McKinsey&Company

McKinsey Global Institute




December 2012

Investing in growth: Europe's next challenge

The McKinsey Global Institute

The McKinsey Global Institute (MGI), the business and economics research arm of McKinsey & Company, was established in 1990 to develop a deeper understanding of the evolving global economy. Our goal is to provide leaders in the commercial, public, and social sectors with the facts and insights on which to base management and policy decisions.

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 job creation, resource productivity, cities of the future, the economic impact of the Internet, and the future of manufacturing.

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

The partners of McKinsey & Company fund MGI's research; it is not commissioned by any business, government, or other institution.
For further information about MGI and to download reports, please visit www.mckinsey.com/mgi.

McKinsey Global Institute

December 2012

Investing in growth: Europe's next challenge

Charles Roxburgh
Eric Labaye
Fraser Thompson
Tilman Tacke
Duncan Kauffman

The challenge

€350 billion fall in EU-27 private investment in 2007–11, larger than any previous decline in absolute terms

The fall in private investment was **20 times** the drop in private consumption and **4 times** the decline in real GDP

$1 trillion fall in private investment in the EU-27, United States, and Japan combined in 2007–11

26 of 27 EU economies had not recovered to 2007 private investment levels by 2011

75%+ of the private investment fall occurred in Greece, Ireland, Italy, Portugal, Spain, and the United Kingdom

...the opportunity

More than

€2 trillion private investment in the EU-27 vs. less than

€0.3 trillion of government investment

€750 billion

excess cash holdings of listed European companies in 2011

Closing only 10% of variation in capital stock per worker at subsector level in Europe could require additional investment of

€360 billion+

€290 billion

new investment in EU-27 fixed telecoms needed to deliver desired data speeds over the next decade

€37 billion

per year of investment in 2010–30 needed to improve the energy efficiency of new and existing buildings in Europe

Executive summary

Behind Europe's growth stagnation is an unprecedented weakness in private investment. European companies and households have been buffeted by the global financial and sovereign debt crises and uncertainty about the future of Europe's economic and monetary union. The fall in private investment between 2007 and 2011 was larger than any previous decline in absolute terms and four times the decrease in real GDP over the same period. History tells us that advanced economies take an average of five years to recover from such a drop in private investment. By that standard, the 27 economies that make up the European Union (EU-27) are, on average, running behind schedule.

Yet Europe's policy debate has focused more on how to balance public budgets than how to reignite growth. And when governments *do* discuss growth, the emphasis has tended to be on increased government investment (including on infrastructure) and private consumption, rather than private investment. Given the central role of private investment in Europe's downturn, we believe that it merits greater attention. In parallel with continuing efforts to restore macroeconomic stability, action to stimulate a recovery in private investment needs to be part of a pro-growth strategy that also embraces reform to labour markets and service sectors.

Private investment has been the hardest-hit component of GDP during the European economic crisis. In 26 of the 27 EU countries, private investment in 2011 remained below its 2007 level, weighed down by a weak demand outlook and ongoing macroeconomic uncertainty. But private investment holds significant promise as a driver of recovery and sustained medium-term growth. Other sources of GDP growth are constrained in many countries and could remain so for some time. Across Europe, the one economic sector that has the capacity to spend is the non-financial corporate sector. Government investment—which in any case accounts for only around 12 percent of total investment in Europe—and government consumption are likely to remain subdued in many European economies as policy makers strive to reduce public debt. Private consumption is under pressure as unemployment rises and as households in parts of Europe rebuild their finances after years of high borrowing. Net exports have been by far the fastest-growing GDP aggregate during the recovery. Nevertheless, the fact is that roughly 60 percent of EU-27 exports are to other EU-27 countries, and many of Europe's major external export markets are experiencing slow or weakening growth.

In contrast to the strapped finances of the public and household sectors, companies have significant cash that they could invest. Listed European companies had excess cash holdings of €750 billion in 2011, close to their highest real level for two decades.[1] To put this into perspective, the value of these cash holdings is more than double the drop in private investment between 2007 and 2011. But despite the low interest rates that prevail in much of Europe, European companies remain hesitant, and private investment remains well below its previous peak. An essential part of the recovery is therefore to get the private sector investing again.

The appropriate balance between government efforts to stimulate demand and to cut high sovereign debt is rightly the subject of ongoing debate. Whatever judgments European governments make on where that balance should lie, it is vital that they individually and collectively do all they can to restore macroeconomic stability. However, in parallel, European economies need a new kind of industrial strategy focused on microeconomic reform. In the 1970s, "picking winners" was often the industrial policy of choice. Europe's taxpayers footed substantial bills as governments offered large financial incentives to investment or acted as investors themselves through nationalised companies and other vehicles. Bitter experience shows that there were as many if not more failures than successes. In any case, given current fiscal constraints, such an approach is not feasible. What European economies need today are activist policies focused on targeted microeconomic reforms that mitigate or remove barriers to private investment and create the conditions for the non-financial corporate sector to propel European growth and renewal.

Even in the short term—and in today's weak demand conditions—governments could unlock private investment by removing regulatory barriers that currently stand in the way. Many projects, from airports to university campuses, benefit from returns over decades and therefore weak demand in the short term will only have limited impact on their overall viability. Even among more near-term projects, there will be those at the margin that could become viable with sufficient action from policy makers. Examples of investment that could kick in relatively quickly include retrofitting buildings with more energy-efficient features and investing in telecoms infrastructure to support Europe's growing data needs. Such investment would not only make a contribution to growth but could also potentially inspire confidence in other firms that are holding back. Through removing barriers, governments could trigger a virtuous circle of private investment. Appropriate microeconomic activism would also mean that, even for projects that are dependent on demand, the right conditions are in place so that when growth returns, investment comes back as a flood rather than a trickle.

In this report, we explore what has driven the sharp decline of private investment and use analysis of past contractions in European and other advanced economies to gain insight into prospects for its recovery. Finally, we discuss a framework for designing a programme of microeconomic activism at the sector level focused on unleashing a wave of new investment that can drive Europe's recovery.

1 McKinsey Corporate Performance Analysis Tool and Standard & Poor's Capital IQ. We define "excess cash" as the sum of cash above 2 percent of revenue.

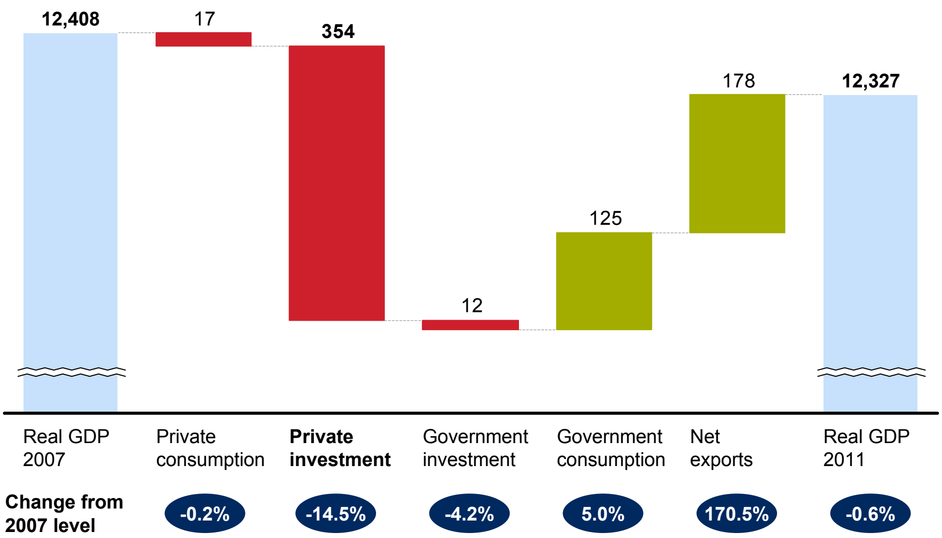
BEHIND EUROPE'S STAGNATION IS A CRISIS OF PRIVATE INVESTMENT

The economic downturn in Europe has hit private investment harder than any other component of GDP. Between 2007 and 2011, annual private investment in the EU-27 fell by more than €350 billion—20 times the drop in private consumption, and four times the decline in real GDP (Exhibit E1).[2]

Exhibit E1

Private investment has been the hardest-hit component of EU-27 GDP

Change in real GDP, EU-27 countries, 2007–11
Constant 2005 € billion



SOURCE: IHS Global Insight; Economist Intelligence Unit; McKinsey Global Institute analysis

The fall in private investment during the current European economic crisis is larger than any previous decline in absolute terms. Private investment is today nearly 15 percent below its 2007 level. In some countries, the decline was significantly larger than the aggregate fall across the EU-27. For instance, Spain's private investment fell by 27 percent from 2007 to 2011. In Ireland, the decline was 64 percent.

More than 75 percent of the private investment drop occurred in Greece, Ireland, Italy, Portugal, and Spain—the GIIPS group—and the United Kingdom. Yet these countries account for only 42 percent of EU-27 GDP. France, too, experienced a substantial decline in private investment. Indeed, the private investment drop in France and the United Kingdom combined was larger than that observed in Spain.

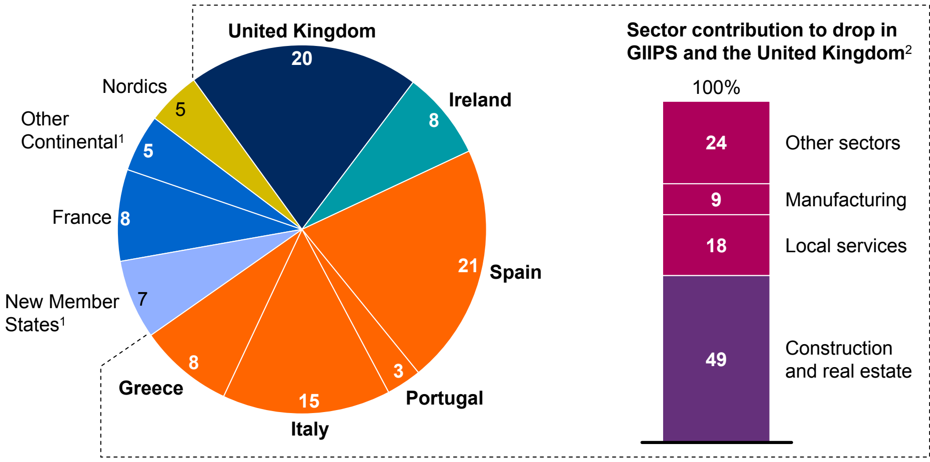
2 All data on GDP and its components, including private investment, are shown in constant 2005 euros.

A collapse in investment in construction and real estate—sectors where investment boomed before the economic crisis—accounted for a significant share of the overall drop in fixed investment between 2007 and 2011. In the GIIPS group and the United Kingdom, construction and real estate accounted for nearly 50 percent of the drop in combined fixed investment (Exhibit E2). Some of this past investment was the product of an unsustainable property market boom, and a swift return to those investment levels would not be expected or desired.

Exhibit E2

GIIPS[1] and the United Kingdom accounted for more than 75 percent of the private investment fall; construction and real estate dominated

% of the overall drop in private investment in the EU-27, 2007–11[2]



1 GIIPS: Greece, Ireland, Italy, Portugal, and Spain; Continental: Austria, Belgium, France, Germany, Luxembourg, and the Netherlands; New Member States: Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, and Slovenia; Nordics: Denmark, Finland, and Sweden.
2 Sector-level data are available for combined private and government fixed investment only.
SOURCE: IHS Global Insight; McKinsey Global Institute analysis

It is difficult to disentangle the effects of many potential causes for the drop in investment. Nevertheless, two factors appear to have played a leading role. First and foremost has been the weak demand outlook and slack capacity in many sectors across Europe. In countries where investment has dropped the most, there has also been a large decline in growth expectations. This relationship has been particularly marked in the construction and real estate sectors. The collapse of the real estate bubble in some European countries and the large amount of spare residential dwelling capacity left in its wake have resulted in a glut in some markets with little new investment taking place. This situation has been compounded by high levels of economic uncertainty—downside risks loom larger than those on the upside. In combination, these forces have sapped firms' confidence to invest. Household and corporate deleveraging in parts of Europe has further dampened residential real estate investment. The second factor is the cost of, and access to, financing for investment. The fall in private investment coincided with tightened credit conditions, especially for small and medium-sized enterprises (SMEs), in parts of Europe. On the evidence, the issue of financing appears to have played only a secondary role, but it will still be an important determinant of the speed and scale of the recovery.

PRIVATE INVESTMENT IS CRUCIAL FOR RENEWED EUROPEAN GROWTH—BUT ITS RECOVERY LAGS BEHIND HISTORICAL STANDARDS

An analysis of 41 episodes in which real GDP fell and private investment dropped by at least 10 percent—as they have in Europe in recent years—shows that current trends in the components of GDP are quite distinct from those observed in the past. Private investment may be the most viable means of kick-starting European growth this time around:

- **Private consumption has led recovery in the past but remains weak in many countries today.** Typically, once GDP has started to grow again after a contraction, private consumption generates around one-third of real GDP growth. But EU-27 private consumption stagnated in 2011. Consumers appear to be unusually pessimistic about their economic prospects. In the United Kingdom and Spain, for example, households built up significant debt before the crisis and are now deleveraging only slowly. This process could still have many years to run.[3]

- **Government investment and consumption are unlikely to fill the hole left by Europe's private investment.** Government investment in the EU-27 accounted for only 12 percent of total investment on average between 1980 and 2011. To make up for the drop in annual private investment between 2007 and 2011, EU-27 governments would have to more than double their combined annual investment. This is highly unlikely given the strain on European public finances. Many of Europe's largest economies are reducing their deficits in order to try to comply with the criteria on debt and deficits prescribed in the Stability and Growth Pact. The International Monetary Fund (IMF) projects that total government expenditure as a share of EU-27 GDP will fall from 48.4 percent in 2011 to 45.5 percent in 2017. Without a major reversal of current policy, expansion of government expenditure is unlikely to be a significant stimulus to growth.

- **Net exports have played a strong role in the recovery so far, but further export-led growth faces headwinds.** Net exports accounted for two-thirds of the 1.6 percent growth in real GDP in the EU-27 in 2011. However, efforts by European governments to promote exports are unlikely to be sufficient to drive economic recovery across Europe. Economies in the eurozone cannot gain export competitiveness through unilateral devaluation; they require structural reform, typically a long and painful process. Additionally, roughly 60 percent of EU-27 exports are to other EU-27 countries, and growth across the EU is anaemic. Outside Europe, with the exception of China, the EU's main export markets are developed economies where GDP growth is also weak.

---

3 *Debt and deleveraging: Uneven progress on the path to growth*, McKinsey Global Institute, January 2012.

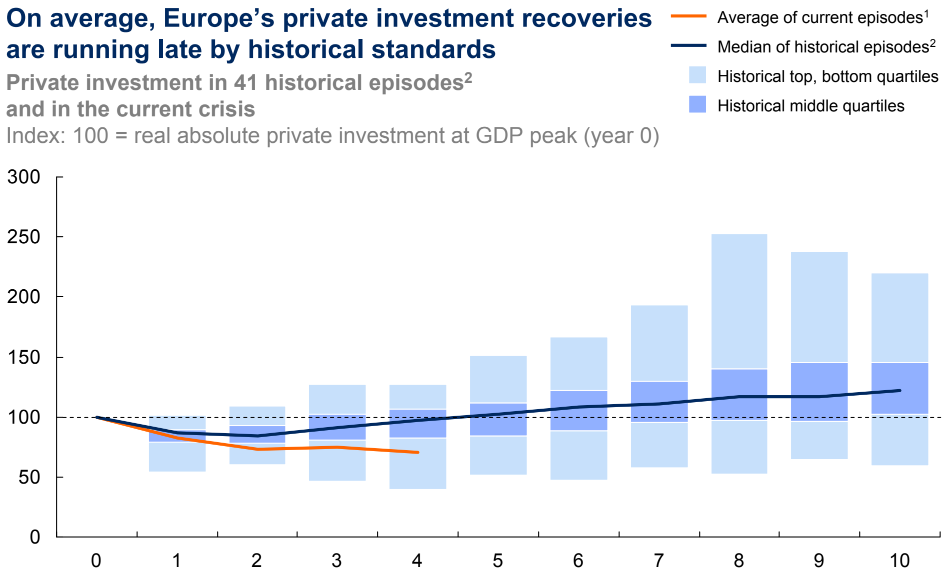
- **Private investment is less restricted, but its recovery is running late by historical standards.** Historically, private investment contributes about the same share of GDP growth during recoveries as during periods of normal growth. Private investment has, in the past, generated about one-third of GDP growth in the first two years of a recovery before settling back to a contribution of about one-quarter of growth. Our analysis of the 41 episodes shows that the median recovery time for private investment was five years from the year in which real GDP peaked. Even by that sobering standard, on average the private investment recoveries in the EU-27 economies are running behind schedule (Exhibit E3). In countries such as Greece and Spain, which had the largest falls in private investment of up to 40 percent or more, private investment had not yet begun to rise again by the end of 2011. However, private investment today is less constrained than other sources of GDP growth and therefore could potentially play a larger role than it has typically done in the past. The one economic sector that has capacity to spend across Europe is the non-financial corporate sector. European companies have significant cash that they could invest: listed European companies had excess cash holdings of €750 billion in 2011.

Exhibit E3

On average, Europe's private investment recoveries are running late by historical standards

Private investment in 41 historical episodes[2] and in the current crisis

Index: 100 = real absolute private investment at GDP peak (year 0)



1 Unweighted average of the 26 European countries that suffered a GDP contraction (in Poland, real GDP did not fall).
2 Episodes in which private investment fell at least 10 percent from GDP peak to GDP trough; this excludes 17 episodes when private investment fell by less than 10 percent. All values in year 0 are equal to 100 since private investment is indexed to 100 in that year.

SOURCE: IHS Global Insight; Economist Intelligence Unit; McKinsey Global Institute analysis

POLICY MAKERS NEED TARGETED MICROECONOMIC ACTIVISM TO UNLOCK PRIVATE INVESTMENT

Restoring macroeconomic stability and confidence by working through the current sovereign debt crisis is essential but will not be sufficient in itself to create an investment-driven recovery. There is rightly a debate in many European economies around the appropriate balance between using fiscal policy to stimulate demand and the imperative to cut high public debt levels. Whatever judgment individual European governments make on that balance, they need to combine any action to restore macroeconomic stability with microeconomic activism that aims to remove microeconomic barriers to private investment.

A range of such barriers currently constrains private investment in virtually every sector across Europe. In retail, for instance, planning regulations in many European countries limit the growth of more productive large-format stores and therefore deter investment. In construction, a large variety of specifications on anything from the height of ceilings to staircase areas means that, in some countries, construction projects are inefficient and expensive—another barrier to investment.[4] In transport, the fact that regulation is not uniform across Europe's internal borders acts as a barrier—consider that there are 11 separate signalling systems for rail freight in the EU-15, for instance.

Countries that have tackled such microeconomic barriers have achieved significant productivity and investment gains. After Sweden eased planning laws in retail during the 1990s, the sector posted the strongest productivity growth of any retail sector in Europe (and outstripped that of the US sector) between 1995 and 2005.[5] In European telecoms, standardisation and liberalisation led value added and productivity to grow at a rate of 9 percent in this period, compared with an estimated 6 percent on both measures in the United States.[6]

Overall, the potential to revive private investment by addressing such microeconomic barriers in Europe could be substantial. If European countries were to close only 10 percent of the variation in capital stock per worker at the subsector level, the impact could be more than €360 billion in additional investment—outstripping the €354 billion difference in private investment between 2007 and 2011.[7]

4 *Beyond austerity: A path to economic growth and renewal in Europe*, McKinsey Global Institute, October 2010.

5 *Creating economic growth in Denmark through competition*, McKinsey & Company, November 2010.

6 *Beyond austerity: A path to economic growth and renewal in Europe*, McKinsey Global Institute, October 2010.

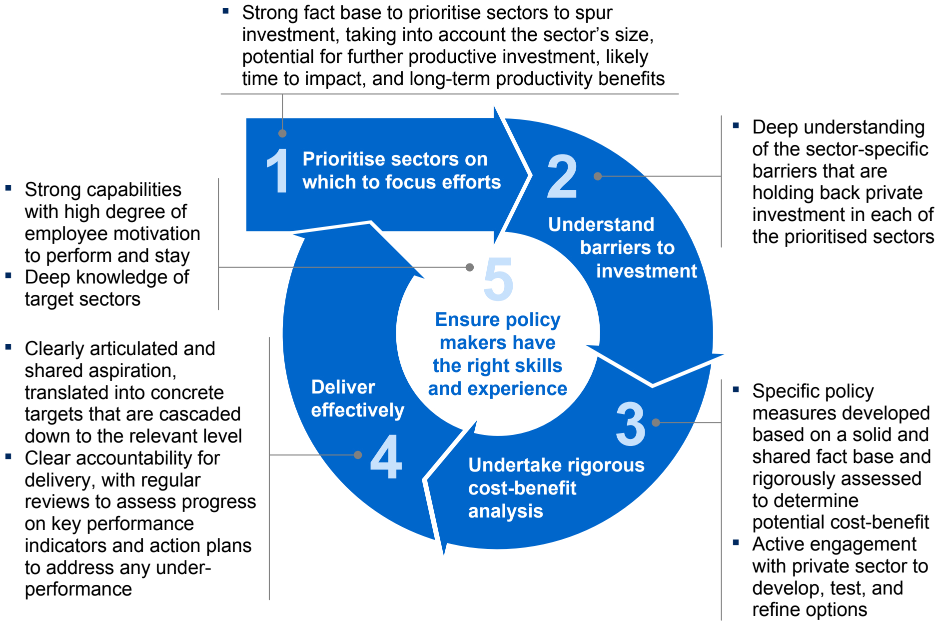
7 This is the gap between countries with similar labour costs. This analysis includes the 20 largest countries in the EU. The estimate is conservative as it excludes several sectors and also does not take account of the higher future investment growth path that closing the capital stock per worker gap would generate (both from the replacement of the additional capital stock that will depreciate in future years and continuing to keep the gap in capital stock per worker narrower than it is today). See Appendix B: Technical notes for more detail.

Yet despite these large potential benefits, the importance of microeconomic reform for investment and growth in Europe appears to have been overlooked in the current public debate. A review of the European media since 2009 finds that the press coverage of fiscal policy has been four times as great as that of microeconomic reform.

It is vital that any programme of microeconomic activism avoids some of the ineffective and costly attempts at policy intervention in the past. MGI's large body of research on productivity and sector competitiveness suggests that adhering to five essential disciplines will help to ensure that policy intervention is effective and to maximise the odds of success (Exhibit E4).

Exhibit E4

Targeted microeconomic activism comprises five essential disciplines



SOURCE: McKinsey Global Institute analysis

First, policy makers need to focus microeconomic activism on those sectors where intervention is most likely to trigger renewed investment on a sufficiently large scale to boost GDP growth and quickly enough to enable private investment to drive the recovery. Many current government strategies focus on innovative sectors such as semiconductors, but such cutting-edge sectors tend to lack the scale to have a sizeable impact on overall investment and economic growth. There may be other good reasons to launch initiatives in these sectors, but microeconomic activism by governments in these areas is unlikely to have a material impact on growth over the medium term.

Second, having established priority sectors, policy makers should develop a deep understanding of the sector-specific barriers holding back private investment. For example, an unsupportive regulatory framework stands in the way of the emergence of a European-wide energy grid. In the United Kingdom, there is evidence that immigration limits inhibit the expansion of the university sector.[8]

8 *Overseas students and net migration*, Business, Innovation and Skills Committee, House of Commons, United Kingdom, September 2012.

Third, governments should undertake a rigorous cost-benefit analysis before making any policy intervention to ensure that any investment is as productive as possible.

Fourth, governments need to deliver these interventions effectively, learning from how others in the public and private sectors have implemented policy. Finally, policy makers need to ensure that they have the right expertise, for example by hiring people with deep knowledge of the target sector. Singapore's impressive economic development has been strengthened by the ability of its public sector, including agencies such as its Economic Development Board, to attract and retain top talent. Because of the need to develop skills, microeconomic activism is not costless. However, because such activism often involves fiscally neutral changes in government policy, its costs are far less than government consumption or investment.

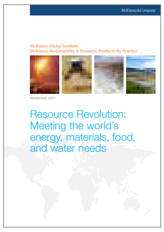
Independent of policy developments, there are three priorities for businesses in the investment sphere. First, they should examine their investment decision-making processes to ascertain whether they are identifying and acting to pursue all promising investment opportunities or whether a "bias against risk" is preventing them from doing so. Too often, managers add an arbitrary "risk premium" on top of the agreed cost of capital in an attempt to "compensate" for risk. Second, businesses need to arm themselves with the detail they need to guide their investment decisions effectively. Past McKinsey research has emphasised the importance of focusing analysis on "micro-markets" of specific products at the level not just of countries but even of areas within those countries, including rapidly growing cities. Based on a sample of 234 European-based companies, more than two-thirds of revenue growth from 1999 to 2009 came from growth in sub-industry segments, with the remainder from mergers and acquisitions and shifts in market share.[9] Finally, there is a need to create a step change in the efficiency with which capital is deployed. Past McKinsey research unearthed opportunities to achieve savings of more than 30 percent on project costs through approaches such as maintaining a top-level focus on value, providing project managers with a well-structured tool kit, and ensuring the project team has the right skills to deliver effectively. Doing so will ensure that more investment projects are viable and productive.

9 These data are from McKinsey & Company's Granularity of Growth database.

Related McKinsey Global Institute publications

Debt and deleveraging: Uneven progress on the path to growth (January 2012)

Major economies have only just begun deleveraging. In only three of the largest mature economies—the United States, Australia, and South Korea—has the ratio of total debt relative to GDP fallen. The private sector leads in debt reduction, and government debt has continued to rise, due to recession. However, history shows that, under the right conditions, private-sector deleveraging leads to renewed economic growth and then public-sector debt reduction.



Resource Revolution: Meeting the world's energy, materials, food, and water needs (November 2011)

We might be entering a new era of high and volatile resource prices over the next two decades as up to three billion people join the middle class. In addition, environmental deterioration, driven by higher consumption, is making the supply of resources—particularly food—more vulnerable. But the challenge can be met through a combination of expanding supply and a step change in the way resources are extracted, converted, and used.

European growth and renewal: The path from crisis to recovery (July 2011)

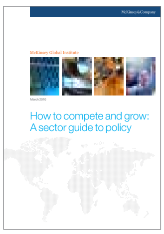
Europe is growing again, but the recovery is uneven and under threat from the continuing eurozone debt crisis. Europe has significant strengths on which to build but needs to address profound long-term challenges that could limit its future growth. MGI sets out a perspective on where the European economy stands, the challenges it faces, and the very considerable strengths on which it can build.

Farewell to cheap capital? The implications of long-term shifts in global investment and saving (December 2010)

MGI analysis suggests that the low interest rate environment that many have come to take for granted is likely to end in the coming years. By 2020, half of the world's saving and investment will take place in emerging markets, and there will be a substantial gap between global investment demand and the world's likely savings.

Beyond austerity: A path to economic growth and renewal in Europe (October 2010)

With multiple pressures on growth and constrained public finances, Europe needs structural reform even to match past GDP growth rates. Parts of Europe have begun to reform with demonstrable success. If the rest of Europe emulated their best practice, the region could add 4 to 11 percent to per capita GDP, without cutting holidays and leave.



How to compete and grow: A sector guide to policy (March 2010)

Drawing on industry case studies from around the world, MGI analyses policies and regulations that have succeeded and those that have failed in fostering economic growth and competitiveness at the sector level. What emerges are some surprising findings that run counter to the way that many policy makers are thinking about the task at hand.

www.mckinsey.com/mgi

E-book versions of selected MGI reports are available at MGI's website, Amazon's Kindle bookstore, and Apple's iBookstore.

Download and listen to MGI podcasts on iTunes or at www.mckinsey.com/mgi.

McKinsey Global Institute
December 2012

www.mckinsey.com/mgi
@McKinsey_MGI
McKinseyGlobalInstitute