/archives/emu_history/documents/treaties/rometreaty2.pdf.

⁶⁷ The five scenarios presented by the EU are: carrying on; nothing but the single market; those who want more do more; doing less more efficiently; doing much more together. *White paper on the future of Europe: Reflections and scenarios for the EU27 by 2025*, European Commission, March 2017.

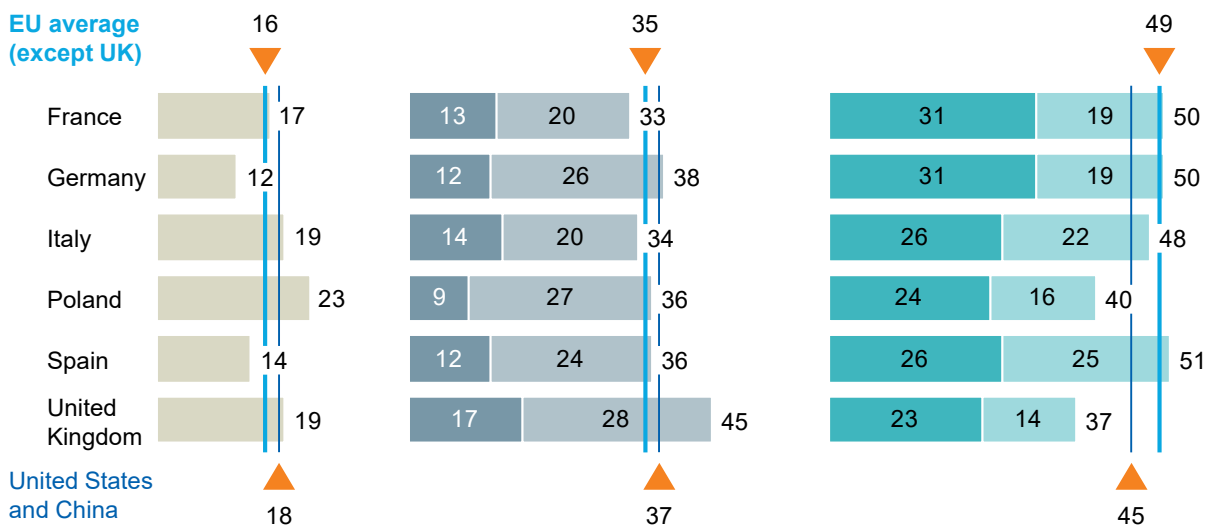
Exhibit 24

Respondents from all countries have split expectations for the future of the EU

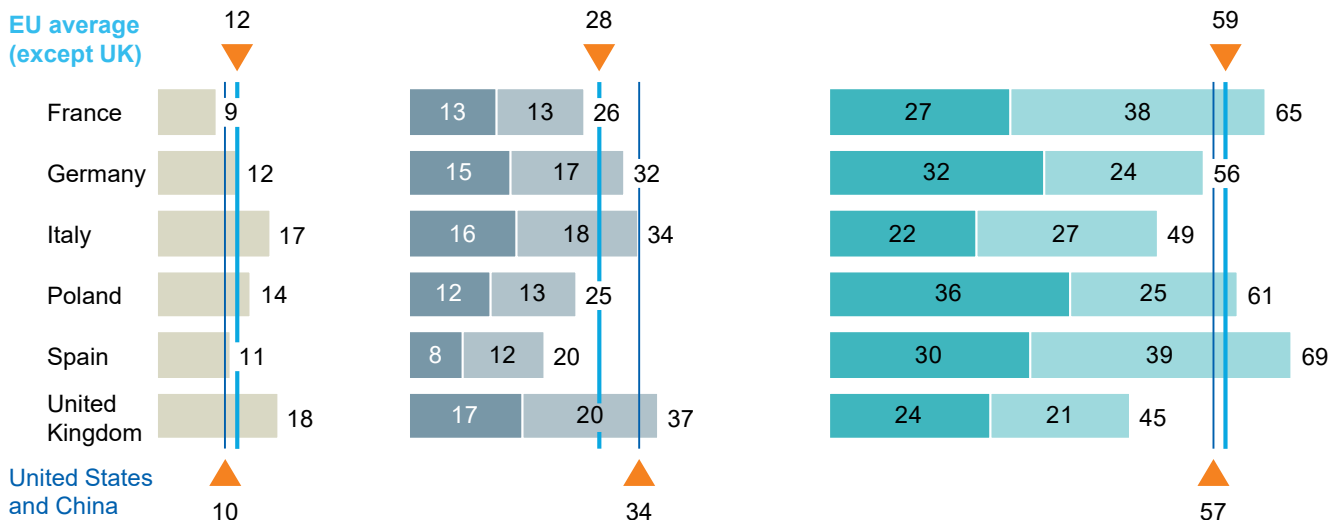
Expected and most beneficial scenarios for Europe
% of EU respondents

| Scenarios | EU and Eurozone will disband | EU remains as is, Eurozone will not remain in the same form | | EU will continue with status quo or move to increased integration | |
|-----------|------------------------------|---|-----------------------------|---|-----------------------|
| | | Eurozone breaks up, EU intact | Eurozone shrinks, EU intact | Status quo | Increased integration |

Q: The following are potential pathways for the future of the EU and the Eurozone. Please indicate which of these scenarios you think are most likely to occur.



Q: The following are potential pathways for the future of the EU and the Eurozone. Please indicate which of these scenarios you think are most beneficial for your business.



NOTE: All top-ranked scenarios. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

As we have seen in previous survey questions, companies in our high flyers category are more upbeat than the advancing or left-behind companies. About half the high flyers (when including the United Kingdom) believe the status quo or increased integration scenarios are the most likely, whereas only 43 percent of the left-behinds do.

From a country perspective, Polish companies expect the most disruption, with almost one in four expecting a breakup of both the EU and the Eurozone. That is an even larger proportion than UK companies, which tie with Italian ones. Spanish companies lead in terms of believing in greater integration. In line with the other trends, small businesses, and especially microenterprises, are most likely to think the Eurozone will change in some way.

Most companies want the EU and the Eurozone to remain intact, despite expectations that it may not

Our survey highlights a gap between what European business leaders think about the future of the EU and the Eurozone. On the whole, their hopes are more upbeat than their expectations, with 56 percent of businesses saying that the EU and Eurozone's staying together would be more beneficial for their business. This number rises to 59 percent when post-Brexit referendum UK is excluded from results. Only 13 percent of non-UK respondents believe it would be positive for businesses if the EU and Eurozone disband, less than the 16 percent who fear it will.

The high flyers are most in favour of an EU that remains intact and moves ahead; 62 percent support status quo and greater integration scenarios, with 35 percent supporting the increased integration option on its own. Even 54 percent of the left-behinds want the EU and Eurozone to remain intact. Once again, Spanish companies are the most enthusiastic about the future, with 39 percent favouring a move to greater integration. France is close behind, at 38 percent. At the other end of the spectrum, there is also a gap between the negative expectations and the hopes (Exhibit 25). For example, while 23 percent of Polish companies expect a disbanding of the EU and the Eurozone, only 14 percent believe that option would be best for their business. How companies view the future of the EU and their perception of global trends and investment are related (see Box 6, "How do business perceptions of the EU, global trends, and investment patterns relate to one another?").

Respondents from China and the United States also favour the EU staying together, with Chinese companies giving 60 percent support to the greater integration and status quo scenarios, which are favoured by 53 percent of US companies.

Box 6. How do business perceptions of the EU, global trends, and investment patterns relate to one another?

Business does not operate in a vacuum. While we have looked at the views of European business leaders on investment, global trends, and the EU separately, there are some linkages. Just like consumers, businesses develop their opinions and perspectives based on interconnected issues. The views on these issues are interrelated and they influence one another.

To explore this idea further, we began by checking the data to ensure it is representative of the typical economic activity and stylised facts regarding firm performance that we would expect to see in economic theory. There are, of course, some limitations to our survey response set. For example, there may be other variables at play that we have not captured through our questions; it is a onetime survey that is snapshot in time of only 2,000 individuals' opinions; and our respondents were asked to respond consistently to over 30 questions. We therefore conducted five tests on the data using both regression and CHAID techniques to ensure the data is consistent with the economic behaviour we would expect. The five tests sought to determine the following relationships:

- A correlation between output (future revenue growth) vs. capital (future investment growth) and labour (future employment growth).¹ This relationship appears to be solid in our data for all industrial splits, e.g., manufacturing, services, and companies in the primary sector. Only in the primary sector is future revenue growth not statistically linked to future investment.
- A strong correlation between past and future performance. We would expect future growth opportunities to be positively linked with the number of existing employees, and found this relationship in our data consistent with evidence presented in academic literature.²
- The relationship between a firm's geographical scope and its performance (future revenue growth). In our survey results, we find that, especially in manufacturing, the level of globalisation of a firm is aligned to its future revenue growth. For example, a manufacturing firm operating only in its domestic European market in that sector would expect 11 percent less average revenue growth.
- The presence of financial constraints, especially a challenging economic environment, limits revenue growth capture opportunities. Europe's last decade has been challenging, with some evidence of credit crunch.³ We find a cross-sectional correlation of 0.5 between historical growth in cash flows and historical revenue growth in our survey data.
- Investment decisions are in line with expected economic behaviours. We found evidence of the presence of a positive correlation between future investment growth and historical cash flow positions, as well as a smaller correlation between future investment growth and expected future revenue productivity.

¹ For details of the production function, see Paul Douglas and Charles Cobb, "A theory of production", *American Economic Review*, volume 18, number 1, March 1928.

² See Timothy Dunne, Mark J. Roberts, and Larry Samuelson, "The growth and failure of US manufacturing plants", *Quarterly Journal of Economics*, volume 104, issue 4, 1989.

³ Andrea F. Presbitero, Gregory F. Udell, and Alberto Zazzaro, "The home bias and the credit crunch: A regional perspective", *Journal of Money, Credit and Banking*, supplement to volume 46, number 1, February 24, 2012.

Box 6. How do business perceptions of the EU, global trends, and investment patterns relate to one another? (continued)

These checks help confirm that our data set is broadly reflective of the typical economic activity and trends we would expect to see. We then examined the interactions between the responses to the questions and confirmed a high level of influence between different topics. Two of our most significant findings are, firstly, that companies with a more positive view on the benefits of global trends are more likely to desire “more Europe”. Secondly, we also found that expectations of future investment are interrelated with perceptions of the EU and wider global trends.

The most important discriminator for whether or not a company wants more or less Europe is its perception of historical EU membership benefits. Similarly, the primary predictor of the future Europe scenario a business will select as most likely, as with more or less Europe, is what it sees as the past benefits of EU membership. Companies that think the EU has had a positive effect on their business are more likely to expect the EU to continue in its current form. The impact of the EU is therefore itself a key influencer of opinions about more or less Europe, and of whether there is support to expand its role and remit.

Two global trends influence business views on more or less Europe. Companies that see rising inequality and increased refugee populations as having a positive impact on their business are also those more positive about Europe. More positive perception of the impact of incoming migration also correlates with a desire for “more Europe”. There are a number of potential causes of—and therefore implications from—this relationship.

Views on whether the EU has benefited businesses in the past are correlated with perceptions of migration, rising populism, and risks of member states leaving the EU. Companies that think EU membership has been beneficial also think migration will be positive for business, while a negative perception of past benefits is correlated with negativity over migration.

By comparison, perceptions of past benefits of the EU have reverse correlations with feelings about the rise in populism and the risk of member states other than the United Kingdom leaving the EU. Respondents who feel these trends negatively impact their businesses are more likely to have a positive perception of past EU benefits. This could be indicative that companies benefiting from the status quo in Europe see incoming disruptions as high-risk, and are more positive about past EU membership and the stability it brought.

Regarding investment decisions, we found some interplay between expected investment decisions and perceptions of Europe. The strongest determinant of expected growth in investment in the EU is historical cash flow growth, as we have noted. However, at the second and third level of analysis there are small subgroups of respondents in which those who have seen past benefits from EU membership are more likely to expect to invest in the future than those who have not.

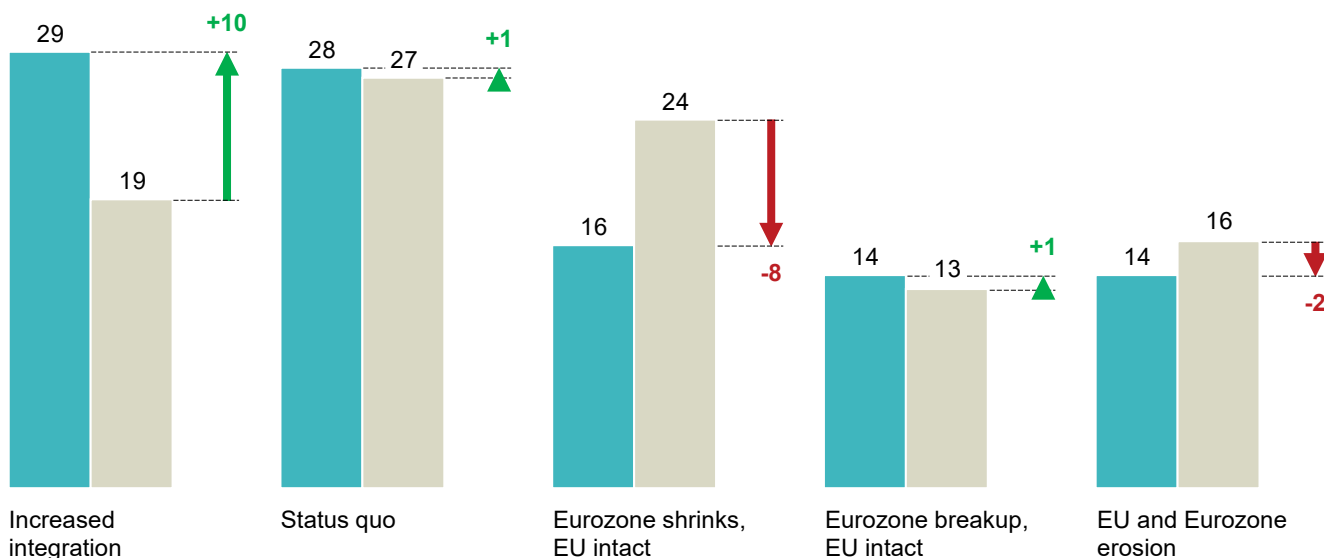
Exhibit 25

More companies report the increased integration scenario would be beneficial for their company than expect it to happen, while the opposite is true for the Eurozone shrinks, EU intact scenario

EU scenarios: expectations vs. most beneficial % first ranked EU responses

■ Most beneficial scenario ■ Most expected scenario

Q: The following are potential pathways for the future of the EU and the Eurozone.
 > Please indicate which of these scenarios you think are most beneficial for your business.
 > Please indicate which of these scenarios you think are most likely to occur.



NOTE: All numbers include UK responses. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

40%
 Share of EU businesses that are negative about effectiveness of EU institutions

IMPROVING THE EFFECTIVENESS OF EU INSTITUTIONS

In addition to gauging businesses’ perspective on the future of the EU, our survey tested reactions to EU institutions today. The results highlight considerable doubts and scepticism among European business leaders with regard to the effectiveness of EU institutions at making and managing policy—even when they support the policies themselves (see Box 7, “European business survey respondents seem supportive of EU Commission initiatives but have mixed views on execution”). About 40 percent of the businesses surveyed are negative about the effectiveness of EU bodies at making and managing policy, while only 28 percent are positive. The label “EU institutions”, of course, includes a range of entities—not just the EU Commission, but also the European Council, the European Parliament, and the European Central Bank. Rightly or wrongly, “the EU” is frequently the scapegoat for a broad range of public and business complaints, without much precision as to which agency or institution is at fault. Indeed, governments themselves sometimes hide behind decisions they have collectively made in the European Council. Despite the inevitable vagueness of responses to a survey such as ours, the general feeling about EU institutions across a broad swathe of European business is noteworthy.

Box 7. European business survey respondents seem supportive of EU Commission initiatives but have mixed views on execution

Our survey asked European businesses for their views on the European Fund for Strategic Investment (EFSI) and the Commission's ten priorities. The EFSI was proposed in 2014 with the aim of mobilising at least €315 billion in investment with maximum private-sector contributions.¹ The ten priorities, first outlined by Commission President Jean-Claude Juncker in 2014, cover areas that include boosting jobs and growth, connecting a digital single market, establishing an energy union, deepening the monetary union, and establishing a new policy on migration.²

Just over one-third of the businesses we surveyed say they have considered using or have used investment from the EFSI, with Polish and Italian companies the most likely to reply in the affirmative. Large businesses active

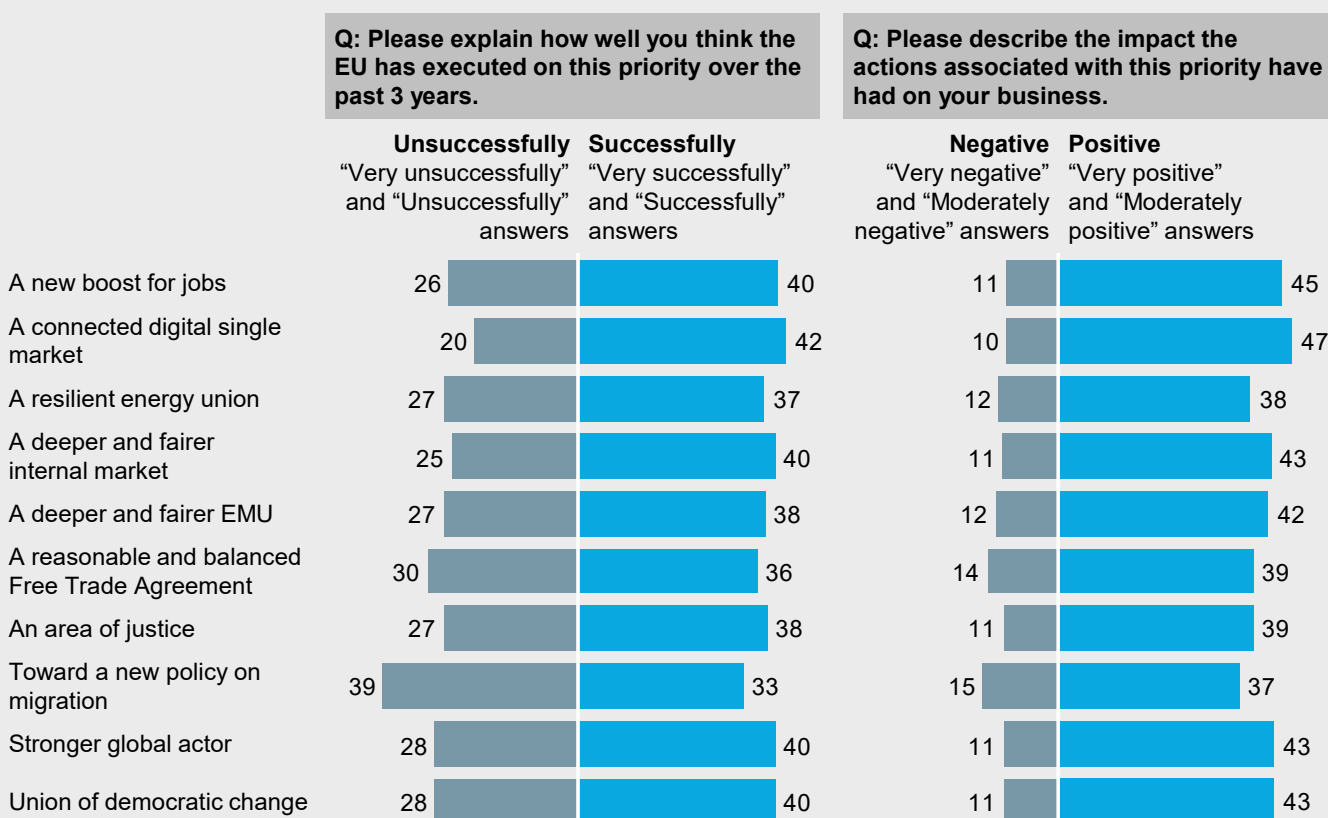
in several countries—including some outside Europe—are the most likely to consider tapping into the fund. Left-behind companies are less likely than high flyers or advancing companies to have considered it.

Regarding the ten priorities, businesses generally say that the impact on their companies has been positive, including the moves to create a connected single market and boost jobs. However, less than half the businesses surveyed think the priorities have been well executed (Exhibit 26). Unsurprisingly, high flying and advancing companies are somewhat more positive about these priorities, and they are generally more likely to think they have been executed well. Large companies, manufacturing companies, and Spanish companies tend to have similarly positive sentiments.

Exhibit 26

Views on the execution and impact of each EU priority¹

% of EU respondents in each category²



¹ The priorities listed are from the EU Commission.

² "Don't know" answers were excluded from the analysis.

SOURCE: MGI Business Survey, 2017; European Commission, *10 priorities for Europe*, October 2015; McKinsey Global Institute analysis

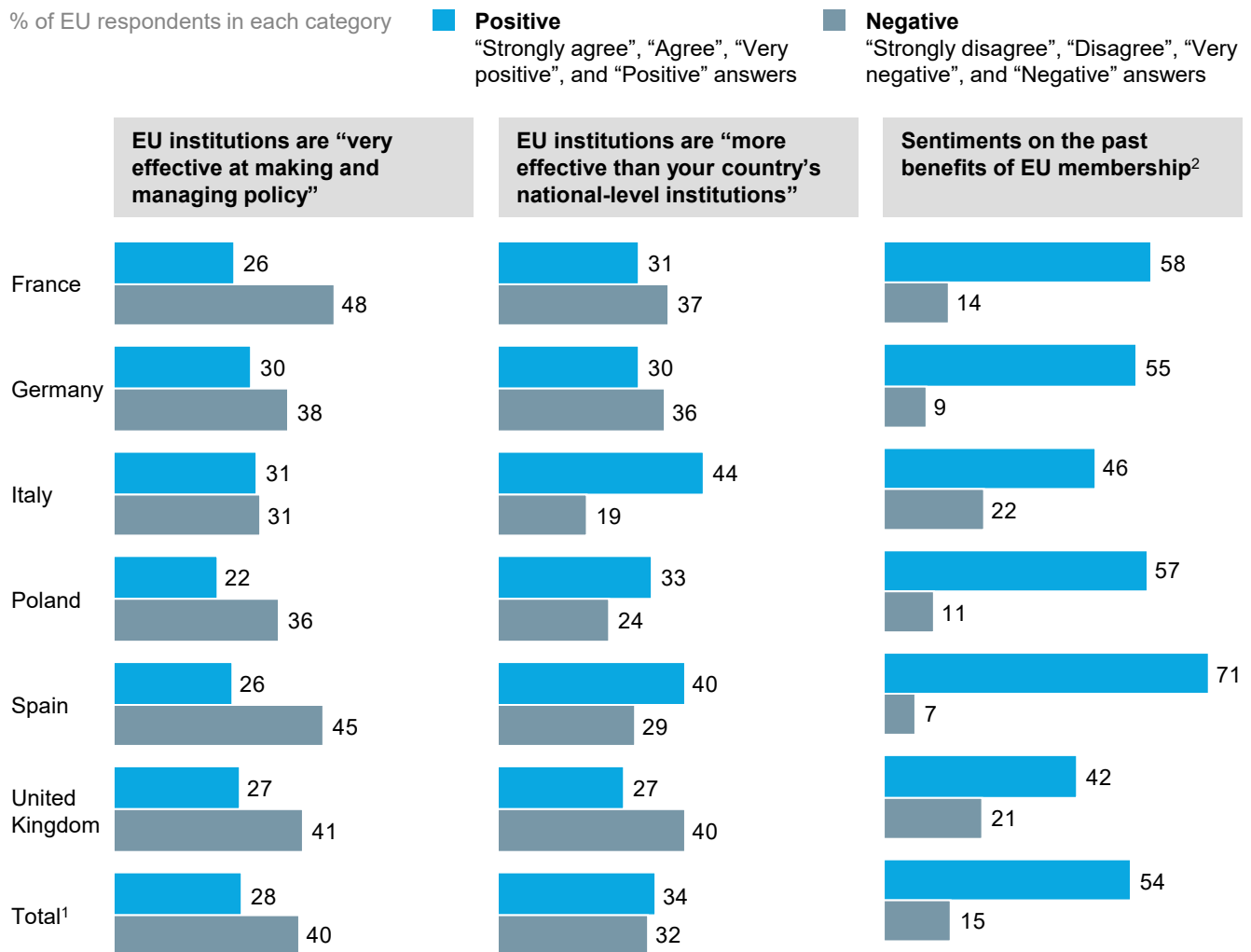
¹ *State of the Union 2016: The European Fund for Strategic Investment (EFSI)—frequently asked questions*, European Commission fact sheet, September 14, 2016; see also the European Investment Bank website dedicated to the fund, <http://www.eib.org/efsi/>.

² *Ten priorities for Europe*, European Commission, October 2015.

French, Polish, and Spanish companies are the most negative about EU institutions, more so even than UK firms, while Italian companies are evenly divided (Exhibit 27). Italian and Spanish firms, along with Polish ones, nonetheless are more likely to report that EU institutions are more effective than their national ones at implementing and making policy. These sentiments on the comparative effectiveness of EU and national institutions mirror consumer-level reports; only 15 percent of Spaniards and Italians surveyed in a recent study agreed that their countries were moving in the right direction, compared with 40 percent in the United Kingdom.⁶⁸

Exhibit 27

French, Spanish, and Polish companies are less likely than the others to agree that EU institutions are effective



1 Total of all 6 EU country survey respondents.

2 Question asked: “In general, how would you describe the impact of your country’s membership in the EU on your business?”

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

The largest divergence of opinion on this issue is to be found among the different performance categories: high flyers are far more supportive of EU institutions than other businesses are, with 34 percent deeming them effective (although 40 percent of high flyers do still take a negative view). Advancing companies divide up between 33 percent

⁶⁸ Catherine de Vries and Isabell Hoffmann, *Supportive but wary: How Europeans feel about the EU 60 years after the Treaty of Rome*, Bertelsmann Stiftung, January, 2017.

supportive and 35 percent critical, while 46 percent of left-behind firms are negative and only 18 percent supportive.

One element that emerges from our analysis of the survey results is that companies' views of the effectiveness of EU institutions do not necessarily reflect their overall opinions about the EU. Spanish companies, for example, are the most enthusiastic about the EU's benefits, and at the same time among the most negative about the effectiveness of its institutions.

It also remains open whether the negative view on effectiveness reflects reality or is mostly a perception issue, as the EU has become a scapegoat for many unpopular decisions over many years. Either way, this perception will need to be addressed in order for EU institutions to convey the image of stability and predictability that businesses need so they can invest in the EU's future.



European business is navigating a complicated world with many unsettling uncertainties, both from global trends such as ageing and growing antiglobalisation sentiment, and from a lack of clarity about the future shape and direction of the European Union. On the heels of the British decision to leave the EU, companies are asking existential questions about the future of the EU and in particular of the Eurozone. Our survey highlights an important gulf between the “more Europe” most companies want and the “less Europe” some firms see as a potential scenario for the future. In our concluding chapter, we look at priorities for the EU to end the uncertainty and strengthen the business environment, to remove the fragility that still lingers, despite the economic recovery under way.



Outside the European Commission's Berlaymont building in Brussels
© Carl Court/Getty Images News

3. STRENGTHENING CONFIDENCE AND STABILITY

Economic and business recovery has arrived in Europe at long last, and optimism is back in many firms, yet uncertainties and doubts about the economic and political future continue to gnaw at European business leaders. As we have seen, many companies cite risks and uncertainties about the future as a principal reason for their still-hesitant investment, and are nervous about possible changes to the shape of the EU and especially the Eurozone. Until those concerns are resolved, there will be downside risk to the recovery. A strong recovery, in turn, is needed to create a more positive perception of Europe's economic stability. Any major risk event could easily turn into a downward spiral at the nexus of economics and politics.

How can Europe overcome this lingering fragility? In this concluding chapter, we discuss three priorities to further boost confidence both in the European economy and in the EU's future. Our aim is not to provide a comprehensive blueprint for economic reform for the EU—nor a political programme aimed at burnishing its image. Our 2015 MGI report on Europe's economic prospects provided detailed suggestions for ways to close its output gap, return to sustained 2 to 3 percent GDP growth, and create millions of jobs through a combination of national structural reforms and pan-European measures to stimulate demand.⁶⁹ A subsequent prize essay contest we held in 2016 sought to crowdsource ways to implement reforms so that they would be palatable to European policy makers and the public alike.⁷⁰ In this concluding section, we mainly take our cue from European businesses themselves, large and small, successful and struggling, across the six EU nations we surveyed, with a discussion of three paths forward. They are: further stimulating recovery and investment; addressing key areas of fragility; and working to create a new narrative for Europe. Europe is no stranger to adversity, and has frequently shown its resilience. In the face of intractable global forces and internal divergence, it needs to do so again today.

FURTHER STIMULATING RECOVERY AND INVESTMENT

The subdued investment climate we described earlier in this report is a major brake on growth. We have sought to calculate what the impact on European GDP would be if all forms of investment—public, business, and household—were to return to pre-crisis levels. Our survey also provided insights into policies that business leaders believe will unlock higher investment.

A €1 trillion boost to GDP from restored investment

To calculate the potential boost that European GDP would receive from a resurgence of investment, we modelled a scenario that examined what would happen if all forms of investment in the EU returned to their pre-2007 crisis levels by 2020. We used McKinsey & Company's Global Growth Model to test the long-term GDP effect of adjusting annual investment—by country, region, and across the EU—without changing the remaining input metrics in the model (for example, we assumed population growth was consistent in all

5.7%

Potential rise in EU GDP by 2030 if investment were to return strongly

⁶⁹ *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

⁷⁰ *An opportunity for Europe? The McKinsey Global Institute 2016 Europe essay prize: Key themes and winning entries*, McKinsey Global Institute, October 2016.

scenarios).⁷¹ We focused on the 28 EU member states, although the model still considered global behaviour as an input, and on how the specific countries and blocks within it deviated from baseline expectations.

Our analysis found that EU GDP could rise by 5.7 percent in 2030, or the equivalent of an additional €1 trillion for the EU economy, if investment across all member states were to return to pre-crisis levels by 2020.⁷² For context, that would be approximately equivalent to the combined GDP of the Czech Republic, Denmark, and Sweden. It would lift labour productivity from an annual average of 1.5 percent to 1.9 percent.

To achieve this potential growth, the 28 EU countries would need to raise their current rate of investment growth by 2.5 times until 2020 or raise annual investment in 2020 by about €300 billion (2 percent of GDP) compared with baseline levels (Exhibit 28). The largest increases would be needed in Southern Europe, where the highest impact would also occur.

A business agenda for stimulating investment in Europe

As we noted in Chapter 1, businesses with high growth prospects and increased historical cash flow positions are the most likely to plan future investment, and in our survey many cited concern around future crises as a prime reason to hold back investment and build cash buffers. What would it take to alleviate those concerns? Our survey of business leaders provided some useful pointers, although their sometimes-conflicting answers should not be taken as exhaustive—and may in some cases be politically unrealistic.

Two policy options stood out: more accommodative monetary and fiscal policy or additional economic stimulus, selected by 23 percent of respondents as the best way to increase investment, and lower taxes and less spending by EU or national governments, an option selected by 21 percent of respondents. While companies elsewhere in the survey pointed to regulatory burdens and uncertainty as a major contributor to the lack of investment, regulatory reform was not particularly high on the wish list; just 11 percent of firms on average identified it as their first-ranked policy to increase investment (Exhibit 29).

More specifically, survey respondents were also asked to select more detailed policy options underneath the broader policy categories. Among the most popular investment-enhancing policies were restructuring of public debt, especially in Southern Europe, and boosting the recovery through larger EU central budgets and stimulus.

⁷¹ McKinsey's proprietary Global Growth Model is an advanced macroeconomic tool that provides growth and GDP outlooks for different economic scenarios. It incorporates more than a dozen major international databases from such institutions as the United Nations, the World Bank, the International Monetary Fund, and the Bank for International Settlements, and uses econometric and statistical equations that account for the interdependency and feedback among the variables considered in the model. For details, see *Shifting tides: Global economic scenarios for 2015–25*, McKinsey & Company, September 2015.

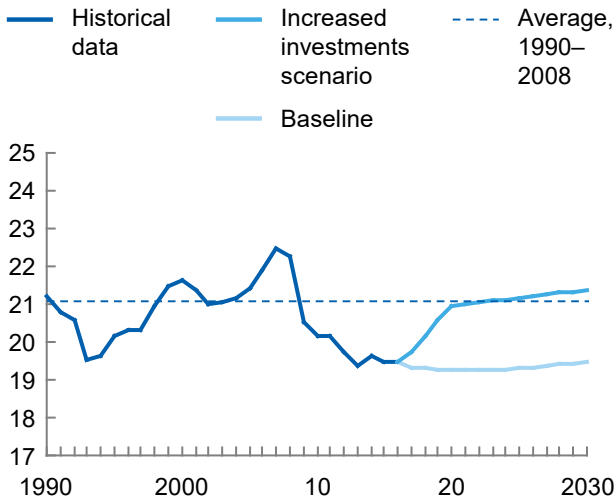
⁷² In 2010 prices.

Exhibit 28

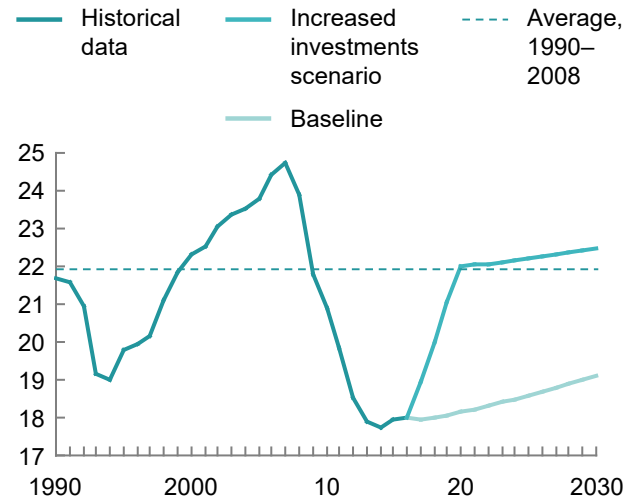
A rise in investment-to-GDP ratios by 2020 for the EU-28 would boost GDP 6 percent higher than baseline

Investment-to-GDP ratio¹
%

EU-28

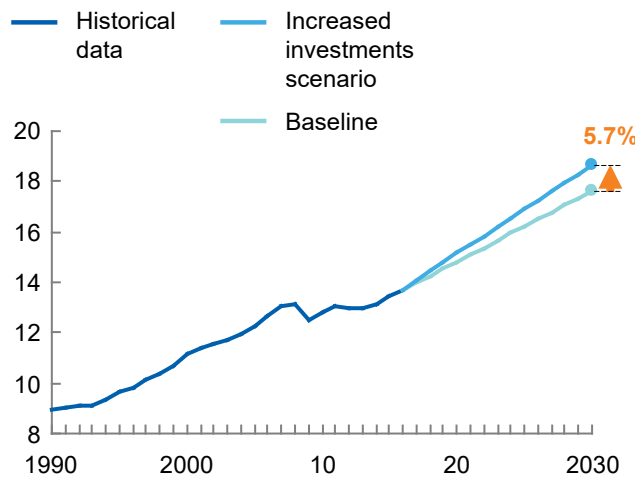


Southern Europe only²

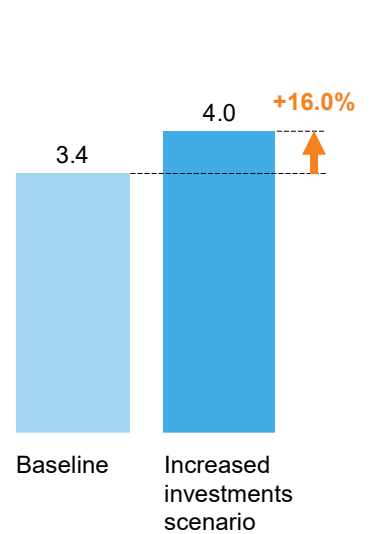


EU-28 real GDP and investments
€ trillion

Real GDP



Real investments, 2030



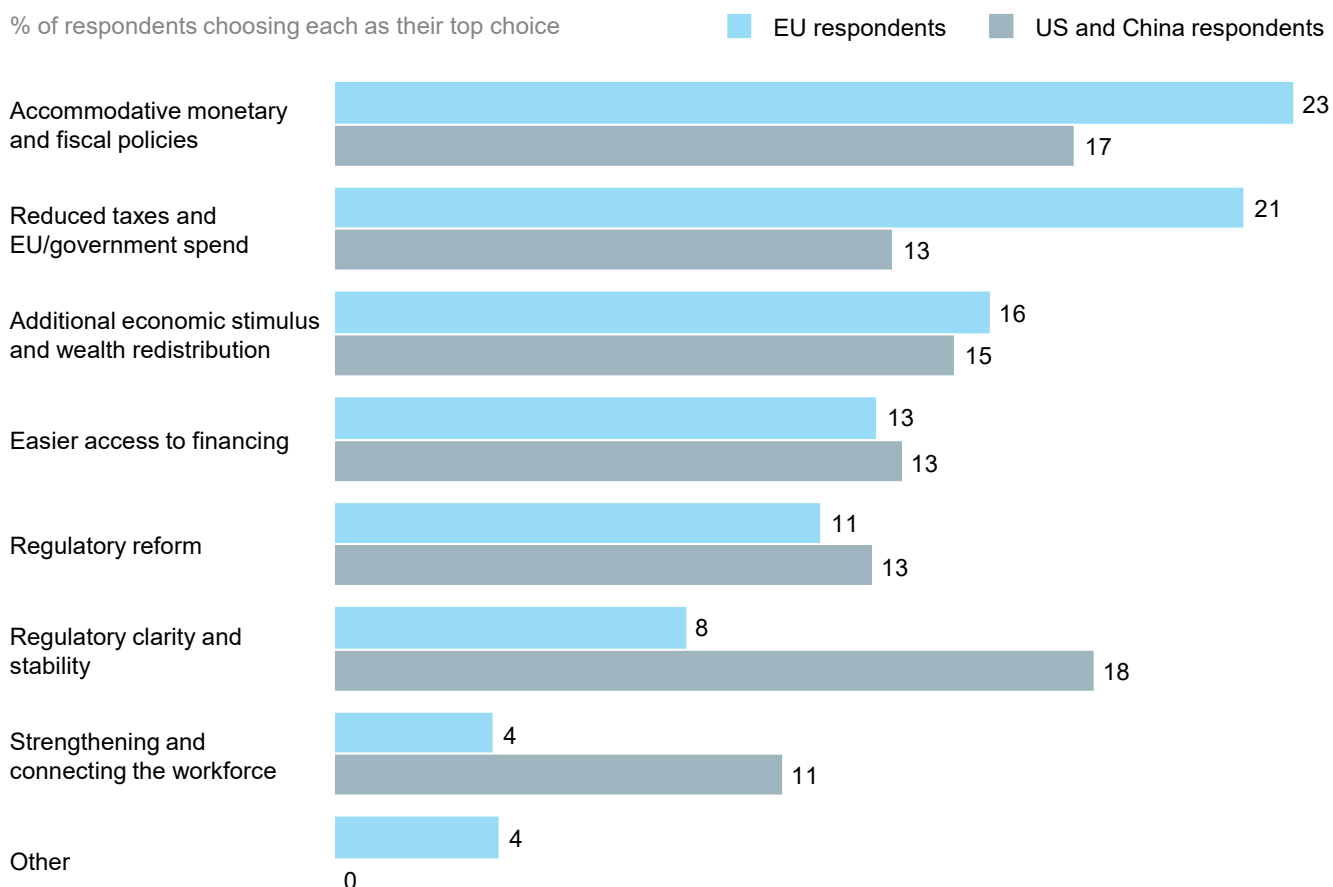
1 The increased investment scenario brings total investment to pre-crisis levels (as a portion of GDP) by 2020, and then maintains those levels until 2030. The baseline reflects expected rates of investment.
2 Scenario only includes Southern Europe (Cyprus, Greece, Italy, Malta, Portugal, and Spain).

SOURCE: McKinsey Global Growth Model; McKinsey Global Institute analysis

Exhibit 29

Businesses think that a wide spectrum of policies—some of which conflict with each other—would help boost investment; no single policy category will appeal to all potential investors

Q: Which of the following policy categories would be most likely to cause you to raise investment in EU countries?



NOTE: Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

Among our three categories of high flyers, advancing companies, and those left-behind, policy preferences are broadly similar, although high flyers are slightly more in favour of reduced taxes as their preferred option. In Germany, Poland, and the United Kingdom, companies favoured reduced taxes, whereas French, Italian, and Spanish firms sought more accommodative monetary and fiscal policies. In Poland, easier access to financing was seen as a significant measure by 19 percent of respondents, compared with just 11 percent in Germany, suggesting that credit may be more of an issue there.

European responses were broadly consistent across sectors, although manufacturing companies were more likely than others to call for additional economic stimulus and wealth distribution, and financial services firms were more likely to suggest regulatory reform.

Chinese and US respondents believe that regulatory clarity would be the most helpful way to increase investment, followed closely by accommodative monetary and fiscal policies.

Raising productive public investment in Europe

Following austerity policies, public investment in many EU countries is still below pre-crisis levels. We asked business leaders about their views on public investment. Some 80 percent of respondents see a case for raising public investment—although the majority of those would not be prepared to pay higher taxes to finance those investment (Exhibit 30). The ratio is even higher among those business leaders who perceived membership in the EU as positive.

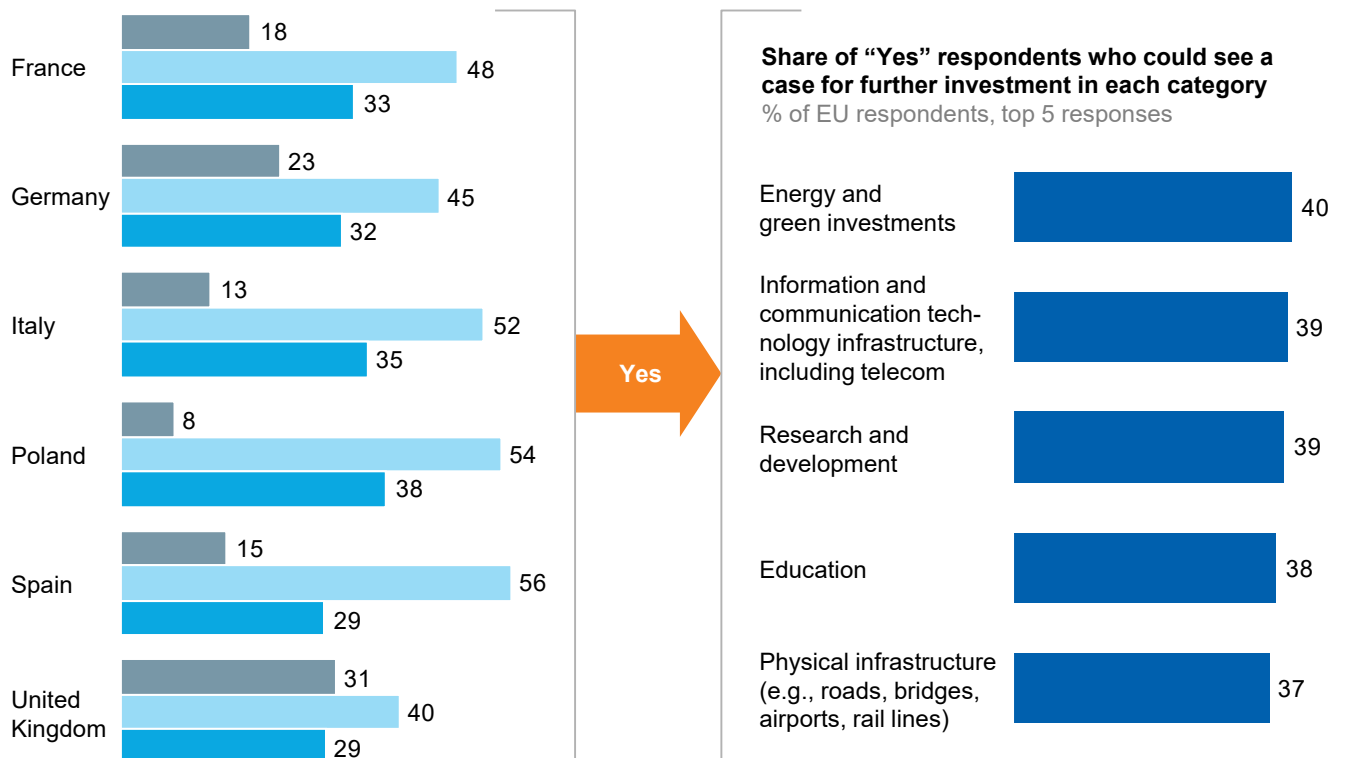
Exhibit 30

Eighty percent of businesses see a case for raising EU public investment, especially in energy and green investments

% of EU respondents

Q: Would you see a case for raising the level of EU public investment (i.e., EU spend)?

- No
- Yes, but only if it doesn't affect tax levels
- Yes, even if it means higher taxes



SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

According to our survey respondents, there would be limited risk of crowding out private investment. In fact, 73 percent said they would co-invest in areas of productive public investment.

The highest priorities for additional public outlays are seen in energy and green investment, information and communications technology, and R&D, closely followed by education, transport infrastructure, health care, and housing and urban development. Ensuring that such spending is productive is an imperative; governments everywhere, not just in Europe,

are under pressure to deliver better outcomes—and a better experience for citizens—at a sustainable cost.⁷³

ADDRESSING LINGERING FRAGILITY

Anxiety and risk drive some of the fragility in confidence and investment decisions that our survey highlights in the business community. Major uncertainties spelled out in the different parts of our survey include risks of another financial crisis, headwinds from political developments and global trends, perceived lack of clarity on the future path of the Eurozone, as well as regulatory risks. Those issues are interlinked, and as a confidence-boosting exercise, the EU will need to find ways to address them—even those that do not directly fall under the remit of European institutions but are rather issues for national governments.

Solidifying financial stability

One essential measure to reduce fragility and shore up confidence in Europe, and especially in the Eurozone, is to focus on greater financial stability. The EU has put in place the first phases of a banking union that include provisions for recapitalising struggling banks and “bail-ins” for those that are failing. However, the continued high level of non-performing loans in a few countries suggests that more strenuous action may be needed to clean up bank balance sheets—and restore investor confidence—be it at the national or at the European level.

Regarding sovereign debt, there is much debate on whether current levels are sustainable in all Eurozone economies. Regardless of where one stands on this debate, our survey results indicate that companies perceive elevated debt levels as a risk. Restructuring is difficult, as it could create instability in the domestic financial sector as well as place a burden on public creditors from other Eurozone member states. This notwithstanding, in our 2016 essay prize contest, the jury selected an essay proposing cancelling sovereign debt in heavily indebted Southern European countries as one way to jumpstart more rapid economic growth in Europe, and explicitly ignoring moral hazard issues, as one of the winners.⁷⁴ Whether such a radical move is the right one or more careful steps are better suited, a sustainable solution seems required.

Laying out and communicating a credible plan for the future of the Eurozone

Our survey highlighted a significant proportion of business leaders who doubt the Eurozone’s durability in its current form, with 51 percent seeing a shrinkage or even a break-up of the single currency zone (even with the United Kingdom excluded from the results). EU leaders will need to sketch out—and commit to—a plan that resolves the unstable equilibrium of monetary interdependence vs. fiscal and economic policy sovereignty, which has led to moral hazard and unaligned policy mixes. Much progress has already been made (for instance the establishment of the European Stability Mechanism and the Fiscal Compact), and many proposals including the Five Presidents’ Report have set out ways to deepen the Economic and Monetary Union, including provisions for a common fiscal function.⁷⁵ But political alignment has proven difficult.

Finding answers to global political challenges

Most businesses see global trends as creating more risk and headwind than benefits for businesses. Politics around migration and refugees and geopolitical tensions that are fuelling a rise of populism in particular stand out as influencing businesses’ perceptions about the EU and its benefits. Some of the issues are not within the control of EU institutions,

⁷³ See *Government productivity: Unlocking the \$3.5 trillion opportunity*, McKinsey Center for Government, April 2017.

⁷⁴ *An opportunity for Europe? The McKinsey Global Institute 2016 Europe essay prize: Key themes and winning entries*, McKinsey Global Institute, October 2016.

⁷⁵ *Five Presidents’ Report: Completing Europe’s economic and monetary union*, European Commission, June 2015.

especially without consensus among member governments, which has proved elusive on some key topics. It is also unclear to what extent the EU can prevent itself becoming a scapegoat, the target of antiglobalisation sentiment. Nonetheless, if the EU were to come up with solid pan-European answers to some of these issues, businesses could become more confident in EU institutions and their ability to deliver.

Defusing regulatory uncertainty

Regulatory uncertainty is cited as a major obstacle to investment by survey respondents (9 percent)—and a significant risk for potential investors from the United States or China. The specific regulation—or lack thereof—of concern will vary strongly by sector. In financial services, for example, the European Central Bank has discussed uncertainty caused by the regulatory agenda including fine-tuning of capital requirements, the treatment of sovereign exposure, and the way in which different regulations will interact with one other.⁷⁶ Ratings agencies have stated that delays in implementing new European rules for bank failure could pose a risk to investors.⁷⁷ Some banks are responding by developing financial instruments with clauses to anticipate future changes in law.⁷⁸ This uncertainty is not restricted to the financial sector, and the EU needs to ensure it does not compound this in the future with an ever more complex regulatory agenda.

A NEW NARRATIVE FOR EUROPE

Successfully addressing these fragilities is no mean feat, and will require bold action by the EU and EU member states' elected leaders. Many individual steps have successfully been taken to “muddle through” and help overcome—for now—the worst financial and economic crisis in almost a century—but have not been sufficient to end the uncertainty satisfactorily. The EU will need to demonstrate that the forces in favour of cooperation are stronger than those opposing it.

One way to move ahead and rally support for bolder moves forward would be to work on creating a new narrative for the European Union for the coming years. The EU's founding fathers did this convincingly in 1957 in the Treaty of Rome, outlining a clear and compelling vision of peace and prosperity and an “ever closer union” (even if turning that union into practical steps proved highly complex already in the early years). The creation of the single market starting in the mid-1980s was another moment of reinvention, as was the momentous step towards establishing a single currency, which set off a decade of moves to bring about closer economic convergence. Today, the EU needs a shared vision, one based on realism about the present but also aspirations for the future.

For all the challenges it faces today, the EU is no stranger to adversity. Since its origins, it has had to tackle a seemingly endless succession of crises and threats to its integrity, from France's “empty chair” policy in the 1960s in a dispute with Germany over agriculture, to the global energy crisis in the 1970s, the complex restructuring of its coal and steel industries in the 1980s, and waves of currency turbulence in the 1990s before—and after—the creation of the euro. While the legacy of the last financial crisis and forces arrayed on the horizon may seem formidable today, and are feeding some pessimism within the business community, resilience has been one of the EU's enduring strengths in the past, and could prove invaluable again in today's turbulent world. But resilience needs a goal that can be articulated, and that can inspire a return to confidence. As our survey of European business indicates, that restoration of faith is needed.

⁷⁶ “Challenges for the European banking industry”, lecture by Vítor Constâncio, Vice-President of the ECB, Madrid, July 7, 2016.

⁷⁷ Thomas Hale, “Moody's warns on delay in European bank failure rules”, *Financial Times*, March 2, 2017.

⁷⁸ Thomas Hale, “Bankers engineer Danish bond to address regulatory uncertainty”, *Financial Times*, March 9, 2017.



The measures contained in this final chapter are by no means exhaustive. Nor should the focus be entirely on what needs to be done next. The EU has much to be proud of over its 60 rich years of existence: it helped secure peace across an often war-torn continent when it was founded and supported fledgling democracies after the fall of Communism. It has boosted trade and free movement of goods and people through the single market, enriching the lives of hundreds of millions of European citizens. Critically, it has many strengths that it can use to address the challenges ahead: its welfare system is globally renowned, it is a place where migrants actively seek refuge because of its adherence to human rights, and some of the most significant businesses and companies of our time have flourished within it. The challenge for Europe today is to build on its strengths and not lose them as it develops a climate for growth and financial stability, brings an end to the lingering fragility, tailors its institutions to support the policies it has chosen, and develops a compelling new narrative for its own existence. Only then will Europe and its business community stride more confidently into the future.





TECHNICAL APPENDIX

This appendix has three parts:

1. Survey questions
2. Robustness and informative tests
3. Detailed survey analysis

1. SURVEY QUESTIONS

As described in Box 1 in the main report, the survey was designed by the McKinsey Global Institute and conducted by an external provider. The 35 questions were:

Firm data

1. How many employees does your organisation have?
 - 1–9, 10–19, 20–49, 50–249, 250–999, >1,000
2. Please describe your role in your organisation. If your exact title is not listed, please choose the option that is closest to your role.
 - Chief Executive Officer or President (or equivalent)
 - Chief Financial Officer, Chief Operating Officer, or other “board-level” role
 - Vice-President⁷⁹
3. If Vice-President, do you have the authority to make decisions about your company’s investments?
4. How much revenue did your company generate last year? Please estimate your revenue in euros if you use another currency.
5. Was your company profitable last year?
- 6a. How have your annual revenues changed (on average) over the past three years?
 - Fallen by more than 10% per year
 - Fallen by 5–10% per year
 - Fallen by 2–5% per year
 - Fallen by 0–2% per year
 - Stayed the same
 - Grown by 0–2% per year
 - Grown by 2–5% per year
 - Grown by 5–10% per year
 - Grown by more than 10% per year

⁷⁹ For companies with fewer than 250 employees, interviews with executives at the vice-president level were terminated at this point.

6b. How do you expect your revenue to change next year?

- Fall by more than 10%
- Fall by 5–10%
- Fall by 2–5%
- Fall by 0–2%
- Stay the same
- Grow by 0–2%
- Grow by 2–5%
- Grow by 5–10%
- Grow by more than 10%

7. In which industries does your company operate? (Choose one option that best applies, or that covers most of your operations)

- Manufacturing: Automotive and assembly
- Manufacturing: Consumer and packaged goods
- Manufacturing: High tech
- Manufacturing: Others
- Business, professional, scientific, and legal services
- Utilities (electricity, oil and gas, water supply, sewage, and waste management)
- Health care and pharmaceuticals
- Wholesale and retail trade
- Transportation, travel, and logistics
- Accommodation, food services, and entertainment/recreation activities
- Telecommunications, media, and information technology
- Financial and insurance services
- Construction and real estate activities
- Agriculture, forestry, and fishing
- Mining
- Other (please specify)

8. In which countries/markets does your company do business?

- Only local market/home country
- In two countries
- Several countries, but only in Europe
- Several countries, including some outside Europe

Questions about perception and impact of trends and scenarios:

9. The following are trends and changes that Europe is experiencing or predicted to experience in the coming years. What kind of impact do you think these trends and changes will have on your business over the next five years (very positive, moderately positive, neutral, moderately negative, very negative)?

Demographic and environmental

- I. Aging populations
- II. Increasing incoming migration
- III. Rising inequality
- IV. Increased digitisation and automation
- V. Rise of emerging economies
- VI. Climate change

Social and political

- VII. Pressures against globalisation (e.g., protectionism)
- VIII. Rise in populism
- IX. Geopolitical disruption
- X. Increased refugee populations
- XI. Member states leaving the EU (e.g., Brexit)

10. The following are potential pathways for the future of the EU and the Eurozone.

a) Please indicate which of these scenarios you think are most likely to occur (rank the first and second most likely).

b) Without considering their likelihood of occurring, please indicate which of these scenarios you think would be most beneficial for your company (rank the first and second most beneficial).

- I. EU and Eurozone erosion: Core countries exit both blocks, and both the EU and the Eurozone disband completely
- II. Eurozone break-up, with the EU intact: Core countries exit the Eurozone, and all countries return to their national currencies. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU).
- III. Eurozone shrinks, with the EU intact: Peripheral economies exit the Eurozone and return to their national currencies, while core countries retain the euro. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU).
- IV. EU and Eurozone remain intact with current responsibilities: Both the EU and the Eurozone maintain their current structure and levels of responsibility, with core countries remaining in place (with only the UK leaving the EU).
- V. EU responsibilities expansion: Both the EU and the Eurozone maintain their current structure, with core countries remaining in place (with only the UK leaving the EU). The EU gains new responsibilities and sets up new institutions such as common defence, external border protection, and partially common fiscal policy.

11. In 2016, the EU-28 experienced a GDP growth rate of 1.9%. As you look to the future, what average growth rate would you expect the EU to experience over the next five years? (Fill in a numbered response to one decimal place.)

Questions on perception towards the EU:

12. In general, how would you describe the impact of your country's membership in the EU on your business (very negative, moderately negative, neutral, moderately positive, very positive)?

13. If you had to choose, which of the following would you want?

- "More Europe" (more policies set at the EU level)
- "Less Europe" (more policies set by member states)

14. Please explain your level of support for the following current or potential EU-level policies and responsibilities (strongly oppose, oppose, neutral, support, strongly support, don't know).

- I. Instituting an EU body to manage all migration to the EU under a common policy, rather than having member states define their own migration rules
- II. Creating a common external border protection policy and enforcement body, and having member states fund it
- III. Moving a large share of defence spending and personnel to an EU military force, and reducing the budgets and size of national forces
- IV. Managing a Europe-wide law enforcement and stronger judicial system to consistently prevent and address high-level or international crimes, rather than solely delegating to national forces
- V. Facilitating the efficient transfer and storage of personal data between national governments under a consistent set of policies, rather than using bilateral agreements between individual countries
- VI. Regulating trade and negotiating trade deals collectively, rather than having each member state make its own trade deals
- VII. Setting consistent wealth redistribution policies across borders, rather than having each country set its own rules for social security, unemployment insurance, tax policy, etc.
- VIII. Defining common monetary policies and financial regulations, rather than having each country manage its own financial sector independently
- IX. Defining common energy and environmental policies to manage costs and sustainability, rather than having individual countries define their own priorities
- X. Prioritising, funding, and managing major infrastructure investments holistically, rather than leaving these decisions solely to individual nations

15. If you were able to define the priorities for EU policy makers, which of the following issues would you choose? Please rank the top three elements you would want the EU to prioritise in future plans.

- I. Promoting defence and security of member states
- II. Encouraging prosperity and convergence
- III. Further freeing the movement of people and goods
- IV. Protecting the democracy and legitimacy of member state governments
- V. Engaging internationally to protect human rights outside the EU

- VI. Promoting technological and digital leadership
- VII. Enabling competitiveness
- VIII. Liberalizing regulations
- IX. Protecting consumers
- X. Improving fairness and social inclusion within Europe
- XI. Leading in sustainability and environmental stewardship
- XII. Securing the European energy supply
- XIII. Stabilizing the financial system
- XIV. Increasing overall public-sector productivity and efficiency
- XV. Other (please specify)

16. Please describe the impact that you think the following EU policies and plans have (or would have) on your business (very positive, moderately positive, neutral, moderately negative, very negative).

- I. Single market for goods: Free movement of goods without tariffs and with harmonised regulation and standards
- II. Single market for services: Free cross-border service activities and investment in service sector with increasing liberalisation, harmonisation of regulation
- III. Unified currency: Single currency across 19 Eurozone member states
- IV. People movement: Free movement of people across EU borders, notably employment/recruiting cross-borders
- V. Banking union (plan): Common supervisory mechanism for all banks in EU to ensure improved protection for depositors and common rules for managing failing banks
- VI. Energy union (plan): Fully integrated energy market within the EU and common regulations around climate action and energy efficiency
- VII. Digital single market (plan): Better online access to digital goods and services across Europe; an environment where digital networks and services prosper; copyright reform

17. The following are commonly considered to be benefits and advantages of EU membership. Which of the following do you see as the most important or beneficial for your business? (Rank top three.)

- I. Access to markets to sell goods/services
- II. Access to cheaper and/or better preproduced goods or raw materials
- III. Access to services needed for my business
- IV. Access to talent (with the right skills and education)
- V. Access to capital
- VI. Access to investment opportunities
- VII. Consistent regulations and unified standards
- VIII. Low transaction costs including speed of transaction (e.g., improved cross-border supply chains, simplified payment)
- IX. Stronger position in world affairs
- X. More support in the fight against terrorism

- XI. Support in tackling climate change
- XII. Maintenance of peace and security across the EU
- XIII. Access to and use of new technologies
- XIV. Ease of doing business (overall competitiveness)
- XV. Freedom from corruption/rule of law
- XVI. Other (please specify)

18. The following are commonly considered to be challenges of EU membership. Which of the following do you see as the most difficult and impactful on your business? (Choose top two.)

- Limitations on borrowing and access to capital for loans
- Exposure to European competition
- Complex and restrictive regulations
- Complex and burdensome regulatory processes
- Inability to control individual country currencies (within Eurozone)
- High taxes
- Loss of national sovereignty
- Limited transparency of decision making
- Other (please specify)

19. Prior to his election as President of the European Commission in July 2014, Jean-Claude Juncker set ten key areas in which he wanted the EU to make a difference and deliver results during his time in office.

a) Please explain how well you think the EU has executed on this priority over the past three years (very unsuccessfully, unsuccessfully, neither successfully nor unsuccessfully, successfully, very successfully, don't know).

b) Please describe the impact the actions associated with this priority have had on your business (very negative, moderately negative, neutral, moderately positive, very positive, don't know).

- I. "A new boost for jobs, growth and investment": includes "the investment plan for Europe", the "circular economy package", education reform, and other measures
- II. "A connected digital single market": includes measures to "improve access for consumers and businesses to digital goods and services", "create growth-conducive conditions and a level playing field for digital networks and services", and to "maximise the growth potential of the digital economy"
- III. "A resilient energy union with a forward-looking climate change policy": focuses on "energy security", "a fully integrated energy market", "energy efficiency", "decarbonizing the economy", "research"
- IV. "A deeper and fairer internal market with a strengthened industrial base": includes establishing a "capital markets union", tax measures, "upgrading the single market", and a "labour mobility package"
- V. "A deeper and fairer Economic and Monetary Union (EMU)": includes completing the EMU and establishing a "European pillar of social rights"

- VI. “A reasonable and balanced free trade agreement with the United States”: includes negotiations of the Transatlantic Trade and Investment Partnership (TTIP) with the United States
- VII. “An area of justice and fundamental rights based on mutual trust”: includes policies to enhance freedom, justice, and security, along with counterterrorism policies
- VIII. “Towards a new policy on migration”: includes short- and long-term measures related to all forms of migration into the EU from other regions
- IX. “Europe as a stronger global actor”: includes the “neighborhood”, “development”, and defence/security policies
- X. “A union of democratic change”: includes policies to increase EU openness, accessibility, and accountability

Questions about productivity and jobs

20. How do you expect the number of employees in your company to change three years from now, as compared to last year?

- >30% fewer than last year
- 10–30% fewer than last year
- About the same
- 10–30% more than last year
- >30% more than last year
- Don’t know

21. If increase, why do you plan to increase headcount? (Check all that apply.)

- I. To increase volume in current markets
- II. To reach new markets
- III. To deepen value chain depth
- IV. To offer higher-value goods or services
- V. Other reasons (please specify):

22. How do you expect revenue productivity (revenue per employee) for your company to change over the next three years? (“Slider” of options from “increase by >20%” to “decrease by >20%”, plus “don’t know”.)

23. Where/how will you try to bring about productivity improvements? (Rank top three.)

- I. Develop new products with higher customer value
- II. Change the business model
- III. Digitise operations
- IV. Automate and/or redesign processes
- V. Boost employee incentives and performance
- VI. Use existing assets (capital/platforms) more efficiently
- VII. Increase revenues on existing fixed capital/platform
- VIII. Improve energy or resource efficiency
- IX. Other (please specify)

Questions about investment:

24. How has your company's cash position (operating cash flow minus short-term and long-term capital expenditures) changed compared to three years ago?

- Fallen by over 10%
- Fallen by 3–10%
- Stayed roughly constant
- Grown by 3–10%
- Grown by over 10%

25. If grown, why did your company increase its cash position? (Choose top two.)

- Debt was excessive
- Mandatory debt repayment
- Saving for future investments
- Building reserves for potential future crises
- No appropriate places to spend
- Other (please specify)

26. How do you expect your company's average annual investment in EU countries over the next three years to change, compared to last year? (Note: Investment is defined here as the purchase of any physical or tangible asset outside of normal operational spend [e.g., new machinery, buildings, etc.]. This excludes the purchase of financial assets [e.g., stocks, bonds] or corporate M&A.)

- Fall by over 30%
- Fall by 10–30%
- Keep roughly constant
- Grow by 10–30%
- Grow by over 30%

27. Do you feel your business has made the appropriate level of investment in Europe over the past three years? (Note: Investment is defined here as the purchase of any physical or tangible asset outside of normal operational spend [e.g., new machinery, buildings, etc.]. This excludes the purchase of financial assets [e.g., stocks, bonds] or corporate M&A.)

- Yes
- No—too much investment
- No—too little investment

28. What do you see as the main obstacles or challenges to investing in the EU? (Choose top three.) (Note: Investment is defined here as the purchase of any physical or tangible asset outside of normal operational spend [e.g., new machinery, buildings, etc.]. This excludes the purchase of financial assets [e.g., stocks, bonds] or corporate M&A.)

- Internal funds needed to pay back debt
- Need to keep cash on hand (e.g., for potential crises, future investment)
- Higher/quicker returns from investment abroad
- Higher/quicker returns from alternatives (e.g., M&A)

- Lack of public infrastructure
- Expected return below target (e.g., hurdle rate) or payback period too long
- Increased uncertainty about future environment
- Lack of appropriate external finance (terms, cost, etc.)
- Reluctance to take on risk
- Regulatory burdens
- Regulatory uncertainty
- Financial market pressure for short-term returns
- Lack of skilled personnel
- Lack of good investment opportunities
- Lack of internal funds (retained earnings)
- No need for new investment because have already invested
- Too little demand to invest
- Other (please specify)

29. The following are considered potential risks for the EU that could limit investment. Which of the following potential risks do you see as the biggest concerns that limit your investment in Europe? (Please pick top three.) (Note: Investment is defined here as the purchase of any physical or tangible asset outside of normal operational spend [e.g., new machinery, buildings, etc.]. This excludes the purchase of financial assets [e.g., stocks, bonds] or corporate M&A.)

- I. New US policies affecting investment in the EU/changes to trade deals
- II. “Hard Brexit” with Britain leaving the single market
- III. Other countries (in addition to the UK) leaving the EU
- IV. Political transitions in core EU countries
- V. Rise in populism across Europe
- VI. Stricter EU regulations
- VII. Interest rate hikes
- VIII. Another financial crisis or economic recession
- IX. A real estate crisis
- X. Energy price volatility
- XI. Exchange rate volatility
- XII. Threat of terrorist attacks
- XIII. Extreme weather events
- XIV. Other (please specify)

30. The following are potential EU policies or changes.

a) Which of the following policy categories would be most likely to cause you to raise investment in EU countries? (Pick top two.)

b) Within the categories chosen, which specific policies do you think would be most effective? (Pick up to two for each category.)

Accommodative monetary and fiscal policies:

- I. Further extension of negative interest rates
- II. Further extension of quantitative easing (QE)
- III. Embarking on “helicopter money” (distribution of central bank money to households)
- IV. Monetisation of budget deficits (using central bank money to finance government)
- V. Restructuring of public debt, especially in Southern Europe
- VI. Cancellation of public debt
- VII. Other (please specify)

Additional economic stimulus and wealth redistribution

- VIII. Larger central EU budgets and stimulus (e.g., 3% rather than 1% of GDP, e.g., for common defence budget, common unemployment scheme, etc.)
- IX. More country-level fiscal stimulus in Germany and other member states
- X. More country-level fiscal stimulus in Southern Europe
- XI. Higher public investment without raising deficit limits
- XII. Relaxing of past austerity policies
- XIII. Fiscal redistribution from capital owners and high-income earners to lower-income earners
- XIV. Development of a voluntary EU fund to restructure banks and unwind non-performing loans, using both public and private funding
- XV. Other (please specify)

Reduced taxes and EU/government spend

- XVI. Reduced central EU budgets, less EU-level stimulus, and lower taxes
- XVII. Fiscal consolidation and austerity
- XVIII. Tighter monetary policy and rising interest rates
- XIX. Other (please specify)

Easier access to financing

- XX. Further extension of financing packages for public, corporate, and SME investors like the European Strategic Fund for Investment
- XXI. Easier access to financing for SMEs
- XXII. Easier access to financing for corporations, e.g., risk capital (venture capital funding) or equity (e.g., Europe-wide equity markets)
- XXIII. Tax exemption for foreign direct investment in EU countries running trade deficits
- XXIV. Other (please specify)

Regulatory reform

- XXV. Reform to product market regulation (e.g., relaxation of market access restrictions, price controls, public-sector ownership, product regulations) (optional: specify)
- XXVI. Labour market reform (e.g., easier “hiring and firing” and more flexible wage bargaining)
- XXVII. Easier access to land/more flexible building permissions
- XXVIII. Other (please specify)

Regulatory clarity and stability

- XXIX. EU-wide agreement and clarity on climate change/environmental regulation
- XXX. Access to cheaper energy
- XXXI. Political stabilisation and EU institutional reform
- XXXII. Other (please specify)

Strengthening and connecting the workforce

- XXXIII. New restrictions on immigration to slow down migrant movement
- XXXIV. Relaxation on immigration regulations to increase freedom of movement
- XXXV. Education reform to better prepare workers for employment
- XXXVI. Incentives to encourage women and older populations to work
- XXXVII. Cross-EU digital platform to match qualified job seekers to open positions
- XXXVIII. Other (please specify)

Other EU policy changes

- XXXIX. New free trade agreements
 - XL. Investment in digital technologies and services
 - XLI. Internal (public sector) productivity improvements
 - XLII. Online innovation platform to connect entrepreneurs and generate business ideas
 - XLIII. Active industrial policy (optional: specify)
 - XLIV. Other (please specify)

Other

- XLV. Other (please specify)

31. How strongly do you agree with the following statements about the effectiveness of EU institutions (e.g., the European Commission) (strongly disagree, disagree, neither agree nor disagree, agree, strongly agree)?

a) EU institutions are very effective at making and managing policy

b) EU institutions are more effective than your country’s national-level institutions at making and managing policy

32. Would you see a case for raising the level of EU public investment (i.e., EU spend)?

- Yes, even if it means higher taxes
- Yes, but only if it doesn’t affect tax levels
- No

33. If yes, in which of the following areas do you think there is a case for increased EU investment (i.e., EU spend)? Choose as many or as few as apply.

- I. Physical infrastructure (e.g., roads, bridges, airports, rail lines)
- II. Information and communications technology (ICT) infrastructure, including telecom
- III. Energy and green investment
- IV. Housing and urban development
- V. Education
- VI. Health care
- VII. Research and development
- VIII. Development of new industries (e.g., genomics, artificial intelligence, “Industry 4.0”)
- IX. Defence and security, including cybersecurity
- X. Social inclusion (including gender equality)
- XI. Other (please specify)

34. If yes, would you co-invest in any of these areas of potential EU investment?

- Yes
- No

35. Have you considered using or used investment from the European Fund for Strategic Investments (“Juncker plan”)?

- Yes
- No

US and Chinese perspective on EU

For our interviews with US and Chinese companies, we asked the same questions about firm data, GDP growth expectations, attitudes towards trends and the European Union, obstacles to investment in the EU and investment risks, and EU policies conducive to raised investment (1, 2, 3, 7, 9, 10, 11, 28, 29, and 30).

Additionally, we asked these US and Chinese companies:

Which of the following has your company done, or does it plan to do? (Choose all options that apply.)

- I. Invest in a European company
- II. Invest in European infrastructure projects, real estate, etc.
- III. Sell goods/services in Europe
- IV. Purchase goods/services from Europe

2. ROBUSTNESS AND INFORMATIVE TESTS

We tested our survey results using traditional statistical tests of bias and did not find evidence of bias in our collected data. We also tested our data against economic theory, which provides a variety of stylised facts regarding firm performance that we hoped to see replicated in our survey data. The five stylised facts below were tested (based on unweighted data) and were found to hold in our survey:

a) Correlation between capital (future investment) and labour (future employment) inputs with output (future revenue)

Typically the product output of a company is the technical result of a production process combining capital and labour. Using a typical Cobb–Douglas production function, and taking the approximation that $\log(X)$ = growth rate of X, one should find that the expected growth in future revenue (output) is a linear function of expected growth in future capital stock and of future employment growth (labour), as well as total factor productivity growth. The coefficients of the linear function in turn approximate the technical ratio of labour and capital.⁸⁰

We tested this relationship via regression analysis, using investment rate as a proportional factor of growth rate of capital; the relationship appears to hold and has the expected statistically positive sign for all sectoral splits, except for the primary sector, where the relationship between revenue growth and investment growth is not statistically significant. In our data, we also find that the elasticity of employment in the short term is typically an order of magnitude less than labour share, demonstrating that new inputs do not translate directly proportionately into future revenue growth over the next three years. This is a typical finding of firm-level production function estimates, and is also consistent with recent output gap measures for Europe and a recent McKinsey global survey that suggests that companies could increase production by 6 to 15 percent in the short term without hiring more staff.⁸¹

b) Correlation between past and future performance

In economics, Gibrat's law implies that growth opportunities are unbounded, so that future performance is independent of company size. In practice, size achieved in a sector by a company may reflect a company's capability to capture those growth opportunities more than its peers, so that we might expect future revenue growth opportunities (future performance) to be positively linked with size as a proxy for past performance. We test this via regression analysis, looking at future revenue expectations and current employment as a measure of size. Our data confirms a positive relationship, consistent with academic evidence.⁸²

c) The level of globalisation of a firm influences its performance (future revenue growth)

There is typically a close link between a company's geographical scope and its future revenue growth; meta-analysis studies demonstrate that exporting firms tend to be more productive than domestic ones.⁸³ We test this in our Cobb–Douglas production function by adding a categorical variable measuring whether a firm markets its products or services domestically, abroad in one extra market, or abroad in a variety of foreign markets. We find that operating domestically is penalizing in manufacturing firms; companies that operate only in their domestic European market expect to see 11 percent less future revenue growth

⁸⁰ Paul Douglas and Charles Cobb, "A theory of production", *American Economic Review*, volume 18, number 1, March 1928.

⁸¹ *McKinsey Quarterly* Global Survey, March 2017.

⁸² Timothy Dunne, Mark J. Roberts, and Larry Samuelson, "The growth and failure of US manufacturing plants", *Quarterly Journal of Economics*, volume 104, issue 4, 1989.

⁸³ Joachim Wagner, "International trade and firm performance: A survey of empirical studies since 2006", *Review of World Economics*, volume 148, issue 2, June 2012.

than peers who also focus on foreign markets. These findings are consistent with the European single market view that scale matters.

d) The presence of financial constraints, especially a challenging economic environment, systematically limits revenue growth-capture opportunities

One factor that could lead to a failure of Gibrat's law is that revenue growth can be affected by financial constraints, especially in the context of a difficult economic situation. Europe's last decade has been challenging, with some evidence of a credit crunch.⁸⁴ We approximate financial resources by the amount of cash flow available to companies. We find a statistically strong cross-sectional correlation of 0.47 between firms' historical growth in cash flow position and historical revenue growth in our survey data.⁸⁵

e) Investment decisions are in line with expected economic behaviours

Various economic theories seek to explain how companies make investment decisions. The neoclassical model postulates that investments are dependent on the evolution of interest rates, for example, while the cash flow model emphasizes that investment decisions are more sensitive to cash evolution, and the accelerator model postulates that investment is a function of economic prospects. In practice, all models can fit the data.⁸⁶ We also sought to test a generalised model of investment behaviour; however, as interest rates are common to all firms, we cannot test the neoclassical view and rather test the prevalence of the two other models, by regressing investment decisions on cash flow evolution and revenue prospects. We found evidence of a positive correlation in our best-fit model between firms' future investment growth and historical cash flow position, and a smaller positive correlation with historical revenue.

3. DETAILED SURVEY ANALYSIS

What are the relationships, if any, between the responses to the range of questions in our survey? For example, do perceptions of global trends in the European business community have any relation to responses on future investment decisions? This section presents additional descriptive analytics and examples of the multivariable analyses we conducted in an examination of such possible relationships. We have used two major types of multivariate analyses: regression analysis, often used to test sample-wide, linear-type relationships, and machine learning-based discriminatory analyses (here, CHAID for Chi-square Automatic Interaction Detector), to uncover more segmented, non-linear relationships in the data. In general, we looked to see if the two types of analyses give the same results, with CHAID providing in-depth insights beyond typical linear approximations in regression settings.

As outlined in the main document, multivariate technique results are themselves sensitive to the underlying assumptions of well-behaved variables. For example, results may suffer from omitted variable bias; that is, there may be other variables affecting European company performance that we have not captured through our questionnaire. To the extent that they correlate with other variables picked up in our survey, their effect can be seen in the regression and can be wrongly attributed to the measured variables. A second source of risk is that the survey is only a snapshot in time and may not fully reflect the dynamics of company responses. A third caveat is that the variables are categorical in nature, which particularly impacts regression techniques, while CHAID works well with categorical variables. A last, usual caution is that most statistical techniques uncover correlation but not necessarily causality.

⁸⁴ Andrea F. Presbitero, Gregory F. Udell, and Alberto Zazzaro, "The home bias and the credit crunch: A regional perspective", *Journal of Money, Credit and Banking*, supplement to volume 46, number 1, February 24, 2012.

⁸⁵ This is statistically significant at the 99th percentile.

⁸⁶ See Richard W. Kopke, "The determinants of business investment: Has capital spending been surprisingly low?" *New England Economic Review*, January/February 1993.

We have tried to mitigate some of those issues in the results below, but the reader must be aware of the caveats. For example, in regard to important causality questions (such as how a desire for “more Europe” or “less Europe” might impact economic decisions, or whether cash availability affects revenue growth), we tested our results using instrumental variable techniques. In these techniques, another variable (“the instrument”) is used to replace the independent variable in our regression in order to overcome concerns about the direction of causality. The instrumental variable must satisfy two conditions: first, it is not correlated with the outcome variable in the regression, which means that it has no direct impact on the outcome variable, and second, it is correlated with the independent variable.

Results have been found qualitatively robust for direction of causality. Thus, we report simple ordinary least square results in the following.

Key descriptive statistics about trends and Europe

Many of the basic descriptive statistics are outlined in our main document. For more information on the economic variables, please see Chapter 1. This section looks at relationships between global trends and perceptions of Europe, beyond our discussion in Chapter 2.

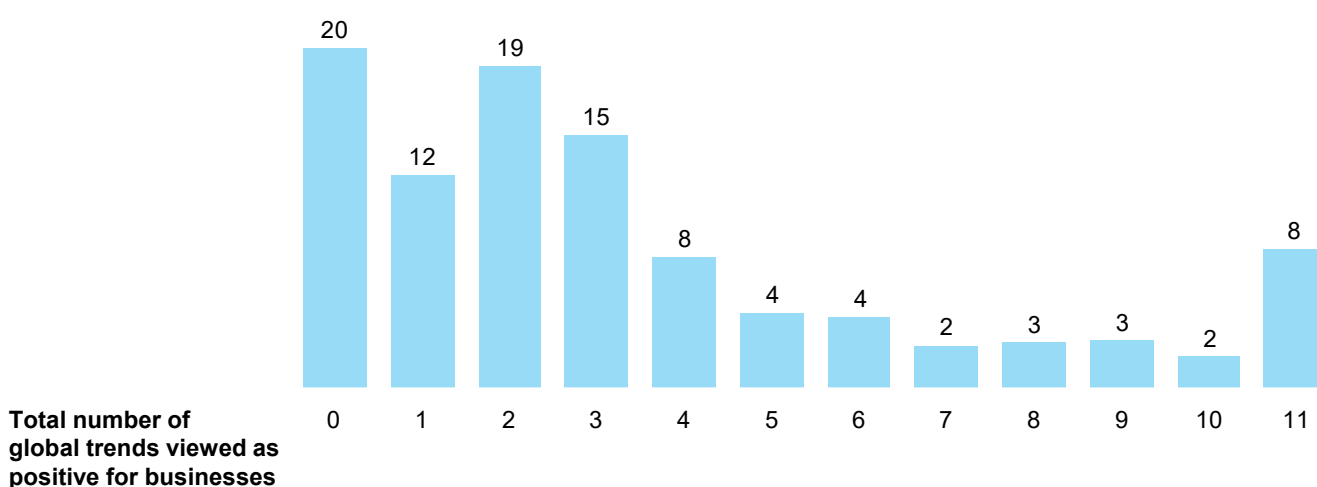
A. Global trends

Companies perceive many trends as risky to their business, as outlined in the main text. Exhibit A1 further describes the frequency distribution of the number of trends companies see as positive: only 16 percent of companies view more than eight trends as positive. On the 11 trends tested, the distribution is skewed towards zero to three positive trends, which implies that companies perceive more headwinds than tailwinds. Further, there is some significant response dependence among trends; for example, a negative reaction to one trend often implies a negative reaction to other trends. The largest dependencies found were between geopolitical disruption and the rise in populism (correlation coefficient = 0.69), pressures against globalisation and geopolitical disruption (0.63).

Exhibit A1

Businesses view global trends more as headwinds than tailwinds, according to survey results

Portion of EU respondents¹
% of total



¹ Total of all 6 EU country survey respondents across all sectors.
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

B. Perceptions of Europe, past and future

Our survey asked respondents about their perceptions of Europe in the past (benefits received) and in the future (whether they wanted “more Europe” or “less Europe”). The essential finding is that Europe has been perceived as an enabler of businesses, which in turn want to continue with Europe (Exhibit A2).

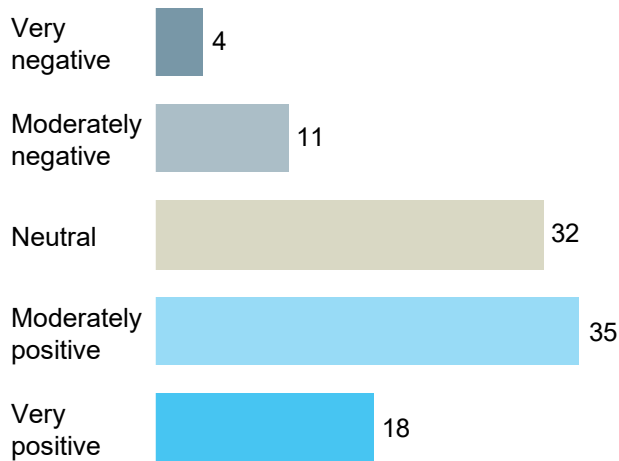
These two variables are highly correlated; perceived benefits from Europe in the past are statistically associated with wanting “more Europe” in the future (Pearson correlation coefficient = 0.37).

Exhibit A2

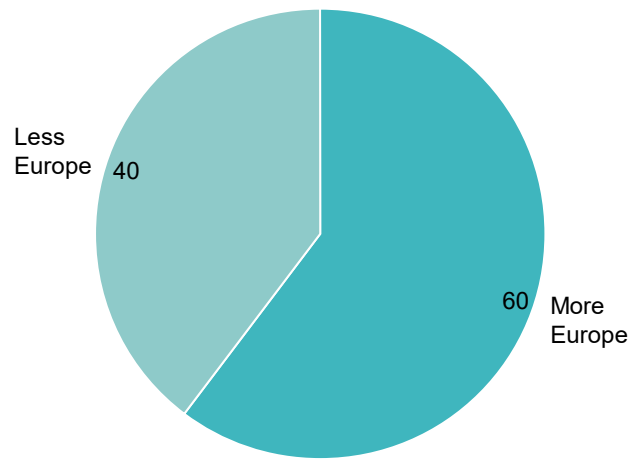
On average, EU respondents saw benefits from past EU membership and want “more Europe” going forward

Portion of EU respondents¹
% of total

Perceived benefits of past EU membership



Preferences for “more Europe” or “less Europe”



¹ Total of all 6 EU country survey respondents across all sectors.
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

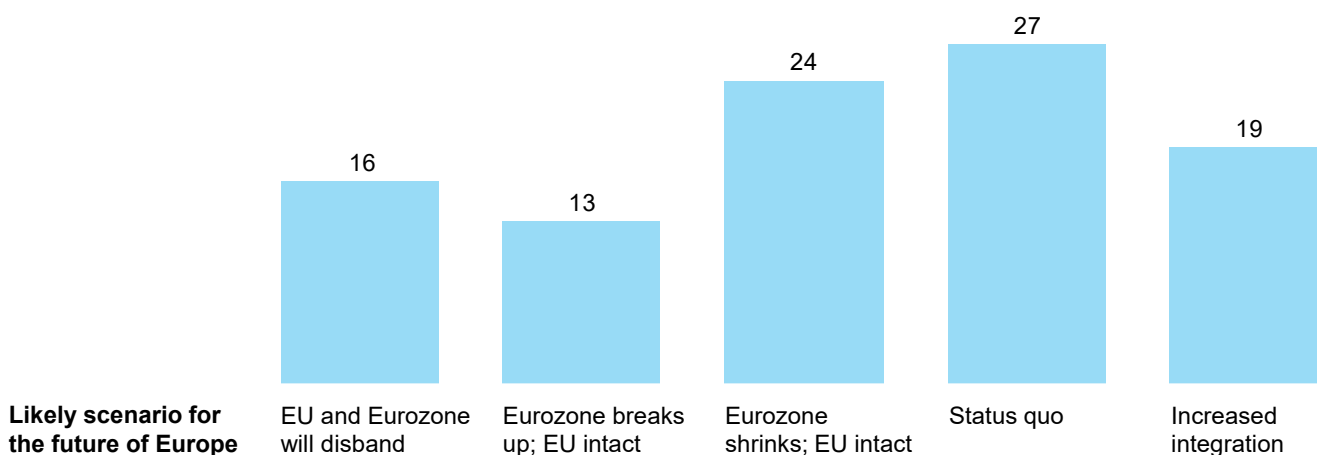
C. Europe’s evolution

Our survey also asked respondents about the most likely scenario they perceive for the future of Europe (Exhibit A3). The largest response, from 27 percent of respondents, was that they expect the status quo to continue. However, a large share of respondents believe European integration will reverse, thereby posing an additional risk to European companies, the majority of which want more rather than less Europe.

Exhibit A3

Forty-six percent of EU respondents believe that the EU and Eurozone will continue as is or experience further integration, while the majority expects disruptive change, especially to the Eurozone

Portion of EU respondents¹
% of total



¹ Total of all 6 EU country survey respondents across all sectors.
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

How global trends and Europe affect firm performance

An important point of our analyses is whether perceptions of trends (mostly negative) and of Europe (a desire for more, but a risk of reversal) carry any weight with company decisions and their performance. We find some clear links between views on Europe and global trends on the one hand and European business performance on the other. This suggests that it will be important for companies to manage against those trend headwinds in order to ensure greater performance in the future.

How important are trends, compared with typical business issues, in guiding a company's performance? Using a variance decomposition analysis, or classification in CHAID, of firm performance regarding both historical revenue growth and expected future investment growth, we find that firm performance is overwhelmingly driven by company assets and endowment and by feature factors, consistent with most economic literature.⁸⁷ These firm effects have been found to be about six to seven times more relevant than global trends, and two to five times more relevant than the European context, in explaining the difference in performance between firms (Exhibit A4).

⁸⁷ One strong contender in this line of work is the resource-based view of the firm, which states that organisations are intrinsically heterogeneous in regard to available resources, and that those differences do not disappear with time. For empirical evidence, see Jaime A. Roquebert, Robert L. Phillips, and Peter A. Westfall, "Market versus management: What drives profitability?" *Strategic Management Journal*, volume 17, number 8, 1996; and Edward H. Bowman and Constance E. Helfat, "Does corporate strategy matter?" *Strategic Management Journal*, volume 22, issue 1, 2001.

Exhibit A4

Economic variables provide more information about historic revenue and future investment than trends or the impact of Europe

| | Average % influence of selected variables on companies across all sectors ¹ | | | |
|--|--|---------------|-----------------------|-------------------------------|
| | Economic variables ² | Global trends | Past impact of Europe | Expected scenarios for Europe |
| Historic revenues | 100 | 14 | 21 | 4 |
| Expected Investment | 100 | 16 | 48 | 0 |
| Average (historic revenues and expected investment) | 100 | 15 | 34 | 2 |

| | Deep dive on impact of trends on historic revenue and expected investment | |
|---------------------------------|---|-------------------------|
| | Total % of companies impacted by trends | % of total trend impact |
| Ageing | 9 | 7 |
| Digitisation | 48 | 40 |
| Rising inequality | 38 | 31 |
| Pressures against globalisation | 25 | 21 |
| Total trend impact | 121 | 100 |

1 Defined as % of companies that are impacted by a variable within these groupings in CHAID analysis across all sector cuts.

2 Variables include historic cash flow position, historic revenue growth, future revenue growth, future employee growth, and future revenue productivity.
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

However, whereas firm performance is mostly accounted by internal firm matters, global trends and Europe matter for the economic future. We discover that:

- Zooming in on Europe, the perceived benefits of Europe carry more influence on firm decisions—notably historical revenue as well as future investment growth—than the future scenarios for the EU. This suggests that the fear of Europe breaking into new scenarios has yet to cancel out the impact from past perceived benefits.
- Regarding global trends, perceptions of digitisation are the most informative for a company's historical revenue growth and future investment decisions. This is followed by perceptions about rising inequality and antiglobalisation pressures. Digitisation is perceived more positively than negatively by companies in our survey.

Exhibits A5 and A6 highlight the relationships between global and European trends on firm performance and decisions to invest.

In Exhibit A5, the first row, reporting expected growth in investment in manufacturing, shows that a 10 percent increase in positive perception of trends corresponds to investment growth of 0.1 percent. The median firm reports just above two trends as positive, while for the top 25 percent of firms, that number goes up to five trends, or 150 percent more. This implies that the top 25 percent of firms, in experiencing positive trends, will plan to grow investment 1.5 percent more, a relatively material boost to investment. We also note in manufacturing that there is a negative correlation between number of trends perceived as positive and employment.

Exhibit A5

Positivity towards global trends has a positive impact, particularly towards capital investment in the manufacturing sector

■ Example discussed in text

| Dependent variable | Sector | Independent variables | Coefficient | Standard error | Standard coefficient | t-stat | Significance level |
|--|---------------|---|-------------|----------------|----------------------|--------|--------------------|
| In (expected growth in investment) | Manufacturing | Positive trends: number of statements scoring 4 and 5 | 0 | 0 | 0.01 | 2.64 | 0.01 |
| | Primary | | 0 | 0 | 0 | 2.48 | 0.01 |
| In (expected growth in employment) | Manufacturing | | -0.03 | 0.01 | -0.14 | -2.14 | 0.03 |
| In (historic growth in cash flow position) | Manufacturing | | 0 | 0 | -0.01 | -2.33 | 0.02 |
| | Primary | 0 | 0 | 0 | -2.43 | 0.02 | |

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

In Exhibit A6, we see a positive correlation between revenue growth in the manufacturing sector for those respondents who indicate more positive scenarios for the future of Europe (such as the scenario in which the status quo is maintained in the EU and the Eurozone). At the same time, we see a negative correlation between employment growth for companies anticipating the scenario in which both the EU and the Eurozone disband.

Exhibit A6

There is a correlation between optimism towards expected future scenarios for Europe and expected growth in certain economic variables

| Dependent variable | Sector | Independent variables | Coefficient | Standard error | Standard coefficient | t-stat | Significance level |
|---------------------------------------|---------------|-----------------------------------|-------------|----------------|----------------------|--------|--------------------|
| In (historical growth in revenue) | Manufacturing | Scenario: status quo | 0.11 | 0.07 | 0.10 | 1.57 | 0.12 |
| In (expected growth in employment) | | Scenario: EU and Eurozone disband | -0.32 | 0.12 | -0.16 | -2.68 | 0.01 |
| In (expected growth in cash position) | Primary | Scenario: Eurozone breaks up; | -0.01 | 0 | 0 | -2.32 | 0.02 |
| In (expected growth in investment) | | EU remains | 0 | 0 | 0 | 3.37 | 0 |

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

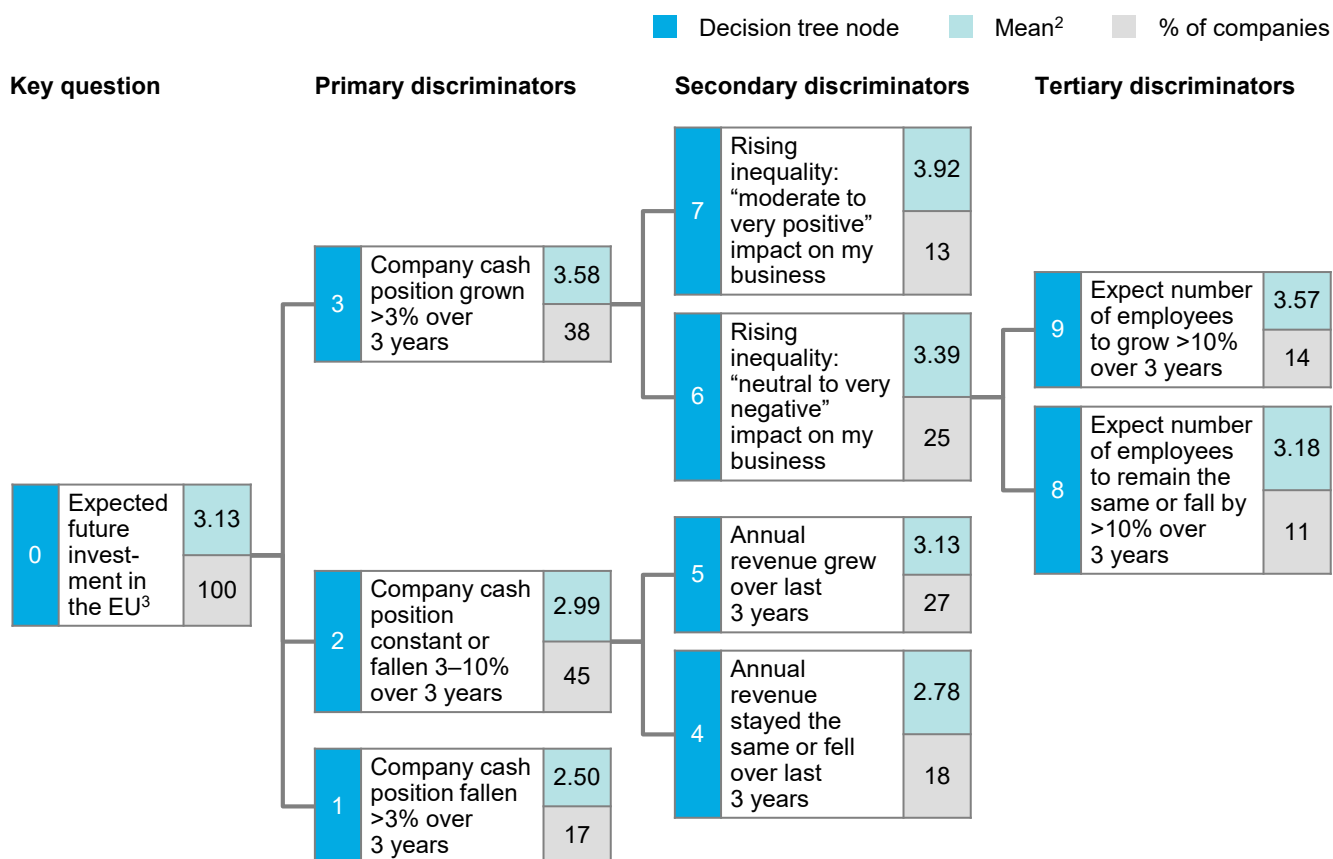
In general, trends do not appear overly significant in the regression analysis, except for digitisation in the manufacturing and primary sectors. One reason is that trends may be playing in a focused, non-linear way on firm performance. We thus resorted to CHAID to show those non-linear relationships.

Reconsidering expected investment growth decisions in the manufacturing sector, the CHAID model reveals interesting interactions with trend perceptions. First, investment decisions in the manufacturing sector appear to be influenced by the risk of rising inequality emerging in Europe (see Exhibit A7). This risk affects only firms with a strongly growing historical cash flow position, or firms that are more willing to invest than the average (see nodes 6 and 7 of the CHAID tree). Firms perceiving that rising inequality is likely to have

a neutral to very negative impact on their business are less likely to invest. This group of companies is large, representing 25 percent of manufacturing firms. Comparing nodes 6 and 7, firms not perceiving the risk of inequality plan to grow their investment rate by 16 percent more than others.⁸⁸ Eliminating this perception of risk would translate into 4 percent more investment growth as a whole.⁸⁹

Exhibit A7

Decision tree based on CHAID analysis of future EU investment by manufacturing companies¹



- 1 Chi-Squared Automatic Interaction Detector (CHAID) analysis determines which survey answers are most able to discriminate against selected dependent variables as a technique to uncover non-linear effects between companies' decisions and their perceptions of trends and of Europe.
 - 2 Mean of responses to expected change in annual investment in the EU among our survey respondents. The mean will change in response to subsequent survey questions, indicating higher or lower expected future investment in the EU among our survey respondents.
 - 3 Respondents were asked to define their expected change in annual investment over the next three years, compared to the previous year. Expected investment is on a scale of 1 to 5, as follows: 1: Fall by >30%, 2: Fall by 10–30%, 3: Keep roughly constant, 4: Grow by 10–30%, 5: Grow by >30%.
- NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

In general, perceptions about Europe and global trends tend to play non-linearly. Another example of this is how they affect expected investment growth within the service sector. As seen in the CHAID tree below (Exhibit A8), the perceived benefits of Europe improve willingness to invest, but at different levels. This primarily affects companies with strongly growing cash positions (nodes 8 and 9). There is also a smaller impact on companies whose cash position has remained roughly constant or fallen by 3 to 10 percent compared to three years ago, but which are expecting to increase employment (nodes 10 and 11).

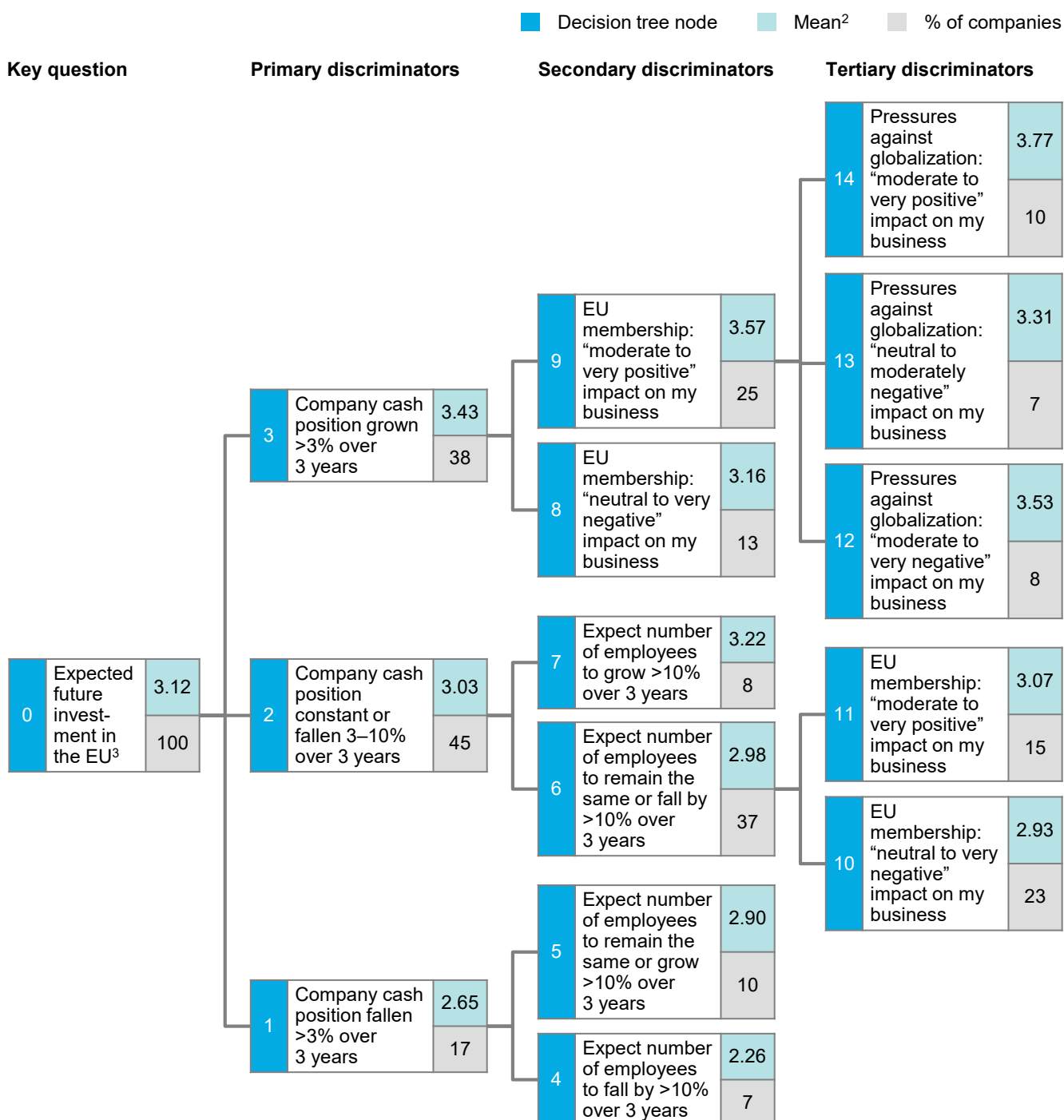
⁸⁸ This is $(3.92 - 3.39) / 3.39$; see CHAID node box.

⁸⁹ This is $(3.92 - 3.39) = 0.53$ for 25 percent of total firms, or 0.13, to be compared to a total average of 3.1 in first node, or $0.13 / 3.1 = 4$ percent.

In terms of trends, globalisation in particular can boost the service industry, but only for a small cluster of firms: those with increasing cash positions (after node 9). Overall, perceptions of Europe affect the investment decision of 75 percent of companies in the service industry, while globalisation affects the decisions of only 25 percent of firms.

Exhibit A8

Decision tree based on CHAID analysis of future EU investment by services companies¹



1 Chi-Squared Automatic Interaction Detector (CHAID) analysis determines which survey answers are most able to discriminate against selected dependent variables as a technique to uncover non-linear effects between companies' decisions and their perceptions of trends and of Europe.
 2 Mean of responses to expected change in annual investment in the EU among our survey respondents. The mean will change in response to subsequent survey questions, indicating higher or lower expected future investment in the EU among our survey respondents.
 3 Respondents were asked to define their expected change in annual investment over the next three years, compared to the previous year. Expected investment is on a scale of 1 to 5, as follows 1: Fall by >30%, 2: Fall by 10–30%, 3: Keep roughly constant, 4: Grow by 10–30%, 5: Grow by >30%.
 NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis



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May 2017
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