

EUROFI

Macroeconomic Scoreboard

SEPTEMBER 2024

**Jacques de Larosière and Didier Cahen
with the support of Elias Krief**

Inside

- Widening of the economic gap between the Euro area and its main global competitors for more than 20 years
- Increasing economic and fiscal divergences across Member States since the creation of the euro
- The Economic and Monetary Union once again at a critical juncture
- Excessive public debt goes against productivity growth and employment
- Is NextGeneration EU a gamechanger?

Eurofi
Macroeconomic Scoreboard

•

Prepared by
Jacques de Larosière and Didier Cahen
with the support of Elias Krief

•

September 2024

Content

EXECUTIVE SUMMARY 7

1. THE ECONOMIC GAP BETWEEN THE EU AND ITS GLOBAL COMPETITORS HAS WIDENED SINCE THE GLOBAL FINANCIAL CRISIS

1.1 Since the 2000s, the European economy has consistently lagged behind the US in terms of growth, productivity and investment.....	9
1.1.1 <i>Since 2008, real GDP growth in the Eurozone has been almost 2.5 times lower than in the United States</i>	9
1.1.2 <i>Labour productivity growth in the US has been more than double that of the Eurozone over the past two decades</i>	10
1.1.3 <i>European firms have underinvested in productive capacities relative to their US peers since 2008</i>	10
1.1.4 <i>Weak productivity gains in the Eurozone have had repercussions on the standard of living of European households, which has fallen sharply behind that of the United States since 2011</i>	12
1.2 Unlike their European counterparts, US firms operate in a macroeconomic, financial and regulatory environment that is more favourable to investment and innovation.....	13
1.2.1 <i>US firms operate in a more business-friendly environment, granting them greater freedom than their European counterparts</i>	13
1.2.2 <i>US firms benefit from lower and more stable energy prices</i>	13
1.2.3 <i>US firms face fewer recruitment difficulties due to more favourable population dynamics</i>	14
1.2.4 <i>Unlike the EU, the US has a genuine single market</i>	14
1.2.5 <i>Despite abundant savings in Europe, financial markets in the US play a role three times more important in financing the economy compared to the EU</i>	15
1.2.6 <i>Several major EU policy shortcomings contribute to explaining its lagging behind the US</i>	16
1.2.7 <i>The decline in European economic competitiveness has been accompanied by a significant loss of competitiveness among EU financial players compared to their US and Asian counterparts</i>	17
1.3 The consequences of the Covid-19 pandemic and the energy crises have been more severe in Europe than in the US, China, and Japan.....	18
1.3.1 <i>In 2020, the Euro area suffered the largest GDP contraction among advanced economies</i>	18
1.3.2 <i>In 2021, Europe recovered at a slower pace than the United States and China</i>	18
1.3.3 <i>The economic impact of the war in Ukraine has been more damaging in Europe than in the United States or China</i>	19
1.3.4 <i>Unlike the United States, which is energy independent, Europe has been hit hard by the rise in energy prices in 2022</i>	20

2. ECONOMIC AND FISCAL DIVERGENCES HAVE WIDENED ACROSS MEMBER STATES SINCE THE CREATION OF THE EURO

2.1 Divergences in terms of productive performance among the Eurozone Member States have been increasing since the late 1990s.....	23
2.1.1 <i>From 1980 to the late 1990s, total factor productivity gaps between Germany and other Eurozone countries remained relatively contained</i>	23
2.1.2 <i>Since the introduction of the euro, there has been a striking coincidence: the productivity gap between EU countries has widened considerably</i>	24
2.2 Since 1999, the Eurozone has been marked by substantial disparities in terms of economic and fiscal performances.....	24
2.2.1 <i>Differentiated Economic Growth in the Eurozone</i>	24
2.2.2 <i>Developments in the public debt-to-GDP ratio reflect economic divergences between the main EMU countries and insufficient coordination of economic policies within the Euro area</i>	25

2.2.3 Divergent Per Capita Income Growth (2000-2024).....	26
2.3 The elimination of the exchange rate risk in the monetary union and progress toward the single market have increased the heterogeneity of productive specialization, particularly benefiting competitive Northern European countries.....	26
2.3.1 Countries that enjoyed a highly effective economy before the introduction of the euro have benefited even more from the external value of the single currency.....	26
2.3.2 Divergent inflation rates between Eurozone countries, which were particularly pronounced up until the European sovereign debt crisis, contributed to differences in competitiveness between countries.....	27
2.3.3 Growing heterogeneity in productive specialization.....	27
2.4 The current account imbalances resulting from these divergences have been significant and have not been corrected, as illustrated by the scale of positions within Target 2.....	28
2.4.1 Persistent divergences in the current account imbalances in the Eurozone despite improvements in peripheral countries since the EU Sovereign Debt Crisis.....	28
2.4.2 Countries with large current account surpluses together with countries showing persistent current account deficits threaten the coherence of the EMU.....	28
2.4.3 Higher returns on financial assets in the United States than in the Euro area.....	30
2.4.4 Target 2 imbalances in the Eurozone have increased with the ECB's asset purchase programs (2015-2022).....	31

3. AFTER PERIODS OF TURBULENCE AND A RETURN TO GREATER COHERENCE, THE MONETARY UNION IS ONCE AGAIN AT A CRITICAL JUNCTURE

3.1 2000-2010: a phase of economic divergence leading to the European sovereign debt crisis (2010-2012).....	33
3.1.1 As soon as the euro was introduced, the Maastricht criteria were no longer respected by large Member States.....	33
3.1.2 The introduction of the euro has been accompanied by a significant disparity in inflation rates, widening the competitive gap between Member States.....	34
3.1.3 In the peripheral countries, the fall in real interest rates has led to a surge in private sector debt, encouraging property bubbles.....	35
3.1.4 ...and created current account imbalances in several EU countries.....	35
3.1.5 The existence of monetary union, as it has been managed, has encouraged these divergences.....	37
3.2 2012-2019: economic divergences narrow, although public debt remains a concern in some Member States.....	38
3.2.1 After 2012, the peripheral countries all improved their fiscal and current account balances.....	38
3.2.2 Growth resumed in peripheral countries, albeit at a slower pace than in the previous decade.....	40
3.2.3 Despite improved budget balances, public debt remained a concern in some countries on the eve of Covid-19.....	41
3.3 2020-2024: economic and budgetary disparities exacerbated by the Covid-19 crisis (2020) and the energy crisis (2022).....	42
3.3.1 In 2020, the impact of the crisis on public accounts and growth was greatest in the countries with the worst public finances in the pre-Covid-19 period.....	42
3.3.2 The energy crisis exacerbated by the war in Ukraine in 2022 was quickly overcome by the Eurozone, which returned to a positive current account balance the following year.....	43
3.3.3 Nevertheless, the shock was managed differently by the Member States, which increased the economic and budgetary divergences between them.....	45

4. EU COUNTRIES WITH THE HIGHEST LEVEL OF GOVERNMENT EXPENDITURE AS PERCENTAGE OF GDP HAVE THE LEAST COMPETITIVE FIRMS

4.1 With 57,3% of GDP in 2023, France holds the record for the highest level of public spending in the EU.....	49
4.2 High public spending implies high tax pressures on firms, increasing their production costs and deteriorating their competitiveness.....	50
4.3 Most government expenditures are allocated to social protection, health and public services.....	52
4.4 Such levels of government expenditure have been reached at the expense of productive investment, hence its limited contribution to gross capital formation.....	53

5. EXCESSIVE LEVEL OF GOVERNMENT DEBT DOES NOT FUEL PRODUCTIVITY GROWTH AND EMPLOYMENT

5.1 The most indebted countries of the Eurozone have achieved the lowest productivity growth performance in the past two decades.....	57
5.2 The highest unemployment rates in the EU since 2007 were reached in the most indebted EU countries (Spain (11.7% in May 2024), Italy (6.8%) and France (7.4%)).....	57
5.3 The employment rate in France, Spain, and Italy is close to 10 percentage points lower than in Germany and the Netherlands.....	59
5.4 "Bad jobs" are more prevalent in deindustrializing economies and are concentrated in low-skilled and precarious activities.....	60

6. IS NEXT GENERATION EU (NGEU) A GAME CHANGER?

6.1 NGEU is an unprecedented joint response to the Covid-19 crisis, making over €800bn available to Member States to become more resilient, mainly investing in the green and digital transitions.....	63
6.1.1 NGEU encompasses several instruments to achieve its objectives: green and digital transitions, structural reforms to recover from the pandemic, and economic resilience in all parts of the EU ...	63
6.1.2 With a dedicated envelope of €648 billion, the Recovery and Resilience Fund (RRF) is the centerpiece of Next Generation EU, with a focus on the green and digital transitions.....	64
6.1.3 Italy and Spain are the main recipients of the RRF.....	65
6.2 Where is the EU at with Next Generation EU?.....	66
6.2.1 The 27 national plans have been approved by the Commission and adopted by the EU Council, but only one-third of the funds had been spent by June 30, 2024.....	66
6.2.2 NGEU is financed by common debt and national resources.....	66
6.3 Is Next Generation EU efficient?.....	69
6.3.1 Billed as a 'game changer' with highly ambitious goals, the RRF has so far had a relatively limited impact on the economic growth of Member States.....	69
6.3.2 NGEU is a slow and complex process that faces Member States' limited capacity regarding the absorption capacity of European funds.....	69
6.3.3 NGEU case studies: Italy has struggled with NGEU funds, while Spain has used them more efficiently.....	71
6.3.4 Concerns about the quality and potential fraud in the implementation of the RRF are becoming increasingly prominent.....	73
6.4 Can the IRA widen the gap between the US and the EU?.....	73
6.4.1 The IRA is a protectionist-inspired subsidy package that aims at making the US the global leader in clean tech and CO2 emission cuts.....	73
6.4.2 The IRA already proved very attractive for both US and foreign companies.....	75
6.4.3 The EU seems to be distanced by the US in the race to clean energy, competitiveness, and industry.....	76

CONCLUSION

For a more dynamic economy in the Eurozone.....	81
---	----

Executive summary

During the past 25 years, the European Union (EU) has accumulated a significant economic performance gap with the rest of the world, particularly the United States (US). One of the most striking aspects of this disparity, as this scoreboard shows, is the persistent difference in growth, productivity, and investment levels.

The economic policy choices made by many European Member States, most often geared towards increasing demand to the detriment of productive investment – encouraged by persistently low or even negative real interest rates – as well as the inadequacies of certain EU policies and structural problems in Europe (demographic slowdown, energy dependency in particular) explain this economic stall. The Global Financial Crisis of 2008, the subsequent Sovereign Debt Crisis in Europe, the more recent Covid-19 pandemic, and the Russian war in Ukraine have all exposed and exacerbated these underlying issues.

After periods of turbulence and a return to greater coherence, the Monetary Union is once again at a critical juncture. The euro's successes cannot mask its weaknesses.

In 1999, the euro became the single currency of a vast economic entity whose market of 350 million inhabitants is one of the largest in the world. This has allowed for an intensification of trade within the zone and has been an important factor in trade integration through the elimination of the exchange rate risk. The adoption of the euro has also reduced the cost of intrazone transactions. Moreover, the euro has become the second international currency after the dollar.

But the single currency was created without a common economic policy, and the last 25 years have been marked by the failure of many Member States to comply with the rules of the Stability and Growth Pact. Against this backdrop, economic disparities and divergences in living standards between the main Eurozone countries have widened considerably since the creation of the euro.

The Covid-19 crisis and the war in Ukraine hit the Eurozone harder than its main competitors. Since 2020, existing heterogeneities across EU Member States have been revived. It is an illusion to try to solve the structural problems of our economies by increasing public debt or by creating money. Yet, this is what has been too often tried by pursuing lax fiscal, monetary, and economic policies that have inevitably created systemic risks to financial stability and thus to future growth. This Scoreboard also shows that the EU countries with the highest levels of government expenditure as a percentage of GDP are those with the least competitive firms. Furthermore, excessive levels of public debt are not conducive to productivity and employment growth.

The NGEU is an unprecedented joint response to the Covid-19 crisis, making more than €800 billion available to Member States to make them more resilient, mainly by investing in the green and digital transitions. However, in contrast to the impact of the IRA, there has been no boost to productive investment in the European countries that benefit most from these European funds.

As long as it is not sufficiently understood, especially in the highly indebted countries, that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and will hamper progress in the construction of an economic and financial European Union. In addition, fiscal and economic divergences between EU countries make it more difficult to define a common interest in Europe, encourage a policy of "every man for himself" and create a climate of mistrust between Member States that hampers progress on public and private risk sharing and weakens the Euro area. →

→ If Europe and the Eurozone are to correct their growth disadvantage compared to the United States and China and not remain at the rank of second-rate powers, a major investment effort will therefore be needed in research and development, industrial equipment, decarbonisation, digital technology and improving the education system and the skills of the population. And the sooner the better, the gap continues to widen, requiring ever greater investment and supply-side efforts.

Consequently, the Euro area needs to get on the right track: strengthen fiscal responsibility, fight persistent inflation, implement more supply-side reforms aimed at raising productivity and promote equity financing, as well as take steps to complete the Banking Union and implement the Capital Markets Union. But these steps can only be contemplated if sufficient discipline begins to reverse the trend of ever-increasing economic heterogeneity across Member States.

1. The economic gap between the EU and its global competitors has widened since the Global Financial Crisis

Over the past 25 years, the European Union (EU) has accumulated a significant economic performance gap with the rest of the world, particularly the United States (US). One of the most striking aspects of this disparity is the sustained difference in growth, productivity, and investment levels.

The Global Financial Crisis of 2008, the subsequent Sovereign Debt Crisis in Europe and the more recent Covid-19 pandemic and the Russian war in Ukraine have all exposed and exacerbated these underlying issues. This succession of crises have highlighted the EU's vulnerabilities, including its heavy regulatory environment, fragmented markets, and underinvestment in key areas such as information and communication technologies and infrastructure.

After illustrating the performance gap between the EU and the US in terms of growth, productivity and investment since 2000, this chapter identifies the underlying causes of the economic gap between the EU and its global competitors, in particular the US. Then, we highlight that this decline in European economic competitiveness has been accompanied by a significant loss of competitiveness among EU financial players compared to their US and Asian counterparts.

Three types of reasons explain Europe's economic lag:

First, the gap in economic performance is the result of different economic national policy choices: stronger investment in research and development and new technologies, a friendlier business environment (including the flexibility of the US labour market), a higher skill level among the US workforce, and the existence of a genuine single market for goods and services are to be found in the US, unlike the fragmented markets that persist in Europe.

Second, exogenous and cultural factors – energy independence in the United States versus Europe's vulnerability to energy shocks (particularly following the Russian invasion of Ukraine), lower risk aversion among American consumers, high geographical mobility of American workers, demographic slowdown in Europe contrasted with the expanding working-age population in the US – have also contributed to the economic shortfall of the Euro area relative to the United States and its global competitors.

The shortcomings of EU policies also explain the economic gap between the EU and the US: insufficient cooperation and coordination of Member States' economic policies, competition policy, that has prevented the emergence of "European champions", available EU resources (NGEU, European Chips act), which face challenges in spending, and are slow to produce effects – in terms of increased productivity and investment – in the countries that benefit most from them (e.g., Italy, ...).

1.1 Since the 2000s, the European economy has consistently lagged behind the US in terms of growth, productivity and investment

The difference between the EU and the US economic performances since 2008, which has become even more marked since 2020, is undeniable: it results from diverging labour productivity gains essentially due to the underinvestment of the European corporate sector. Lower investment in key areas such as technology, research and development, and infrastructure has led to slower productivity growth in the EU compared to the US.

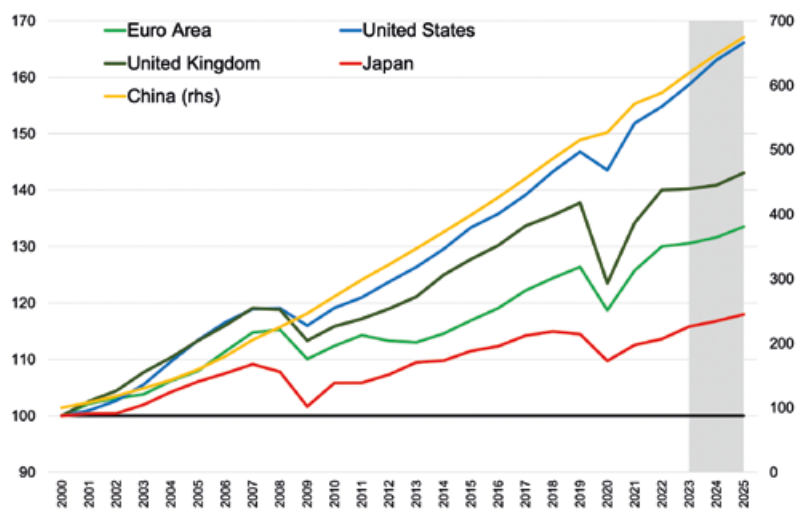
1.1.1 Since 2008, real GDP growth in the Eurozone has been almost 2.5 times lower than in the United States

Between 2008 and 2023, real GDP in the Eurozone grew at a modest average annual rate of just over 0.8%, representing an overall increase of around 13% since the start of the Global Financial Crisis. By contrast, the US economy grew by around 33% over the same period.

The performance gap between the two regions has widened since 2020. US real GDP grew by 8.2% between Q4 2019 and Q1 2024, compared with just 3.4% in the Eurozone.

In 2023, US growth (+2.5%) was 5 times higher than in the Eurozone (+0.4%).

CHART 1.
Real GDP Growth Trend, 2000=100

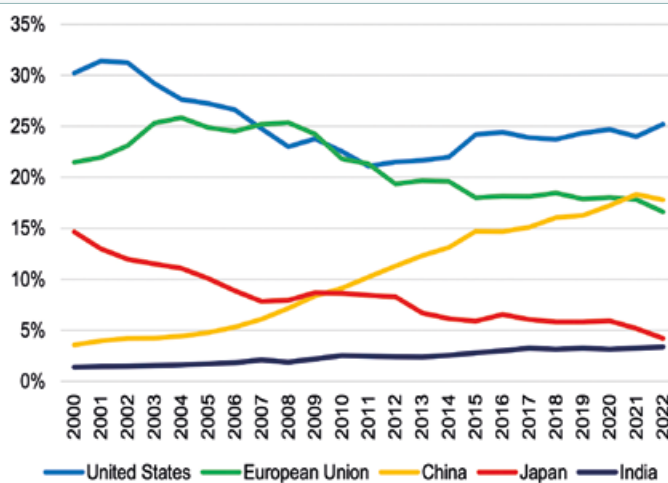


Source: IMF World Economic Outlook, April 2024

As noted by L. Subran & al¹, in 1999 – the year when the euro was introduced, the US economy was 11% larger than the Eurozone in purchasing power parity (PPP) terms. After three major crises (the 2008 Financial Crisis, the Sovereign Debt Crisis and the Covid-19 pandemic) and poor national economic policy choices, this gap has widened to 30%.

As a result of this weakness in GDP growth, the EU's share of the world economy has declined. According to the World Bank, the EU's share of global GDP was 25.4% in 2007, compared to 23% for the US (see Chart 2). By 2022, the EU's share had fallen to 16,6% while the US's share had risen to 25.2%.

CHART 2.
EU GDP, worldwide comparison,
Share of world GDP, %



Source: World Bank
At current price and exchange rate

1.1.2 Labour productivity growth in the US has been more than double that of the Eurozone over the past two decades

Productivity gains have significantly contributed to the growth gap between the US and the Euro area in recent years. Measured by output per capita, labour productivity rose by 36.8% in the US between 2000 and 2023, compared with only 10.5% in the Euro area (see Chart 3.b).

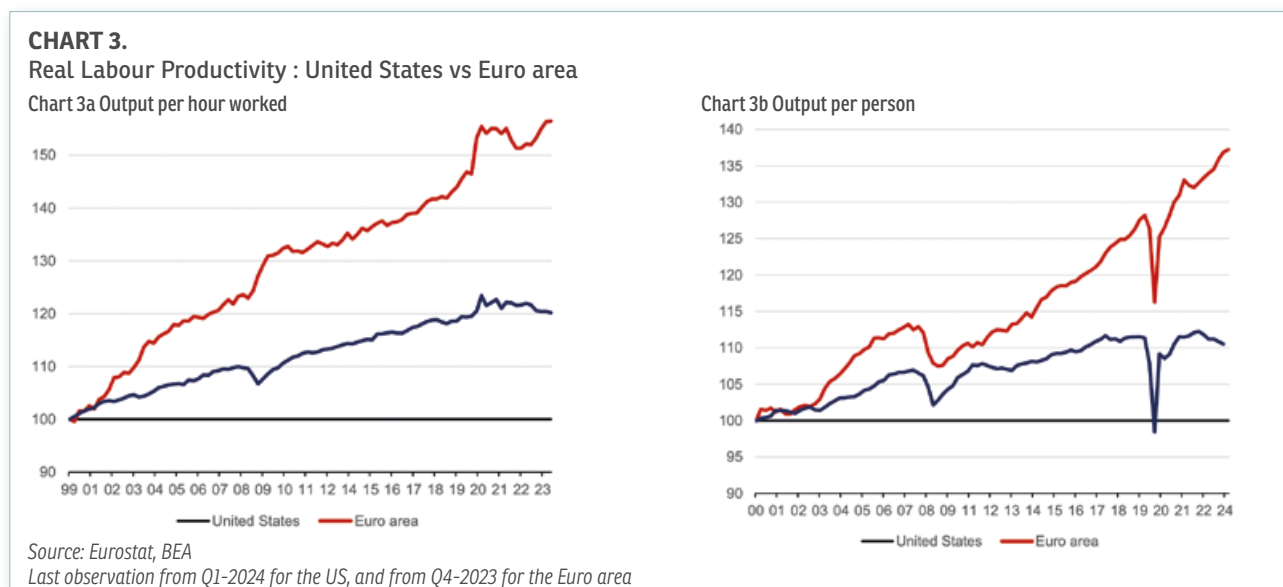
The gap is even larger when considering hourly productivity, which rose by 56.9% in the US, compared with only 18% in the Eurozone (see Chart 3.a). According to this metric, the level of productivity in the Euro area accounted for only 75% of that of the US in 2023.

1.1.3 European firms have underinvested in productive capacities relative to their US peers since 2008

The increasing gap between the EU and the US in terms of GDP and productivity growth is mainly attributed to European companies under-investing in productive assets compared to their US counterparts. Indeed, investment

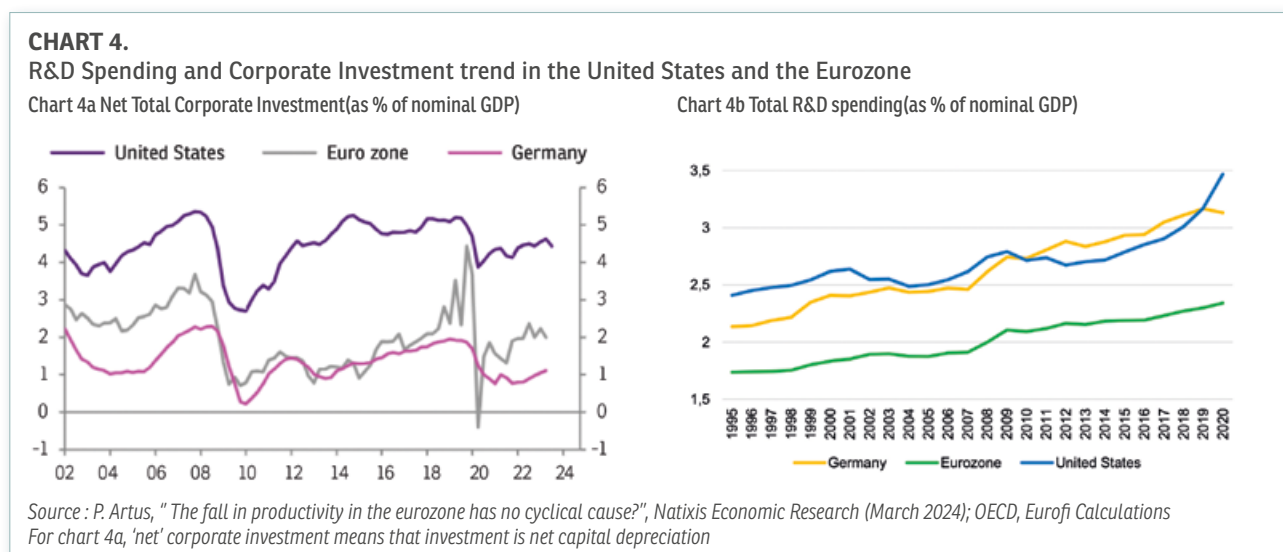
1. L. Subran & al. "Europe needs to step up its game: Lessons from the American playbook step up its game", Allianz Research (January 2024).

is the lifeblood of competitiveness and productivity. A report from McKinsey Global Institute² emphasizes that investment in capital, like machinery, accounts for 70 to 80% of productivity growth across regions. The remainder comes mainly from investment in R&D, human capital, and other intangible assets.



Adjusted for capital depreciation, the investment rate (investment/GDP) of European companies has always been between 1 to 1.5 points of GDP lower than in the US between 2000 and 2023 (see Chart 4.a). After the Global Financial Crisis, net investment³ in both the US and Europe fell significantly, but the decline was especially pronounced in Europe.

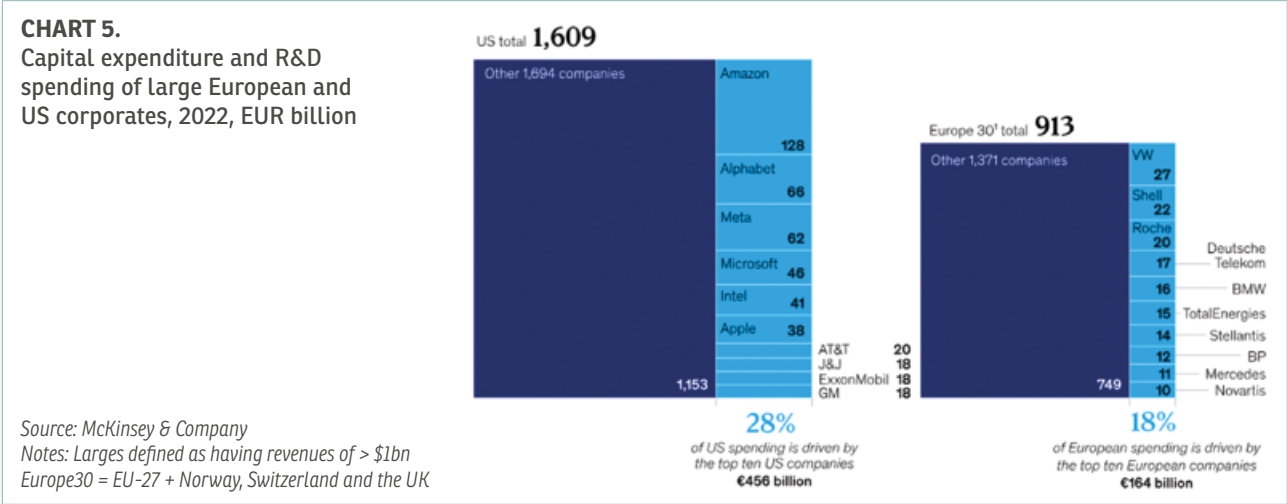
The quality of investment is also a major concern in the EU. As Business Europe⁴ shows, there is a clear gap between the two sides of the Atlantic in terms of investment rates in equipment from around 2010 onwards. The US has continuously outstripped the Euro area in R&D spending, and the gap widened in 2020, when it overtook Germany, the EU's powerhouse, for the first time since 2008 (see Chart 4.b). As reported by M. Arnold, S. Flemming & C. Jones⁵, the R&D spending of the so-called "Magnificent Seven" companies – Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla – amounted to more than \$200 bn in 2023, around half of Europe's total R&D spending across all private and public sectors. Similarly, the top ten US companies invest three times more than the top 10 European companies.



2. M. Giordano & al. "Investment: Taking the pulse of European competitiveness", McKinsey Global Institute (June 2024).
3. This Mc Kinsey research emphasizes net fixed capital formation (that is after subtracting depreciation and impairment of existing assets) rather than the commonly used gross numbers. This is because only net additions to the capital stock, not their replacement, drive capital deepening, productivity and wealth.
4. "Putting competitiveness at the forefront of the next political cycle", Business Europe (March 2024).
5. M. Arnold, S. Flemming & C. Jones, "Can Europe's economy ever hope to rival the US again?" Financial Times (May 2024).

As a result, US companies have taken a considerable lead in investment in intangible assets. According to Business Europe, the share of intangible investment in total value added has risen from 15.8% in 2006 to 20.2% in 2019 in the US, well above the EU level of 14.6% in 2019. Such “a striking gap in the real IT-related capital stock” between the two regions may have illustrated “Europe’s lost IT revolution” in recent years, as I. Schnabel pointed out in her February 2024 speech⁶. Slow technology diffusion is also a core reason why firms in Europe have failed to benefit from the IT revolution.

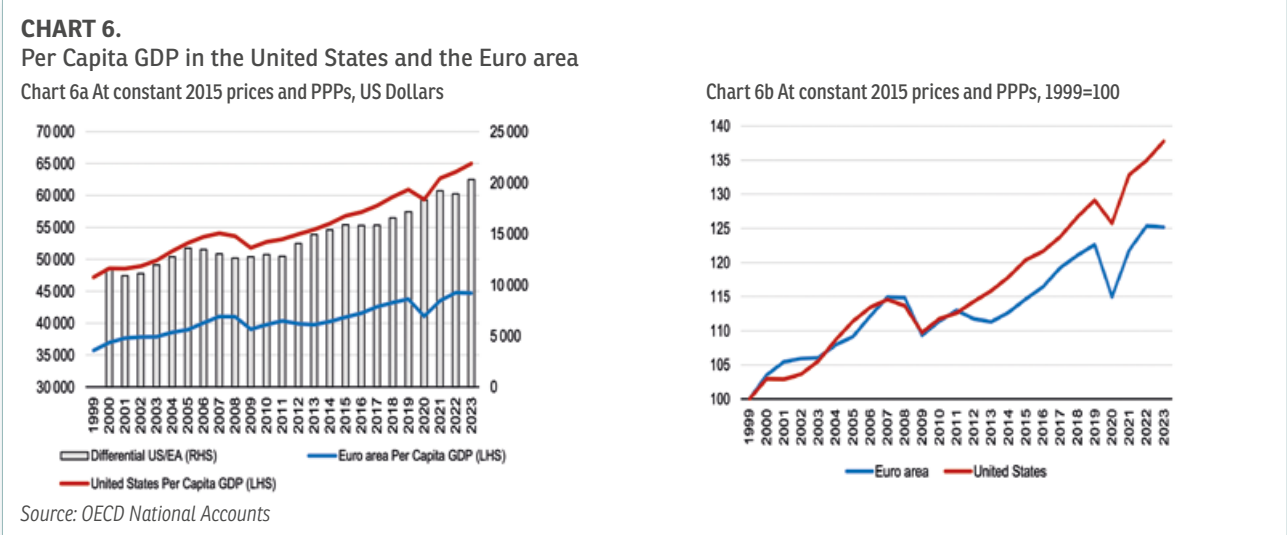
Large European firms invest €700 billion or about €3,000 per capita less than their US counterparts. The McKinsey report shows that “through a corporate rather than geographic lens, large US corporations (defined as having more than \$1 billion in revenue) devoted about €700 billion or €3,000 per capita more to capital expenditure and R&D than their European counterparts in 2022. US corporations increased their share of total investment by large European and US firms (capital expenditure and R&D) from 54% in 2010 to 64% in 2022.”



The report illustrates that this gap is evident in every sector except the materials and automotive sectors, but is particularly pronounced in technology, energy, and industrials, including semiconductors. Even in industrials, which is typically a European stronghold, US firms have higher capital expenditure.

1.1.4 Weak productivity gains in the Eurozone have had repercussions on the standard of living of European households, which has fallen sharply behind that of the United States since 2011

The gap in living standards between European and American households has almost doubled between 2011 and 2023. Until 2011, the real GDP per capita of European households was \$11,000 to \$12,000 lower than that of their US peers. The gap has only widened since 2011, pushing the Euro area GDP per capita to be \$17,000 lower than that of the US in 2019. The gap has further increased since the Covid-19 crisis, reaching \$20,000 in 2023.



6. I. Schnabel, “From laggard to leader? Closing the Euro area’s technology gap” Speech at the European University Institute (February 2024).

1.2 Unlike their European counterparts, US firms operate in a macroeconomic, financial and regulatory environment that is more favourable to investment and innovation

Most of the reasons for this transatlantic performance gap can be attributed to the differing business environments in which companies operate. Compared to their European peers, US corporates (I) operate in more flexible and less regulated markets; (II) benefit from cheaper and more stable energy prices; (III) face fewer recruitment difficulties, thanks to a younger, more dynamic and better-qualified workforce; (IV) produce on a large scale and can serve a large number of consumers, benefiting from a truly single domestic market; and (V) finance themselves more easily in larger, more liquid and deeper markets.

1.2.1 US firms operate in a more business-friendly environment, granting them greater freedom than their European counterparts

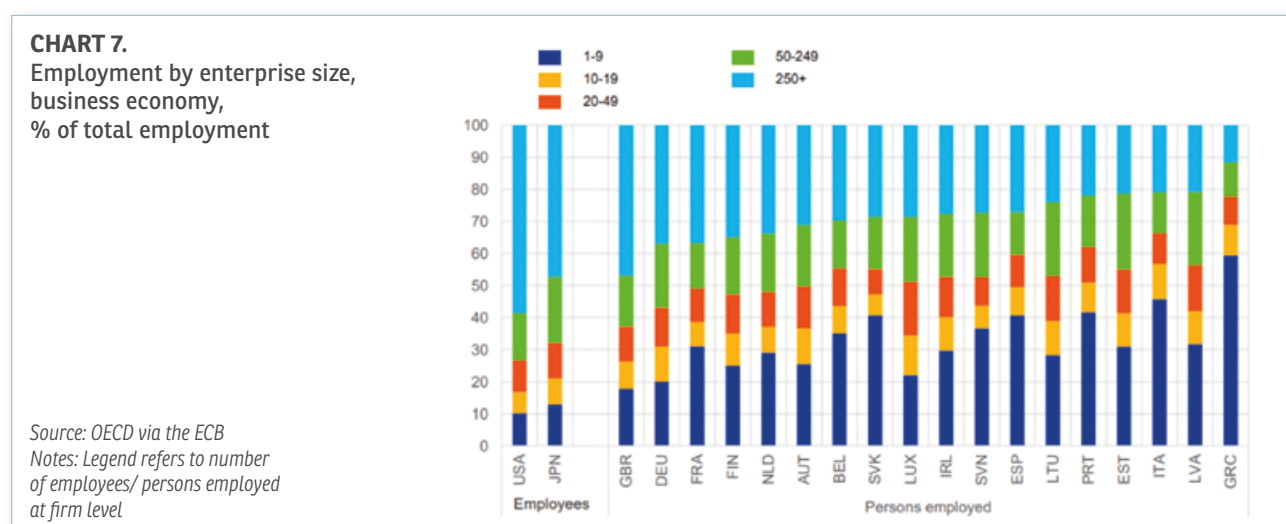
Products and the labour market in the Euro area often remain heavily regulated. Unlike the US, the EU imposes administrative burdens on creating new firms and expanding beyond arbitrary thresholds, triggering higher compliance costs.

Moreover, tax and social contributions are higher in Europe due to the generous welfare states and high social spending, which weighs on the competitiveness of European businesses.

The continual expansion of the public sector in some Eurozone countries, such as France, has led to an unwieldy and burdensome system. Sustaining this large public sector demands increasingly substantial financial resources, resulting in heavier tax burdens on both companies and individuals.

Higher administrative burdens may prevent younger firms from expanding. In France, for example, several labour laws only become binding when a firm exceeds the 50-employee threshold⁷.

While larger firms tend to invest more and be more productive, many European companies are too small and constrained by regulation to exploit new technologies to their full potential. As noted by I. Schnabel, companies with more than 250 employees account for almost 60% of private sector jobs in the US, but only 12% in Greece and 37% in Germany (see Chart 7).



Without the implementation of domestic structural reforms to address these supply-side hurdles (labour shortages, administrative & tax burden, high labour costs...) that weaken the competitiveness of European companies, the performance gap between the EU and the US is set to widen further in the long term.

1.2.2 US firms benefit from lower and more stable energy prices

Unlike the Eurozone, which is almost entirely dependent on energy imports, the US is a net exporter of energy. It became the world's largest oil and natural gas producer in 2018. The US oil supplies amounted to a fifth of the world supply in 2022 according to the EIA⁸.

7. See Garicano, L., Lelarge, C. and Van Reenen, J. (2016), "Firm Size Distortions and the Productivity Distribution: Evidence from France", *American Economic Review*, Vol. 106(11), pp. 3439-79.

8. Frequently Asked Questions (FAQs) – U.S. Energy Information Administration (EIA).

Being energy self-sufficient, the US has not been vulnerable to energy supply disruptions to the same extent as the EU following the war in Ukraine in 2022. In 2023, electricity prices in the industrial sector in the EU were almost three times as high as in the US and more than twice as in China.

1.2.3 US firms face fewer recruitment difficulties due to more favourable population dynamics

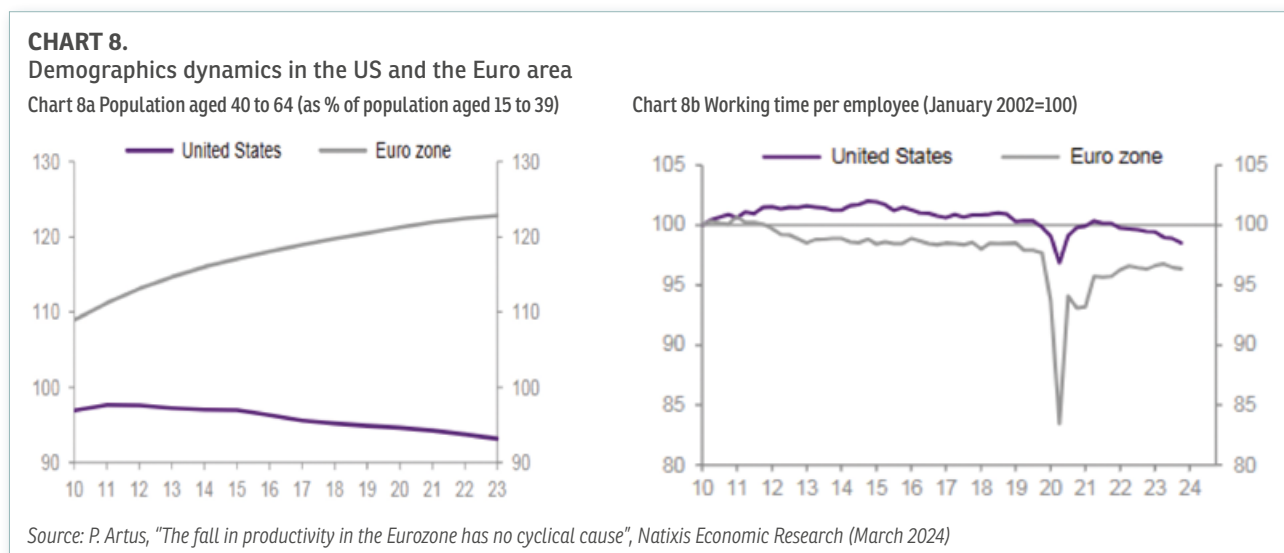
Demographics reflect both the quantity and quality of the workforce available to firms in the labour market. In both aspects, the US outperforms the EU. The US benefits from an abundant workforce, either measured by the size of the working-age population or the total number of hours worked. Additionally, employees in the US are better skilled and better aligned with companies' expectations.

Considering the size and the age structure of the workforce, the US population is younger and grows faster than the European one. The US working-age population – people aged 25 to 64 – increased from 127 million in 1990 to 175 million in 2022, a rise of 38%. In contrast, the EU's working-age population grew by only 9% during the same period, from 94 million to 102 million.

In the US, the old-age dependency ratio (the proportion of people aged 65 and above relative to the 20–64 segment of the population), is expected to increase from 31% in 2022 to 42% in 2050, while in the EU it is expected to reach more than 60% by mid-century.

The volume of worked hours is lower in the EU than in the US. As noted by A. Krammer, "European workers have shorter work weeks and retire earlier than in other regions". An average American works approximately 1,800 hours per year (36 hours per week with four weeks of vacation), roughly 200 hours more than a European, though 500 less than a Chinese⁹. The typical working day in the UK, France, and Germany is half an hour shorter than in the US, according to the International Labour Organisation.

In addition, American workers are better skilled. America is home to 11 of the world's 15 top-ranked universities and America's economy makes good use of its highly educated workforce. By comparison, the latest OECD PISA scores of EU Member States show that European students lag significantly behind compared to other G7 countries. The lack of skilled workers is also visible in the persistence of staff shortages. In 2023, over 46% of EU companies report difficulties in recruiting experts with specialist IT skills, according to Business Europe¹⁰.



1.2.4 Unlike the EU, the US has a genuine single market

The US benefits from a large consumer market at home and has many multinational companies around the world. Consequently, US businesses can be scaled up more quickly, as it offers a large market supporting innovation with a common language and regulatory system.

This contrasts with the EU, where companies operate in smaller, less integrated domestic markets. Linguistic, administrative, and cultural differences, heterogeneous bankruptcy laws and contractual conditions, as well as various regulatory barriers and protectionist policies, prevent banks and companies from easily operating across borders.

9. Figure quoted in The Economist's study on The American economy published on 17 April 2023.

10. Op. cite note 4.

Regarding product markets, a recent IMF study¹¹ indicates that a 10% reduction in existing barriers within the single market for goods and services could increase European output by 7 percentage points in the long term. This highlights the significant fragmentation in European goods markets.

Furthermore, labour mobility is weak in the EU. Indeed, H. Keith & T. Mayer¹² calculated that the cost of relocation between EU Member States is about 8 times higher than the one between American states.

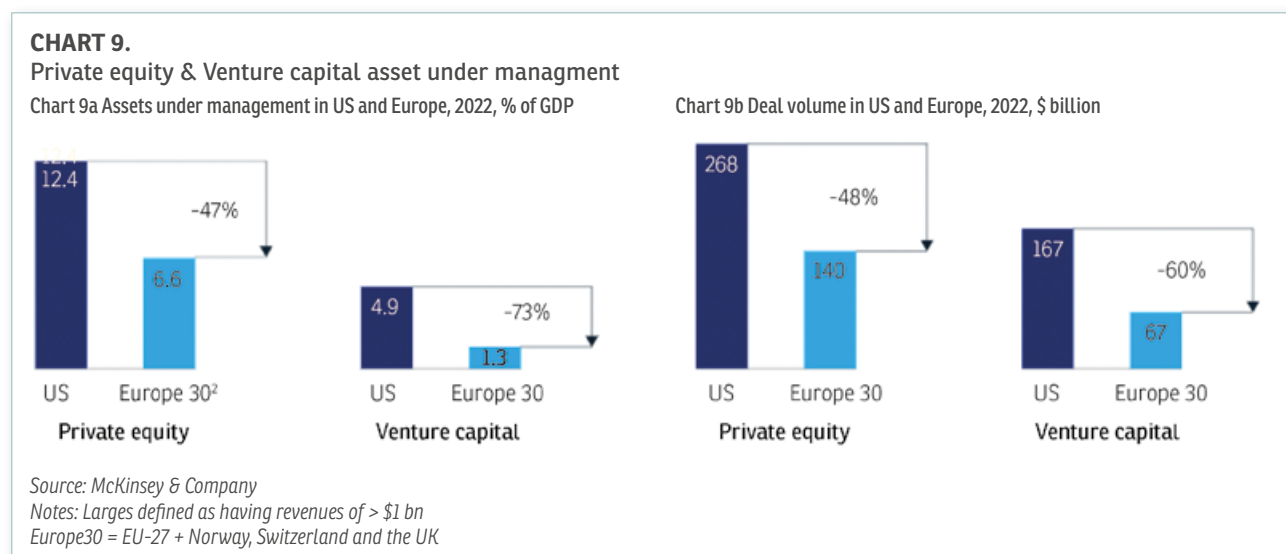
1.2.5 Despite abundant savings in Europe, financial markets in the US play a role three times more important in financing the economy compared to the EU

The US boasts the world's deepest and most liquid financial markets, providing efficient channels for financing businesses. The stock market capitalization in the US amounts to 170% of GDP; whereas in most other countries, it lies below 100%. Funding for potentially high-growth startups is particularly abundant, with about half of the world's venture capital being directed to American firms.

In AI alone, venture capital investment over the past decade has reached \$450 bn in the US, nearly 10 times that of the Eurozone or the UK, according to V. Romen & C. Smith¹³. Yet in 2023, Europe invested \$1.7 bn in gen AI, compared with \$23 bn in US venture capital (VC) and private equity (PE), according to McKinsey¹⁴. According to *the Economist*¹⁵, the market value of America's "Magnificent Seven" tech giants is about the same as the combined stock market capitalisation of the EU 27 Members.

In comparison, the EU only attracts 8% of the US level of venture capital investment, and EU start-ups receive less than half the funding of their US counterparts, which leads to many innovative companies being hit by funding constraints once they have entered the growth phase. As a result, Europe is lagging in the areas of robotics, big data, and artificial intelligence.

In Europe, VC undermanagement as a percentage of GDP is only about one-quarter of that in the United States. PE assets under management are half the level in the United States.



The lack of investment and innovation in the EU can be explained by three main reasons.

The first is **the structure of corporate financing**. In the EU, 75% of corporate borrowing comes from bank loans and 25% from bond markets, whereas in the US, the proportions are reversed. Banks are naturally reluctant to finance long-term investments due to the limits of their credit-granting capabilities based on short-term deposits. By contrast, market-based financing, particularly equity financing, is better suited for high-growth sectors such as digital and high-tech, where capital is mostly intangible. Unfortunately, this type of financing is very limited in Europe.

11. C. Baba & al., "Goeconomic Fragmentation: What's at Stake for the EU", IMF Working Paper (November 2023).

12. K. Head and T. Mayer, "The United States of Europe: A Gravity Model Evaluation of the Four Freedoms", *Journal of Economic Perspectives*, Spring 2021.

13. V. Romen & C. Smith, "How is the US economy managing to power ahead of Europe", *Financial Times*, 20 October 2023.

14. M. Giordanno & al., "Accelerating Europe: Competitiveness for a new era", McKinsey Global Institute (January 2024).

15. *The Economist*, "The American Economy", 17 April 2023.

The second is **the remuneration of private savings**. Unlike in the US, nominal long-term interest rates in Europe have remained negative for an extended period, as a result of the ECB's negative interest rate policy and asset purchase programs between 2014 and 2022. Inadequate returns on savings are detrimental to productive investment. As a result, economic agents prefer to allocate their savings towards liquid instruments rather than allocating them to the financing of innovative projects, given the insufficient return relative to the risk taken. As detailed in the Eurofi Monetary Scoreboard, outstanding liquid savings have been at a record high in the main European countries during the period of negative real interest rates.

In this context, and considering the principle of portfolio diversification, European savings are increasingly being diverted to overseas financial markets, where returns are more attractive. The ECB recently highlighted that €193 bn, the amount of the Euro area current account surplus, flows to the US each year. This flight of capital from Europe to the US is not surprising, given the difference in equity market returns between the two regions: between 1900 and 2020, the average annual nominal return on US equities was 9.6%, compared to 7.2% for Europe¹⁶.

The third reason is **the fragmentation of the European banking market**. This fragmentation stems from the lack of cross-border capital and liquidity fungibility within single banking groups due to compartmentalization practices by national supervisory authorities, from varied tax and insolvency regimes, and from different macro-prudential requirements. Additionally, as long as government deficits remain high, the link between sovereign debt and the banking sector cannot be broken.

The absence of a securitization market and the heterogeneity of regulatory frameworks across Member States are major impediments to the Capital Markets Union, which has seen very little progress over the past 25 years¹⁷. This heterogeneity affects securities regulation, investor protection, bankruptcy laws, tax procedures, market and entity supervision, accounting standards for SMEs, trading rules (including for short selling), and investment rules for institutional investors such as pension funds, insurance companies and mutual funds. It also affects listing requirements, including the languages used for prospectuses. Consequently, EU capital markets remain segmented along national borders, with institutional investors displaying a significant home bias.

1.2.6 Several major EU policy shortcomings contribute to explaining its lagging behind the US

The introduction of the Euro in 1999 was intended to unify and strengthen the European economy. However, the economic performance of the Eurozone has not lived up to expectations especially when compared to the robust growth observed in the US. As detailed above, several indicators illustrate this growing chasm: real GDP growth rates, labour productivity, and levels of corporate investment. The US has consistently outperformed the EU in these areas, leading to a significant shift in global economic power.

As global competition intensifies, the EU's relative decline in economic performance has broader implications. It affects not only the prosperity of European nations but also their influence on global economic policy and their ability to respond to future economic challenges. Understanding the causes of this lag is essential for policymakers invested in bridging this gap and ensuring sustainable economic growth for the EU in the decades to come.

I. The EU Commission faces significant challenges in coordinating economic policies across Member States within the Eurozone.

Despite the introduction of mechanisms like the Stability and Growth Pact (SGP), the Six Pack, and the Two Pack, effective economic governance remains elusive. These frameworks were designed to enforce fiscal discipline and enhance economic surveillance, yet their implementation has often been inconsistent and slow to adapt to crises.

II. The EU's competition policy, focused on preventing market dominance and state aid, has inadvertently stifled the development of European champions capable of competing globally.

The EU's competition policy framework emphasizes maintaining a level playing field within the internal market, often at the expense of fostering large, competitive firms that can scale up internationally. This approach contrasts sharply with the US, where regulatory frameworks are more supportive of mergers and acquisitions that create globally competitive firms. For example, American tech giants like Apple, Amazon, Microsoft, and Google have benefited from a more permissive regulatory environment, allowing them to dominate global markets. By contrast, the EU has blocked several high-profile mergers, such as the proposed merger between Siemens and Alstom, citing competition concerns. This policy stance prevents the consolidation needed to build firms capable of competing with their American and Asian counterparts.

16. See Hung Tran, "The Enrico Letta Report and the state of the EU's Capital Market Union", *Econographics*, Atlantic Council (May 2024).

17. With the exception of the initiative chaired by Alberto Giovannini's group.

III. The EU's lack of a cohesive industrial policy has left it vulnerable to the protectionist measures of other major economies, such as the US and China.

While the US and China have aggressively supported their domestic industries through subsidies, tariffs, and strategic investments, the EU has been slower to respond.

The EU needs to adopt a more strategic industrial policy that promotes key sectors like technology, renewable energy, and advanced manufacturing. This policy should include targeted investments, research and development funding, and measures aimed at protecting critical industries from foreign competition. The recent introduction of the Digital Strategy is a step in the right direction, but more comprehensive and aggressive policies are needed to ensure the EU remains competitive.

IV. The community resources available are furthermore difficult to spend and slow to produce effects in the countries that benefit most from them.

The Next Generation EU (NGEU) fund, designed to support economic recovery post-Covid-19, has collected significant financial resources comparable to those in the US. However, the bureaucratic complexities and slow disbursement processes have hindered its effectiveness. Countries like Italy and Spain, which are among the largest beneficiaries, have faced difficulties in effectively utilizing these funds due to administrative bottlenecks and stringent compliance requirements.

NGEU aims to promote the digital and green transitions, but the impact on productivity and investment has been limited so far. Streamlining the application and approval processes, along with better coordination at the national and EU levels, could enhance the effectiveness of these funds.

1.2.7 The decline in European economic competitiveness has been accompanied by a significant loss of competitiveness among EU financial players compared to their US and Asian counterparts

The decline of the European banking industry has been particularly pronounced, reflecting broader challenges faced by the EU in maintaining its competitive edge in the global financial sector. As Chart 10 below shows:

- I. European banks' share of global market capitalization has fallen significantly. In 2009, European banks accounted for 34% of global market capitalization, but by 2022, this share had plummeted to 17.5%. By contrast, US banks have increased their share from 23% to 34% over the same period¹⁸. This shift highlights the growing dominance of US financial institutions and the declining global influence of European banks.
- II. The EU's share of global capital markets has also decreased sharply. In the last 16 years, this share has fallen from 18% to just 10%. This decline is partly due to the more dynamic and better-integrated financial markets in the US and Asia, which offer more attractive conditions for investment and growth.
- III. The European asset management sector has experienced an even steeper decline. In 2007, European asset managers accounted for 47% of global funds, and US managers for 51%. By 2022, the European figure had dropped to just 22%, compared to 70% for US funds. Only two European asset managers (Amundi and Natixis) are among the world's top 20.
- IV. The EU's share of the global insurance market has fallen from 37% in 2010 to 26% in 2020. Meanwhile, the US's market share has risen from 32% to 45%. This shift highlights the stronger growth and resilience of the US insurance industry compared to its European counterpart.
- V. In the payments market, American players (Visa, Master Card, Paypal, Apple Pay, Google Pay) dominate in most European countries. This dominance not only reflects the technological superiority of these companies but also highlights the lack of competitive European alternatives. The reliance on American payment systems raises concerns about strategic dependencies and the ability of European firms to innovate and compete in this critical sector.

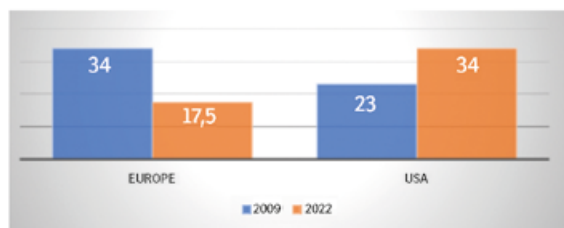
The decline in the competitiveness of European financial players reflects broader structural and regulatory challenges within the EU. Addressing these issues will require significant policy shifts, greater integration of financial markets, and a more supportive regulatory environment to enable European banks and financial institutions to compete effectively on the global stage. Without these changes, the gap between the EU and its global competitors is likely to widen further, affecting the overall economic performance of the region.

¹⁸. Europe's leading bank BNP Paribas had a market cap of around \$70 bn in 2022. JPMorgan Chase, the US leader, was worth more than \$400 bn. The market capitalization of the 4 largest European banks was about half that of JP Morgan in 2022. Scale is not everything of course. Profitability and efficiency are also vital considerations. But for profit, scale gives the biggest banks a huge competitive advantage. Take the issue of technology – arguably the battleground of the future of financial services. Bank of America spends more than \$10 bn a year on maintaining and building its technology. That's almost double the profits made in 2022 Societe Generale.

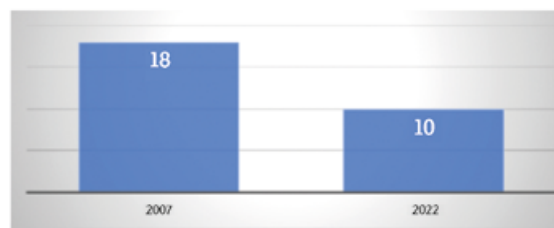
CHART 10.

European financial sector relative to the US and the rest of the world

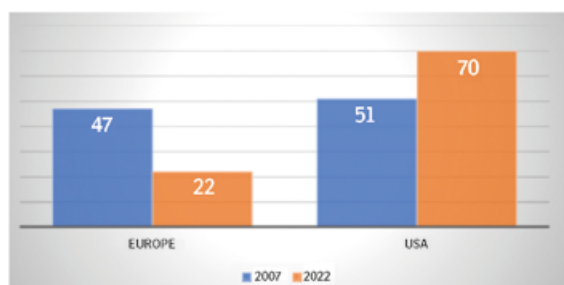
Share of market capitalisation of banks in the world (%)



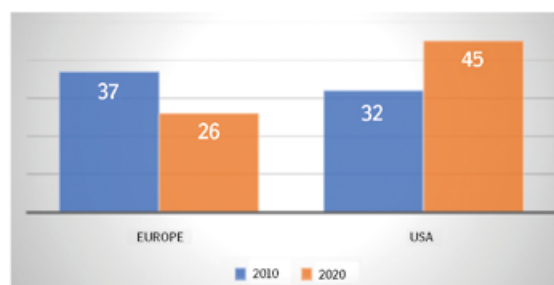
Europe's share in global capital markets (%)



Global funds market share (%)



Share of the global insurance market (%)



Sources: *Competitiveness of European financial services, Luxembourg Finance, January 2024.*
"L'autonomie stratégique passe par l'Union des Marchés de Capitaux", Fabrice Demarigny, January 2024

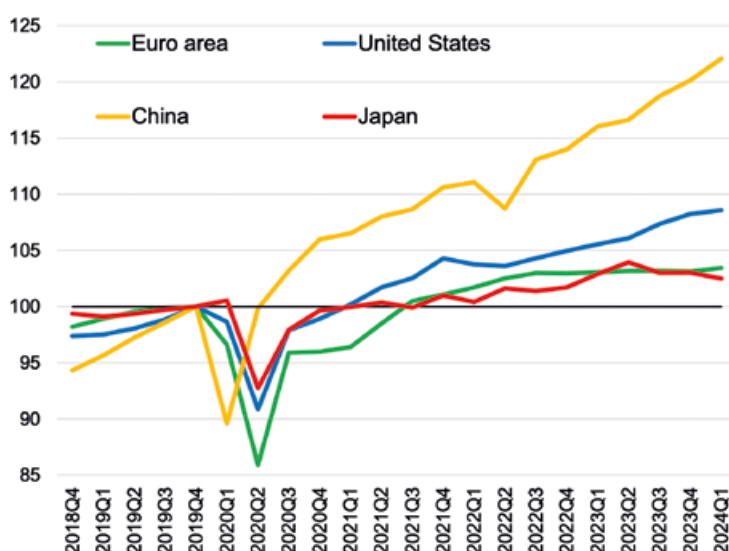
1.3 The consequences of the Covid-19 pandemic and the energy crises have been more severe in Europe than in the US, China, and Japan

1.3.1 In 2020, the Euro area suffered the largest GDP contraction among advanced economies

In 2020, the Eurozone GDP fell by 6.1%, almost three times more than that of the US (-2.2%). Japan (-4.4%) also experienced a smaller output fall than the Eurozone, and China even recorded a 2.2% rise in GDP.

CHART 11.

Real GDP growth, 2019-Q4=100

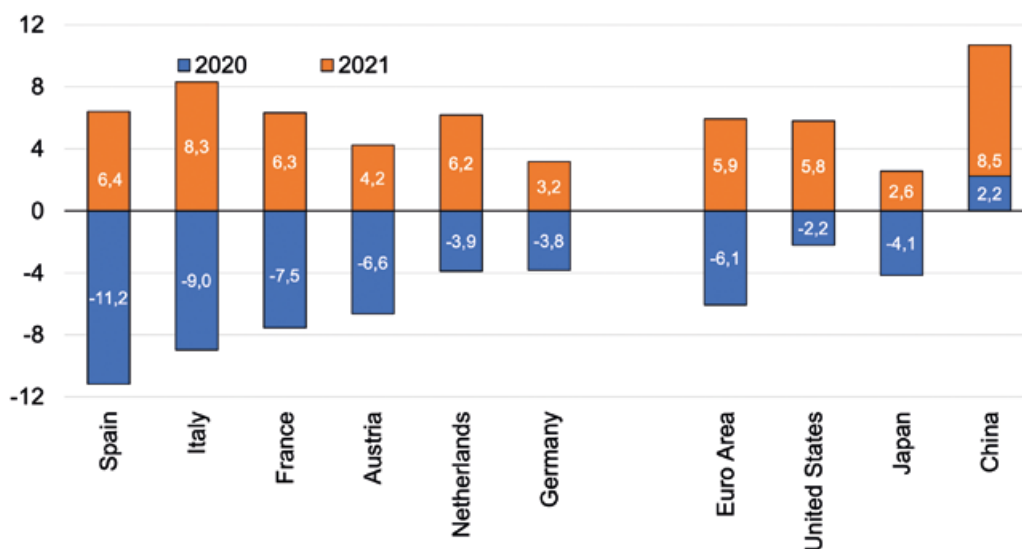


Sources: OECD, Eurostat
 Last observation = 2024-Q1

1.3.2 In 2021, Europe recovered at a slower pace than the United States and China

The real GDP growth of 5.9% in the Eurozone slightly outpaced that of the US (+5.8%) in 2021. However, this performance was insufficient to bring GDP back to its pre-pandemic level: at the end of 2021, the Eurozone's GDP was 0.5 percentage points below its 2019 level, while it was 3.4 pp above in the US.

CHART 12.
Real GDP Growth,
Annual Change



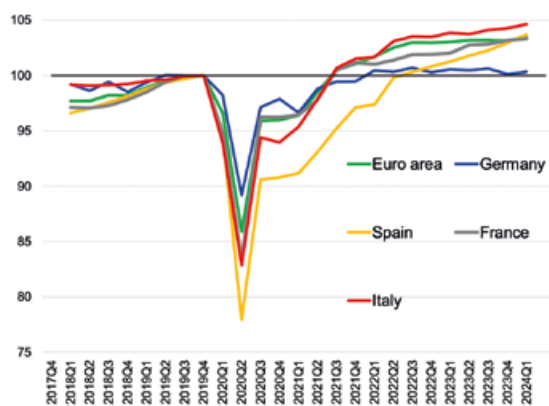
Sources: IMF, Eurostat

Recovery among Member States has been uneven. Most of them experienced a fast rebound in 2021, notably France, the Netherlands and Belgium whose real quarterly GDP already exceeded their pre-pandemic levels as of the fourth quarter of 2021 (see Chart 13).

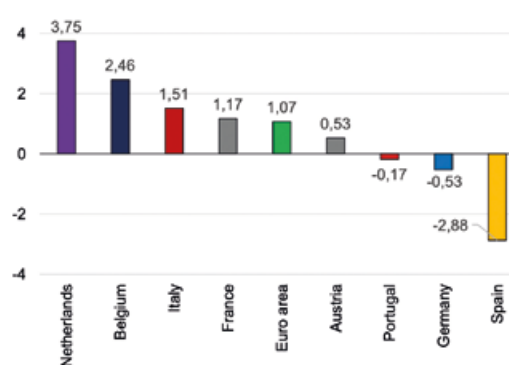
Sixteen Euro area Member States returned to pre-pandemic quarterly levels of output by the end of 2021. However, by the last quarter of 2021, the output of three Member States, namely Germany, Spain and Portugal, had not reached pre-pandemic levels from the fourth quarter of 2019.

CHART 13.
Real GDP Growth in Selected EU Member States

13a Real GDP Growth Trend, 2019-Q4 = 100



13b Distance with 2019-Q4 GDP as of 2021-Q4, percentage points



Source: Eurostat

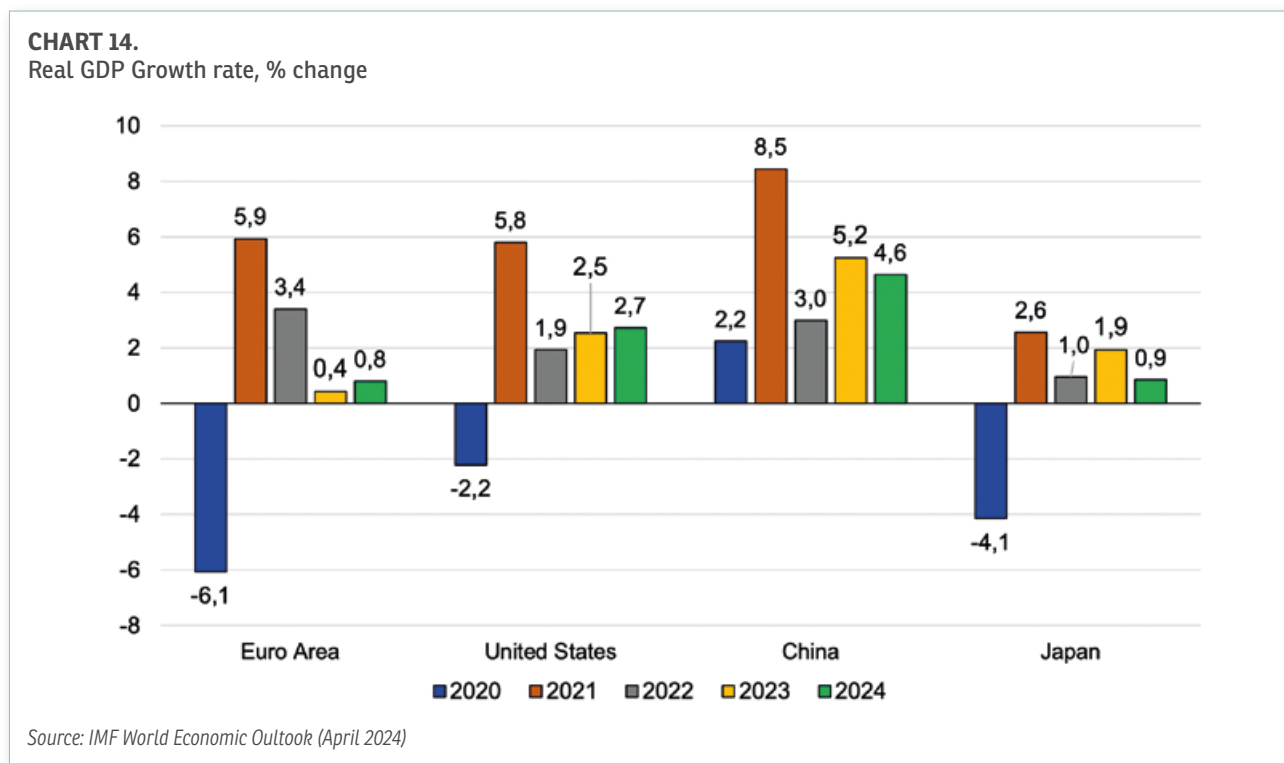
1.3.3 The economic impact of the war in Ukraine has been more damaging in Europe than in the United States or China

According to the IMF, the Eurozone real GDP grew by 3.4% in 2022, compared to 1.9% in the US, and 3% in China (see Chart 14).

The resilience of the European economy to the 2022 energy shock is partly due to the significant resort to public spending. Indeed, the recovery coincided with high fiscal deficits across Member States (see Part 3), which mainly helped to support consumer spending.

In 2023, economic activity broadly stagnated in the Euro area, with real GDP growing by 0.4%, which is five times less than the US, whose GDP grew by 2.1%.

For 2024, the IMF forecasts a slight rebound in Eurozone growth, reaching 0.7%, which would still fall behind the US growth rate of 2.7%.



1.3.4 Unlike the United States, which is energy independent, Europe has been hit hard by the rise in energy prices in 2022

The war in Ukraine created another negative supply shock for the world economy, particularly impacting Europe.

The major difference between the United States and the Euro area is that the former produces its energy, whereas the latter has to import it. Therefore, as opposed to Europe, the United States benefits from an external trade surplus for energy (see Chart 15).

The energy crisis has widened the competitiveness gap between Europe and the US for at least two reasons: (I) gas prices have remained higher and more volatile in Europe, whereas they have rapidly returned to pre-war levels in the US; (II) Europe has replaced its gas and oil imports from Russia with more expensive imports, partly from the United States. This transfer of wealth has resulted in a widening of Europe's energy balance deficit with the United States.

Dependence on energy imports has been very costly for the Euro area in 2022: higher energy prices led to a deterioration in its terms of trade, which accounted for 1.9% of GDP for 2022 as a whole. As a net energy exporter since 2019, the US did not suffer from the economic consequences of the energy shock, as illustrated by the virtually unchanged level of its terms of trade during this period (see Chart 15.b).

The United States comes out as a winner of the EU's ban on Russian gas imports. While the Eurozone imported nearly annually €230 billion worth of energy products from Russia in 2019, the value of these imports has significantly decreased since 2022, reaching €52 bn in March 2024. The United States has greatly benefited from this reallocation: before 2019, annual energy imports from the US were worth no more than €30 billion; they have been exceeding €150 bn per year since 2022 (see Chart 16).

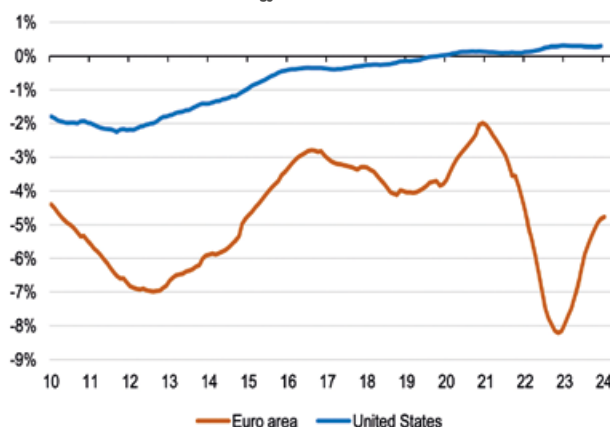
Indeed, the United States has become the leading supplier of gas to the Old Continent. Europe purchased nearly 64% of US exports of Liquefied Natural Gas (LNG) in 2022, compared to 34% in 2021, according to the US Energy Information Administration¹⁹. In September 2023, Europe remained the main buyer of US LNG, still accounting for 60% of all US LNG exports according to Reuters²⁰.

19. "Europe was the main destination for U.S. LNG exports in 2022", Report from the US Energy Information Administration (March 2023).

20. US October LNG exports climb to second highest level on record | Reuters.

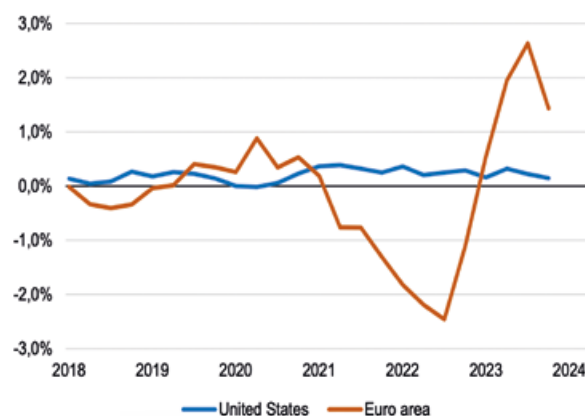
CHART 15.
Energy dependance and terms of trade

Chart 15a Trade balance in energy (as % of nominal GDP)



Sources : Eurostat, US Energy Information Administration
Notes : balances are expressed as 12-month sum;
Last observation from March 2024

Chart 15b Income effect of the terms-of-trade shock: Euro area versus United States (impact on year-on-year GDP growth in percentage points)

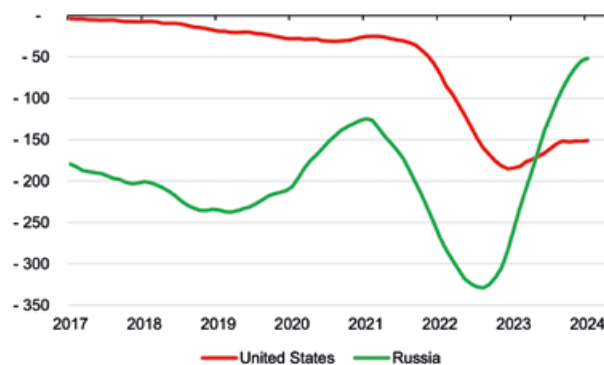


Sources: Eurostat, US Bureau of Economic Analysis
Notes: The income effect of terms of trade is calculated by weighting export and import price changes by their respective past values (one-year lag) and is expressed as a percentage share of GDP. The latest observations are from March 2024

Another advantage in favour of the United States is its low and stable price of gas compared to Europe. While they were roughly similar in 2019, gas prices in the two regions have diverged sharply since early 2021 (see Chart 17): in August 2022, when European gas prices peaked at 70 USD/ MMBtu²¹, US gas prices were 8 times lower, at 8.5 USD/ MMBtu.

Despite the fall in the price of energy since the end of 2022, it is still higher than in the past in Europe and much higher than in the United States: between March 2023 and May 2024, European gas prices averaged 10.9 USD/ MMBtu, more than twice their 2019 level (4.71 USD/MMBtu), and nearly four times higher than the US level (2.34 USD/MMBtu).

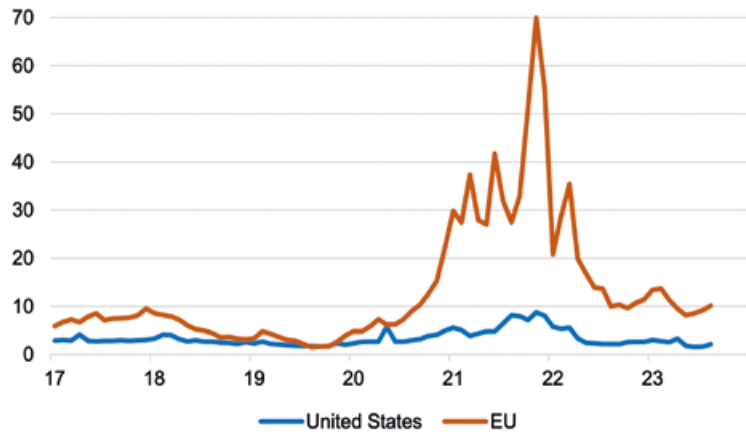
CHART 16.
Euro area's Trade balance in energy with Russia and the United States, € bn (12-month sum)



Sources: Eurostat
Last observation from March 2024

21. To compare the European TTF gas price - denominated in euro per megawatt-hour – with the US price, it should be converted into dollars per million British thermal units (MMBtu).

CHART 17.
Natural gas prices (US Dollars per Million British Thermal Unit)



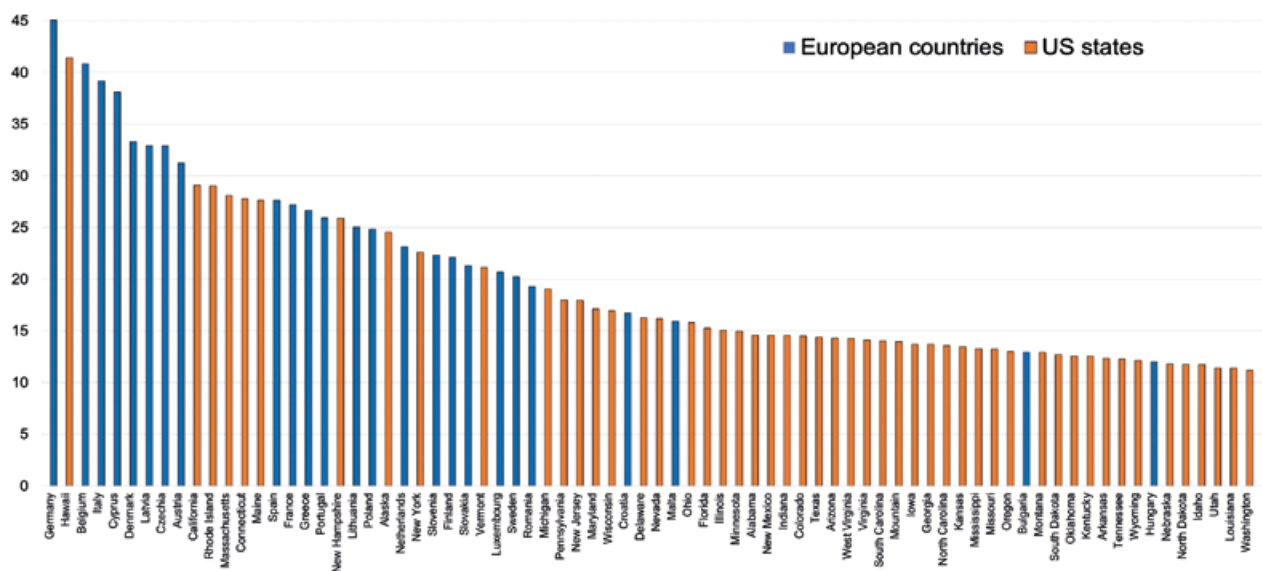
Sources: IMF, EIA
Last Observation from May 2024

Another illustration of the difference in energy costs between the two regions lies in the price of electricity paid by consumers. In the second half of 2024, one kilowatt-hour (kWh) of electricity paid by a European household costs 30.8 US cents (28.5 EUR cents), twice as much as in the US (16US cents).

Nevertheless, the two prices are calculated as global averages of several countries or federal states, potentially masking some heterogeneities across jurisdictions in terms of energy mix and consumption. Comparing the 27 EU Member States with the 50 US states (see Chart 15), one observes that European countries have higher overall retail electricity prices than the US states: at 45 ¢/kWh, the price of electricity in Germany, the highest in Europe, is 4 cents higher than in Hawaii (41 ¢), the US state with the highest electricity prices. Belgium (40.8 ¢), Italy (39.2 ¢) and Austria (31.2 ¢) have higher prices than California and the other 48 US states.

Thanks to nuclear power, France benefits from relatively lower prices, averaging 27.2 ¢/kWh in the first half of 2024. Still, it remains higher than 44 American states, including New York (22.6 ¢), Texas (14.4 ¢) and Nebraska (11.8 ¢).

CHART 18.
Average residential electricity prices across European and US Federal States in the first half 2023, \$ cents/kWh



Sources: Eurostat, EIA

This difference in price levels is sufficiently high to be detrimental to the competitiveness of the European industry and to foster a movement of relocation of energy-intensive companies (chemicals, fertilizers, etc.) to countries where energy is cheaper, such as the United States, especially with the implementation of the Inflation Reduction Act (see Part 6).

2. Economic and fiscal divergences have widened across Member States since the creation of the euro

So far, the euro has certainly been a success. It has become the second international currency after the dollar and has enjoyed a high and constant level of support from Europe's people since its introduction. In 1999, the euro became the single currency of a vast economic entity whose market of 350 million inhabitants is one of the largest in the world. This has allowed an intensification of trade within the zone and has been an important contributor to trade integration through the elimination of exchange rate risk. It has also reduced the costs of intra-zone transactions.

However, the single currency was designed without a common economic policy, and the last 25 years have been marked by increasing heterogeneity in the economic and social policies pursued by the Member States, and the failure of large Member States to comply with the rules of the Stability and Growth Pact. Furthermore, the European Commission has proved to be powerless in enforcing the rules of the Stability and Growth Pact due to a lack of leadership, which the Council is struggling to accept.

In such a context, economic disparities among the Member States of the monetary union have significantly widened since the euro's creation. This chapter delves into the growing gaps in productivity, economic growth, per capita income, public debt levels, and current account imbalances among Eurozone Member States over the past 25 years. Eliminating exchange rate risk and advancing toward a single market enabled countries that joined the monetary union to exploit their comparative advantages. This however increased the heterogeneity in productive specialization of Eurozone countries and led to divergent living standards between Euro area countries.

Cross-border capital flows between EU Member States have not recovered since the European Sovereign Debt Crisis, with excess savings in countries like Germany and the Netherlands no longer financing investment projects in lower GDP per capita Member States.

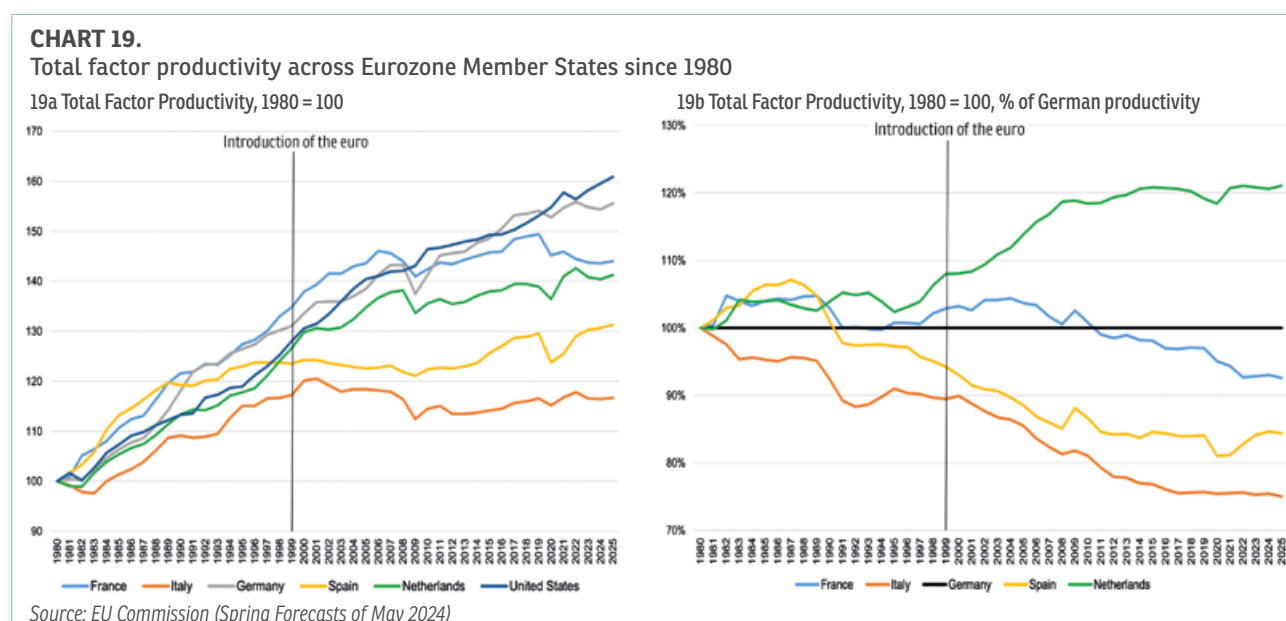
As a consequence, Target 2 imbalances have been on the rise since 2015. Today, they reflect differences in Europe's financial markets more than market tensions, interbank market fragmentation, or capital flight.

2.1 Divergences in terms of productive performance among the Eurozone Member States have been increasing since the late 1990s

2.1.1 From 1980 to the late 1990s, total factor productivity gaps between Germany and other Eurozone countries remained relatively contained

During this period, the countries participating in the European Monetary System achieved a degree of economic convergence. Indeed, the Charts 19.a and b highlight that:

- France and Germany exhibited similar productivity growth rates, which were higher than those of the United States.
- In Spain: TFP's level fluctuated between -5% and +5% relative to Germany.
- In Italy, TFP's level was consistently about 10% lower than in Germany.



2.1.2 Since the introduction of the euro, there has been a striking coincidence: the productivity gap between EU countries has widened considerably

Since 1999, the productivity gap between EU countries has widened markedly, notably compared to Germany and the Netherlands.

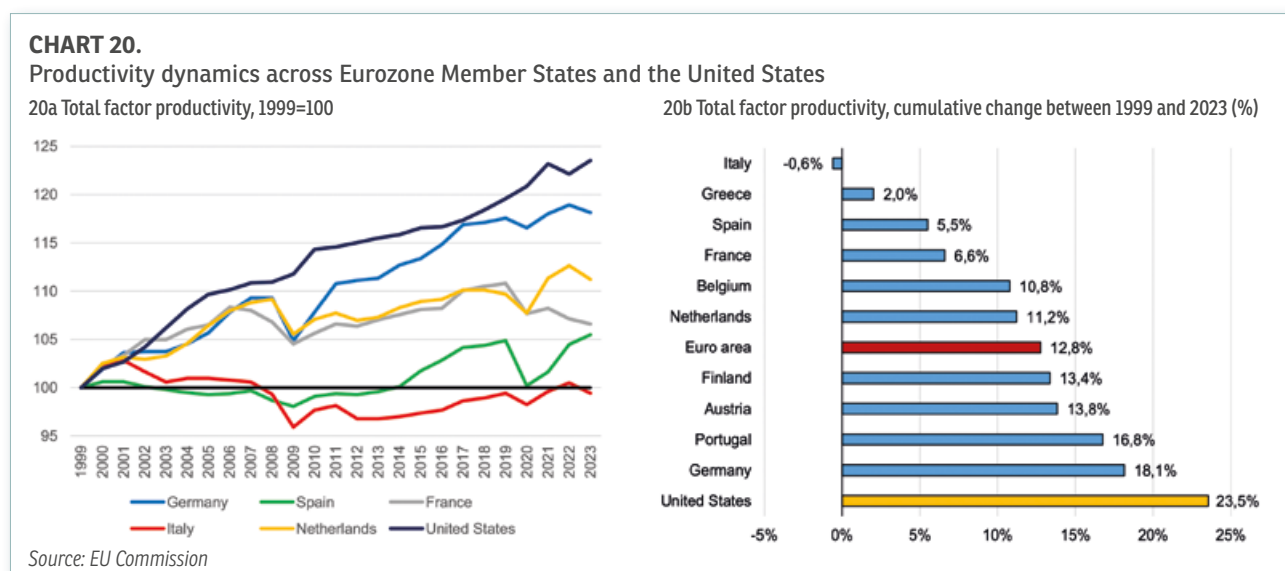
Productivity growth has been three times higher in Germany than in Spain. Indeed, TFP in Germany has grown at an average annual rate of 0.7% over the past 25 years while it has stagnated in Spain with a mere 0.2% average annual growth. TFP has declined at an average annual rate of -0.6% in Italy in the same period.

As a result, productivity gaps have widened considerably across Member States. In 1999, Italian and Spanish productivity levels were respectively 89% and 94% of the German's level. By 2023, these figures had dropped to 75% for Italy and 85% for Spain.

In France TFP growth has been half the rate of the Eurozone average since the launch of the euro. Initially outpacing Germany, TFP in France grew faster until 2010. However, the trend reversed, resulting in an uninterrupted deterioration, and by 2023, French productivity was 7% lower than that of Germany, compared to 2% higher in 1999.

TFP in the Netherlands consistently outperformed Germany since 1980, Dutch productivity was 8% higher than the German one in 1999 and surged to 21% higher by 2023.

Portugal stands out among Southern countries with a notable cumulative productivity performance of 16.8% between 1999 and 2023, attributed to fiscal consolidation and structural reforms implemented since 2012.



2.2 Since 1999, the Eurozone has been marked by substantial disparities in terms of economic and fiscal performances

Over the past two decades, the dynamics of real GDP growth and public debt and per capita GDP have become increasingly heterogeneous among Eurozone Member States.

2.2.1 Differentiated Economic Growth in the Eurozone

Real GDP growth over the past 25 years reveals three distinct groups (see Chart 18):

- "Lagging" countries: Greece and Italy, with around 10% growth cumulatively.
- "Intermediate" countries: Germany, France, Austria, and Finland, with 30-40% growth.
- "High growth" countries: Netherlands, Spain, and Belgium, each with over 40% growth. However, these nations still grew 10-15 percentage points less than the United States (+63.6%).

However, the performance of the Spanish growth deserves comments:

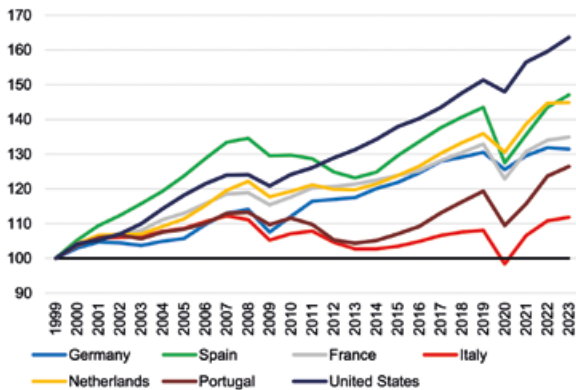
- 2000-2008: As A.-V. Robert notes, low real interest rates in Southern European countries (Greece, Spain, Portugal, Italy) encouraged borrowing. In Spain in particular, this led to a speculative bubble in real estate

and financial assets, due to a lack of productive investment opportunities driven by stagnant productivity. The development of this bubble has been to the detriment of increased productive investment, reinforcing the slowdown in productivity gains during this period.

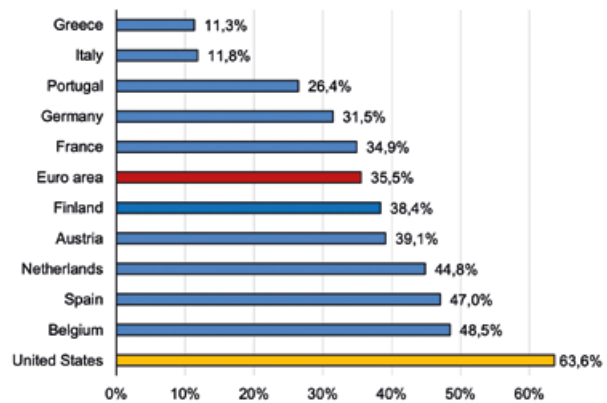
- 2012-2023: Spain's economic performance was buoyed by the tertiary sector, notably tourism, which involves low-skilled and low-value-added jobs. Productivity gains were minimal, with total factor productivity increasing by only 5.5% from 1999 to 2023, one of the lowest in the Eurozone.

CHART 21.
Real GDP growth dynamics across eurozone Member States and the United States

21a Real GDP trends, 1999=100



21b Real GDP trends, cumulative change between 1999 and 2023 (%)



Source: EU Commission

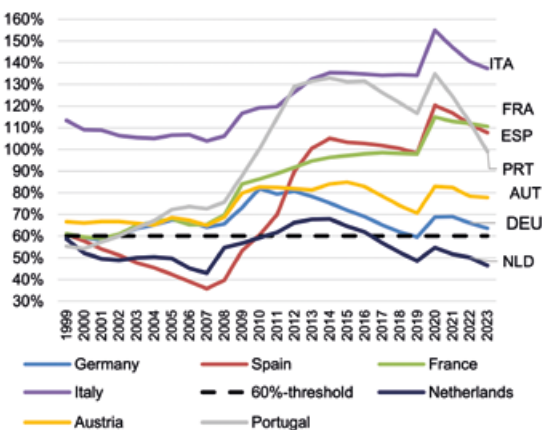
2.2.2 Developments in the public debt-to-GDP ratio reflect economic divergences between the main EMU countries and insufficient coordination of economic policies within the Euro area

In 2000, France, Spain, and Germany had similar levels of public debt, close to the 60%-Maastricht threshold, with ratios of 59.5%, 57.8%, and 59.3% of GDP, respectively.

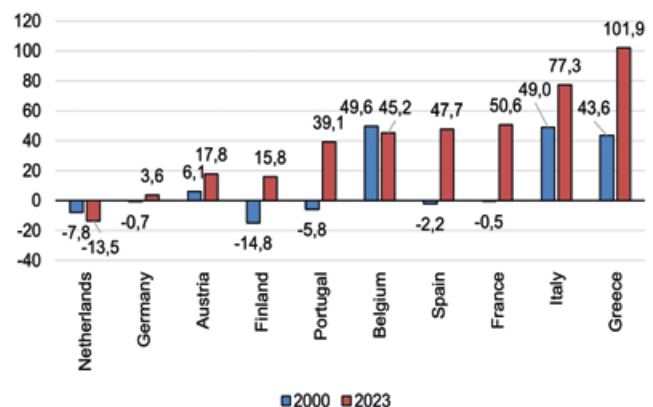
By 2023, the situation had dramatically changed: Germany maintained a relatively stable debt level at 63.6% of GDP. By contrast, public debt in France surged to 110.6% of GDP, exceeding the 60%-threshold by 50.6 points. In Spain, the public debt to GDP ratio rose to 107.7% of GDP in 2023, 47.7 points above the threshold. Italy joined the Eurozone with a government debt ratio of 109% of GDP. By 2023, this had increased to 137.3%, 77.3 points above the Maastricht Treaty threshold.

CHART 22.
Gross public debt across Member States

22a Gross Public Debt, % of GDP



22b Deviation from 60%-threshold (pts%)



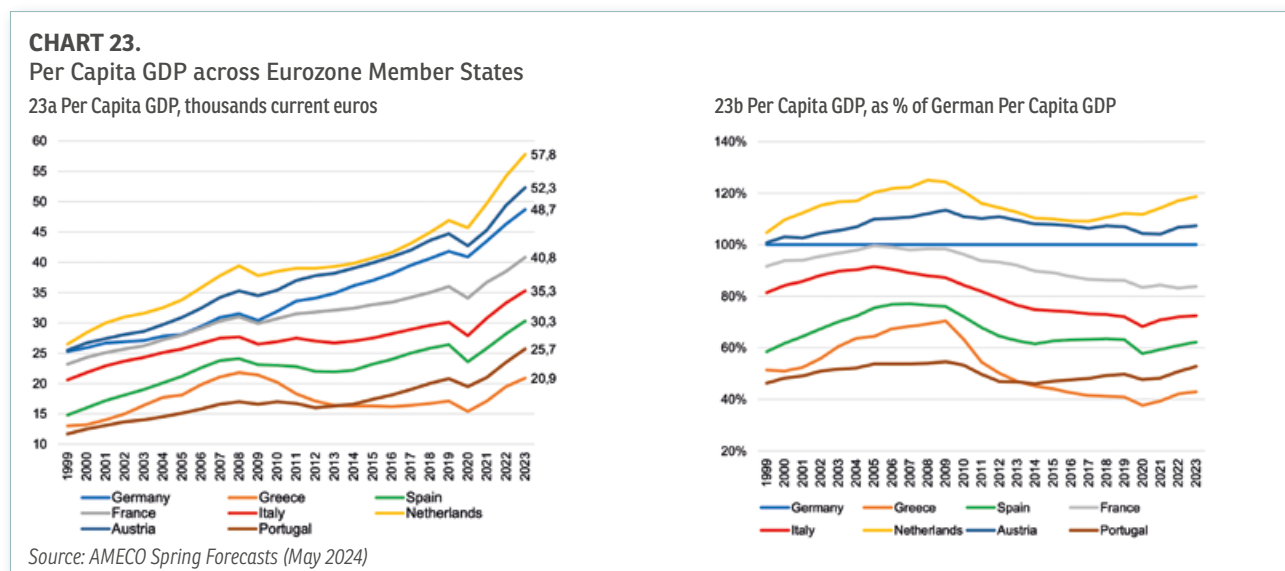
Source: EU Commission (Spring Forecasts of May 2024)

Lecture (Chart 22b): While France's public debt ratio was just below the 60% threshold in 2000, it is now 50.6 points above the Maastricht standard for 2023

2.2.3 Divergent Per Capita Income Growth (2000-2024)

GDP per capita has grown in all Eurozone countries since 1999, with more rapid growth in Northern Europe compared to the South:

- Italy: €20,600 (1999) to €35,300 (2023).
- Germany: €25,300 (1999) to €48,700 (2023).
- The Netherlands and Austria: Experienced stronger GDP per capita growth than Germany between 1999 and 2023.
- In 2004, France's GDP per capita was equal to that of Germany. However, by 2023, French GDP per capita was only 83.5% of Germany's, highlighting a significant divergence.



With such disparities in GDP per capita among its Member States, the Eurozone is significantly more heterogeneous than the United States. In the US, the per capita income of the poorest state is nearly 80% of the national average. By contrast, in Europe, eight countries have an income per capita below 80% of the EU average²².

The divergence in living standards in Europe was masked by the real estate boom of the first years of the euro (1999 to 2008). After the 2008 Global Financial Crisis, the single currency masked this divergence, providing southern European countries a relatively strong currency that did not penalize, through its depreciation, the fall in their productivity that would normally be reflected in a lower exchange rate.

2.3 The elimination of the exchange rate risk in the monetary union and progress toward the single market have increased the heterogeneity of productive specialization, particularly benefiting competitive Northern European countries

The euro has strengthened the more industrialized countries, at the detriment of those experiencing deeper industrial decline. Achieving the European single market is an essential objective, but the progress made in recent years has not remedy to the heterogeneity of economic performance of all Member States. It would only have positive results if all Member States advanced at an almost similar pace in terms of structural reforms.

2.3.1 Countries that enjoyed a highly effective economy before the introduction of the euro have benefited even more from the external value of the single currency

2.3.1.1 The external value of the euro appears undervalued in Northern Countries...

Northern countries (notably Germany, or the Netherlands in particular), which are less prone to inflation and possess competitive industries, have benefited from a euro that has depreciated in real terms, given its role as an average, which has strengthened their export competitiveness. Indeed, the external value of the euro represents an average for the entire economic zone, and appears undervalued relative to their economic performance, giving these countries an additional competitive advantage. Without the euro, their national currencies would have otherwise appreciated.

22. "Improving the EU's global economic competitiveness", Ghent Eurofi High Level Seminar Summary, February 2024.

For example, CEPII and IMF estimated²³ in 2017 that Germany's exchange rate was 10-20% undervalued, in terms of a real effective exchange rate relative to the Euro area. Its correction would imply, arithmetically, a 2% annual inflation rate in Germany and a 0% inflation in the other countries for a decade – which would be unrealistic and probably misconceived.

In other words, thanks to the euro, competitive countries have been able to avoid the appreciation of their currencies that would have occurred in its absence and that would have reduced their exports to Europe.

2.3.1.2 ... and overvalued currency in Southern Countries

In parallel, the euro has prevented the currency depreciation in southern countries which tended to be more inflationary and that would have occurred in its absence. Indeed, without the euro, their currencies would have undergone repeated devaluations, which would have been detrimental to their populations (lower purchasing power in the event of currency depreciation). These devaluations would have reflected market forces and promoted competitiveness, provided domestic demand was properly managed to contain inflationary pressures and reduce the propensity to import.

However, this stability comes at a cost: reduced competitiveness for Southern countries and increased competitiveness for Northern countries.

2.3.2 Divergent inflation rates between Eurozone countries, which were particularly pronounced up until the European sovereign debt crisis, contributed to differences in competitiveness between countries

With the introduction of the euro in 1999, inflation disparities between southern countries (Greece, Italy, Spain) and Germany increased. Until 2008, these nominal divergences widened the competitiveness gaps among member countries, causing many (Spain, Greece, Italy, Portugal) to incur significant current account deficits. Between 2000 and 2010, the average annual deficits for Spain and Portugal were -6.5% and -9.5% of GDP, respectively.

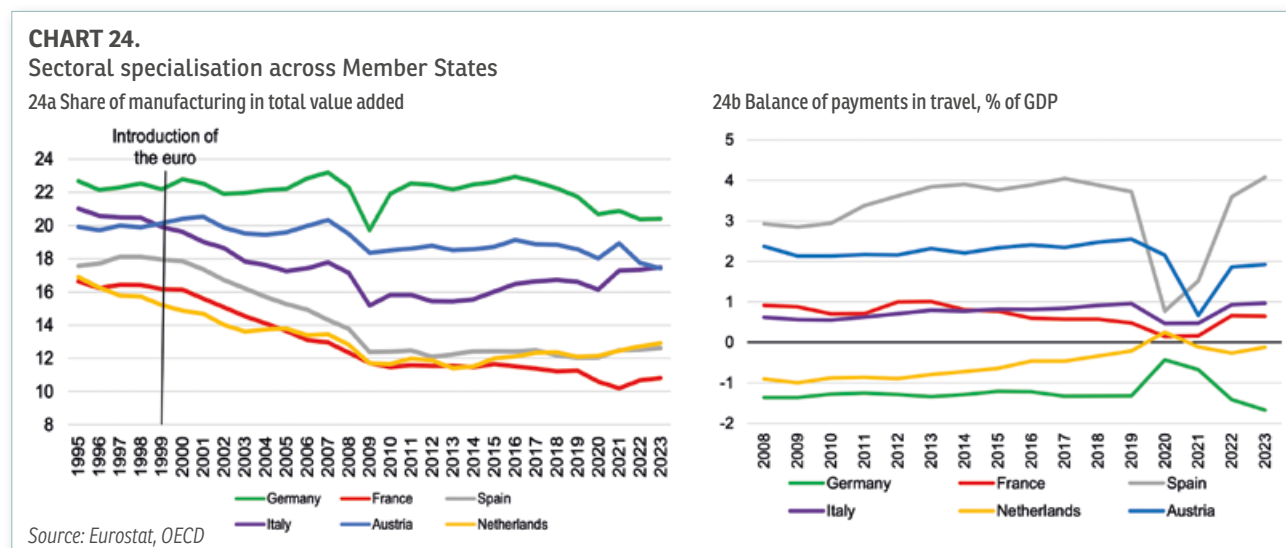
Since 2012, competitiveness gaps have narrowed due to the adjustment policies these countries had to implement following the Sovereign Debt Crisis.

2.3.3 Growing heterogeneity in productive specialization

As it is common in a currency area, Member States of the Eurozone have divergent sectoral specializations with consequences on relative productivity and potential growth rates. The elimination of foreign exchange rate risks normally encourages specialization within the Monetary Union; it mainly benefits net exporting countries, *i.e.* the ones that have specialized in tradable products for which they exhibit a strong competitiveness.

Moreover, as observed earlier, countries that were already productive and performing well before the introduction of the single currency were further advantaged by the euro's external value and lower inflation rates.

In such a context, the northern countries of the Monetary Union (Germany and the Netherlands in particular) have been able to maintain a competitive industry, while southern countries (Greece, France, and Spain in particular) have progressively experienced deindustrialization. Northern countries have gained market shares in world trade, while southern countries have lost market shares. Charts 24a and 24b highlight the divergence of industry and tourism across Member States.



23. IMF, External Balance Assessment, external Sector Report, 2017
La lettre du CEPII, "Sur- et sous-évaluations de change en zone euro : vers une correction soutenable des déséquilibres", March 2017.

Chart 24a illustrates the deindustrialization of France over the last two decades, unlike Germany, Austria, and Italy, for all the reasons mentioned in Chapter 4: the level of tax burden and labor cost are too high due to the excessive weight of public expenditure as a proportion of GDP and the insufficient level of non-residential investment.

This de-industrialization led to a drop in productivity gains and business revenues, which in turn led to an increase in public spending to offset them ("vicious circle of government debt").

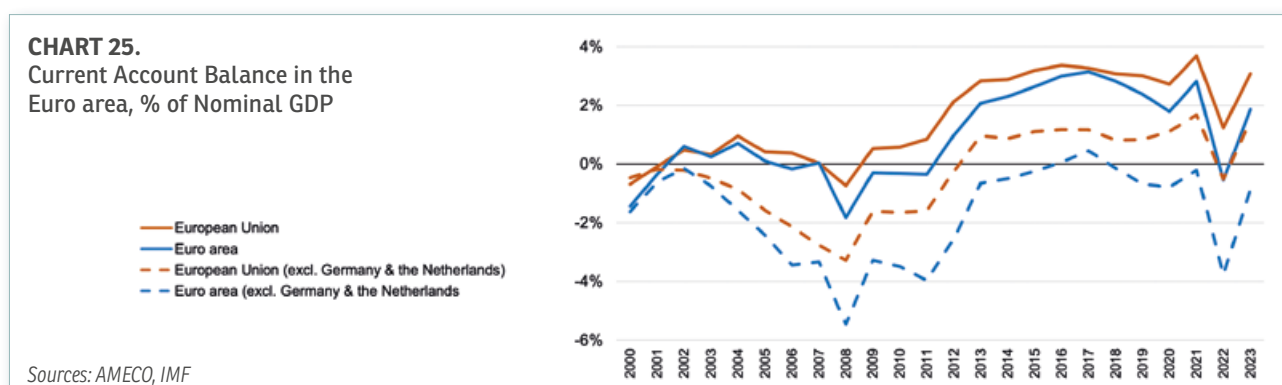
2.4 The current account imbalances resulting from these divergences have been significant and have not been corrected, as illustrated by the scale of positions within Target 2

2.4.1 Persistent divergences in the current account imbalances in the Eurozone despite improvements in peripheral countries since the EU Sovereign Debt Crisis

Despite the return to balanced current account positions in peripheral countries since 2012 (Italy, Spain, Portugal), significant divergences remain within the Eurozone.

Since 2012-13, Spain and Italy have recorded current account surpluses, both averaging 1.7% of GDP per year. However, these performances are considerably lower than those of Germany and the Netherlands, where surpluses averaged at 7.3% and 8.5% of GDP per year, respectively.

If Germany and the Netherlands had been excluded, the Eurozone's current account balance would have been in deficit during most of this period (see Chart 25).



Charts 25 and 26 underline the existence of significant discrepancies between Member States in terms of current account imbalances. Current account surpluses in Germany and the Netherlands respectively averaged 8.1% and 7.7% of GDP over the 2014-2019 period, while France suffered from a permanent deficit of 0.5% on average between 2014 and 2019.

Heterogeneity remains significant in 2023: Germany and the Netherlands recorded surpluses of respectively 5.9% and 10.1% according to the EU Commission, while France and Belgium experienced a deficit of respectively 0.7% and 1% of GDP (see Chart 26).

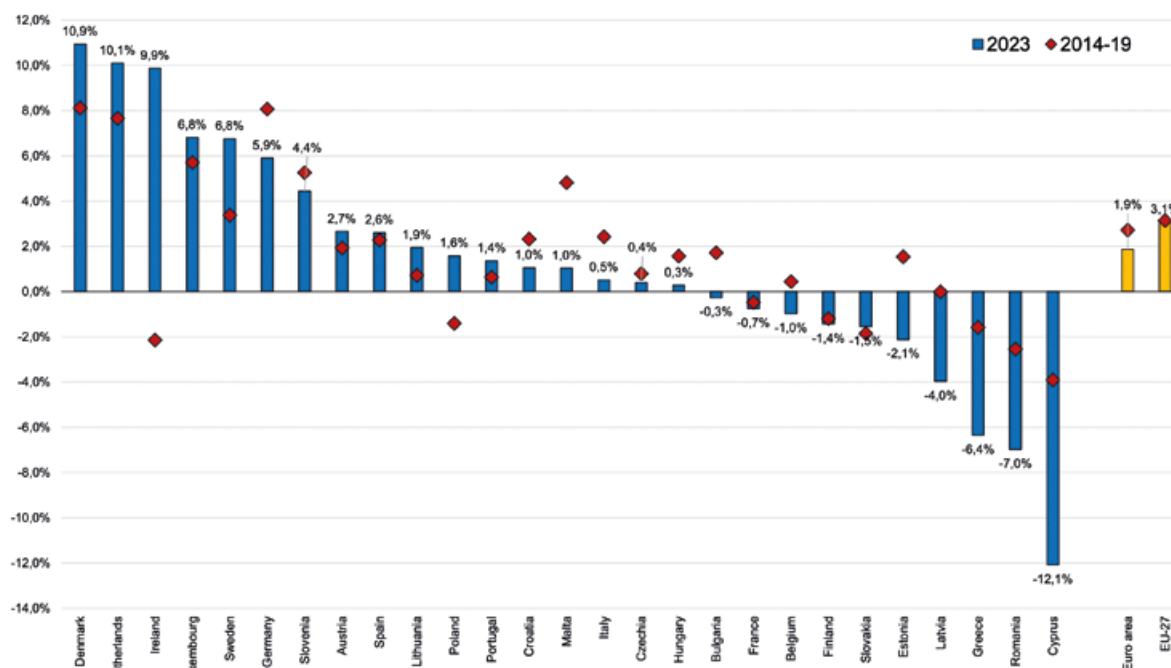
2.4.2 Countries with large current account surpluses together with countries showing persistent current account deficits threaten the coherence of the EMU

In principle, imbalances in a genuine Union are not a source of concern. But, as of today, the Eurozone is not a genuine union; national budgets coexist, and so do bilateral current account balances.

If the Eurozone was the equivalent of a nation, such discrepancies in current account balances would not only be acceptable but would hardly matter.

Indeed, since there would only be one balance of payments for the entire zone, as in the US for example, rebalancing adjustments would take place automatically through the mobility of capital and labor and automatic fiscal transfers. Sub-regions with high current deficits (and therefore overvalued "currencies") would be winning because they could "import" cheap goods from surplus-generating subregions, the latter contributing through this implicit subsidy to the adjustment of the deficit zone.

CHART 26.
Current Account Balance across EU Member States in 2023



Source: Eurostat, EU Commission's Spring Forecasts (May 2024)

But in fact, the EMU is composed of countries with their own balance of payments and national budget. Macro-economic imbalances relative to the "highest performing economy" are not a matter to be corrected by the Union. These issues are exclusively dependent on national economic policies.

Since countries cannot adjust their nominal exchange rates to maintain their competitive positions, it takes place through internal devaluations – *i.e.* through prices and wage adjustments – leading to a reduction of domestic demands and incomes.

Of course, the objective is not to unify all balances of payments within the EU. Some countries have to catch up from very low standards of living which has necessarily involved some balance of payment deficits. However, the EMU should not exacerbate this heterogeneity but rather reduce it.

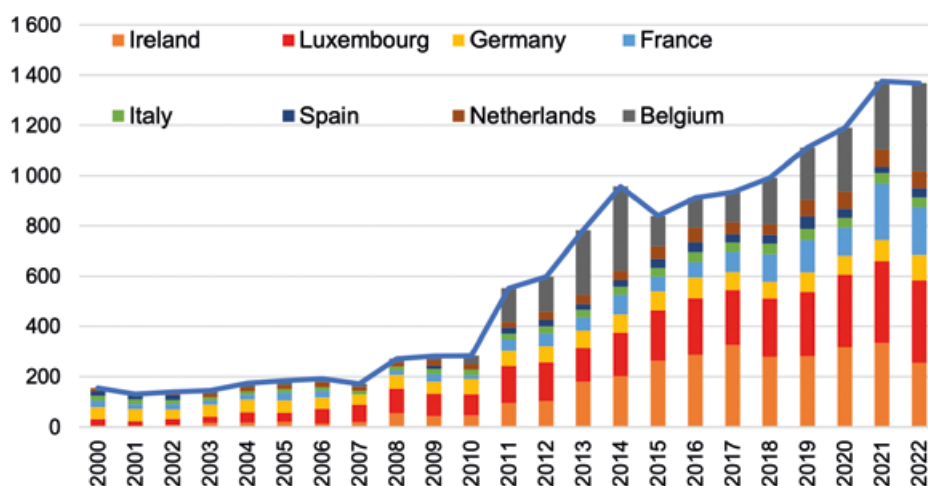
Until 2008, European cross-border capital flows mainly fueled unproductive asset bubbles. Since the EU Sovereign Debt Crisis (2011-2012), Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower GDP per capita countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate and return on assets difference between the US and Europe (risk is better remunerated in the US than in Europe) and the insufficient number of investment projects in Europe. These limited cross-border capital flows in the Euro area reflect the persistent doubts of investors in Northern Europe regarding the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

The fact that Germany and the Netherlands' current account surpluses are no longer lent to other Member States reduces the capacity of peripheral countries to invest, as well as their potential growth and contributes to increasing the heterogeneity of per capita incomes in the Euro area (*see Chart 23*).

Consequently, the Euro area exhibited a savings surplus of €267.4 bn (or 1.9% of GDP in 2023), which is reallocated to the rest of the world. An important proportion takes the form of bonds purchase especially US Treasuries (*see Chart 70*).

Between 2000 and 2022, the volume of US federal debt held by Eurozone residents increased tenfold, from USD106.3 bn to USD1368.5 bn. Within the Euro area, all countries that registered a positive current account balance lent to the United States (*see Chart 27*) and therefore financed the US external and fiscal deficits. These include Germany (USD100.7 bn in 2022), the Netherlands (USD67.4 bn), Luxembourg (USD329.3 bn), Spain (USD36.9 bn), Belgium (USD351.2 bn) and Italy (USD39.2 bn). Although achieving an average current account deficit, France and Ireland also hold a significant amount of US federal debt, lending respectively USD189 bn and USD254.8bn to the US Treasury in 2022.

CHART 27.
Outstanding Treasuries held (USD bn)



Source: US Department of the Treasury

Developing cross-border financial flows within the Euro area is essential. The true objective of a currency area is to make savings flow to finance the most productive investments within it. Indeed, in a monetary union, the elimination of currency risk allows savings from the countries that have a high level of capital per capita (Germany, the Netherlands, France) to finance investments in the countries with lower capital per capita and higher marginal productivity of capital (for example Spain, Italy, Portugal). Income convergence therefore normally stems from the transfer of savings from high per capita income countries to low-income per capita countries. But, as mentioned above, such transfers disappeared after the 2008-2010 period.

This phenomenon is there to stay. Indeed, the Eurozone is not a true monetary union. We need to take into account a structural feature, which is the increasing industrial specialization of surplus countries. Success breeds success. Helped by the implicit devaluation stemming from the favourable cost evolution, exports of surplus countries become more profitable.

It would be illusory to believe that the structural advantages of German exports could be transmitted to and copied by southern or eastern European countries that have a different industrial story and cannot become little Ruhr (while the Ruhr can become and is becoming stronger).

2.4.3 Higher returns on financial assets in the United States than in the Euro area

The main cause of capital outflows from the Euro area to the rest of the world, and in particular to the United States, is the low return on financial investments in the Euro area compared with the United States.

P. Artus²⁴, highlights that this higher return concerns bonds, equities, and stakes in companies (see Chart 28).

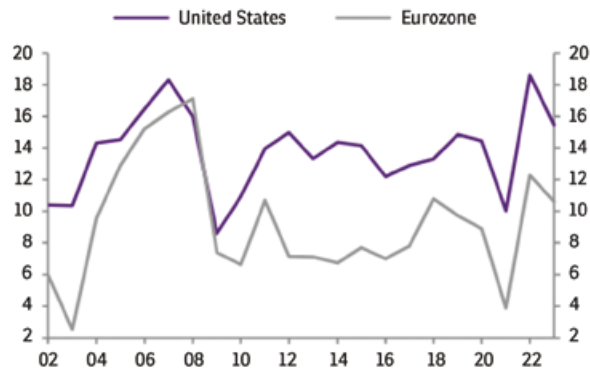
CHART 28.
Yields differential between European and US assets

28a 10-year sovereign bond yields, %



Source: OECD, Natixis

28b Return on equity



24. P. Artus, "Will the European capital markets union keep savings in the Eurozone?", Flash Economics, Natixis, 7 June 2024.

H. Tran²⁵ also underlines that investment flows to the United States because of higher returns on American equity markets compared to those of the EU. Specifically, for the period 1900–2020, the average annual nominal return on US equities was 9.6% compared to 7.2 % for Europe²⁶. So long as this remains the case, savings from the EU and the rest of the world will continue to be attracted to the United States, where foreign investors own 40 percent of the stock market.

According to McKinsey²⁷, returns on invested capital in corporate Europe were four percentage points lower than in the United States between 2015 and 2022. Over that period, large public companies in Europe had an ROIC of about 14%, compared with about 18% in the United States. Europe's lower returns undermine investment at a time when capital is becoming scarcer. The disparity is largest in the technology hardware, software services, and pharmaceutical sectors.

The EU therefore needs both reforms and investment: structural reforms making its economy more effective and its corporations more profitable will create more investment opportunities to deploy European savings at home – while more investment could help improve EU productivity and growth prospects. Thus, while it is wise to find ways to increase investment in the EU, the problem is more fundamental than just the efficiency of capital markets.

2.4.4 Target 2 imbalances in the Eurozone have increased with the ECB's asset purchase programs (2015–2022)

Since the euro was created, Target 2 balances have gone through several distinct phases. Prior to 2008, balances were practically zero: current account imbalances between Euro area countries were settled through interbank liquidity transfers. After the 2008 financial crisis and the 2012 Sovereign Debt Crisis, Target 2 balances rose dramatically due to tensions on the interbank market and a flight of deposits from "peripheral" countries (Italy, Greece, Spain, Portugal, Ireland) toward "core" countries (Germany, Netherlands, Luxembourg), before gradually going back down. Total Target 2 national surpluses stood at €900 bn in mid-2012 before gradually declining to stabilize at around €600 bn by the end of 2014.

Since 2015, balances picked up again as a result of the ECB's Asset Purchase Programs (APP). Since the mid-2010s, the main countries with the highest Target 2-liabilities (in € bn) have been Greece, Ireland, Portugal, Spain, and Italy, and the countries with the biggest surpluses have been Germany, the Netherlands, Finland, and Luxembourg.

The net Target 2 liabilities of the Bank of Italy and the Bank of Spain are quite high, standing at respectively €438 bn and €433 bn in April 2024 (which represents 22.9% of GDP for Italy and 32.6% for Spain). Conversely, the Bundesbank had a net Target 2 credit of €1,048 bn in April 2023 (27% of Germany's GDP).

Today, Targets balances reflect the legacy of Quantitative Easing (QE) bond portfolios and will fall steadily as the ECB reduces its balance sheet. In January 2017, in a letter to members of the European Parliament, Mario Draghi wrote²⁸ that "if a country were to leave the Eurosystem, its national central bank's claims on or liabilities to the ECB would need to be settled in full".

According to B. Drut²⁹, "At least three problems would arise in the event of the exit from the Euro area of countries with significant net Target 2 liabilities:

- I. For several countries (Spain, Italy, Portugal), the Target 2 liabilities are very large when taken as % of GDP, which implies that the amounts needed to settle the commitments would be colossal,
- II. In the event of the exit of the Euro area from a relatively weaker country from an economic point of view, its new currency would probably be weaker, which would further increase the settlement to be made,
- III. Would a country leaving the Eurozone necessarily want to settle all its commitments? We have seen in the case of Brexit that some British politicians were totally opposed to the divorce bill".

In the end, the Target 2 imbalances – and the potential losses in case of departure from the Eurozone and the non-settlement of the Target 2 balances – might strengthen the bargaining power of debtor countries in the case of harsh negotiations with core countries.

Target 2 imbalances should fall as the ECB reduces its Asset Purchase Programs and, more generally, if progress is made on the Banking Union and Capital Markets Union to the extent that cross-border flows will be more north-south than south-north.

25. H. Tran, "The Enrico Letta Report and the state of the EU's Capital Market Union", Atlantic Council, 7 May 2024.

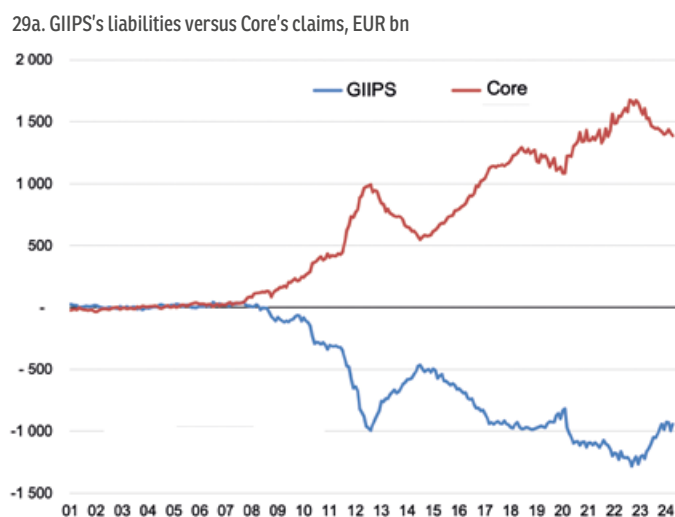
26. Mindfully investing, "Historical Returns of Global Stocks", 6 January 2022.

27. McKinsey Global Institute, "Investment: Taking the pulse of European competitiveness", June 20, 2024.

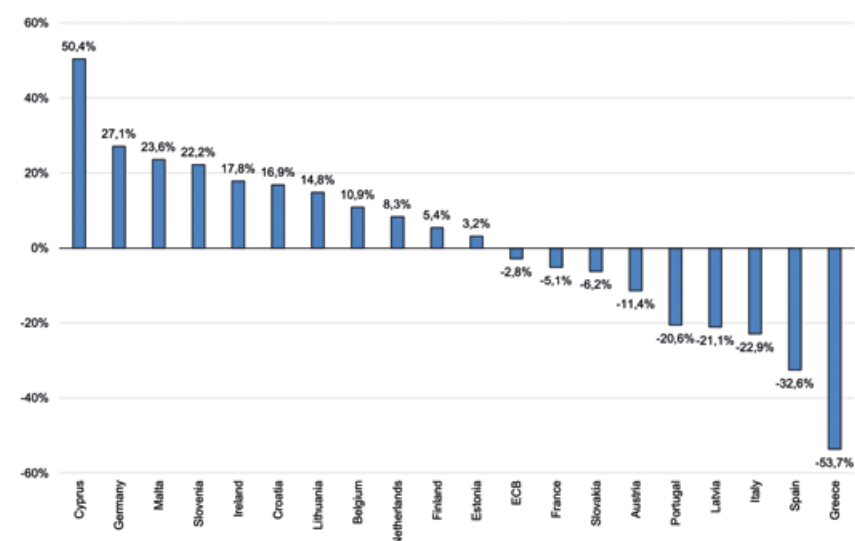
28. Letter from Mario Draghi to the members of the European Parliament Marco Valli and Marco Zanni, January 2017.

29. B. Drut, "Target 2 imbalances, again at the center of attention", CPR, 2018.

CHART 29.
Target 2's imbalances
in the Euro area



29b. Target 2 imbalances as of April 2024, % of GDP



Source: Euro Crisis monitor
For chart 29.a, GIIPS = Greece, Italy, Ireland, Portugal, Spain ; Core = Germany, Netherlands, Luxembourg
Last observation from April 2024

A reading of this chapter shows that the Member States have not taken their destiny into their own hands by ensuring the minimum coordination that could have made the system work better.

The current intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a current policy of "every man for himself", and creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the Eurozone. Consequently, it is not easy to achieve global objectives (e.g., green transition, digitalization, defense, social redistribution, migration, ...) including monetary stability, while maintaining fiscal policies so divergent from one another.

As long as it is not sufficiently understood, notably in highly indebted countries, that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to progress in Europe towards more public or private risk sharing.

3. After periods of turbulence and a return to greater coherence, the monetary union is once again at a critical juncture

The euro has weathered almost a quarter of a century of crises and storms without sinking. But this success cannot mask the internal divisions within the monetary zone.

A close look at the euro reveals that, unlike other currencies, it is far from being a reflection of national unity. The euro experienced dramatic turbulence during the Sovereign Debt Crisis and is regularly a source and manifestation of discord between Member States.

Why is this? There are several reasons:

- First, there are as many fiscal policies as there are members of the Eurozone, and these national economic policies have never been sufficiently coordinated, which has hampered the adoption of reasonable solidarity mechanisms.
- Second, there are heterogeneous perceptions of inflation (northern countries are less prone to inflation than southern countries),
- Third, the euro key interest rate is the same for all members of the monetary zone. It is an average which, by definition, is inadequate for countries with highest inflation rates.
- Fourth, since the 1960s, the Union has moved from structural European policies (industrial, agricultural and energy competition, etc.) to a single market without Community preferences and with strong national tendencies.

In other words, the management of the single currency is the subject of ongoing discussions between the members of the ECB and the Eurogroup. Since the EU is not a single nation but a confederation of national states, we have to accept that it seeks compromises aimed at optimizing national objectives. But a monetary union can only work if a minimum of fiscal discipline is ensured by the Member States, which has not been the case for the past 25 years. The single currency has not brought all the expected benefits because some Member States have not demonstrated the economic discipline required for a monetary union.

Three periods can be distinguished in the Eurozone's history from its creation to the present day. After a decade of economic divergence (2000-2010) that led to the euro 'sovereigns' crisis, the European economic system improved over the following decade. However, since the Covid-19 crisis and the energy crisis that arose with the war in Ukraine, the EU's economies have become increasingly divergent, and the economic disparities between the major Member States are continuously growing, threatening the future of the euro.

3.1 2000-2010: a phase of economic divergence leading to the European sovereign debt crisis (2010-2012)

From the outset of the monetary union, the various countries in the zone took advantage of their freedom in terms of economic policy. The heterogeneity of the Eurozone economic policies increased during the first ten years of its history. While the northern European countries focused on strengthening their industrial base, decentralizing wage bargaining and keeping government finances under control, the southern European countries (Greece, Portugal, Italy and Spain) favoured credit, consumption, and social redistribution without worrying about the consequences for their government's fiscal situation or their balance of payments imbalances.

3.1.1 As soon as the euro was introduced, the Maastricht criteria were no longer respected by large Member States

The Monetary Union got off to an inauspicious start. Admittedly, the public debt ratios of France and Germany were close to 60% of GDP in 1999 and their public deficits were limited (1.5% of GDP in 1999). But already in 2002, fiscal deficits began to exceed the 3% threshold.

In 2003, these countries lobbied for exemption from the rules of the Stability and Growth Pact and succeeded. Thus, on 25 November 2003, against the advice of the European Commission, Austria, the Netherlands, Finland, and Spain, the Eurogroup opted to assign less ambitious fiscal consolidation targets than those recommended by the Commission to the Union's two leading economic powers for 2004. As demanded by Paris and Berlin, the Eurogroup also agreed to suspend the automatic enforcement of the articles of the Pact that would have ensured that deficits would fall below the limit of 3% of GDP by 2005.

The transition from a mechanical and almost automatic application of the various articles of the Stability and Growth Pact to a henceforth political management ruined its effectiveness. This bad example opened the door to fiscal excesses in several southern European countries (Greece, Italy, Portugal), as shown in the table below.

TABLE 1.
Government Budget Balance across the main EA Member States, (2000-2010), % of GDP

	2003	2004	2005	2006	2007	2008	2009	2010	Average
Germany	-3,7%	-3,3%	-3,3%	-1,7%	0,3%	-0,1%	-3,2%	-4,4%	-2,4%
France	-4,1%	-3,5%	-3,5%	-2,7%	-3,0%	-3,5%	-7,4%	-7,2%	-4,3%
Italy	-3,2%	-3,5%	-4,1%	-3,6%	-1,3%	-2,6%	-5,1%	-4,2%	-3,5%
Spain	-0,4%	-0,1%	1,2%	2,1%	1,9%	-4,6%	-11,3%	-9,5%	-2,6%
Netherland	-3,1%	-1,8%	-0,5%	0,0%	-0,2%	0,1%	-5,2%	-5,3%	-2,0%
Austria	-1,8%	-4,8%	-2,5%	-2,5%	-1,3%	-1,5%	-5,3%	-4,4%	-3,0%
Belgium	-1,8%	-0,2%	-2,7%	0,2%	0,1%	-1,1%	-5,4%	-4,1%	-1,9%
Greece	-7,8%	-8,8%	-6,2%	-6,0%	-6,7%	-10,2%	-15,2%	-11,4%	-9,0%
Portugal	-5,7%	-6,2%	-6,1%	-4,2%	-2,9%	-3,7%	-9,9%	-11,4%	-6,3%
Euro area	-3,1%	-2,9%	-2,6%	-1,6%	-0,7%	-2,2%	-6,3%	-6,3%	-3,2%

Source: EU Commission

Germany did improve its public finances between 2004 and 2007, with the fiscal deficit rising from -3.3% to a balanced position. But this virtuous budgetary path did not materialize everywhere. For instance, despite a favourable economic climate between 2004 and 2007 (2.5% average annual growth over these 3 years), France continued to record public deficits above 3% of GDP, thereby abandoning the economic discipline it had adopted to join the Eurozone.

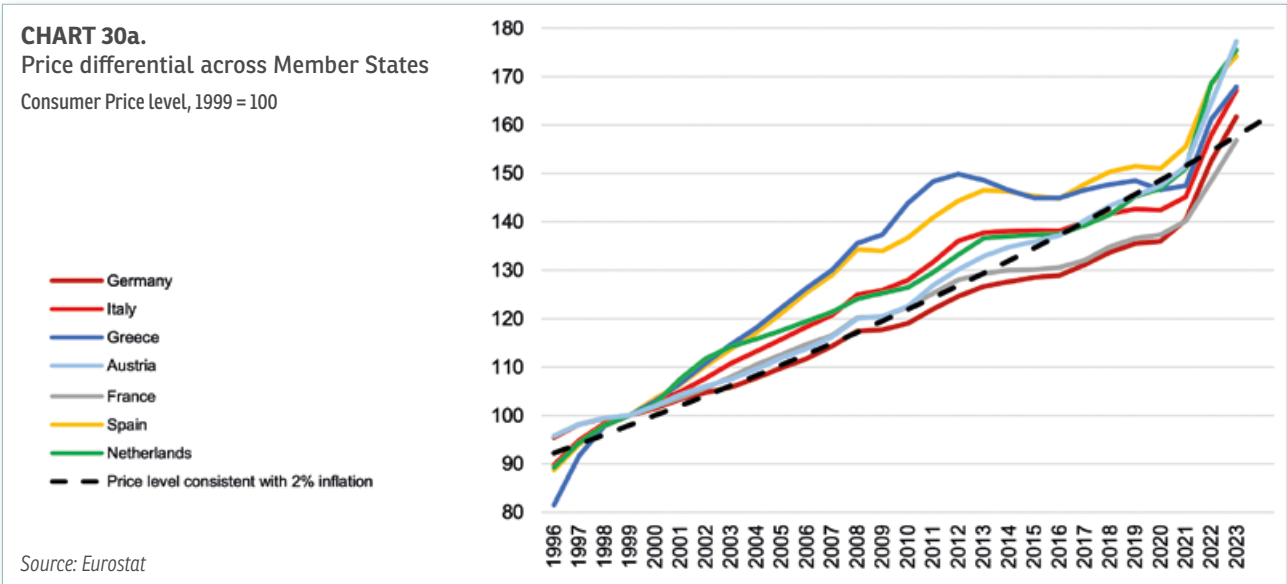
Following the Global Financial Crisis of 2008, France recorded two years of deficits above 7% of GDP. In 2009, the budget deficit exceeded 10% of GDP in Spain (-11.3%), Portugal (-9.9%) and Greece (-15.3%), while it remained below 4% in Germany (-3.2%).

3.1.2 The introduction of the euro has been accompanied by a significant disparity in inflation rates, widening the competitive gap between Member States

After the introduction of the euro, production costs in the peripheral Member States increased much more than in the “northern” countries.

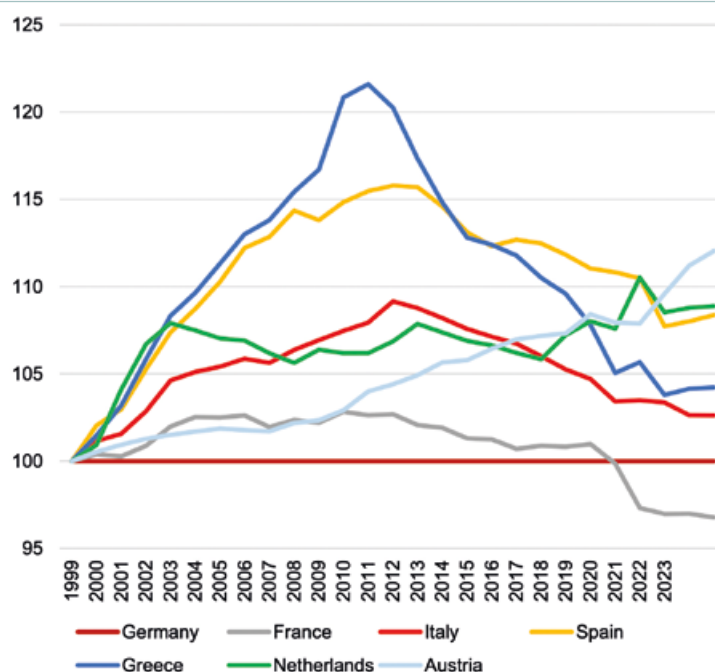
Between 2000 and 2007, the consumer price index rose by more than 25% in Spain (+28%), Greece (+30.5%) and Portugal (+27%), almost twice as fast as in Germany (+14.3%), France (+16.5%) or Austria (+16.4%).

If we focus on hourly labour costs between 2000 and 2008, Germany (+9%), Austria (+4%), Sweden (+8%) improved their competitiveness by achieving a reduction in their labour costs relative to the EU average³⁰. Conversely, the Western industrialized countries like Belgium, Denmark, Finland, France, and the Netherlands only saw a slight worsening of their labour cost position – between -2% and -8% – compared to the EU average. In contrast, the picture for the Southern European countries and Ireland is quite different. Greece (-22%), Ireland (-40%), Italy (-12%), Portugal (-25%), Spain (-13%) and Cyprus (-29%). Such disparities are unsustainable in the long run.



30. M. Beck, "Comparison of labour costs and competitiveness in the EU 2000 to 2019", Federal Statistical Office, 2020.

CHART 30b.
Price differential across Member States
Consumer price level, relative to German's price level (%)



Source: Eurostat

3.1.3 In the peripheral countries, the fall in real interest rates has led to a surge in private sector debt, encouraging property bubbles

As there is only one key interest rate in a currency zone, real interest rates (after deducting inflation) in peripheral countries became lower than in northern countries, or even negative after joining the euro. This increased the incentive to borrow. The easing of financial conditions stimulated the granting of credit (particularly real-estate mortgages) in southern Europe and Ireland, and property prices soared. As a percentage of GDP, outstanding credit to the private non-financial sector almost doubled between 2000 and 2007 in Spain and Greece. In Italy and Portugal, it increased by more than a third over the same period (see Chart 31.b).

During this decade (2000 to 2010), there was a high level of capital mobility within the Eurozone. However, it mostly resulted from inter-bank funding which supported the financing of inefficient investments (e.g. in real estate bubbles, sub-optimal business ventures and infrastructure projects notably in Spain, Italy, Portugal, Ireland and Greece) and which contributed to massive current account deficits.

One way of correcting this imperfection could have been to introduce corrective policies that restrict credit in countries where monetary runaway was threatening, and to encourage countries with below-average inflation rates to develop domestic demand. This is what is known as differentiated macroeconomic management.

But nothing was done. As a result, economic disparities between Eurozone countries widened. This is a major flaw in the management of the Eurozone's monetary policy. Far from being an optimal zone, the Eurosystem has generated unsustainable inflationary disparities due to heterogeneous and uncontrolled credit expansion, with all the attendant consequences for the balance of payments. It's a textbook case.

The experiment was very dangerous and risky. Monetary policy was conducted in an incompatible manner. It is disconcerting. Does monetary policy have to be conducted in such a disastrous way? Neither the European Commission nor the ECB carried out their role of macroeconomic surveillance. The concept was wrong, the safeguards non-existent. The best way of heading for disaster.

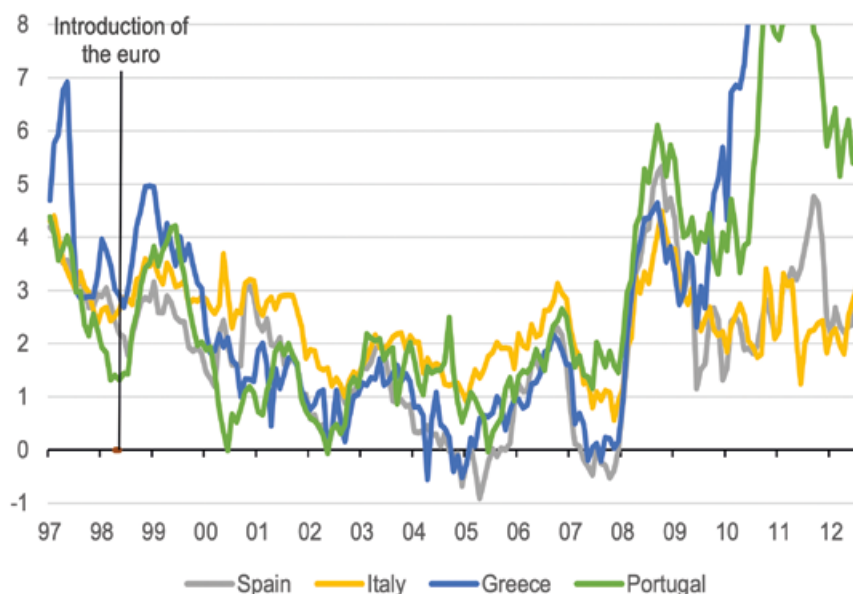
3.1.4 ...and created current account imbalances in several EU countries

The fiscal deterioration and widening inflation differentials have been accompanied by widening current account deficits in the Eurozone's peripheral countries as shown in Table 2.

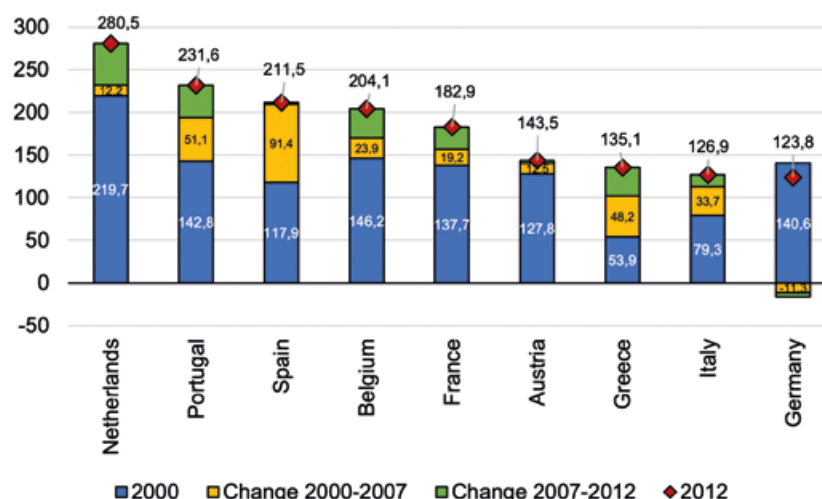
The most striking cases are those of Greece, which, from 2002 to 2011, recorded an average annual current account deficit of -9.2% of GDP, Portugal (-8.8%) and Spain (-6.4% of GDP), unsustainable deficits that always end up in crisis as external financing dries up.

CHART 31.
Real interest rates and credit dynamics across euro area Member States (2000-2012)

31a. 10-year sovereign bond yields, adjusted for inflation in selected periphery Member States(%)



31b. Credit to non-financial private sector, % of GDP



Sources: Bank for International Settlements, OECD

TABLE 2.
Current Account Balances across the main EA Member States, (2003-2010), % of GDP

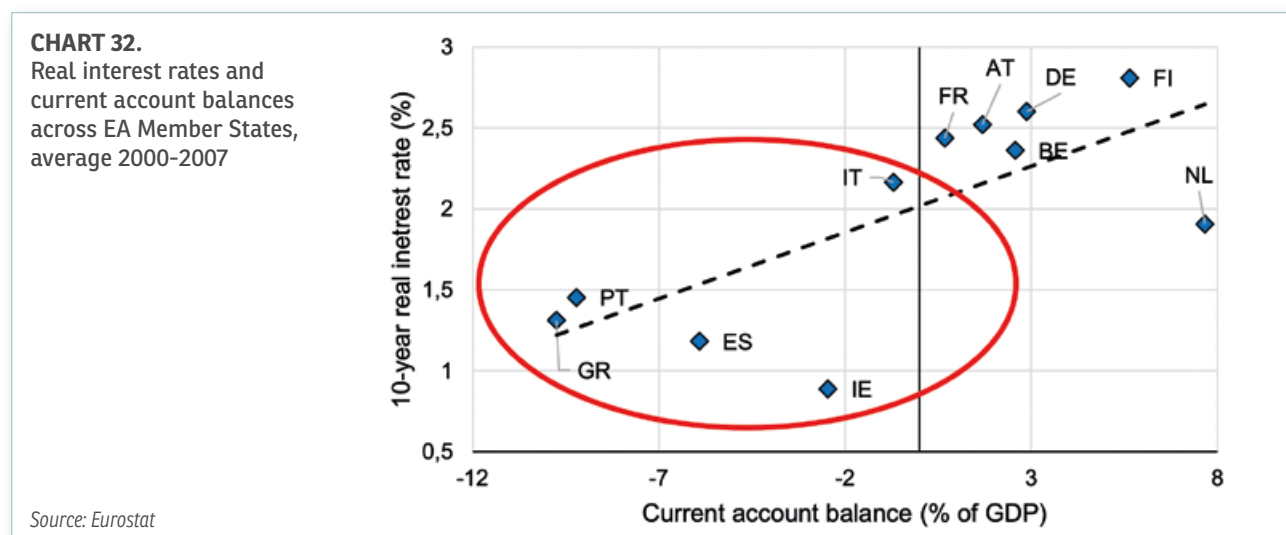
	2003	2004	2005	2006	2007	2008	2009	2010	Average
Germany	1,4%	4,5%	4,7%	5,8%	6,9%	5,7%	5,8%	5,7%	5,1%
France	0,8%	0,5%	0,1%	0,3%	-0,1%	-0,7%	-0,6%	-0,6%	0,0%
Italy	-0,8%	-0,5%	-0,9%	-1,5%	-1,4%	-2,8%	-1,9%	-3,3%	-1,6%
Spain	-3,9%	-5,5%	-7,3%	-8,9%	-9,4%	-8,9%	-4,1%	-3,7%	-6,4%
Netherlands		7,6%	7,1%	9,1%	6,9%	5,0%	5,4%	7,0%	6,9%
Austria	1,6%	2,1%	2,2%	3,3%	3,8%	4,5%	2,6%	2,8%	2,9%
Belgium	3,6%	3,3%	2,1%	1,9%	1,9%	-1,0%	1,6%	1,6%	1,9%
Greece	-8,4%	-7,7%	-8,9%	-11,5%	-15,2%	-15,1%	-12,3%	-10,1%	-11,2%
Portugal	-6,6%	-8,0%	-9,6%	-10,3%	-9,6%	-11,8%	-10,3%	-10,2%	-9,6%
Euro area	0,2%	0,7%	0,1%	-0,2%	0,0%	-1,8%	-0,3%	-0,3%	-0,2%

Source: EU Commission

The expansion of private credit has contributed to the development of external imbalances in the peripheral countries of the Eurozone. Indeed, the use of credit stimulated domestic consumption, which in turn accentuated the rise in imports. Between 2002 and 2008, consumption increased in Greece, Portugal, and Spain as a result of the expansion of credit to the private sector. In Greece, Portugal, and Spain, consumption grew by an annual average of 4.15%, compared with 1.85% for the Eurozone as a whole.

Spain, Italy and Greece recorded persistent current account deficits in the 2000s (Greece at annual average of -9.8% between 2000 and 2007, Italy at -0.7% and Spain at 5.8%) This reflects the loss of competitiveness (particularly as a result of rising wages) in countries with deficits (see Part 3.1.2 above). Unit labour costs rose by 3.4% and 2.8% annually respectively in Greece and Italy over the period 2000-2010, compared with 0.4% in Germany and 2.1% in France. By contrast, over the same period, Germany recorded an average annual current account surplus of 5.1%.

Growth in countries that have lost competitiveness has therefore been driven mainly by increased consumption rather than by growth in exports or productive investment.



As J. de Larosière points out³¹, “since exchange rate adjustments are by definition impossible in a monetary union, such current account imbalances should have destabilized the financial markets and led to higher interest rates in overheating countries. This did not happen.”

3.1.5 The existence of monetary union, as it has been managed, has encouraged these divergences

The financial markets behaved as if all the Euro area Members formed a single bloc. From 2000 to 2007, countries with serious imbalances did not experience an increase in their spreads, and therefore their sovereign interest rates remained virtually identical to those of Germany.

These virtually zero risk premiums encouraged a number of governments to embark on high levels of public spending and deficits. They also facilitated the expansion of private credit in countries such as Ireland and Spain, where property could be financed at low interest rates, since monetary policy was, by definition, unique and, in fact, too accommodating for such countries.

These construction booms increased tax revenues and, as a result, did not increase budget deficits. Before the crisis, Ireland and Spain were praised for running budget surpluses. But these surpluses were, of course, fragile and dependent on the credit boom.

Over these ten years, Europe experienced a system with a single monetary policy, but with national fiscal and economic policies that were uncoordinated and poorly supervised by the European Commission. This system, with the help – or blindness – of the markets, eliminated external constraints on debtor countries. It therefore allowed them to borrow more and more to spend more than they produced.

Two models coexisted during the 2000s: export-led economies (Austria, Germany, the Netherlands, etc.) and import- and consumption-led economies ('peripheral' members).

In a 'no bailing out' system like the Maastricht Treaty, the balance of payments remains national. But the markets did not take this into account until 2008-2009. In fact, the markets and rating agencies behaved as if there was an implicit bailout mechanism. When it became clear that no such mechanism existed, reality took its revenge and spreads soared, leading to the outbreak of the so-called sovereign debt crisis in Europe. Countries then had no choice but to reduce their external imbalances.

31. J. de Larosière, “Les 10 préjugés qui nous conduisent au désastre économique et financier”, Odile Jacob, 2018.

3.2 2012-2019: economic divergences narrow, although public debt remains a concern in some Member States

After 10 years of divergence, the European economic system has gradually become more coherent. Efforts have been made to improve Europe's economic governance, with the creation of the European Stability Mechanism in 2012, the introduction of the Macroeconomic Imbalance Procedure in 2011, and the reform of the Stability and Growth Pact in 2011/2012 via the Six Pack, the Two Pack and the Treaty on Stability, Coordination and Governance (TSCG).

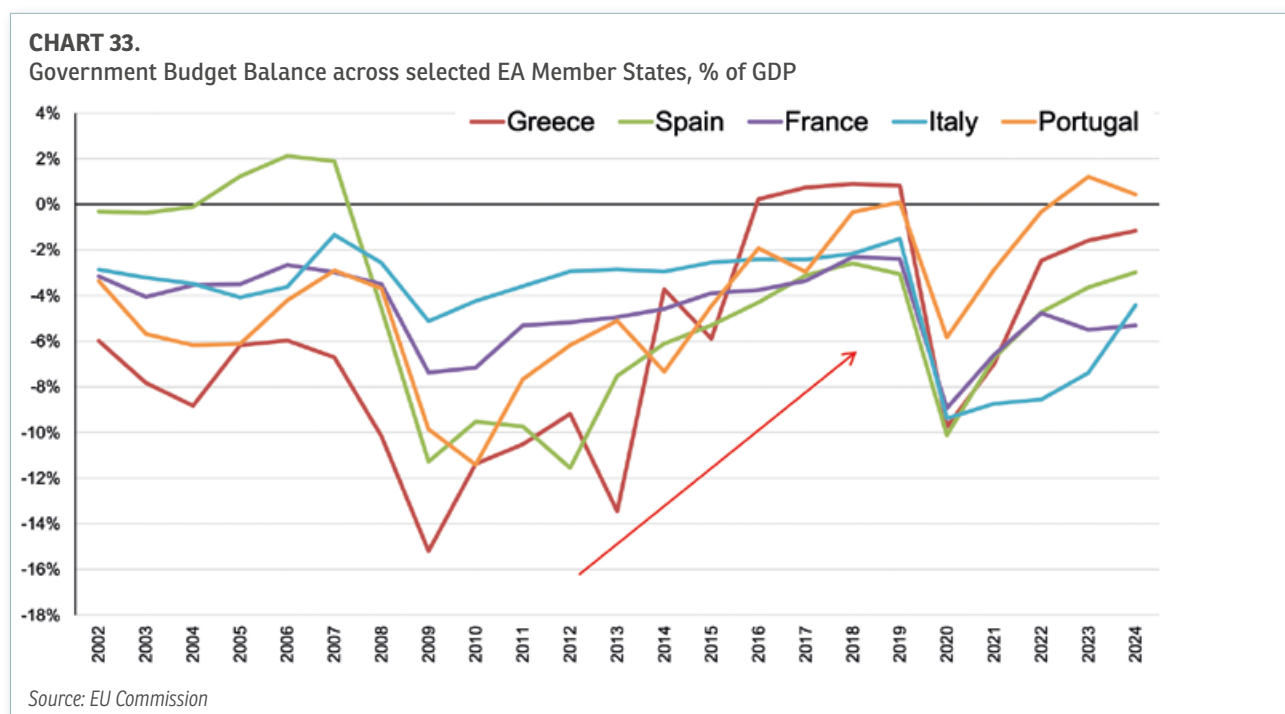
Monetary policy has also made possible the reduction of interest rate differentials within the Eurozone, albeit at the cost of financial stability.

But the picture was still far from perfect on the eve of the pandemic outbreak (2020). The system had not yet been fully repaired, the "fundamental imbalances" of countries with excessive current account surpluses had not been addressed, and the government debt remained a cause for concern in a number of countries.

3.2.1 After 2012, the peripheral countries all improved their fiscal and current account balances

The Eurozone countries, including the peripheral countries, had, in 2019, all improved their public accounts compared with their 2010-12 levels.

- The **Italian** deficit fell below 3% of GDP from 2015 onwards, fluctuating between 2.5% and 1.5% of GDP. The fiscal efforts can be seen in the achievement of primary surpluses over the period (an average of 1.6% between 2014 and 2019), although insufficient to offset the much higher interest burden (3.9% of GDP on average).
- Still in deficit at 5.9% of GDP in 2015, the **Greek** fiscal balance moved into surplus the following year, fluctuating around 0.8% of GDP until 2019. Adjusted for interest payments, it stood at 2.2% of GDP over this period.
- The consolidation of government finances has also been visible in **Portugal**, which achieved its first primary surplus in 2015 (+0.1%). By 2019, this had risen to 3.1%.
- The fiscal adjustment was less extensive in **Spain**, where the deficit was only once below 3% of GDP between 2012 and 2019. In 2019, the deficit was still 3.1% of GDP, down on the previous year (-2.6%). Unlike Italy, Greece, and Portugal, Spain never recorded a primary surplus between 2012 and 2019.

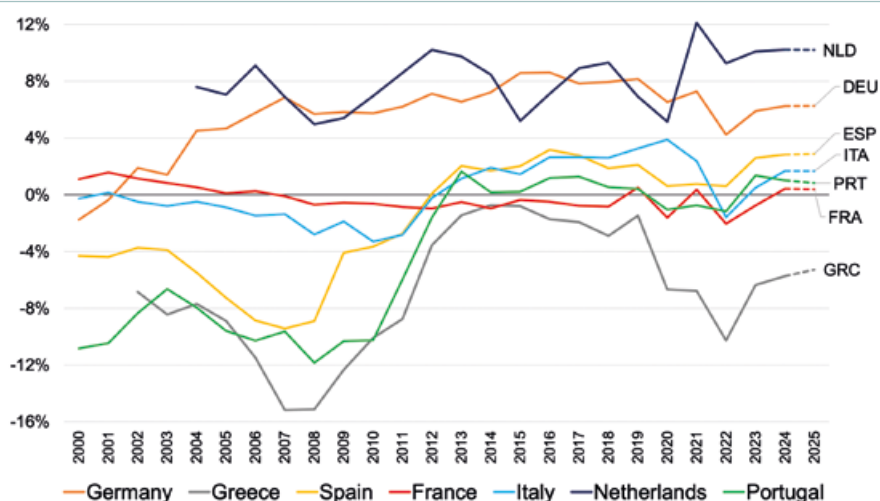


Current account balances – which express relative competitiveness – have also become more consistent over the period 2012-2019

The table below shows that the Eurozone has become much more coherent in the wake of the European sovereign debt crisis.

In fact, in 2016-2017, most of the countries in the Monetary Union – except France and Greece – managed to eliminate their current account deficit.

CHART 34.
Current account balance,
% of GDP



Source: Eurostat, EU Commission's Spring Forecasts (May 2024)

TABLE 3.
Current Account
Balances across
the main EA Member
States, [2012-2019],
% of GDP

	2012	2013	2014	2015	2016	2017	2018	2019	Average
Germany	7,1%	6,6%	7,2%	8,6%	8,6%	7,8%	8,0%	8,2%	7,8%
France	-1,0%	-0,5%	-1,0%	-0,4%	-0,5%	-0,8%	-0,8%	0,5%	-0,5%
Italy	-0,2%	1,1%	1,9%	1,4%	2,6%	2,7%	2,6%	3,3%	1,9%
Spain	0,1%	2,0%	1,7%	2,0%	3,2%	2,8%	1,9%	2,1%	2,0%
Netherlands	10,2%	9,8%	8,5%	5,2%	7,1%	8,9%	9,3%	6,9%	8,2%
Austria	1,5%	1,9%	2,5%	1,7%	2,7%	1,4%	0,9%	2,4%	1,9%
Belgium	-0,1%	1,0%	0,8%	1,4%	0,6%	0,7%	-0,9%	0,1%	0,4%
Greece	-3,6%	-1,4%	-0,7%	-0,8%	-1,7%	-1,9%	-2,9%	-1,5%	-1,8%
Portugal	-1,6%	1,6%	0,2%	0,2%	1,2%	1,3%	0,5%	0,4%	0,5%
Euro area	1,0%	2,1%	2,3%	2,6%	3,0%	3,1%	2,8%	2,4%	2,4%

Source: EU Commission

This period also saw a return to more significant shifts in relative labour costs³². Further improvements were made in countries hit particularly hard by the financial and economic crisis. Cyprus (+18%), Italy (+10%), Portugal (+7%), Spain (+7%), Ireland (+6%) and Greece (+5%) achieved the biggest increases in competitiveness between 2012 and 2019, measured by relative labour costs. In Germany, labour costs rose for the first time again compared to the EU average, resulting in a slight loss of competitiveness (-3%). This is roughly comparable to the figures in Denmark (-5%), Finland (-0%), Austria (-7%) and the United Kingdom (-2%), but somewhat lower than in Belgium (+3%), France (+2%), the Netherlands (+3%) and Sweden (+5%).

But the picture is far from perfect: the current account surpluses in Germany and the Netherlands (over 8% of GDP on average over this period) reflect a situation of "fundamental imbalance" in IMF terms.

As J. de Larosière points out³³, German exports have stood up well to global competition and have also benefited from the additional competitiveness conferred by the euro compared with a situation where each country had an equilibrium exchange rate.

"From this collective point of view, Germany must commit – in particular by investing in infrastructure, by supporting internal demand, and by accepting European solidarity mechanisms – to using the "abnormal" part of its structural surpluses for the benefit of the Union overall growth.

This is not about tax redistribution or a "Union of transfers". It is about correcting a "fundamental imbalance" that risks jeopardizing the survival of the Union if nothing is done to remedy it.

Indeed, we cannot expect the countries of the South – which have balanced their current accounts – to be the only ones to adjust their incomes downwards indefinitely to offset the growing surpluses of the countries of the North.

It is time to implement a symmetrical adjustment mechanism in which structural surpluses are adjusted in the same way as deficits. Countries with long-term surpluses should modify their economic policy by agreeing to increase their investment in infrastructure and to encourage some wage shift."

If this effort is not undertaken quickly, he wrote in 2018, "it is to be feared that the unleashing of populism will threaten the survival of Europe."

32. See the article by M. Beck quoted above.

33. J. de Larosière, "Les 10 préjugés qui nous conduisent au désastre économique et financier", Odile Jacob, 2017.

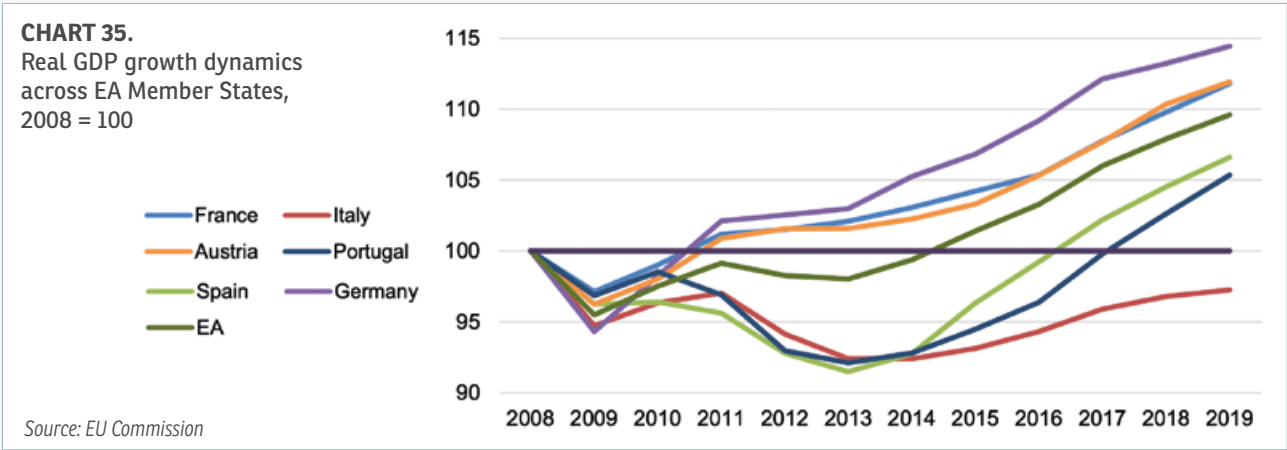
The Macroeconomic Imbalance Procedure has never been modified to remedy this situation. The design and implementation of a symmetrical adjustment mechanism where surpluses are treated in the same way as deficits have never been undertaken, this procedure being limited to addressing the problems of countries with current account deficits.

3.2.2 Growth resumed in peripheral countries, albeit at a slower pace than in the previous decade

Real GDP growth resumed in all EU countries after 2012, but at a slower pace than before the crisis: Spanish real GDP grew by 2.3% on average between 2014 and 2019, compared with 3.8% between 1999 and 2007.

The French GDP growth fell from an average of 1.5% between 1999 and 2007 to an average of 0.9% between 2014 and 2019.

However, in 2019, the Italian real GDP had not returned to its 2007 level, while Spain and Portugal surpassed it in 2017 and 2018 (see Chart 35).



With budget deficits above 3% of GDP and current account deficits throughout the period, France stands out as an exception

France was one of the few countries in the Eurozone, along with Finland and Slovakia, to have maintained public and external accounts deficits between 2012 and 2019, despite a favourable economic climate.

- Between 2012 and 2019, **the French government deficit** has only been below 3% for two years. Unlike all the other major Member States, and following the example of Spain, France has never recorded a primary surplus during this period.
- With the exception of 2019, **France's current account balance** remained in deficit between 2012 and 2019, while Italy's, Spain's, and Portugal's returned to balance in 2013. While these three countries improved their external balances thanks to adjustment policies to correct their external imbalances, moving from a deficit in the previous decade to a surplus, France experienced the opposite trend. Positive between 2000 and 2006, the French current account balance became structurally negative throughout the following decade.

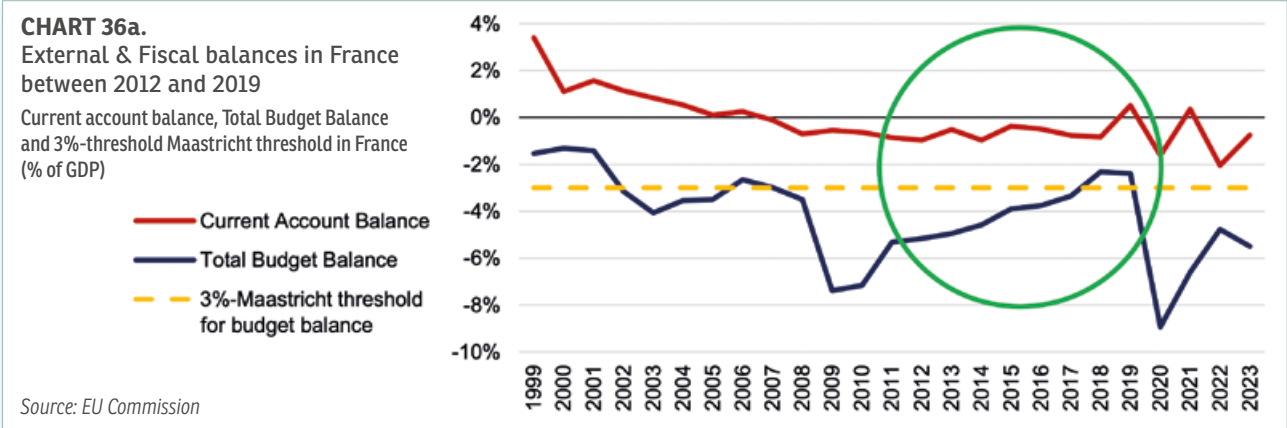
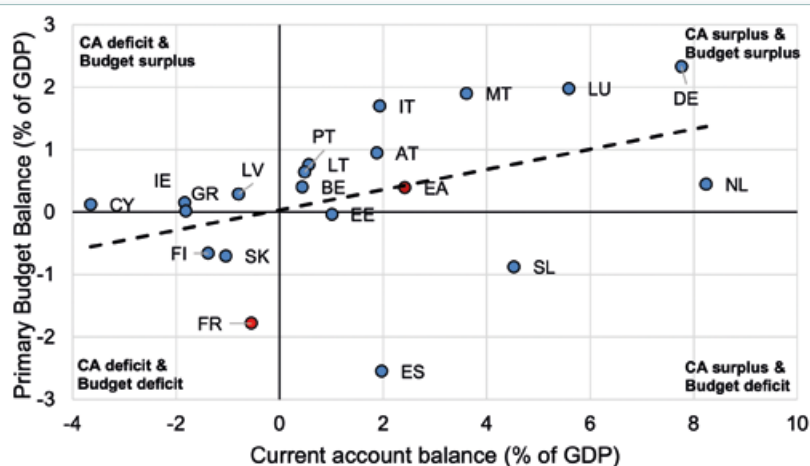


CHART 36b.
External & Fiscal balances
in France between 2012
and 2019

Current account balance vs Primary
Budget Balance across EA Member
States, average 2012-19



Source: EU Commission

3.2.3 Despite improved budget balances, public debt remained a concern in some countries on the eve of Covid-19

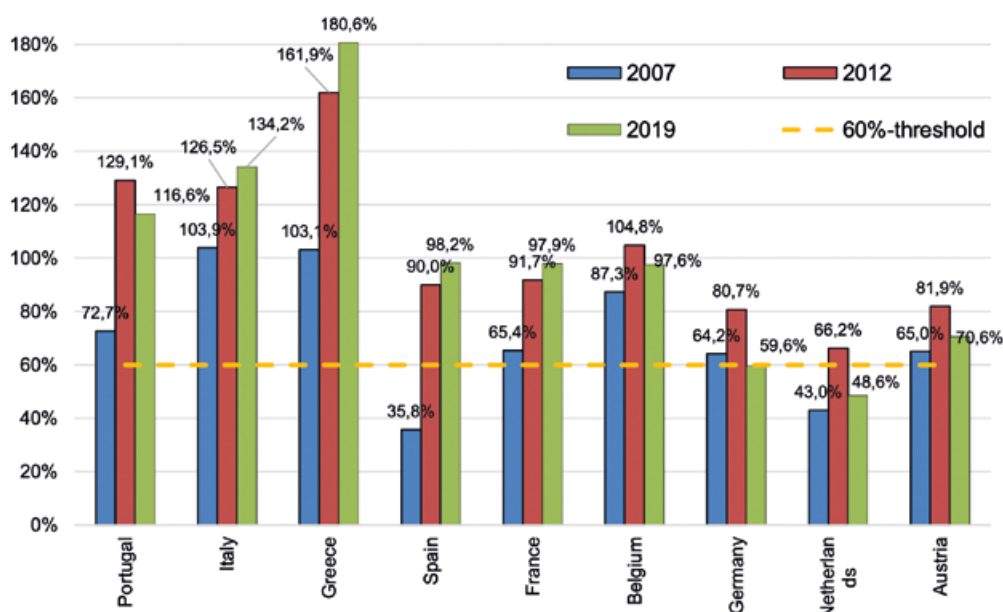
In 2019, seven Member States had a public debt ratio above 90% of GDP. The ratio exceeded 100% of GDP in Greece (180.6%), Italy (134.6%) and Portugal (116.6%). It exceeded 90% in France (97.9%), Spain (98.2%), Belgium (97.6%) and Cyprus (93.1%).

In Italy and Greece, the primary surpluses recorded were not enough to offset high debt service costs and weak growth, leading their public debt to in by 18.7 points and 7.7 points respectively between 2012 and 2019. On the other hand, they were beneficial to Portugal, where public debt fell by 12.5 points over the same period.

In France and Spain, which both ran primary deficits throughout this period, public debt increased by 6.2 points and 8.2 points respectively between 2012 and 2019. The deterioration in public finances in France and Spain contrasts sharply with the budgetary efforts made by Germany, the Netherlands, and Austria, where public debt ratios fell by 21.5 points, 17.7 points, and 11.3 points respectively between 2012 and 2019.

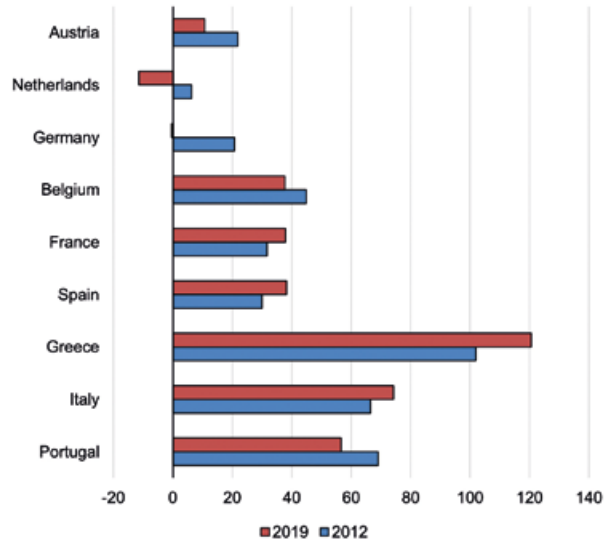
While the public debt of some Member States (Spain, Portugal, and Belgium) moved slightly closer to the 60% threshold between 2012 and 2019, it moved further away from this threshold in Italy, France, and Greece over this period (see Chart 37.b).

CHART 37a.
Gross Public Debt & deviation to Maastricht threshold in 2012-2019
Gross Public Debt, % of GDP



Source: EU Commission

CHART 37b.
Gross Public Debt & deviation to Maastricht threshold in 2012-2019
Deviation relative to the 60%-threshold, percentage point



Source: EU Commission

3.3 2020-2024: economic and budgetary disparities exacerbated by the Covid-19 crisis (2020) and the energy crisis (2022)

The economic consequences of the Covid-19 crisis (2020), exacerbated by the energy crisis caused by the war in Ukraine (2022), have revived economic disparities, particularly between the countries of northern and southern Europe. Northern countries, such as Germany and the Netherlands, were able to rely on healthier public finances to mitigate the economic effects of these shocks. In France and southern countries, such as Italy and Spain, debt levels increased significantly due to a lack of sufficient reforms in the years leading up to these shocks. Against a backdrop of rising interest rates to combat inflation, and slower growth, the divergence in public debt levels between Member States has become a major concern.

3.3.1 In 2020, the impact of the crisis on public accounts and economic growth was greatest in the countries with the worst public finances in the pre-Covid-19 period

EU countries that best managed their public finances after the Global Financial Crisis (2008) and the EU Sovereign crisis (2011-13) are those that suffered the least from the Covid-19 shock.

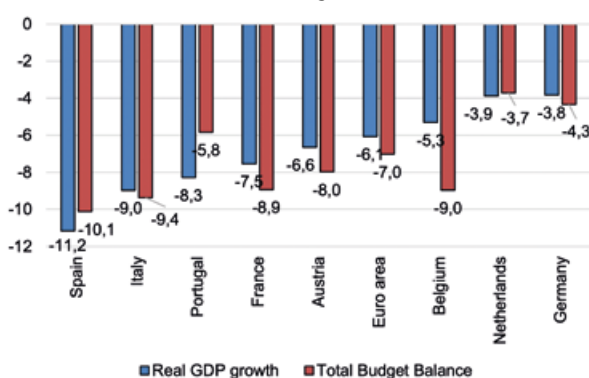
Thanks to the fiscal discipline achieved since 2013, Germany and the Netherlands largely contained the shock induced by the Covid-19 crisis. At 4.3% of GDP and 3.7% respectively, their 2020 fiscal deficit remained below the Eurozone average of 7%. These achievements contrast with the close to double-digit deficit ratios that France (-8.9% of GDP), Spain (-10.1%) and Italy (-9.4%) experienced during the crisis.

During the Covid-19 crisis, France, Italy, and Spain were the most severely hit in terms of output shortfall in the Euro area. In 2020, GDP in Spain fell by 11.2%. It collapsed by respectively 9% and 7.5% in Italy and France.

CHART 38.

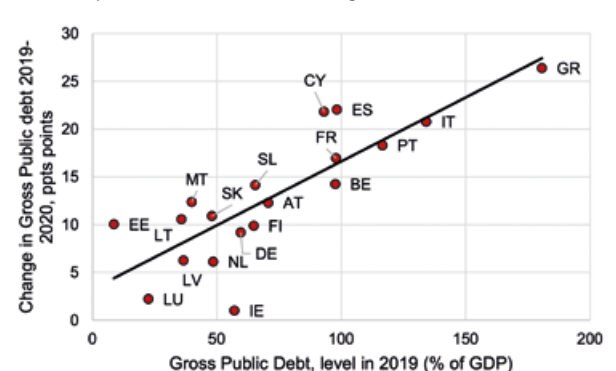
Real GDP growth, Budget Balance & Gross Public Debt dynamics across EA Member States during the Covid-19 crisis

38a Real GDP Growth (%) and Total budget balance (% of GDP) in 2020



Source: EU Commission

38b Gross public debt level in 2019 vs change in 2020



With public finances already deteriorated on the eve of the pandemic, the three countries are among those that have recorded the largest increase in their public debt-to-GDP ratio between 2019 and 2020. Spain experienced the highest rise (+22 percentage points, against 13.2 pp for the Euro area). Italy and France followed, as their public debt grew by respectively 20.8 pp and 17 pp.

3.3.2 The energy crisis exacerbated by the war in Ukraine in 2022 was quickly overcome by the Eurozone, which returned to a positive current account balance the following year

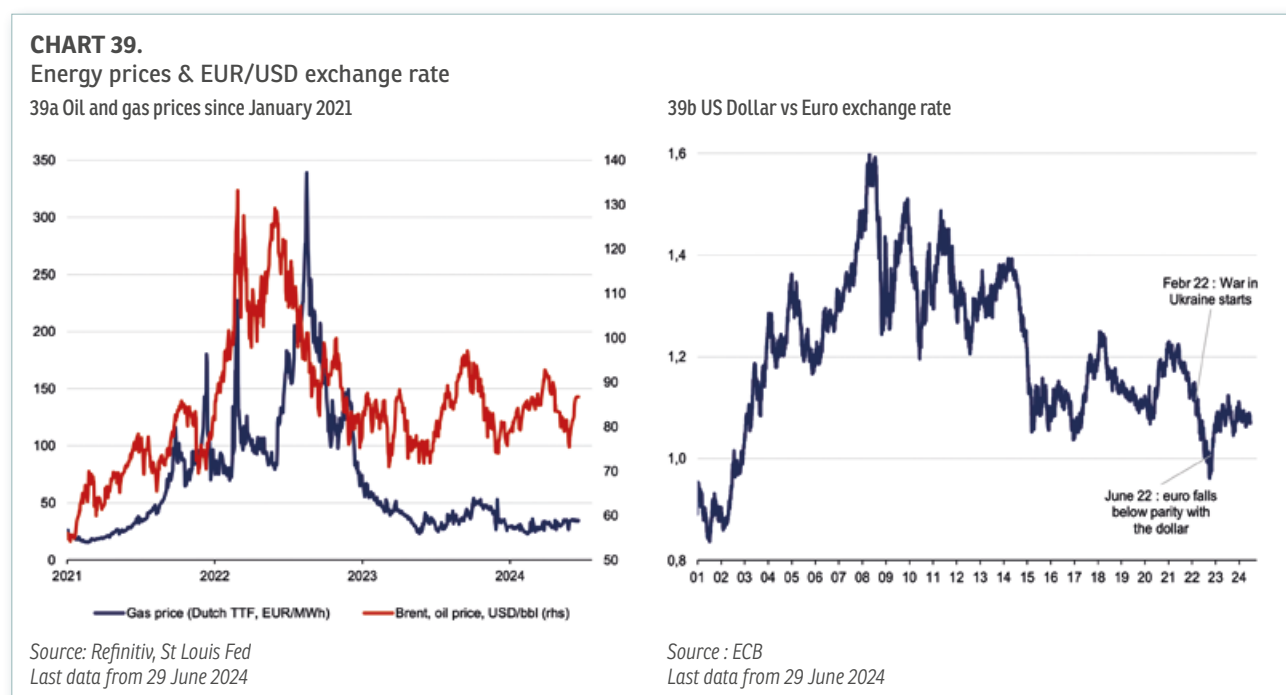
Following the war in Ukraine, the economies of the European Union suffered from a loss of income due to the rise in prices of energy and other imported commodities in 2022. Since the end of 2022, the fall in energy prices and the appreciation of the euro have partially reversed the negative effects of the terms-of-trade shock, which allowed the Euro area's current account balance to return to surplus in 2023.

The Russian war in Ukraine has caused energy prices to soar in 2022, but a substantial reduction in European gas prices occurred after its peak since end-2022.

From slightly above €10/MWh in early 2020, the price of natural gas delivered in Europe increased to €80/MWh before the start of the war in Ukraine. In February 2022, it soared to peak at €339 in August 2022 and has now stabilized at around €50 since January 2023, helped by demand restraint, diversification of supply sources, and exceptionally mild weather.

The drop observed between mid-2022 and the second quarter of 2023 is explained by the diversification of gas supply and its storage which was higher than expected, as well as the mild winter temperatures, the energy savings, and the weak industrial activity.

The depreciation of the euro in 2022 also contributed to higher import costs, as monetary policies diverged between the Euro area and the United States between January 2022 and September 2022. Over that period, the euro plunged by 13.3% against the USD, bringing the value to its lowest level since 2002 (see Chart 39.b).



The movements in international prices triggered significant transfers of wealth between net commodity importing and exporting countries. From the point of view of European economies, this resulted in a real income shock that reduced household purchasing power and corporate profit margins, while deteriorating the competitiveness of exporting firms.

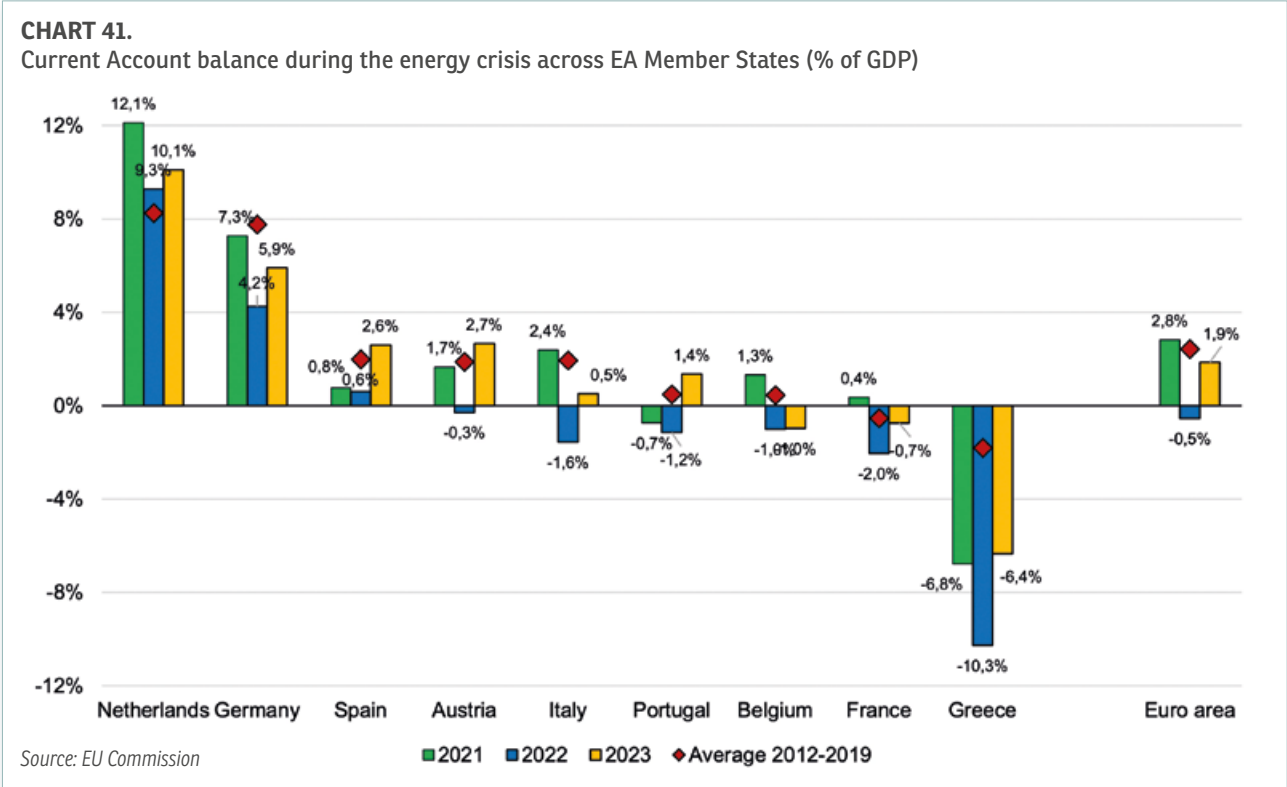
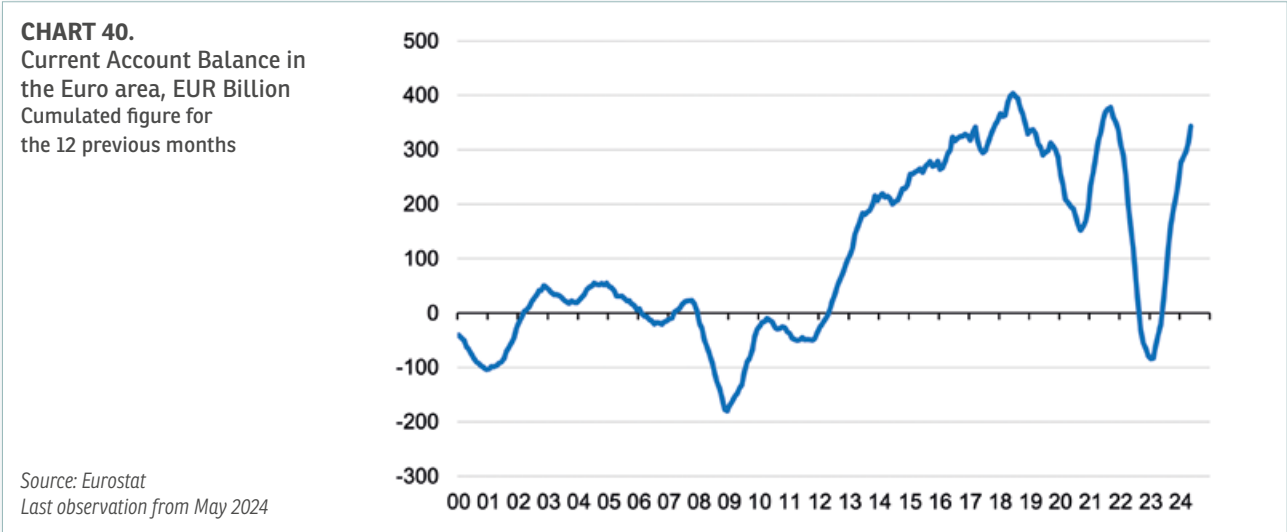
High energy prices and lower exports to China have led to the disappearance of the Euro area current account surplus in 2022.

In 2022, the Euro area current account recorded a deficit of €73.6 bn (-0.5% of GDP), compared with a surplus of €351.2 bn (2.8% of GDP) in 2021.

The energy bill in Europe has risen in a differentiated way depending on Member States' dependence on fossil fuels and their industrial specialization. Energy imports have increased in the Euro area countries as follows:

- From €40 to 50 bn in France in the years 2019-2020 and 2021 (2% of GDP), it rose to €100 billion in 2022 (i.e. 4% of GDP)
- In Italy and Spain, the cost of energy imports reached respectively €100 bn (5.3% of GDP) and €47 bn in 2022 (6% of GDP), compared with an average of €30 before the war (i.e. 2% of GDP in these countries).
- The Italian current account surplus has turned into a deficit, joining France and Belgium which have also reached a current account deficit.
- Germany and the Netherlands have lost most of their current account surplus due to the sharp increase in energy bills.

In 2023, the current account balance surplus reached 1.2% in the Euro area, after a deficit of 0.7% in 2022.



This improvement was mainly due to the trade balance of goods, which rebounded by €300 bn between 2022 and 2023, as a result of falling import energy prices and an easing of supply disruptions. The trade balance in services – tourism in particular – also played a role in the recovery of the current account balance.

According to the EU Commission, the current account surplus reached 5.9% of GDP in Germany and 2.6 % in Spain in 2023, rebounding from respectively 4.2% and 0.6% in 2022. In Italy, the current account returned to a surplus of 0.5% in 2023, following a deficit of 1.6% in 2022. In France, the deficit narrowed to 0.7% of GDP in 2023, from 2% in 2022.

However, as global energy prices are assumed to persist at elevated levels and consequently weigh on import prices, the current account balances in EU countries are expected to remain well below their pre-pandemic levels. Expected at 6.3% of GDP in 2024, the German current account surplus is set to be lower than its 2014-19 average of 8.1%.

3.3.3 Nevertheless, the shock was managed differently by the Member States, which increased the economic and budgetary divergences between them

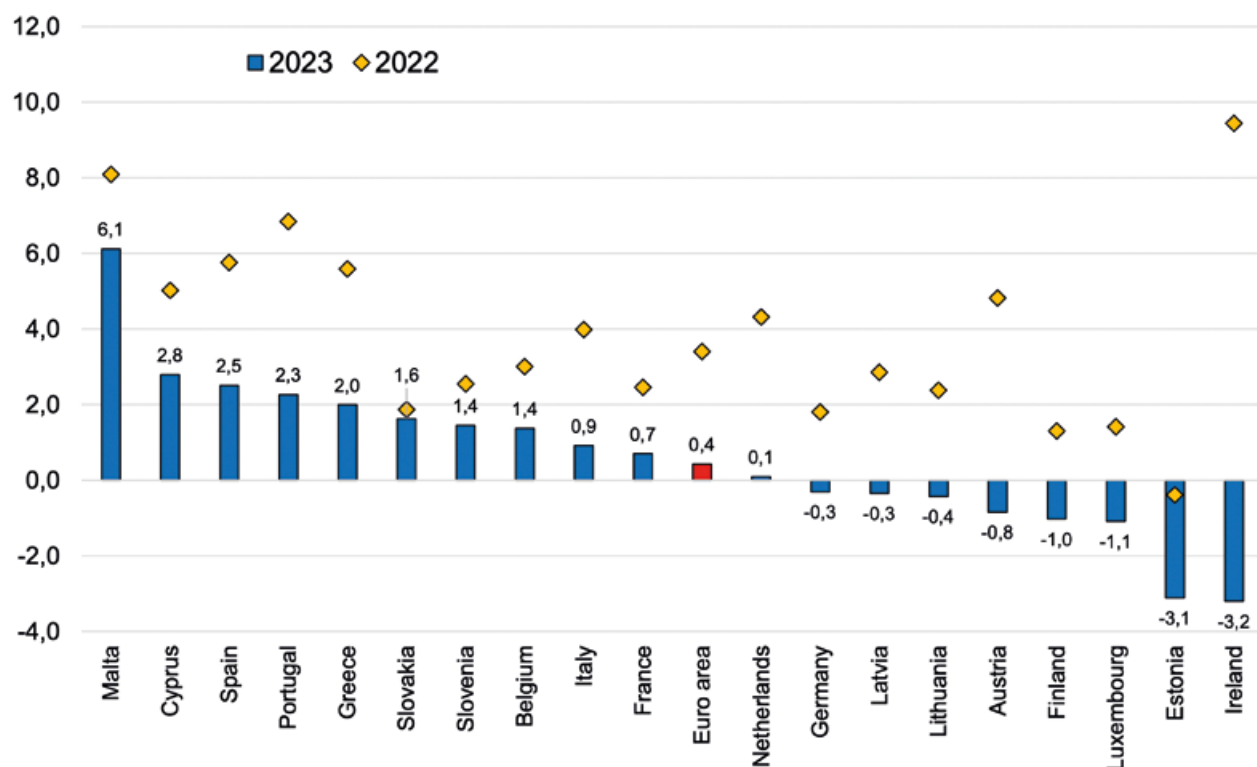
These divergences can be seen in the rates of growth and the scale of budget deficits between countries.

Out of the 20 members of the Eurozone, 8 have recorded a contraction in their real GDP in 2023, including Germany (-0.3%) and Austria (-0.8%). The Baltic States also recorded a significant contraction (Latvia (-0.3%), Lithuania (-0.4%) and Estonia (-3.1%)).

This contrasts sharply with the good performance of the countries of Southern Europe. In 2023, Spain (+2.5%), Portugal (+2.3%) and Greece (+2%) recorded growth close to or even above 2%. With growth in excess of 0.5%, France (+0.7%) and Italy (+0.9%) are doing better than the Eurozone (0.4%).

According to the IMF, the sectoral composition is one explanation for the growth differential in 2023. Advanced European economies dependent on manufacturing (e.g. Germany) have suffered more from the energy shock, while countries dependent on services and tourism fared better (e.g. Portugal and Spain), largely due to the ongoing normalization of travel activity since the Covid-19 crisis.

CHART 42.
Real GDP Growth rate across Eurozone Member States in 2022 and 2023 (%)



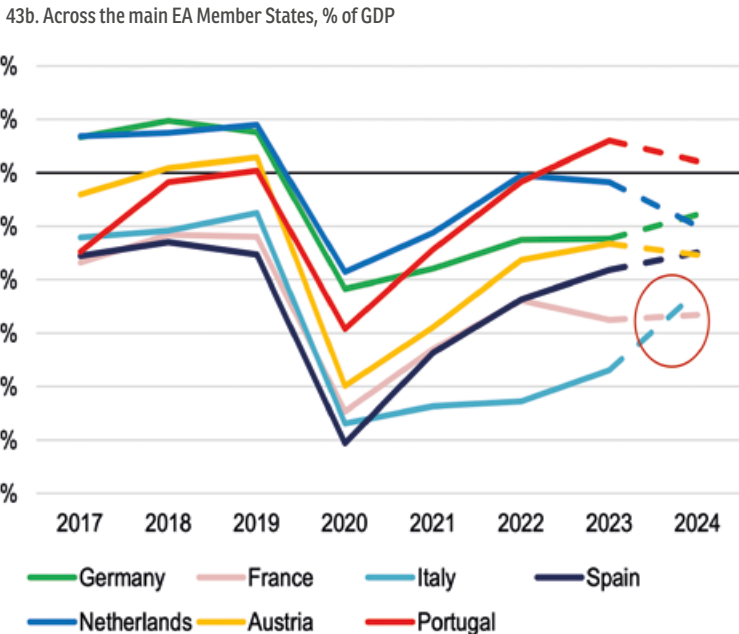
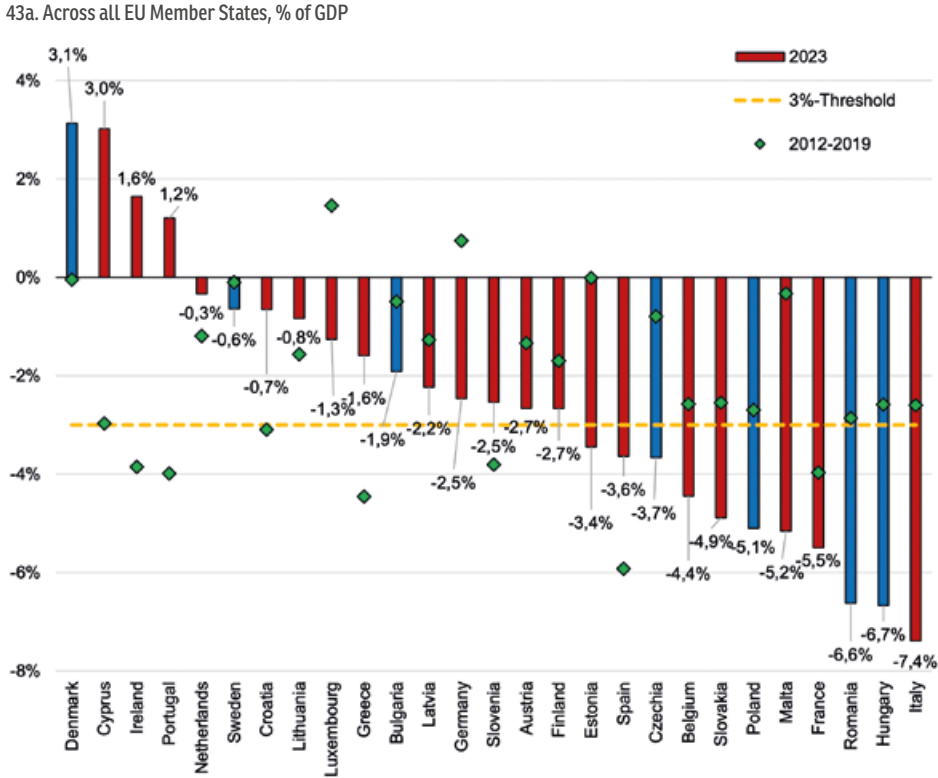
Source: AMECO Spring Forecasts (May 2024)

In 2023, France and Italy recorded budget deficits exceeding 5% for the third consecutive year since 2020, leading them to enter the excessive deficit procedure.

In addition to sectoral composition, the extent of fiscal expansion also helps explain growth differentials across countries. When it comes to budget deficits, France and Italy especially stand out from the other European countries. For the third consecutive year in 2023, the deficit was over 5% of GDP in both countries, at 7.4% in Italy and 5.5% in France. Belgian (4.4%) and Spanish (3.6%) deficits also remain above of 3% of GDP for 2023.

Germany, Portugal, and the Netherlands managed to maintain relatively balanced current account balances, even surpluses in some cases, thanks to sustained efforts since 2021 to bring their public deficits down to 3% or less.

CHART 43.
Recent trend in Government Budget Balance across EU Member States



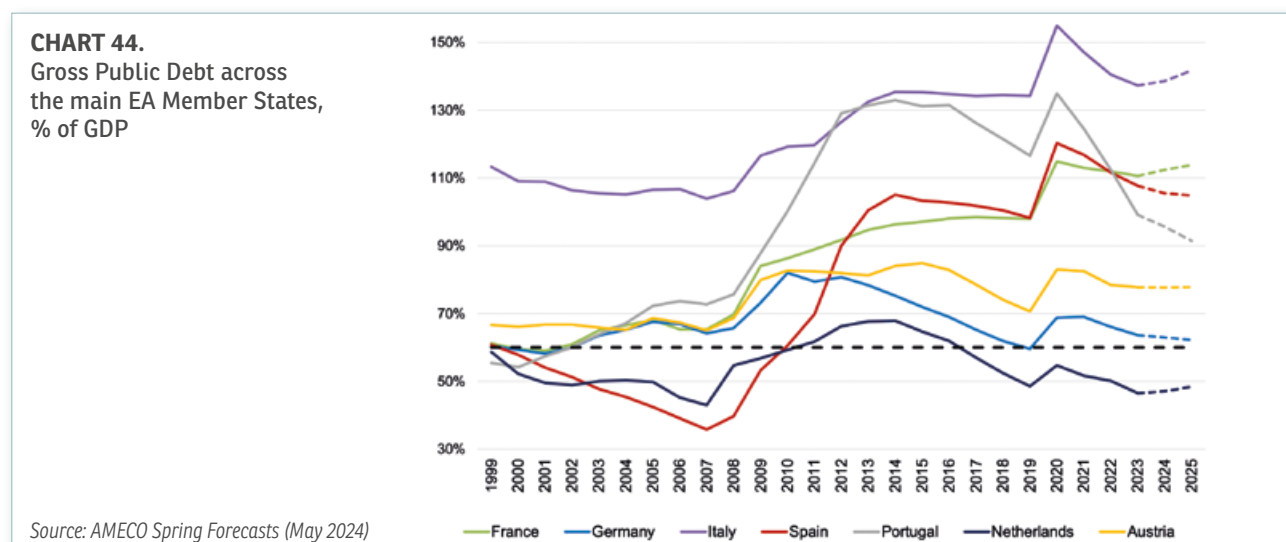
Source: AMECO Spring Forecasts (May 2024)

Although high inflation has helped to reduce public debt since 2021, rising interest burden combined with slower GDP growth should reverse this trend from 2024 in some indebted countries.

Until 2023, the continuation of high primary deficits combined with the increase in the debt burden was more than offset by nominal growth, which itself was largely boosted by inflation. This mechanism has been particularly favourable to the most heavily indebted countries, which have seen their debt ratios fall since 2021. In Spain, the public debt ratio has fallen by 13 points, from 120% of GDP in 2020 to 107% in 2023. At 155% of GDP in 2020, Italian public debt amounted to t 138.6% of GDP in 2023. In France, the ratio has fallen by 4 points, from 114.9% in 2020 to 110.6% in 2023.

However, this trend is set to reverse as early as 2024. The reduction in nominal growth, combined with rising interest charges and continuing high primary deficits, could lead to a rise in the debt ratio in some Member States. According to the European Commission's May 2024 forecasts, debt ratios are projected to start rising again from 2024 in France (from 110.6% of GDP in 2023 to 112.4% in 2024) and Italy (from 137.3% to 138.6%). Unlike France, which is expected to maintain a primary deficit above 3% of GDP (3.3% in 2024 vs. 3.8% in 2023), the increase in Italian public debt is more likely to be linked to the expected rise in the interest burden, which the reduction in the primary deficit (-0.5% in 2024 vs. -3.6% in 2023) may not offset.

Thanks to continued primary surpluses in 2024, the public debt ratio should continue to fall in Portugal (99.1% to 95.6%) and Greece (161.9% to 153.9%). Combined with nominal growth still exceeding 5%, the reduction of the Spanish primary deficit should also help to reduce public debt in 2024 (105.5% in 2024 vs. 107.7% in 2023). Despite their encouraging trends, the public debt ratios of Spain, Greece and Portugal will nevertheless remain well above those of Germany (62.9%) and the Netherlands (47.1%) in 2024.



One major uncertainty continues to weigh on the future of the euro: the sustainability of the public debt of major Eurozone countries (France, Italy, Belgium).

Continued fiscal stimulus since the pandemic has led to a deterioration in these countries' public finances. Their public debt ratio exceeds 100% of their GDP.

It is important to understand that as public debt ratios worsen, the problem of debt sustainability becomes more acute.

Historically, a negative "r-g" difference³⁴ does not eliminate sustainability problems. First, the growth rate and the interest rate are not independent of the level of debt. The higher the level of debt, the greater the tendency for market interest rates to rise and for the economy to become more fragile, hence the need to be extremely cautious about the risks to debt sustainability in Europe. We need to understand that money creation and the purchase of government securities will not always solve this problem. The Maastricht Treaty sets limits on the monetary financing of treasuries, and opinions on this issue are far from unified.

Second, even with a negative "r-g", their debt ratio will increase as long as their primary deficit is greater than the "stabilizing deficit", which depends on economic growth and the level of interest rates and the level of public debt of the previous year.

34. With *r*, the apparent interest rate (debt service cost/government debt at *t*-1); and *g*, the nominal GDP growth rate.

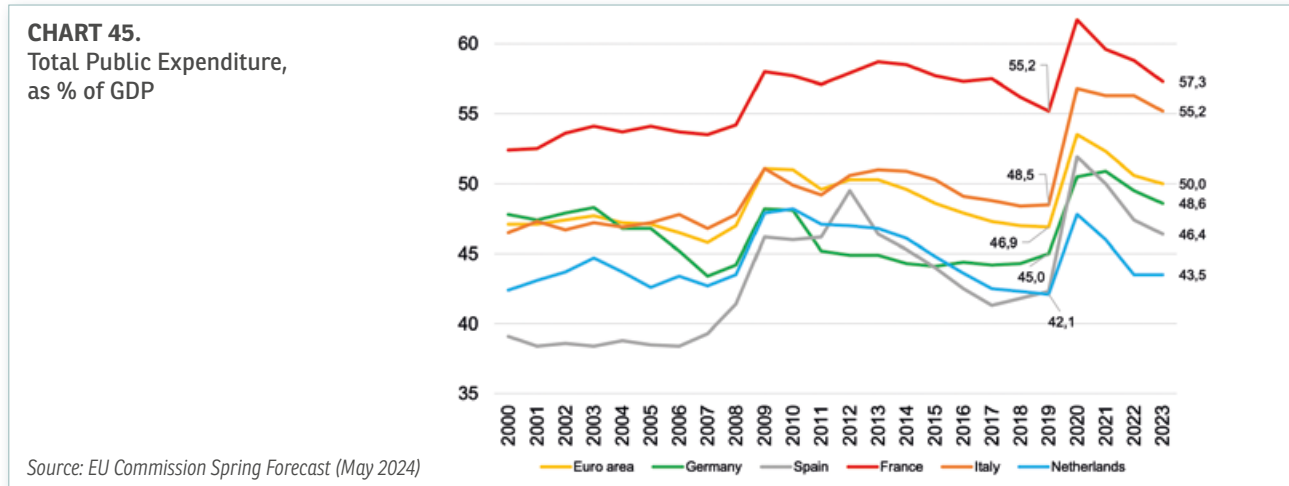
Against this backdrop, there is an urgent need for over-indebted countries to improve their budget balances, at the risk of exposing themselves to a market correction. Securing primary surpluses over a long period (as Portugal has done in recent years) is the only credible solution to reducing public debt, particularly in an environment where $r-g$ is becoming less favourable.

Ultimately, the fate of the euro will depend on the political will to achieve genuine cooperation within the zone. If the fiscal, inflationary, and economic drift continues in the Eurozone, the 'virtuous' countries will end up paying the price. This would be the definition of an uncooperative game, where most of the players try to evade their obligations by passing on the cost to those who respect them. We must therefore take control of the Union's destiny and not let it drift. If we do not, the logical outcome could well be another inevitable Eurozone crisis.

4. EU countries with the highest level of government expenditure as percentage of GDP have the least competitive firms

4.1 With 57,3% of GDP in 2023, France holds the record for the highest level of public spending in the EU

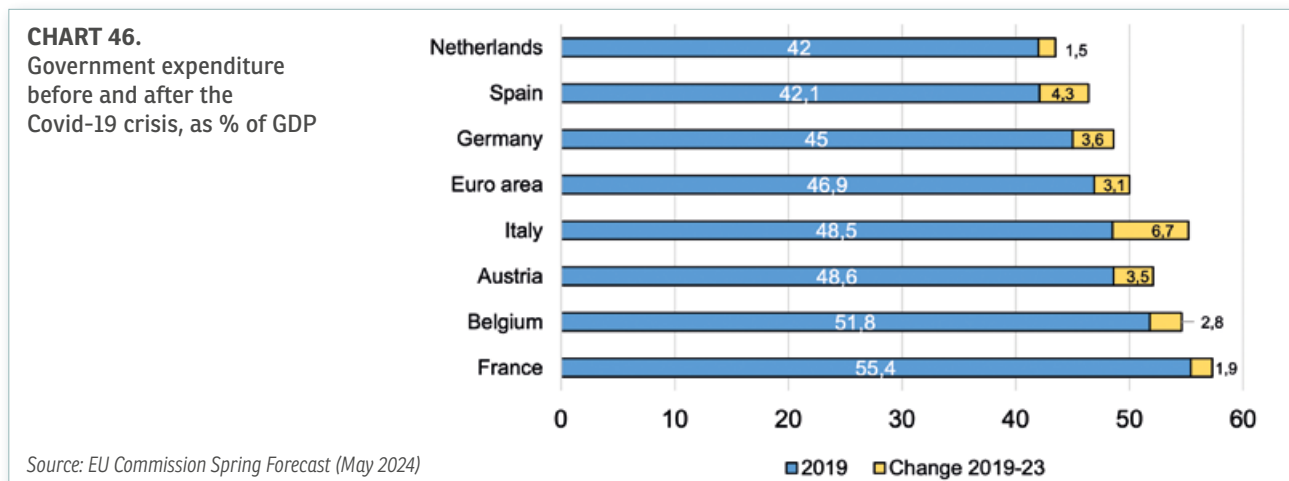
France already had the highest level of public spending in the EU before the Covid-19 crisis, with 55.2% of GDP in 2019. Finland (53.3%) and Belgium (51.9%) were the only two other countries in the Union where this ratio also exceeded 50% of GDP in 2019. By contrast, the level of public spending in Germany, the Netherlands, Spain and 17 other EU members remained below the EU average of 47% of GDP.



Following the Covid-19 crisis, government expenditure increased by 1.9 pp in France from 2019 to 2023, compared with 3.1 pp in the Eurozone (see Chart 46). France is among the countries whose increase in spending as a percentage of GDP was the lowest: it was 3.6 percentage points in Germany, 6.7 pp in Italy, 3.5pp in Austria, 4.3 pp in Spain and 1.5 pp in the Netherlands.

The recent decline in government expenditure between 2020 and 2023 in EU Member States reflects mainly the phasing out of pandemic-related measures. Except for Denmark, Portugal Ireland and Sweden, public spending to GDP ratios remained above their pre-pandemic levels in all EU Member States in 2023. The implementation of energy support measures by governments in response to the energy crisis contributed to keeping public spending elevated in the EU (see Part 3).

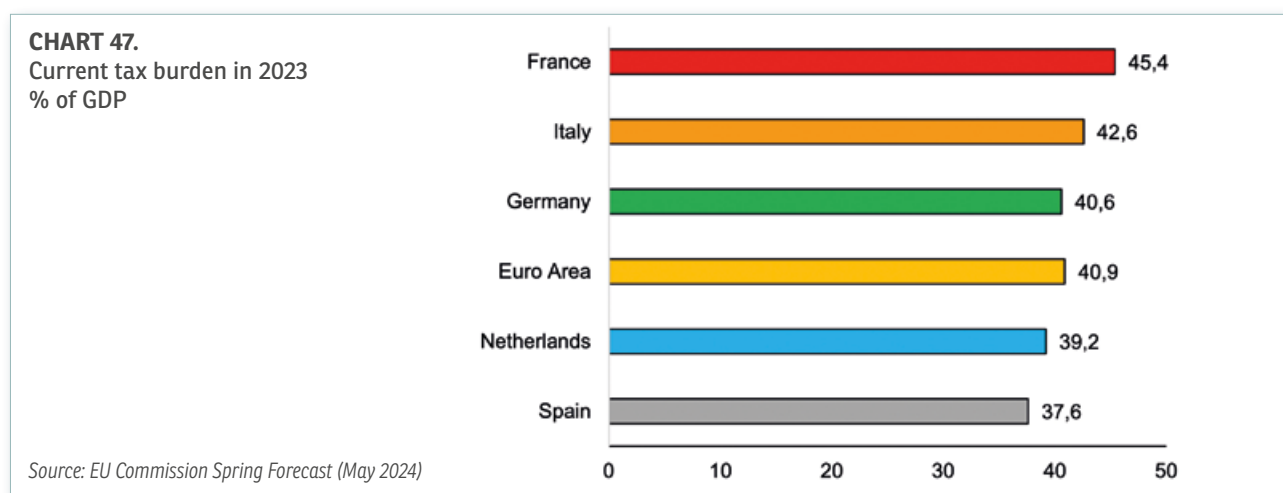
Starting from a much higher level of spending than the other countries in 2019, France remained at the top of the Eurozone, with public spending equal to 57.3% of GDP in 2023. This is more than seven points above the Eurozone average of 50% of GDP, 8.7 pp above the German's level of 48.6% of GDP, and 13.8 pp above the Dutch's level of 43.5%. In Italy, public expenditures still exceeded 55.2% of GDP in 2023.



4.2 High public spending implies high tax pressures on firms, increasing their production costs and deteriorating their competitiveness

France, followed by Denmark, has the highest tax rate in the EU. Its current tax burden – the amount of tax levied on companies and households³⁵ – accounted for 46.6% of GDP in 2019. That was nearly five percentage points higher than the Euro area average (41.1%).

In 2023, the level of current tax burden decreased marginally across Member States, but the ranking remained the same as before the Covid-19 crisis: the level of taxation remained the highest in France, reaching 45.4% of GDP in 2023, above Belgium (45%) and Denmark (44.4%). In 2023, France's level was almost 5 pp higher than that of Germany (40.6%), the Netherlands (39.2%) and Spain (37.6%), according to the European Commission.



Too much taxation contributes to the erosion of domestic firms' competitiveness. With a level of taxes on production and imports exceeding the Euro area average by 3.8 points in 2022 (see Table 4), France has been suffering from a permanent deficit in its trade balance and more broadly its current account balance since 2007 (see Chart 48). Within the EU, eight other Member States experienced a negative current account balance on average, between 2014 and 2019. Among them, Cyprus has the highest deficit (-3.9% of GDP), followed by Romania (-2.5%) and Greece (-1.6%).

TABLE 4.
Breakdown of tax revenues by country and by detailed tax categories in 2022, % of GDP

	Taxes on production and imports	Current taxes on income, wealth, etc	Capital taxes	Net social contributions	Total
Germany	11,1	13,6	0,2	17,2	42,1
France	17,0	13,5	0,7	16,9	48,0
Italy	14,5	15,0	0,1	13,4	42,9
Spain	12,2	12,2	0,4	13,4	38,3
Netherlands	11,7	13,9	0,3	13,1	39,0
Euro Area (20)	13,2	13,5	0,3	14,9	41,9

Source: Eurostat

By contrast, countries with tax levels below the Euro area average are home to the Eurozone's most competitive companies. With tax revenues on production and imports accounting for 11.1% of GDP in 2022, Germany has the third highest current account surplus, behind the Netherlands, which also boasts a relatively low-level tax burden (11.7% of GDP).

The French trade balance deficit of €47.1 bn in 2021 was mainly due to the negative trade balance of goods, which amounted to €69.8 bn, following a steady decline since 2014. This deficit was partly offset by the surplus in the balance of services (+€22.7 bn in 2021), rising thanks to the recovery of global tourism after the pandemic.

35. The current tax burden of total economy is the sum of Indirect taxes (VAT, imports production), direct taxes (income and wealth, and capital) and social security contributions (actual and imputed), according to the AMECO definition.

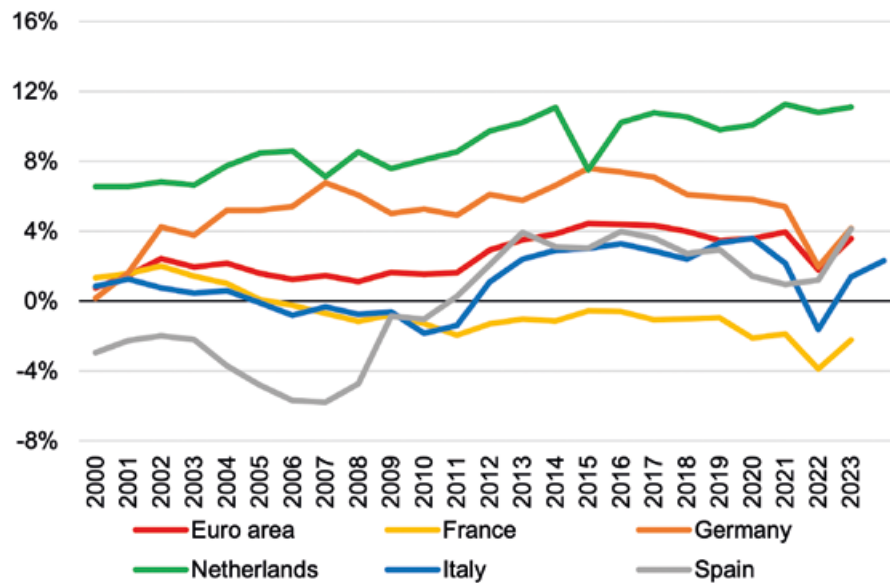
In the same year, Germany recorded a trade surplus of €195.2 bn, resulting entirely from trade in goods (see Chart 49). The German trade balance in goods has always been in surplus over the past two decades, while it has gradually fallen into deficit in France since 2004. Such a poor performance is the result of deindustrialization and the expansion of the less export-oriented service sector that began in the late 1980s (see Part 5).

As described in Part 3, the energy crisis strongly deteriorated the external balance of EU Member States in 2022. Higher energy imports coupled with lower exports to China pushed Germany's trade balance to €76.3 bn, a drop of 40% from 2021. In France, the trade deficit doubled compared to 2021, to -€102.4 bn in 2022.

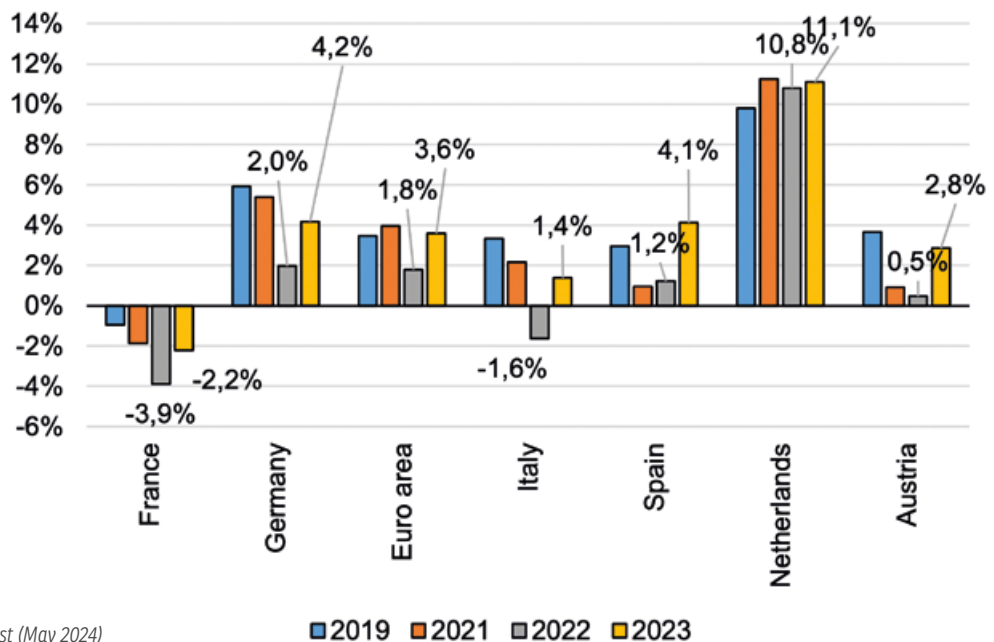
Although the trade balance improved the following year in both countries, the picture remained the same: in 2023, Germany recorded a trade surplus of €171.6 billion (4.2% of GDP), while the French deficit amounted to €62.2 billion (-2.2% of GDP).

CHART 48.
Net Exports of Goods and Services, % of GDP

48a. Over the past decade



48b. Recent trend

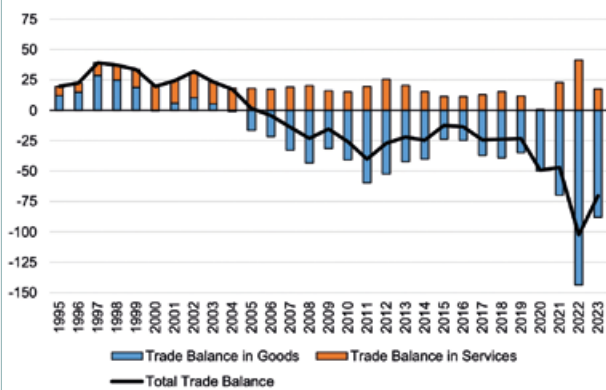


Source: AMECO Spring Forecast (May 2024)

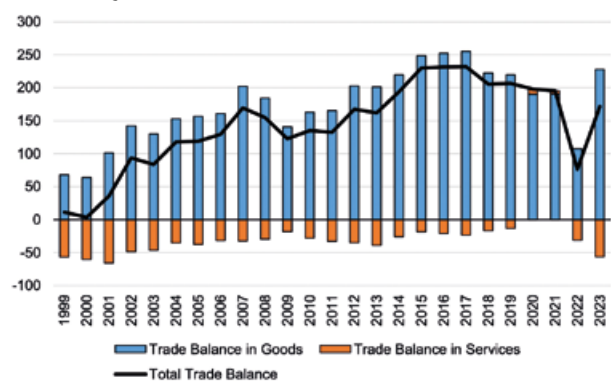
CHART 49.

Trade Balance in France and Germany, € bn

49a. France



49b. Germany



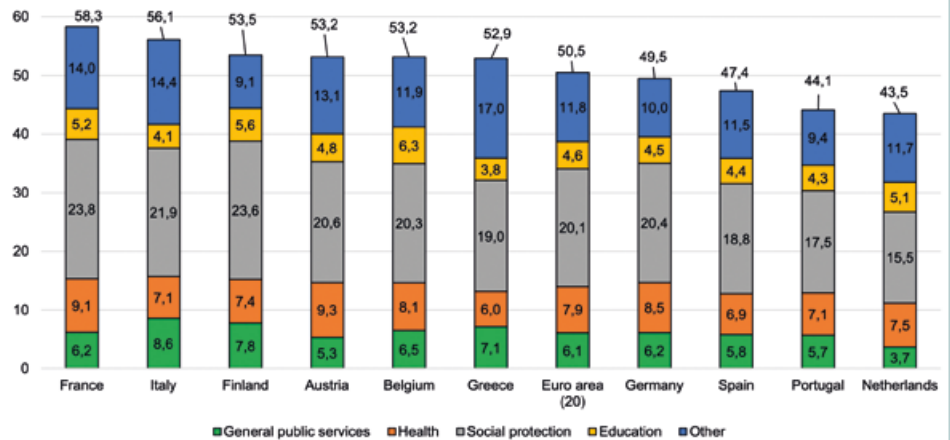
Source : AMECO Autumn Forecast (May 2024)

4.3 Most government expenditures are allocated to social protection, health and public services

On average, Euro area countries allocated 39.7% of their public spending to social protection, corresponding to 20.1% of GDP in 2022 (see Chart 50). As a percentage of GDP, France has the highest share at 23.8%, followed by Finland (23.6%). Health is another prominent function of public spending in the Euro area (15.6% of total expenditure in 2021), followed by general public services³⁶ (12%).

CHART 50.

Major Functions of Public Expenditures of Selected EU Member States, % of GDP (2022)



Source: Eurostat

Notes: 'Other' includes Defence, Public Order and Safety, Economic Affairs, Environmental protection, Housing and community amenities; Recreation, culture and religion

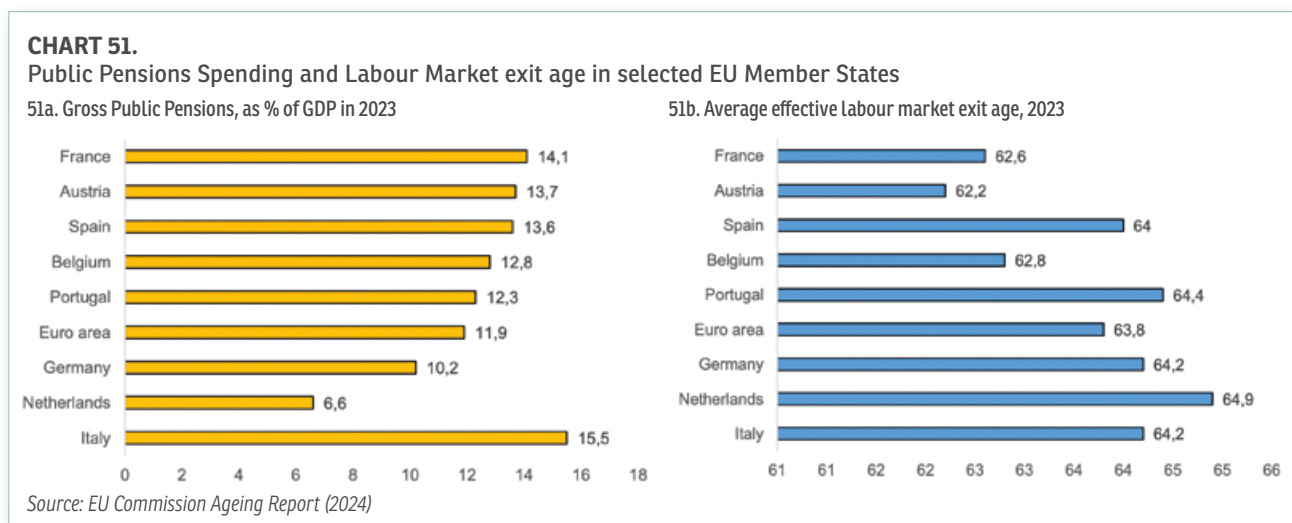
Public pensions represent the largest component of social protection expenditure. Representing 11.9% of the Eurozone's GDP in 2023, their level is closely linked to the average age of effective exit from the labour market (see Chart 51). In most EU countries, the earlier people of working age retire, the higher the total cost of pension. France, whose average exit age from the labor market is one of the lowest in the EU (62.6 years), is the country that spends the most on pension schemes: 14.1% of its GDP in 2019, compared with an 11.9% Eurozone average.

The issue is even more worrying in the context of an aging population, characterized by a growing number of elderly compared to a declining working-age population. By 2030, the proportion of the total population aged 65 and over is set to rise to 23.7% (from 21.4% in 2023), while the ratio of the working-age population (25–64) is set to fall to 35.6%, from 36.5% in 2023.

36. According to Eurostat, "general public services" cover the financing of administration, operation or support of executive and legislative organs, foreign economic aid, general services provided by the public sector, as well R&D spending made by public administrations – see Manual on sources and methods for the compilation of COFOG statistics – Eurostat (2019), for further details.

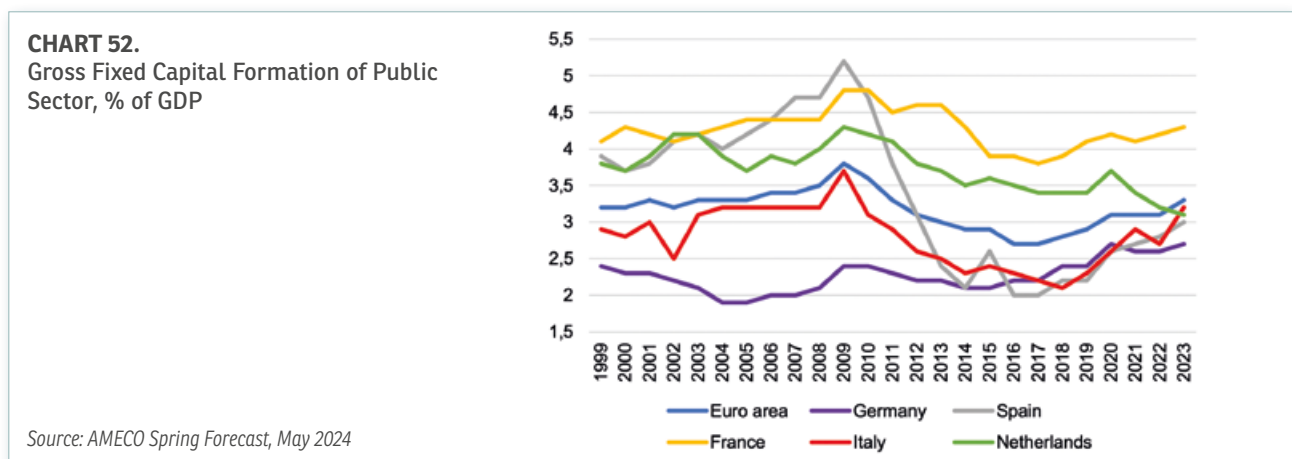
In Italy, the pension system remains one the costliest for the government in terms of GDP, despite the relatively high effective average retirement age in the EU. There are three main reasons for this:

- **The generosity of the system.** The replacement rate – which is the percentage of an individual's annual employment income that is replaced by retirement income – was 15 pp higher than the EU average in 2022 (59.3% in Italy against 44.2% in the EU).
- **The persistent low level of employment rate.** In 2019, 64.8% of people aged between 20–64 were employed. This is the second lowest employment rate in the EU, just above Greece (66.3%), and nearly 10 pp below the EA average (74.1%).
- **The ageing population.** The Italian downward demographic trend is one the most salient in the EU. In 2023, 24.2% of the Italian population was aged 65 or over. This is the highest level in the EA (whose average is 21.8%). This figure contributes to further deteriorating the old-age dependency ratio, which corresponds to the number of dependent people aged over 65 relative to the working population (20–64). The ratio stood at 41.3% in 2023 (vs 37.3 in the EA) and is expected to reach 48% by 2030 (vs 43.3 in the EA).



4.4 Such levels of government expenditure have been reached at the expense of productive investment, hence its limited contribution to gross capital formation

Apart from periods of crisis, the share of public investment³⁷ has never exceeded 3.5% of GDP in the Euro area since 1996³⁸. Moreover, against the backdrop of rising public expenditures, the share of public investment in total public spending fell between 2007 and 2023 in several Member States (see Chart 52).

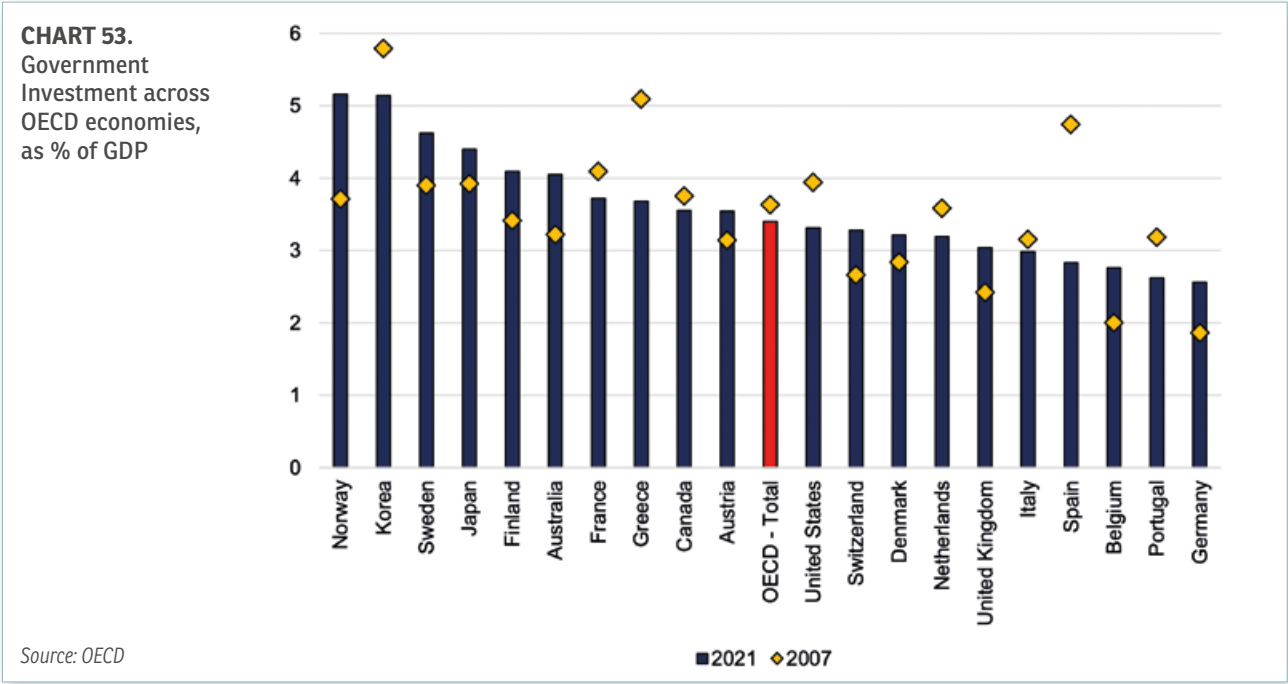


37. For government, gross fixed capital formation includes transport, office buildings, housing, school and hospital infrastructures.

38. 1996 is the first available year recorded by Eurostat.

After reaching 3.4% of GDP in 2007 – its highest level outside the crisis period – the ratio of public investment to GDP in the Euro area gradually declined to 2.6% in 2017 (see Chart 52) before rising slightly to 2.8% in 2019. At an average of 2.7% of GDP between 2014 and 2019, public investment in the Euro area remained below the level of most non-European economies, including the United States (3.2%), Canada (3.7%), Australia (3.6%) and South Korea (4.4%) according to OECD data.

This period of under-investment at the EU level can be attributed to Germany, where public sector investment never exceeded 2.4% of GDP between 1995 and 2019. The Spanish and Italian governments also contributed to this decline, both investing less than 2.5% of GDP between 2012 and 2018. In the two countries, public investment was still below its pre-2008 level in 2023.



Limited spending on R&D – a measure of immaterial investment – is also a concern. Most EU Member States allocate less of their spending to this matter than the OECD average (of 2.9% of GDP in 2021). Among the larger EU Member States, only Germany and Austria stand out, with levels close to the US and Japan (see Chart 54).

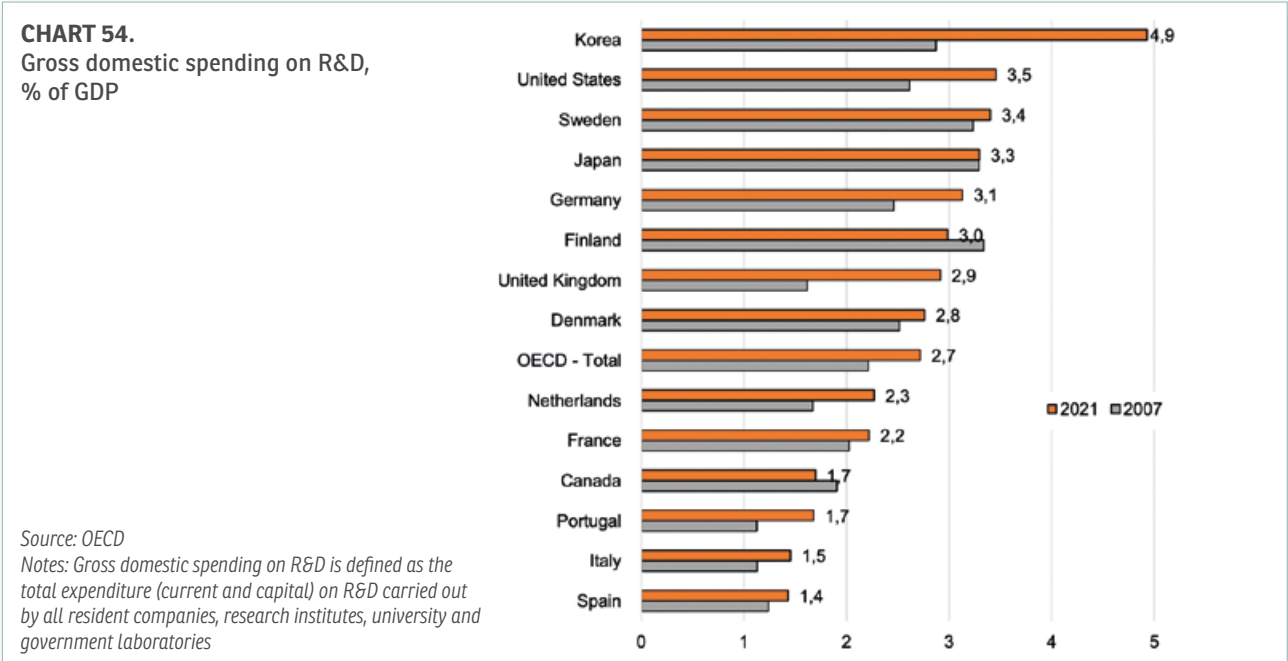
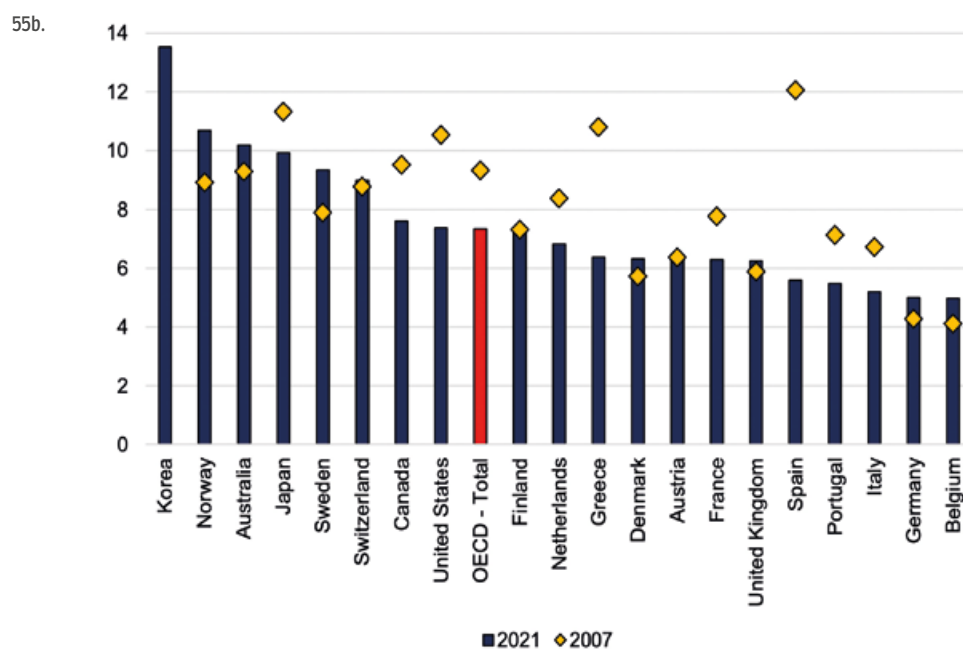
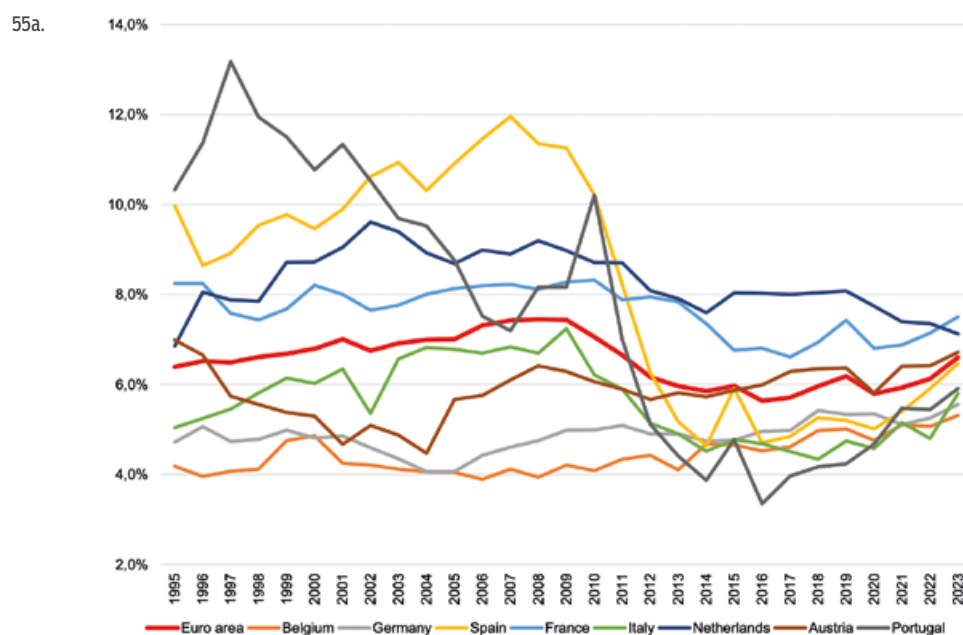


CHART 55.
Share of Public
Investment in
Total Government
Expenditure, %



Source: AMECO, OECD

Although public expenditures increased in some key EU Member States, the share of public investment in total public expenditures declined overall between 2007 and 2023, by approximately 0.5 pp at the EU level, from 7.6% in 2007 to 7.1% in 2021. With an average of 6.1% between 2014 and 2019, the share of public investment in the Euro area is one of the lowest among other advanced economies, such as the UK (6.5%), the US (8.5%) and Canada (9%) (see Chart 55).

Among the largest EU Member States, only Germany and Belgium have seen an increase in the share of public investment in total government spending, although their level of gross fixed capital formation remains among the lowest in Europe.

The most indebted Member States have seen the sharpest decline in the share of expenditure allocated to public investment over the last two decades. While France devoted an average of 8% of its total expenditure to investment between 2000 and 2007, this share fell to an average of 7% between 2014 and 2019, a decline of 1 pp. It fell by 1.8 pp in Italy, 4.4 pp in Greece and 5.6 pp in Spain.

In other words, these data show that the countries with the highest public debts are those that invest the least to increase their potential growth and thus prepare for the future. As stated by the EU Commission, such decline

among highly indebted countries suggests that “the accumulation of public debt has not translated into a higher capital stock, indicating that deficit spending has not been channeled towards capital expenditure but financed consumption.”³⁹

In 2021, the share of public investment in total government spending exceeded its pre-pandemic level in most European economies, although it remained lower than in most non-European economies.

According to the EU Commission, the EU aggregated public investment-to-GDP ratio is set to increase from 3.1% of GDP in 2019 to 3.7% in 2025, as almost all Member States are expected to spend more on public investment than they did before the pandemic. As stated in the Spring Forecast of May 2024⁴⁰, “the increase between 2019 and 2025 is related to investment financed by both the EU budget – particularly by the RRF – and national budgets.”

Introduced in February 2021, the RRF aims to repair the immediate economic and social damage of the coronavirus pandemic, disbursing up to €648 bn (in 2022 prices), of which €357 billion are paid in grants and the remainder in loans over the period 2021–2026. As the largest beneficiary, Italy is set to receive €191.5 bn in grants and loans, equivalent to 10.8% of Italy’s GDP in 2021 by 2026. By the end of 2023, it had absorbed 52% of the available funds. Spain is the second largest beneficiary, with available funds amounting to €163.5 bn in grants and loans, or 13.5% of its GDP. Less than a quarter (23%) have been disbursed so far (see *Part 6 for a detailed analysis of the NGEU plan*).

39. S. Langedijk et al. “The role of the fiscal framework to foster public investment, including in light of the green and digital transitions” Quarterly report on the Euro area, vol 21 n°4 (2022), February 2023.

40. Spring Forecast, EU Commission, May 2024.

5. Excessive level of government debt does not fuel productivity growth and employment

5.1 The most indebted countries of the Eurozone have achieved the lowest productivity growth performance in the past two decades

Since 1999, Member States whose public debt to GDP has risen steadily to reach the highest levels in the Eurozone have recorded the weakest performance in terms of total factor productivity growth⁴¹. In fact, the countries where public debt increased the most between 1999 and 2023 are those where productivity grew by less than 5% over this period. Most of these countries have public debt well above 90% of GDP, such as France, Italy – where productivity has fallen over the past 25 years – and Spain.

By comparison, productivity gains have been almost twice as high in countries where public debt has risen little, or even fallen, over the 1999–2023 period. These are essentially Member States where public debt did not exceed 80% of GDP in 2023, such as Austria, the Netherlands, and Germany.

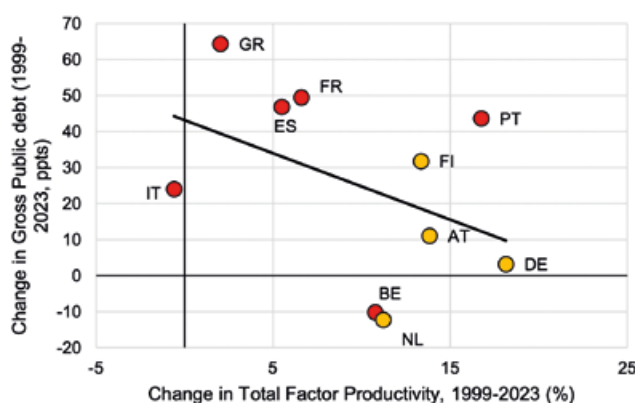
Such a negative relationship between public debt and productivity gains also shows the extent to which excessive recourse to public debt can damage the supply side of the economy by undermining incentives for undertaking long-term investments and innovation. This is detrimental to productivity.

These divergences in productivity translate into differences in living standards in the Euro area. The Covid-19 crisis exacerbated this problem: some of the economies with the lowest productivity gains over the past ten years are also those harder hit by the pandemic crisis.

K. Knot, Governor of the De Nederlandsche Bank (DNB) stated that this issue is concerning⁴², “because it threatens the coherence of the Economic and Monetary Union [...]. Resilience is about balance [...]. If you put more pressure on one leg than the other, you are bound to get some serious health problems at some point. That is not what the patient needs [...]. What the patient needs is some care to wean it from its dependence on debt and to bring back balance in economic growth.”

CHART 56.
Change in public debt vs change in productivity across the main EA Member States between 1999 and 2023

Source: EU Commission
Notes: Countries with red dots had a gross public debt to GDP ratio above 90% in 2023



5.2 The highest unemployment rates in the EU since 2007 were reached in the most indebted EU countries (Spain (11.7% in May 2024), Italy (6.8%) and France (7.4%))

Although French unemployment rate declined slowly below its level of 2007 in 2024, massive unemployment reveals a key structural labour market weakness.

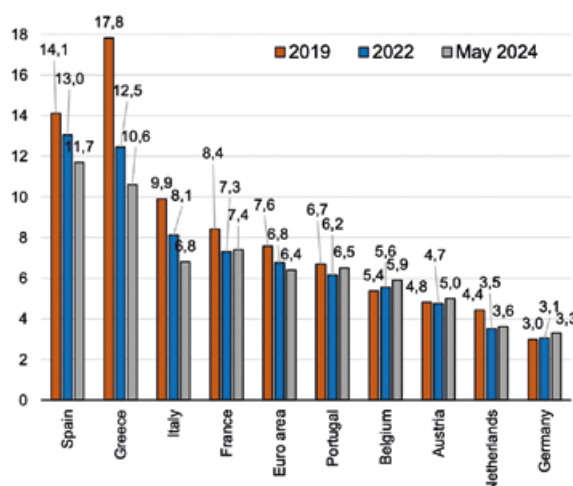
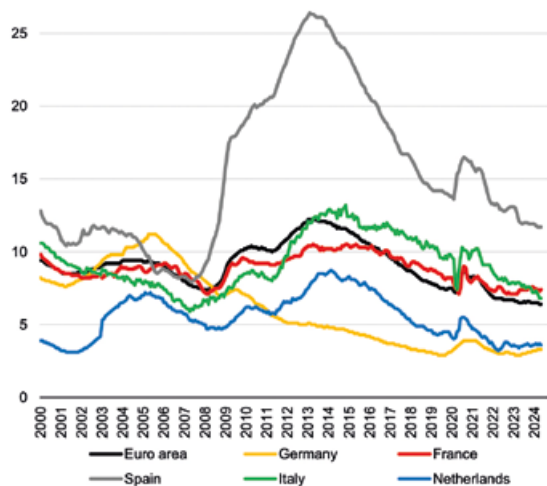
More generally, Spain, Italy, and France are among the countries with the highest rates of long-term and youth unemployment (see Chart 57). In the first quarter of 2024, Spain and Greece people aged 15–29 had the highest

41. According to the OECD, the indicator reflects the “overall efficiency with which labour and capital inputs are used together in the production process. Changes in Multifactor Productivity Growth reflect the effects of changes in management practices, brand names, organisational change, general knowledge, network effects, spillovers from production factors, adjustment costs, economies of scale, the effects of imperfect competition and measurement errors.”

42. K. Knot, “Rebuilding resilience: meeting the challenges beyond Covid-19”, Eurofi Forum, 11 September 2021.

unemployment rate in Europe (20.6% and 21.6% respectively), followed by Italy (15.1%). Despite record spending on education and job training (5.2% of GDP in 2022, compared to 4.6% in the Euro area), France is also among the hardest hit (14.3% youth unemployment, versus 11.6% in the Euro area). By contrast, youth unemployment did not exceed 10% in Austria (7.2%), the Netherlands (6.9%), and Germany (5.3%) in the second quarter of 2023.

CHART 57.
Unemployment rate, as % of labour force



Source: Eurostat

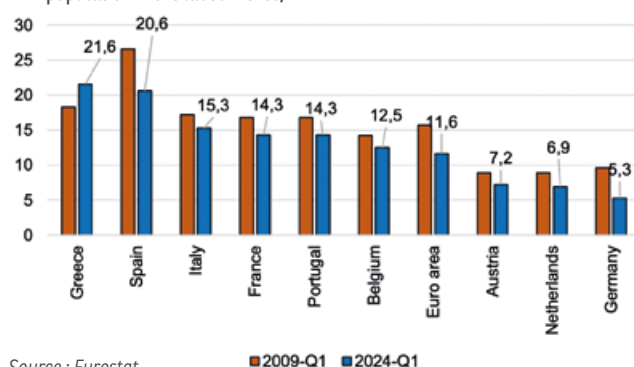
Notes: data on left-chart are taken on a monthly-frequency – last observation from May 2024

Such high levels of public expenditure highlight the inefficiency of education and professional training policies, as well as the absence of domestic structural reforms.

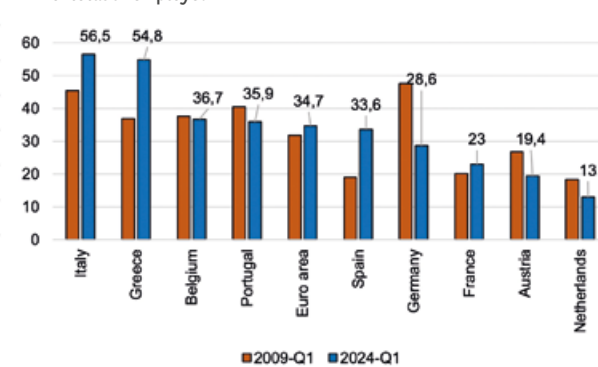
High unemployment in some member countries is partly structural. In the first quarter of 2024 Q1-2024, long-term unemployment stood at 56.5% in Italy⁴³. France and Spain followed at 23% and 33.5% respectively, although these levels have recently fallen below the Euro area level of 34.7% (see Chart 58.b).

CHART 58.
Youth and long-term employment rates across main EU Member States before and after the Covid-19 crisis

58a. Youth Unemployment rate* (as % of total population in the labour force)



58b. Long-term unemployment**, as %, of total unemployed



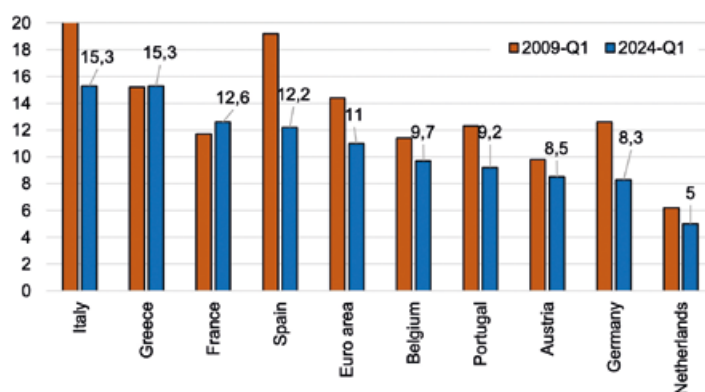
Source: Eurostat

*15-29 years-old, ** People staying unemployed for at least twelve consecutive months (OECD definition)

The significant share of the youth unemployment rate in some EU countries reveals the existing difficulties in joining the labour market. Such failures favor the proliferation of Youth 'NEET' (youth that are Neither in Employment, Education or Training). In Italy, 15.3% of young people aged between 15 and 29 were in this situation as of Q1-2024, the highest share among European Union countries (see Chart 59).

43. People staying unemployed for at least twelve consecutive months (OECD definition).

CHART 59.
Young People Neither Employed,
in education or Training, as %
of 15-29 population

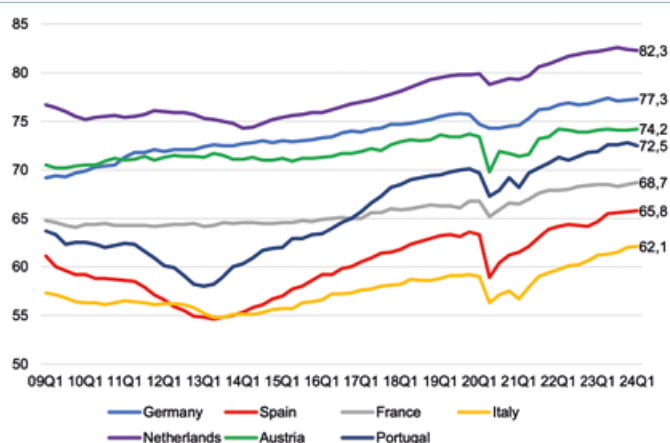


Source: Eurostat

5.3 The employment rate in France, Spain, and Italy is close to 10 percentage points lower than in Germany and the Netherlands

Two groups can be distinguished within the Euro area: countries where the proportion of employed people exceeds 70% of the working-age population such as the Netherlands, Germany, and Austria in particular, and countries where the employment rate is below 65%, such as Italy and Spain (see Chart 60). With an employment rate above 70% from 2021, Portugal has moved from the second group to the first.

CHART 60.
Employment rate of the 15-64,
as share of total active population



Source: Eurostat

In 2024-Q1, 68.7% of people aged 15-64 were employed in France, compared to 77.3% in Germany.

The employment gap between France and Germany is primarily due to the fact that the employment rate of the 60-64-year-old is 35% in France versus 62% in Germany in 2021. As the effective retirement age is lower in France (see Part 4), workers leave the labor market earlier than in Germany.

In addition to the nature of the pension system, the reasons for the persistent gap in employment between France and Germany lie in (I) the lack of appropriate skills in the workforce, and (II) the burden of taxes on companies, which forces them to make trade-offs such as relocating their activities to the detriment of domestic employment and investment.

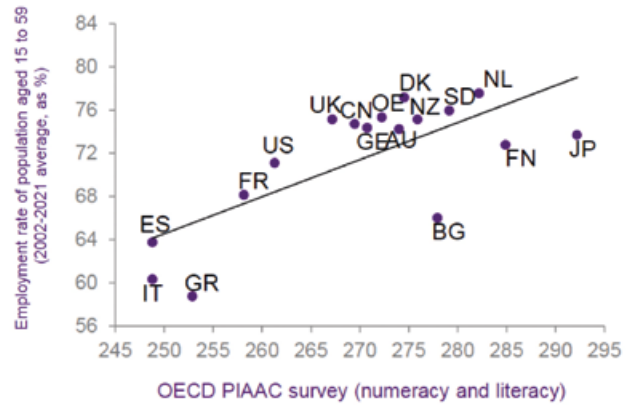
According to P. Artus, the skills of the workforce account for 53% of the gap in employment rates between OECD countries, while the burden of corporate contributions and production taxes explains 35%.

As highlighted by P. Artus⁴⁴, the employment rate is the lowest in countries with a low-skilled force (see Chart 60). France is in the bottom quarter of OECD countries in terms of adult skills and last in terms of young people's science skills. France also has, after Sweden, the highest tax burden on production in Europe (17% of GDP versus 13.2% in the Euro area in 2022, see Part 4). This overall weakness in skills and this heavy tax burden largely explain the low employment rate in France.

44. P. Artus, "France: is public spending the answer?", Flash Economics, Natixis (09 May 2022).

CHART 61.
Employment rate and OECD PIAAC survey

Source: P. Artus, "The effects of skills, corporate taxes and the employment rate of those aged 60 to 64 on the employment rate of people aged 15 to 59", Natixis Economic Research, February 2023



The persistent low employment rate is closely linked to public finances and inequality. As fewer people are employed and therefore paid and as fewer firms produce domestically, public revenues – a source on which the government can rely to finance long-term public investments – are reduced. As tax revenues are linked to potential output, which in turn is linked to the employment rate, an increase in the employment rate would boost tax revenues and thus create fiscal leeway.

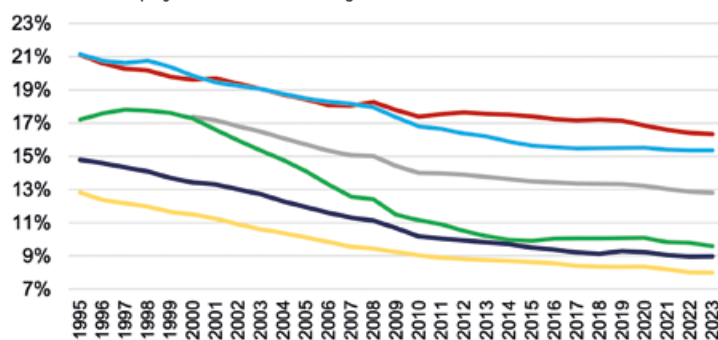
There is a negative correlation between income inequality (before redistribution) and the employment rate. This relationship is even more pronounced in countries undergoing deindustrialization, where job quality and remuneration have deteriorated. This is because workers' living standards have fallen since productivity per capita, and wages are relatively higher in the manufacturing sector than in the rest of the economy.

5.4 "Bad jobs" are more prevalent in deindustrializing economies and are concentrated in low-skilled and precarious activities

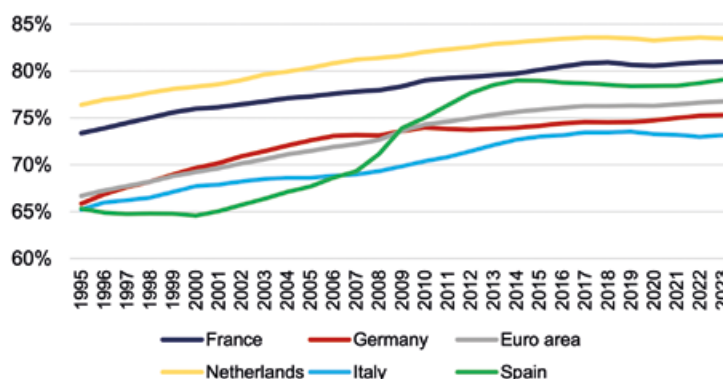
Although employment rates have risen over the past decade, job quality has deteriorated over the same period in some EU Member States. This deterioration is due in particular to the sectoral reorientation of these economies in favor of services, to the expense of manufacturing activities.

CHART 62.
Employment in manufacturing and services activities, as % of total employment

62a. Share of employment in manufacturing activities



62b. Share of employment in services activities



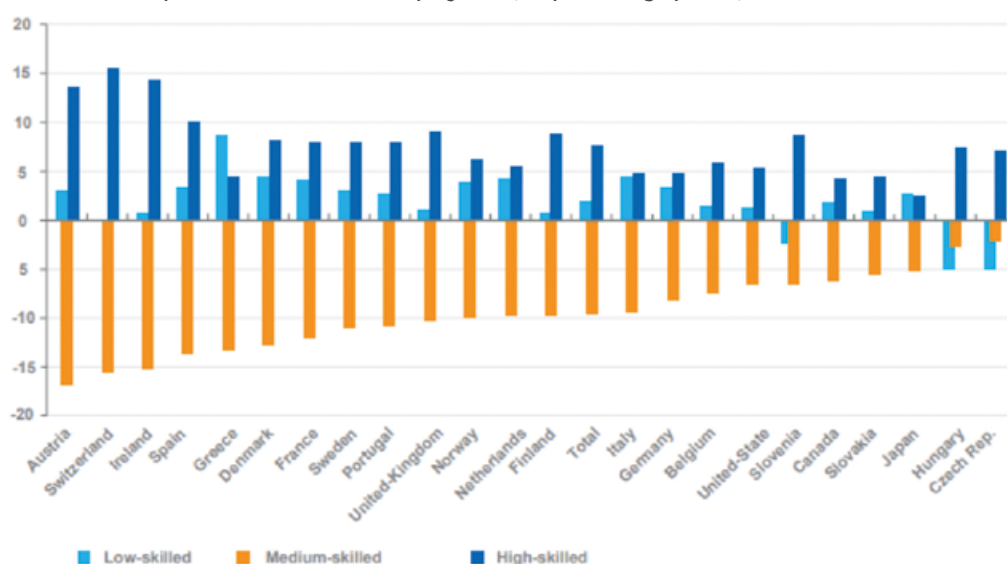
Source: Eurostat

Since the 1980s, manufacturing employment in France, for example, has fallen by over 35%, while employment in services has risen by over 60%. Employment in the service sector thus reached 81% of total employment in 2022, well above the Eurozone level of 76.7% (see Chart 62). As a result, the share of employment in manufacturing has fallen considerably in France, from 18.5% in 1985 to 9% in 2022, a level below that of the Eurozone (12.9%).

Among the other major EU Member States, the shift towards a service-oriented economy has been particularly pronounced in Spain and the Netherlands, where respectively 79% and 83.5% of the workforce was employed in the service sector in 2023, from 65.3% and 76.4% in 1995.

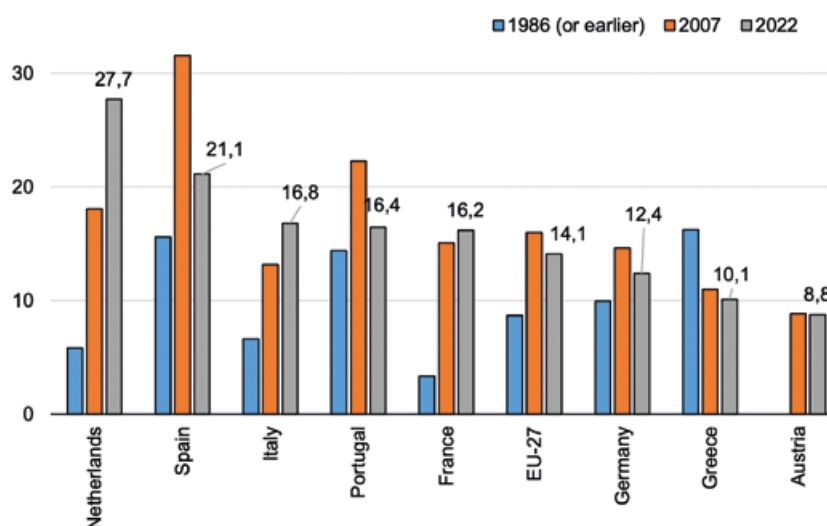
The bulk of job creation in the service sector is concentrated at the extremes of the skill ladder: high-skilled jobs (finance, information and technology, complex business services, etc) and low-skilled or unskilled jobs (hospitality, catering, distribution, transport, leisure, personal services). This labor market polarization has led the share of medium-skilled workers to drop (see Chart 63) – formerly prominent in manufacturing sectors. One can also note an increase in the number of low-skilled or “bad jobs” that are poorly remunerated and characterized by a high degree of precariousness and hardship.

CHART 63.
Change in the share of qualifications in total employment, in percentage points, 1995-2015



Source: OECD (2017), OECD Employment Outlook 2017, based on European, U.S., Canadian, Japanese, and Swiss Employment Surveys
 Note: High-skill occupations include jobs classified under the ISCO major groups 1, 2, and 3. That is, legislators, senior officials, and managers (Group 1), professionals (Group 2), and technicians and associate professionals (Group 3). Medium-skilled occupations include jobs classified under the ISCO major groups 4, 7 and 8. That is, clerks (Group 4), craft and related trades workers (Group 7), plant and machine operators and assemblers (Group 8). The low-skilled occupations include jobs classified under the ISCO major group 5 and 9. That is, service workers and shop and market sales workers (Group 5), elementary occupations (Group 9)

CHART 64.
Temporary employment, as % of total dependent employment



Source: OECD
 Notes: Temporary employment includes wage and salary workers whose job has a pre-determined termination date, according to the OECD. This indicator is broken down by age group and it is measured as percentage of dependent employees (i.e., wage and salary workers); data labelled “1986 or earlier” date from 1983 for France, Italy, the Netherlands, Greece, the EU-27; It dates from 1984 for Germany, and from 1986 for Spain and Portugal; The first available data for Austria dates from 1995

The proportion of temporary employment is highest in countries where employment is mainly concentrated in the service sector, such as Spain or the Netherlands. France, which gradually became a service-based economy over the past three decades, saw the share of temporary employment rising fivefold, from 3.3% of dependent employment in 1983 to 16.2% in 2021 (see *Chart 64*). Although this phenomenon has been widespread across advanced economies through the development of automation notably, it has been even more pronounced in countries experiencing the process of deindustrialization, according to the OECD⁴⁵.

Accordingly, the combination of low employment rate and low productivity growth leads to a weak output potential for indebted Member States.

45. "Perspectives de l'emploi : l'avenir du travail", OECD (2019) https://www.oecd-ilibrary.org/sites/b7e9e205-fr/1/2/2/index.html?itemId=/content/publication/b7e9e205-fr&csp_=2a079d50bcd66cec314da33d3c16ff87&itemIGO=oecd&itemContentType=book#figure-d1e4389

6. Is Next Generation EU (NGEU) a game changer?

The Covid-19 crisis hit economies worldwide. On 21 July 2020, the EU Council agreed upon a massive and unprecedented recovery plan – Next Generation EU (NGEU) – to kick-start the European economy and support the energetic and digital transitions, making Europe more resilient and better adapted to future challenges. The announcement of this program also aimed at reassuring markets about the EU's stability and strength, through increased solidarity among Member States.

NGEU, which officially entered into force on 19 February 2021, consists of a massive subsidy plan focused on the EU Member States and financed by common debt. Based on Member State requests for funding under the Recovery and Resilience Facility and the funding needs of other programs supported by NGEU, the EU expects to raise €712 billion (out of a maximum program envelope of €806.9 billion) by 2026⁴⁶. Combined with the 2021-2027 EU budget, the total funding exceeds €1,800 billion, representing 12.4% of the EU's 2021 GDP.

However, despite being an innovative initiative grounded in sound principles, such as a performance-based approach, NGEU remains significantly underutilized compared to its initial plans and ambitions. Its deployment is suboptimal, and NGEU procedures are proving to be slow, complex, and highly bureaucratic.

This section proposes an overview of the NGEU program, assessing the current status of its implementation as well as its effectiveness, and delves into a comparative analysis with the US, particularly examining whether the Inflation Reduction Act (IRA) might widen the gap between the US and the EU.

6.1 NGEU is an unprecedented joint response to the Covid-19 crisis, making over €800 bn available to Member States to become more resilient, mainly investing in the green and digital transitions

6.1.1 NGEU encompasses several instruments to achieve its objectives: green and digital transitions, structural reforms to recover from the pandemic, and economic resilience in all parts of the EU

NGEU builds on earlier initiatives such as the temporary Support to mitigate Unemployment Risks in an Emergency (SURE), the European Investment Bank's Guarantee Fund, and the European Stability Mechanism's Pandemic Crisis Support.

NGEU is part of a broader movement toward CO2 neutrality and strategic autonomy. It complements initiatives like the European Green Deal (EGD), which aims to strengthen the EU regulatory framework with the Fit for 55 energy and climate package.

NGEU encompasses several instruments (see Chart 74). The centrepiece is the Recovery and Resilience Facility (RRF) – an instrument that offers grants and loans to support reforms and investments in the EU Member States. The RRF represents 5.2 % of the EU-27 2019's GDP⁴⁷. At least 37% of RRF funds are dedicated to combating climate change, supporting the EU's goal of CO2 neutrality by 2050. Additionally, 20% of RRF funds are allocated to the digital transformation, including cybersecurity, artificial intelligence, and supercomputing.

TABLE 5.
NGEU program,
breakdown by
instruments

Name of the instrument	Amount of the instrument	Purpose of the instrument
Recovery and Resilience Facility	€672.5 bn (€312.5 bn in grants + €360bn in loans)	Supporting the implementation of structural reforms, investing in green and digital transitions, and enhancing the resilience of national economies
React-EU	€47.5 bn	Supporting investments and reforms, focusing on mitigating social and economic of the Covid crisis, especially through employment
Just Transition Fund	€10 bn	Assisting regions that are heavily dependent on fossil fuels in addressing challenges associated with the green transition
Rural Development	€7.5 bn	Supporting the vibrancy and economic viability of rural areas through funding and actions that support rural development
InvestEU	€5.6 bn	Mobilizing private and public investment by providing guarantees and technical assistance to support sustainable infrastructure projects, R&D, and SMEs
Horizon Europe	€5 bn	Strengthening the impact of R&D in developing, supporting and implementing EU policies while tackling global challenges
RescEU	€1.9 bn	Protecting citizens from disasters and managing emerging risks
Total	750	

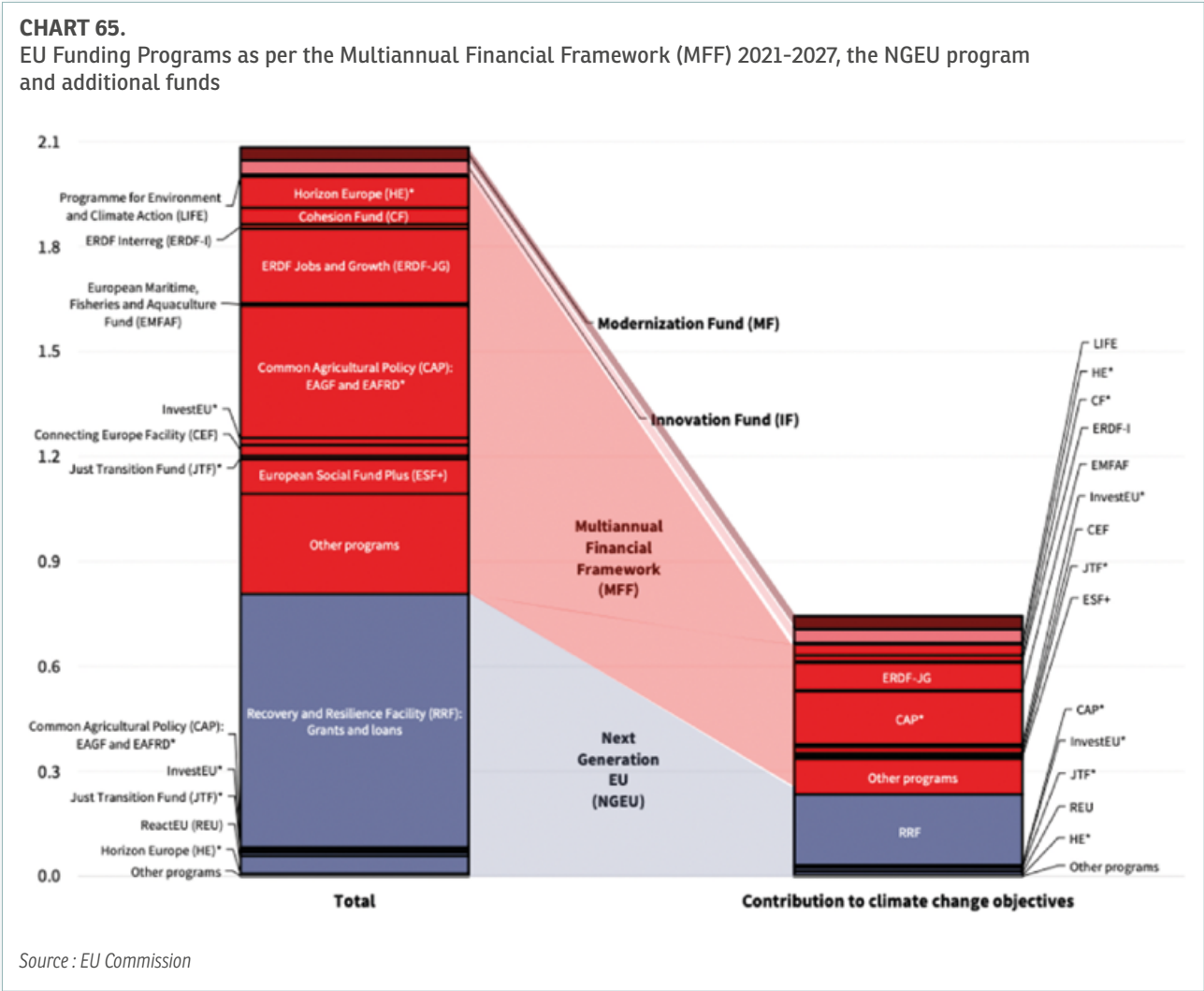
Sources: NGEU tracker,
European Council
Notes : figures are expressed
at 2018 prices

46. European Commission, "The EU as an issuer – the NextGenerationEU transformation", EU budget policy brief, July 2022.

47. "NGEU delivery – How are the Member States doing?", European Parliament (EGOV), April 2024.

Apart from the RRF, NGEU encompasses the REPowerEU plan, launched in October 2022 in response to the Ukrainian crisis, aims to phase out Russian fossil fuels and encourage clean energy production in Europe. REPowerEU is based on three pillars: energy savings, renewable deployment and supply diversification.

In addition, up to €77.5 billion of NGEU funds (at 2018 prices) are being used to reinforce several existing EU programs, such as React-EU (which provides additional funding for cohesion policies and recovery from the pandemic), the Just Transition Fund (which supports regions most affected by the transition to a green economy), Rural Development (aims to improve the quality of life and economic prosperity in rural areas), Horizon Europe (the EU's largest research and innovation program), InvestEU (which stimulates investment in sustainable infrastructure, research, and innovation) and RescEU (which enhances EU disaster response capabilities).



6.1.2 With a dedicated envelope of €648 billion, the Recovery and Resilience Fund (RRF) is the centerpiece of Next Generation EU, with a focus on the green and digital transitions

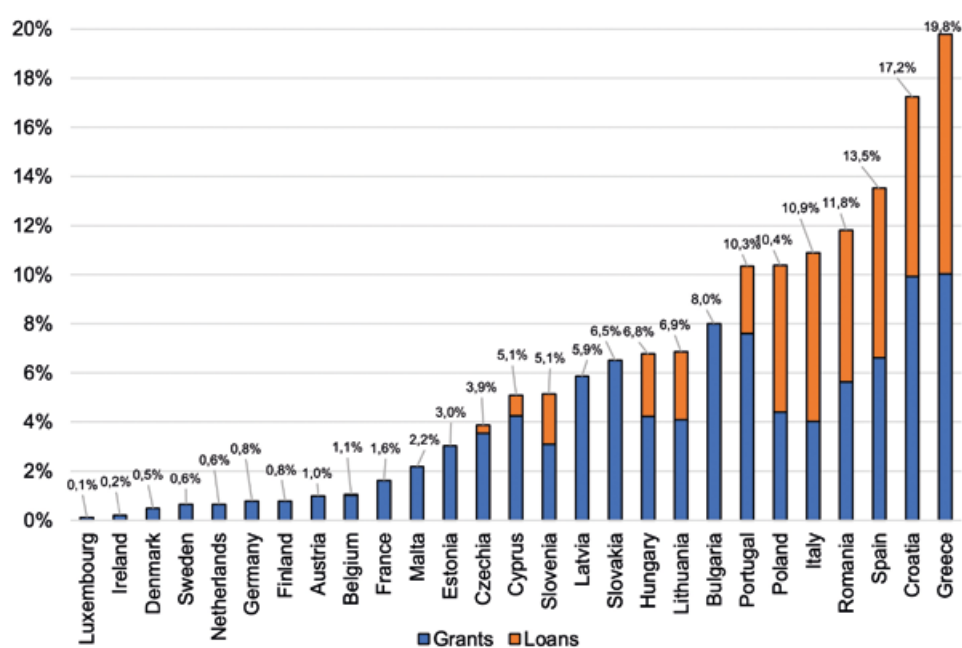
With up to €357 billion in grants and €291 billion in loans (at 2022 prices) available to Member States from 2021 to Q3 of 2026, the RRF is the centrepiece of the NGEU program.

The RRF is a performance-based instrument. It offers grants and loans to Member States which are not linked to the eligibility of a beneficiary, specific project, or declared costs, unlike other EU spending programs. Instead, payments are based on the satisfactory achievement of predefined milestones and targets submitted by Member States to the EU Commission – national plans, contingent on delivering specific reforms and investments. The allocation of grants also considers factors such as population, GDP per capita, and average unemployment rates.

Additionally, as a preventive action, if the Commission discovers deficiencies, it can interrupt or suspend payments to Member States until the problems detected are resolved. The Commission can also take action after payments have been made by introducing financial corrections if it identifies failures at a later stage.

CHART 66.

RRF funding (loans and grants) to be received by EU Member States, % of GDP



Source: EU Commission, NGEU tracker

6.1.3 Italy and Spain are the main recipients of the RRF

Italy and Spain are the largest beneficiaries of the RRF. Italy is set to receive €194.4 billion (of which €71.8 billion in grants and €122.6 billion in loans), representing 10.9% of Italy's 2021 GDP and 26.1% RRF⁴⁸. Spain follows with €79.8 billion in grants and €83.2 billion in loans, equating to 13.5% of Spain's 2021 GDP.

6.1.3.1 Spain's plan is considered one of the most advanced among EU member states

By July 2023, Spain had received €38,08 billion in grants, which is 46.7% of its total initial grant amount⁴⁹. The inclusion of loans in the revised plan from October 2023 marks a significant increase in the plan's value to €163 billion. The Spain' NRRP exceeds the RRF's targets, with 39.9% of funds allocated to the green transition and 25.9% to digitalization.

Spain plan includes 11 policy levers, with a significant focus on modernizing and digitalizing the Spanish industry and SMEs, particularly through public-private partnerships (PERTEs – Strategic Projects for Economic Recovery and Transformation). These partnerships aim to foster important projects of common European interest, with 29% of the budget for these projects already awarded or opened to calls.

6.1.3.2 Conversely, the Italian NRRP initially set ambitious goals, but progress has been slower than expected

In 2022, Italy achieved only 10 out of 27 goals and spent €12 billion of the planned €40 billion. The Commission temporarily froze the third Italian instalment in March 2023 due to missed milestones. Despite these setbacks, Italy's revised NRRP was adopted in September 2023, and as of July 2024, €41.54 billion in grants and €60.94 in loans had been disbursed to Italy⁵⁰, with a sixth payment request of €8.5 billion submitted.

This sixth tranche of the NRRP will fund significant strategic investments⁵¹. The main one remains the construction of the Trans-Adriatic Pipeline. Its purpose is to transport natural gas from the Caspian Sea to the European market from Azerbaijan. It starts at the Greek-Turkish border and crosses Greece, Albania, and the Adriatic Sea to reach Italy.

The Italian government also committed to Brussels to implement tax credits to accelerate the ecological transition, improve the country's sports and school infrastructure, implement electricity production systems in the agricultural and agro-industrial sectors, strengthen railway connections in the *Mezzogiorno*, and clean up numerous illegal garbage dumps.

48. NGEU delivery: How are the Member States doing? », European Parliament, April 2024.

49. https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/country_overview.html?lang=en

50. https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/country_overview.html?lang=en

51. "Giorgia Meloni bâillonne la Cour des comptes italienne, trop critique", *Les Échos*, juillet 2024.

6.2 Where is the EU at with Next Generation EU?

6.2.1 The 27 national plans have been approved by the Commission and adopted by the EU Council, but only one-third of the funds had been spent by June 30, 2024

All 27 Member States' National Recovery and Resilience Plans (NRRPs) have been approved by the Commission and adopted by the EU Council. By January 2024, all 27 Member States had submitted amendments to their plans, primarily to include REPowerEU chapters aimed at enhancing energy independence and addressing administrative capacity issues. These amendments are intended to improve the absorption capacity of RRF and other EU funds.

TABLE 6.

RRF funds available and disbursed as of end-June 2024

Source: EU Commission

Notes: amounts are expressed in 2022 prices

	Total RRF	RRF Grants	RRF Loans
Available (EUR bn)	648	357	291
Disbursed (EUR bn)	240,3	156,2	84,1
Percentage disbursed	37,1%	43,8%	28,9%

With 13 payment requests in progress and an additional 30 expected to be processed by the end of the year, total RRF disbursements for 2024 are projected to reach between €80 billion and €100 billion. This would bring the cumulative total since the RRF's inception to €300 billion.

6.2.2 NGEU is financed by common debt and national resources

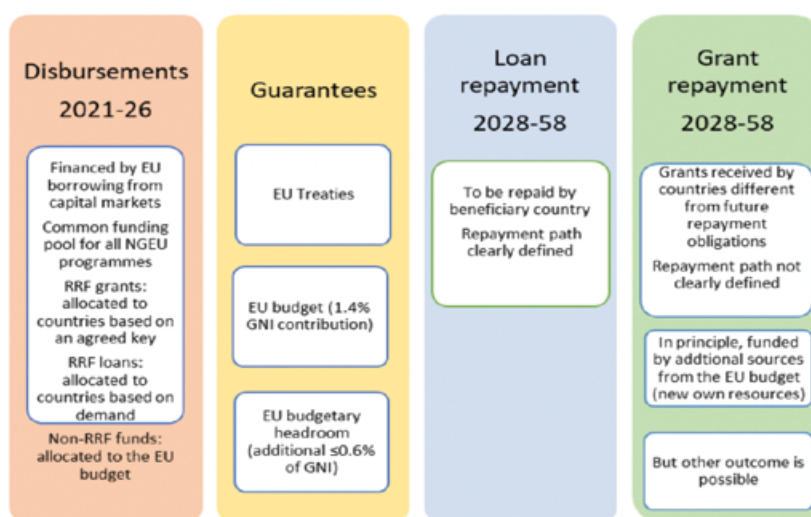
6.2.2.1 NGEU is by far the largest EU bond-financed program ever

NGEU is financed primarily through common debt, a historic first for the EU. It is the first time such a substantial common borrowing and, to a certain extent, risk-sharing mechanisms have become characteristics of an EU budgetary plan.

To issue the common debt, the Commission resorts to multiple instruments: a combination of medium – and long-term debt issuance across different maturities via EU-Bonds (both regular and green bonds) and short-term via EU-Bills.

CHART 67.

Key features of EU debt within the NGEU/RRF program



Source: ECB

The borrowing strategy to finance NGEU relies on the safety and cost-effectiveness of the way money is raised. The European Commission borrows on capital markets, allowing low-rated countries to benefit from its high credit rating which helps obtain more favourable financial terms⁵². To protect this credit rating, the EU is using the EU budget headroom⁵³ as a guarantee. In order to protect the borrowing under NGEU, the EU headroom is

52. The EU's credit rating (AAA by Fitch and Moody's) is better than the rating of 22 out of the 27 EU Member States.

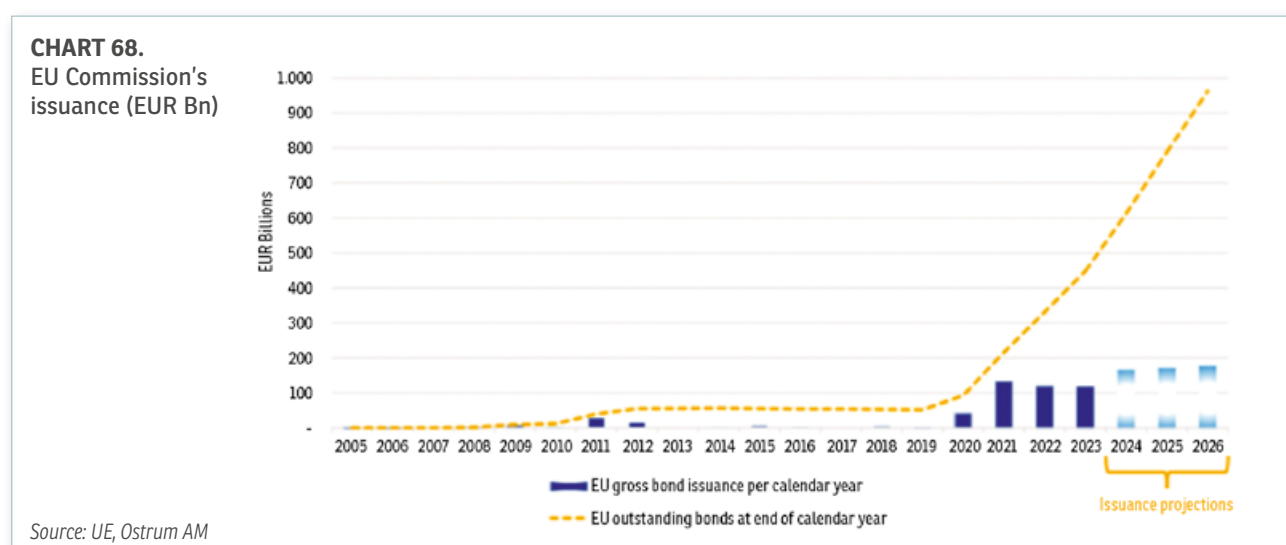
53. The headroom is the difference between the maximum amount of revenue that the EU can raise for the EU budget and the actual spending from the EU budget.

0.6 percentage points higher than the standard one for the period ending in 2058, as the debt will be gradually reimbursed by the borrowing Member States over the period 2025-2058⁵⁴. Indeed, the average maturity of EU securities is 11 years, and payback deadlines are spread out between 2025 and 2058.

Additionally, the ceiling on own resources that each country must contribute to the EU budget was temporarily raised by 0.6 percentage points of GNP, to 2% of EU GNP. EU resources will also be increased.

The SURE and NGEU programs have allowed the EU to massively issue bonds on the markets. Despite rising interest rates since 2022, which have affected all sovereign issuers including the EU, the issuance of EU bonds to fund the RRF continued successfully, attracting steady investor demand even amid market volatility.

In less than 4 years, European bond outstandings have risen from barely €50 billion to €514 billion at the end of May 2024. By 2026, when the NGEU program is concluded, the EU is expected to have issued nearly €1 trillion. This market will thus be roughly equivalent in size to the Spanish market, making it the 5th largest issuer in the EU after France, Italy, Germany, and Spain.



Moreover, the EU plans to finance up to 30% of NGEU, *i.e.* €240 bn, by issuing green bonds. NGEU green bonds can solely fund eligible green measures. In this perspective, EGOV explained that "NGEU is making the EU one of the largest issuers of euro-denominated debt (on average €150 bn a year) and the world's biggest green-bond issuers, in line with the diversified funding strategy."

The first issuance of EU green bonds took place in October 2021, with a maturity of 15 years and an amount of €12 billion, the largest ever at that time. It was heavily oversubscribed: demand amounted to €135 billion⁵⁵.

6.2.2.2 The NGEU faces significant uncertainties regarding the repayment of its common debt

While the repayment schedule for loans provided under NGEU is well-defined, the pathway for repaying grants remains ambiguous. The European Commission has proposed several new sources of revenue to address this issue, including the Carbon Border Adjustment Mechanism (CBAM), the EU Emissions Trading System (EU ETS), and a digital levy. These measures aim to ensure a sustainable and fair repayment strategy for the grants portion of the programme.

The grants, in particular, will be repaid from the EU budget, necessitating the introduction of these new own resources to ensure financial stability and compliance with legal obligations to investors.

However, the approval of these new revenue sources requires unanimous consent from all EU member states, adding a layer of complexity to the process. The implementation of these resources is critical for reducing reliance on member state contributions based on Gross National Income (GNI) and avoiding cuts to essential EU programs.

Despite the proposed mechanisms, delays and disagreements among Member States over these new revenue streams create uncertainties.

54. *i.e.*, Member States agreed to a temporary increase in the maximum amount of revenue the EU can call from Member States per year (adding an allocation of 0.6% to the basic own resources ceiling of 1.4% of EU Gross National Income) until all NGEU liabilities have ceased to exist. (source: EU Budget Policy Brief).

55. Ostrum weekly note n°166, July 2024.

Like all economic players, the EU, despite its AAA rating, is seeing the cost of money rise. When the Next Generation EU (NGEU) recovery project was conceived, it assumed of borrowing rates would oscillate between 0.55% and 1.15% over the period 2021-2027. They have now risen to 3%. As a result, the debt burden will cost more than the anticipated €15 billion a year. According to B. Bayart⁵⁶, "The Commission will be short by between €15 billion and €24.8 billion over the period 2025-2027 (the framework of its current budget), and more after that, since from 2028 onwards it is not just the interest that has to be paid, but the principal that has to start being repaid (for the subsidy part of the NGEU programme, *i.e.* €390 billion out of a total of €750 billion). The peak is expected between 2028 and 2030, with, according to Bruegel's calculations last autumn, an annual cost of between €22 and €27 billion, ..."

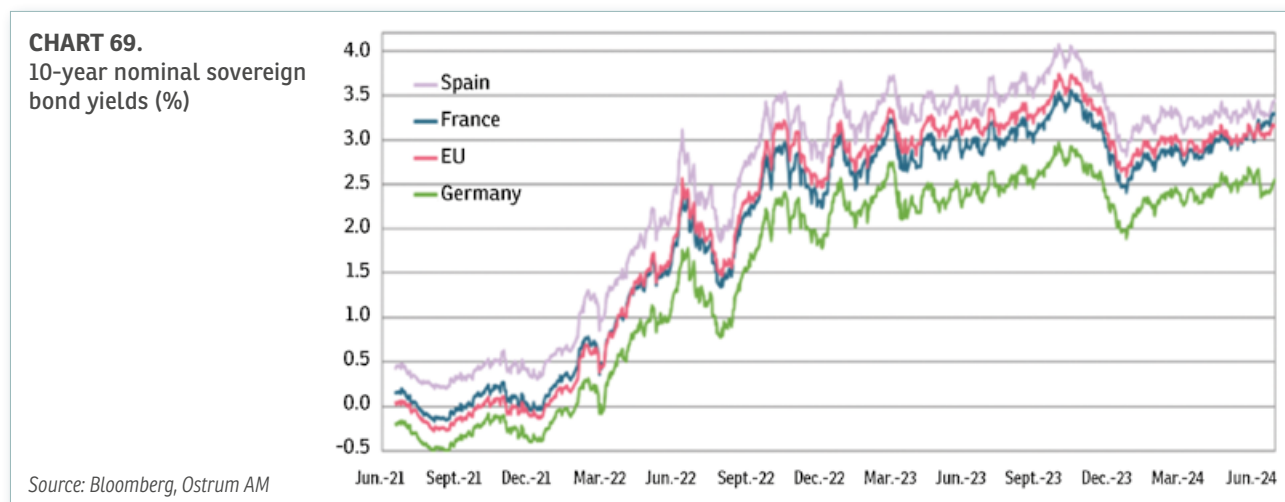
6.2.2.3 Is EU common debt a fantasy?

The EU is among the safest issuers in the Eurozone. EU debt is rated AAA by Fitch and Moody's (Aaa) and AA+ by S&P. This very high quality is linked to EU debt being backed by the European budget. This allows the EU to finance itself at rates lower than the weighted average rate of the EU countries.

However, EU debt trades at levels close to French debt despite a better rating. On June 28, 2024, the EU's 10-year rate closed at 3.2%, compared to 3.3% for the French 10-year and 2.5% for the German 10-year.

This premium is a liquidity premium. It is not equivalent to that of the German and French bond markets. Despite massive issuances across the entire yield curve, even in the short term, and significant transactions on the secondary market, the yield spread between bid and ask on the secondary market is larger for EU bonds than for those of Germany and France.

This is attributable to the fact that the EU yield curve is recent and, above all, to the limited duration of the NGEU program. Net issuances end in 2026, which creates uncertainty for investors beyond this date. Repayments will end in 2058. MSCI did not include EU bonds in its sovereign bond indices in June 2024. EU bonds are thus classified in the indices as supranational bonds (like those of the European Investment Bank) rather than sovereign bonds. MSCI will review this issue during the first half of 2025.



Some indicators can lead to wonder if the common debt issued under NGEU is indeed a first step towards a European safe asset. As explained by the Banque de France, "a genuine European safe asset would have several benefits for financial stability and European integration and would facilitate the financing of public policies by reducing borrowing costs."

However, the current situation is different: after three years of issuance, and even though the EU has not faced significant issues in getting funds, the EU debt turned out to be less attractive for investors than that of its main Member States for two reasons:

- Even if the EU budget provides a strong guarantee, it does not have the sovereignty over its debt as other sovereign states do. Indeed, Europe is not an independent state and does not have the power to levy taxes. In other words, the EU does not currently have the resources to repay its debt. It is therefore the Member States that will have to transfer funds to pay the creditors when the bonds mature.

56. B. Bayart, "Il n'y a plus d'argent magique européen", *Le Figaro*, 27 mars 2024.

- The fact that NGEU is a unique and temporary initiative implies that EU securities are not going to remain on markets forever, which can have a deterrent effect for investors looking for liquid and easily tradable assets. Though liquidity has improved with the introduction of the unified funding approach in January 2023, the current market of EU common debt remains narrow and not deep enough, and so, insufficiently liquid.

As highlighted by Ostrum in its weekly analysis on July 1, 2024, the inclusion of EU debt in sovereign indices would allow EU bonds to be treated as sovereign bonds.

6.3 Is Next Generation EU efficient?

6.3.1 Billed as a 'game changer' with highly ambitious goals, the RRF has so far had a relatively limited impact on the economic growth of Member States

In 2020, the European Commission estimated that recovery support would add an average of 1.9% to GDP by 2022 – in reality, the boost was much smaller, at only 0.4%. Analysis by Goldman Sachs suggests that for the top four EU economies – Germany, France, Italy, and Spain – the impact of recovery grants on output was minimal and expected to turn negative as the fund tapers off⁵⁷.

Many governments backdated investments, effectively replacing national expenditure with EU funds, which reduced the additional growth effect. "Some of the projects allowed in the recovery fund are investments that governments would have done anyway", said Peter Vanden Houde, chief economist for Belgium and Luxembourg at ING. In other cases, including Belgium, reforms proved to be a stumbling block and held up payments. "Even a very efficient public administration would not be able to spend all of this money, especially when it is investments rather than transfers, in a relatively short amount of time", declared Tito Boeri, a professor of economics at Bocconi University. As time pressure mounts, there is concern that it could negatively affect the quality of expenditure and increase the risk of fraud.

6.3.2 NGEU is a slow and complex process that faces Member States' limited capacity regarding the absorption capacity of European funds

6.3.2.1 The implementation of NGEU, including the RRF, has encountered significant administrative burdens, impacting its effectiveness

Despite its innovative performance-based approach, NGEU's deployment has been slower and more complex than initially anticipated. It has encountered numerous challenges that jeopardize its effectiveness and timely execution, including delays in preliminary assessments, bureaucratic complexities, administrative burdens, and disagreements over necessary reforms.

The European Commission has faced delays in preliminary assessments for disbursement requests, further complicating the timely allocation of funds. This backlog raises concerns about the Commission's capacity to manage the heavy workload required for assessing and approving funding requests efficiently.

The NGEU program involves seven different funds and is intertwined with other plans like REPowerEU, leading to a cumbersome bureaucratic process. The dual funding systems (RRF and regular EU funds) have strained administrative capacities, resulting in complex and burdensome procedures.

Moreover, disagreements between Member States and Brussels over necessary reforms have delayed payments, and inflation has forced many investments to be downsized. The fund's complex structure, which requires countries to meet specific reform and investment targets to receive grants and loans, has led to further delays and complications. For instance, changes in government, as seen in Italy, have resulted in lengthy renegotiations of national plans. Additionally, in June 2022, the Commission's retroactive adjustment of grant allocations based on countries' actual economic performance caused further disruptions, exemplified by Belgium's significant reduction in funds.

This led to the downsizing or removal of several projects. Moreover, the fund's audit systems, while necessary to prevent fraud, have imposed a high administrative burden on implementing authorities. A national official criticized these measures as using "a bazooka to control things that are very restricted in scope", indicating that the administrative processes are disproportionately cumbersome. The dual system of managing both the RRF and regular EU funds has resulted in "nightmarish" procedures, contributing to a negative outlook on the fund's practical implementation.

57. "Is the EU's Covid-19 recovery fund failing?", *Financial Times* article, February 2024.

In June 2024, Valdis Dombrovskis, Executive Vice President of the European Commission, stressed the urgency of addressing bottlenecks before the 2026 deadline, noting that “the clock is ticking.”⁵⁸

6.3.2.2 Member States struggle with the capacity to absorb the allocated funds efficiently

This difficulty is not unprecedented; historical data from the 2014-2020 multiannual financial frameworks (MFF) indicate a persistent issue with fund absorption. During this period, even the largest and most economically robust Member States managed to absorb only 60-70% of the allocated funds over nine years. This limited absorption capacity raises concerns about the feasibility of fully utilizing the NGEU funds within the stipulated timeframe.

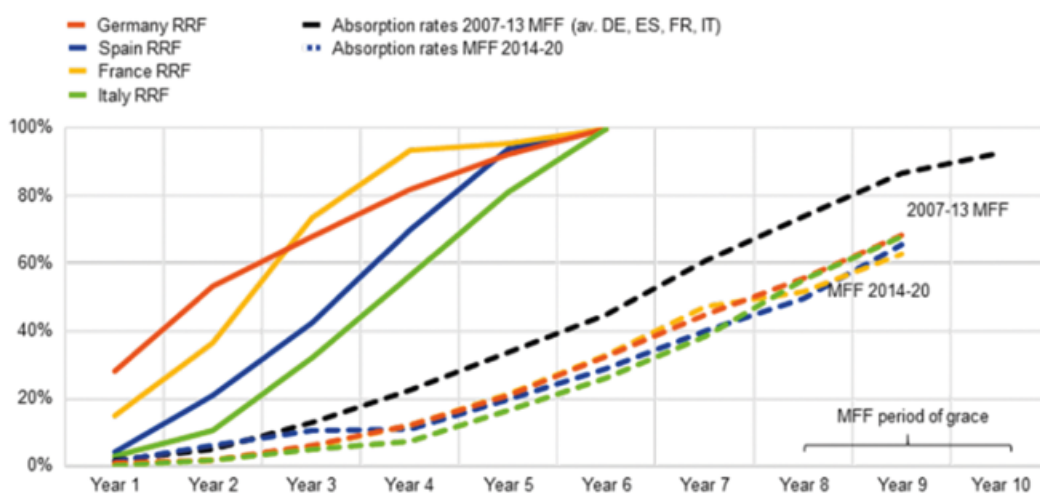
Unlike the previous MFF, which had a longer implementation period, NGEU demands full absorption of the allocated funds in just five and a half years. This compressed timeline amplifies the existing challenges faced by Member States in fund utilization.

Several factors contribute to the difficulties in fund absorption, among which the bureaucratic complexity mentioned above. Moreover, many large-scale infrastructure projects, which form a significant part of EU funding allocations, require extensive planning and long lead times. The shorter NGEU timeline puts additional pressure on project readiness and execution.

EU funding often requires co-financing from national budgets. Economic strains from the pandemic have left some Member States with limited fiscal space, making it challenging to meet these co-financing obligations.

CHART 70.

Projected cumulative absorption rates of RRF funding compared with realized absorption rates of past EU multiannual financial frameworks (x-axis: year of programme; y-axis: absorption as cumulated percentage of total envelope)



Source: Dorrucchi and Freier (2023), based on European Commission data and estimates of the Working Group on Public Finance of the European System of Central Banks. For France cash pay-outs under RRF according to Coeuré report (2021).

Notes: The solid lines refer to the foreseen absorption of RRF funds in Germany (DE), France (FR), Italy (IT) and Spain (ES) over the RRF period (2021-26). The dotted lines refer to the actual absorption by these four countries of past EU resources made available under the EU's multiannual financial framework (MFF). The absorption rate is the amount paid to a Member State as a percentage of the total EU budget made available to that country. Year 1 is the first year of the respective programme, i.e., 2007 for the 2007-13 MFF, 2014 for the 2014-20 MFF, and 2021 for the RRF. Pre-financing under the RRF is included in Year 1. The absorption rate of the 2007-13 MFF (black dotted line) is shown as average of the four countries and includes the European Regional Development Fund (ERDF), the Cohesion Fund (CF) and the European Social Fund (ESF), while the 2014-20 MFF includes only the ERDF and the CF. Data under the 2014-20 MFF are provisional for the year 2021 (Year 8 in the Chart)

6.3.2.3 Both at the national and EU levels, there is a shortage of skilled and efficient workforce to manage and deploy the funds, hindering the speed and effectiveness of the program's implementation

The complexity of managing EU funds requires a workforce equipped with specialized skills in areas such as financial management, project planning, regulatory compliance, and strategic investment. Many Member States, however, face significant skill gaps in these crucial areas, which can delay project approval and fund disbursement processes.

58. Remarks by Executive Vice-President Valdis Dombrovskis at the ECOFIN press conference, 21 June 2024.

Moreover, effective management of NGEU funds requires seamless coordination and collaboration between various levels of government and across different sectors. The shortage of a skilled workforce can impede these collaborative efforts, resulting in fragmented and inefficient fund deployment.

Attracting and retaining qualified personnel is a persistent issue. The public sector often competes with the private sector for skilled professionals, and the former may struggle to offer competitive salaries and career advancement opportunities. This can result in high turnover rates and a lack of continuity in fund management roles.

Investment in the continuous training and development of personnel responsible for managing EU funds is often inadequate. Without ongoing professional development, the workforce may struggle to keep pace with the evolving requirements and best practices associated with fund management and deployment.

6.3.3 NGEU case studies: Italy has struggled with NGEU funds, while Spain has used them more efficiently

6.3.3.1 Italy's NRRP implementation has been hampered by bureaucratic inefficiencies and a lack of skilled workforce

Italy's initial NRRP was highly ambitious, targeting comprehensive reforms and investments across various sectors. "We are in an absolutely positive phase despite the spending difficulties that characterize our country", commented Raffaele Fitto, Minister of European Affairs responsible for the implementation of the NRRP, in July 2024⁵⁹. "I will soon launch an assessment of the 69 objectives of the seventh tranche, which represents 18.5 billion euros. The significant increase in investments in public works, which in the South recorded a growth rate of over 50% during 2023, confirms that we have fully entered phase 2 of the NRRP. This phase involves the concrete anchoring of investments to shape the Italy of tomorrow."

However, the government's enthusiasm contrasts with the semi-annual NRRP report presented by the Commission in February 2024. It highlighted the difficulties in launching and completing projects to meet the deadline set by Brussels for June 30, 2026⁶⁰. As of December 2023, 45.6 billion euros had been effectively spent, representing only 23% of the resources allocated to Italy. The Ministry of Transport, for example, had spent only 15% of the resources made available to it.

This significant shortfall highlighted the operational challenges Italy faced in executing large-scale projects within the stipulated timelines. The complexity of coordinating multiple reforms and investments simultaneously proved to be a daunting task, further exacerbated by an inadequate administrative framework and procedural delays.

One of the critical areas where Italy faced issues was in the house refurbishment sector. In May 2020, the Italian government, led by Giuseppe Conte, introduced substantial tax deductions for the "sustainable" refurbishment of residential properties through the Relaunch Decree. This initiative – the Superbonus scheme – offered a 110% tax credit for work aimed at improving energy efficiency and a 90% tax credit for seismic retrofitting of facades. The measure has been immensely popular among households, with renovation work qualifying for a 110% tax credit⁶¹.

However, this initiative inadvertently created a bubble, characterized by skyrocketing prices and widespread fraud. The sudden influx of demand outstripped the capacity of the construction industry, leading to inflated costs and delays in project completion. This bubble not only strained the sector but also contributed to broader challenges in meeting NGEU milestones.

The impact on public debt will become evident as tax revenues decrease due to the non-collection of these taxes⁶². This shortfall in tax receipts will be compensated by an increase in debt over several years, assuming no other changes. Consequently, the Superbonus will have a delayed effect on government debt levels. Public finances are expected to deteriorate relative to the government's objective of maintaining the debt-to-GDP ratio below 140% until 2027. If no fiscal consolidation occurs and the Superbonus remains in place, the debt-to-GDP ratio could reach 145% as early as 2025. Although this scenario is not the government's current message, it remains uncertain what additional measures the executive will announce to comply with changes to the Stability and Growth Pact, applicable to budgets submitted for 2025. Adhering to these new requirements is crucial for continuing to benefit from NextGenerationEU funds and to remain theoretically eligible for the ECB's Transmission Protection Instrument (TPI) in case of a significant widening of spreads.

59. "Giorgia Meloni bâillonne la Cour des comptes italienne, trop critique", *Les Échos*, juillet 2024.

60. see footnote 59.

61. "Italy: is the government debt at the mercy of superbonus effects?", Natixis Research, 16 May 2024.

62. see footnote 62.

Professor Jean Pisani-Ferry believes that the large scale of Italy's plan is a suitable response to the country's challenges, emphasizing that Italy's debt issues are due to a lack of growth rather than fiscal irresponsibility⁶³. He suggests that although the plan may not resolve all of Italy's structural economic weaknesses, its success will hinge on whether it can boost productivity. Pisani-Ferry argues that the outcomes of Italy's National Recovery and Resilience Plan (NRRP) will significantly influence future economic discussions within the EU. Similarly, the European Council on Foreign Relations (ECFR) views the NRRP as a pivotal chance for Italy to initiate a long-term development strategy, with its results expected to impact EU integration over the coming years.

The Centre for European Policy Studies (CEPS) think tank supports the strategy of implementing reforms early in the plan, considering it beneficial for enhancing the NRRP's structural impact in the medium to long term⁶⁴. CEPS finds that most reforms align with the Country-Specific Recommendations (CSRs) and the Recovery and Resilience Facility (RRF) objectives. However, it notes that labour market reforms only partially meet the CSRs, and improvements in education and skills are limited. Additional concerns include the temporary hiring of new public administration personnel, which could diminish the reforms' long-term effectiveness, and the stringent timeline for judicial system reforms.

6.3.3.2 As opposed to Italy, Spain has demonstrated a more efficient use of NGEU funds

The Spanish success can be attributed to its strategic focus on high-impact projects and efficient processes. The Spanish NRRP includes major investments in green energy and digital technologies, aligning with the EU's overarching objectives. For instance, Spain has prioritized projects that not only meet immediate economic recovery needs but also lay the groundwork for long-term sustainable growth. This ability to quickly mobilize and utilize funds has set a positive example within the EU.

TABLE 7.
Execution status of the Spanish PERTE projects (€ millions, as of 14/12/2023)

PERTE project	Public funds	Awarded and open calls
Microelectronics	12,250	–
Renewable energies, hydrogen and storage	10,475	4,957
Electric and connected vehicle	4,295	2,018
Decarbonisation	3,100	–
Digitalisation of the water cycle	2,790	425
Aerospace	2,126	1,844
Social and care economy	1,808	380
State-of-the-art health	1,650	912
Agrifood industry	1,450	1,063
New language economy	1,101	298
Circular economy	792	192
Marine sector	310	250
Total	42,146	12,339

Source: Caixabank research, Portal of the Recovery, Transformation and Resilience Plan
Note: * Strategic Projects for Economic Recovery and Transformation

The PERTE projects are a key element of Spain's strategy to efficiently utilize the NGEU funds. Notable PERTE projects include:

- **PERTE Chip:** This project aims to bolster Spain's microelectronics and semiconductor industries with a public investment of €12,250 million by 2027. It focuses on the entire value chain, from research and development to the manufacturing of advanced microchips, and aims to position Spain as a significant player in the global semiconductor market.
- **PERTE ERHA (Renewable Energies, Renewable Hydrogen, and Storage):** This project mobilizes around €16,370 million and focuses on several thematic areas such as biogas, wind, photovoltaic, hydrogen, and energy storage. It aims to enhance Spain's renewable energy capacity and reduce its reliance on fossil fuels.
- **PERTE Aerospace:** This initiative plans to mobilize approximately €4,533 million between 2021 and 2025, combining public and private investments. The project targets advancements in aeronautical technologies to reduce environmental impacts and increase the efficiency of future aircraft.

63. "NGEU delivery – How are the Member States doing", European Parliament, April 2024.
64. See footnote 63.

6.3.4 Concerns about the quality and potential fraud in the implementation of the RRF are becoming increasingly prominent

As the fund's expiration date looms, there is growing anxiety among observers and officials that the time pressure to disburse funds could lead to inefficiencies and raise the risk of fraudulent activities. One national official highlighted the pervasive worry, stating that "observers and officials worry that time pressure, while acting as an incentive for governments to keep on schedule, could affect the quality of expenditure negatively and, in some cases, increase the risk of fraud."

This concern is particularly relevant for countries like Spain and Italy, which have historically struggled with the efficient absorption of EU funds. A Financial Times article from February 2024 notes that "because they have the lowest absorption rates of regular EU funds, the amount of their entitled budget that they spend, it raises questions about their capacity to spend huge amounts of additional money efficiently and safe from graft."

The Italian experience with its tax credit scheme for building renovations illustrates these challenges. Originally projected to cost €35 billion over fifteen years, the tax incentive had already cost the government €219 billion by early April 2024⁶⁵. The country allocated nearly €14 billion of its recovery funds to this initiative, which has a total cost of €100 billion. While the scheme stimulated a construction boom, its long-term benefits are questionable, and it has been marred by fraudulent activities, as reported by Italy's tax authority.

To mitigate the risk of graft, EU countries have implemented audit systems, though these come with significant administrative burdens. The high cost of these audits has drawn criticism, with one national official remarking, "To reduce the risk of graft, all EU countries have an audit system in place, but countries lament the high administrative burden it places on implementing authorities", notes the FT article. Another official emphasized the mismatch between the tools used and the risks managed: "This is not proportionate to the risk. There are important risks of fraud and corruption, but we must use the right tools to fight this, and here we're using a bazooka to control things that are very restricted in scope."

The complex and often cumbersome procedures associated with the fund's implementation have fostered a negative sentiment among those responsible for managing it. One official described the situation as "nightmarish", stating, "The mood is reluctantly negative towards the practical implementation of the instrument", adding that they sometimes face "nightmarish" procedures.

These challenges have significant implications for the future of EU funding mechanisms. The ability of Member States to use the Recovery and Resilience Facility effectively is seen as a crucial test for the viability of future common funding initiatives. As the article concludes, "The willingness among EU countries to repeat such an exercise relies on the ability of Member States to prove the instrument has been a success."

6.4 Can the IRA widen the gap between the US and the EU?

On 16 August 2022, the Biden administration promulgated the Inflation Reduction Act (IRA), a **\$369 bn subsidy package that aims at making the US the global leader in clean tech, notably by cutting CO2 emissions by 40% by 2030**. Though it was announced nearly two years after the launch of NGEU, the IRA raises many questions and concerns on the European side.

6.4.1 The IRA is a protectionist-inspired subsidy package that aims at making the US the global leader in clean tech and CO2 emission cuts

The IRA is a massive subsidy package that was signed into law by President Biden on 16 August 2023 and that clearly states the US ambition to:

- Become the global leader in the environmental transition by cutting its CO2 emissions by 40% by 2032,
- Attract investments in the US territory to reinforce its industrial fabric,
- Enhance innovation in the US to stay at the edge of the digital transition,
- Reinforce its strategic autonomy by weakening China's position at the global level and avoiding supply chain disruptions,
- Lower prescription drug prices.

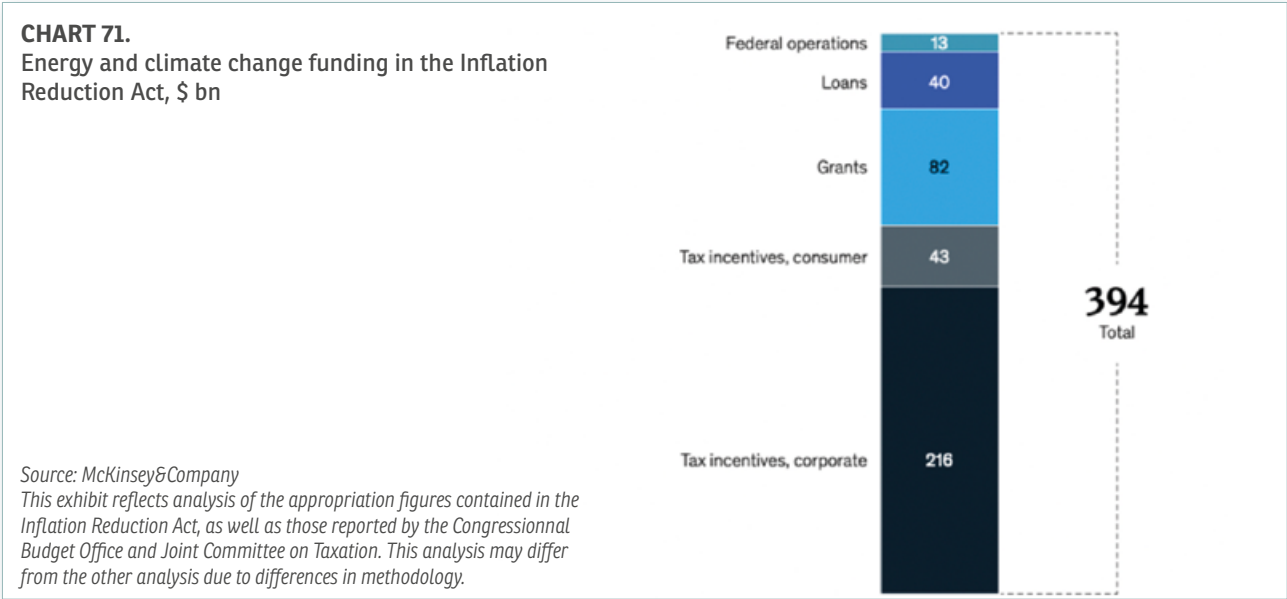
To do so, the IRA commits **\$400 bn in tax credits, loans, and subsidies over the next 10 years**.

65. "Italy: is the government debt at the mercy of superbonus effects?", Natixis Research, 16 May 2024.

A central element of the IRA – and the most criticized overseas – is the protectionist measures on which it relies. Indeed, to benefit from IRA funds, Local Content Requirements (LCRs) must be met, which establishes a disloyal competition between the US and its competitors.

One of many examples of LCRs is the fact that half of the subsidy for EVs depends on a minimum percentage of critical minerals being extracted and processed in the US or a country with which the US has a free trade agreement, and the other half on a threshold percentage of battery components being manufactured or assembled in North America. Additionally, the final assembly must take place in North America to qualify for the IRA tax credit⁶⁶.

It is unarguable that the IRA's primary goal is to provide incentives for private investments, which is a key difference compared to the European approach focusing on public investment: out of the \$393.7 bn allocated to energy and climate funding, \$216 bn will be received by corporations in the form of tax credits⁶⁷ (see Chart 71). Moreover, \$43 bn in IRA tax credits aim at making EVs, rooftop solar panels, and other clean technologies more affordable, and thus reduce CO2 emissions. For instance, qualifying new EVs will be eligible for a tax credit of up to \$7,500.



The IRA is the third piece of law passed since late 2021 that seeks to improve US economic competitiveness, innovation, and industrial productivity.

The IRA is part of a wider US plan to assert its leadership position on the economic stage and launch a new era of American industrial policy. Indeed, the IRA joins two other pieces of law that seek to improve economic competitiveness, industrial productivity, and innovation in the US.

First, the Bipartisan Infrastructure Law (BIL) voted in November 2021 is a piece of law aiming at rebuilding America's roads, bridges, and railroads, expanding access to clean drinking water, ensuring that every American has access to high-speed Internet, tackling the climate crisis, advancing environmental justice and investing in social justice. Over 10 years, the act should allocate an estimated \$1.2 tn in total funding, of which \$550 bn will be spent on the surface-transportation network (\$284 bn) and society's core infrastructure (\$266 bn) over the first five years.

Second, the CHIPS and Science Act passed in August 2022 aims at boosting US innovation and competitiveness, as well as enhancing US national security regarding semiconductor manufacturing. Out of the \$280 bn dedicated to this act, \$200 bn will be allocated to scientific R&D and commercialization. Additionally, about \$53 bn will benefit the semiconductor manufacturers, R&D, and workforce development and \$24 bn worth of tax credits will enhance chip production. The remaining \$3 bn will be spent on programs aimed at developing leading-edge technology and wireless supply chains. Overall, the goal is to keep the US the leader of the industries of tomorrow, including nanotechnology, clean energy, and Artificial Intelligence (AI).

66. "LCRs come in gross violation of the international trade architecture that is enshrined in the WTO statutes, of which the most-favored-nation principle is blatantly disregarded."
67. "The Inflation Reduction Act: Here's what's in it", McKinsey & Company, October 2022.

TABLE 8.

The three main pieces of legislation passed by the Biden administration, (in \$bn and %)

	Over 10 years	On average per year	% of 2022 GDP
Inflation Reduction Act	391	39.1	0.2
Chips and Science Act	278	27.8	0.1
Bipartisan Infrastructure Law	1200	120	0.6
Total	1869	186,9	0,9

Source: CEPII

Note: only the "climate and energy" part of the IRA was taken into account in this table, because public spending increase for healthcare is estimated to 0.05% of US 2022 GDP per year

The BIL, the CHIPS and Science Act, and the IRA have partially overlapping priorities and together introduce \$2 tn in new federal spending over the next ten years.

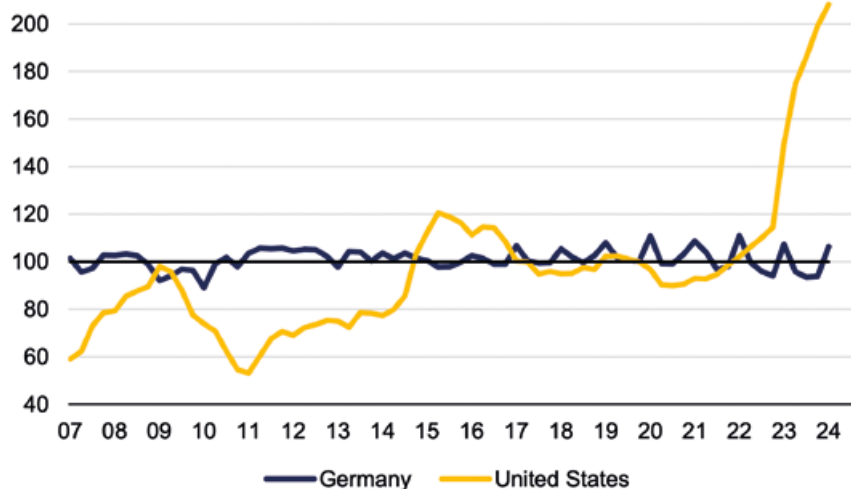
Parallely, President Biden inaugurated on 29 November 2023 a Council on Supply Chain Resilience⁶⁸. While measures have been taken to bring manufacturing to the US and strengthen supply chains since supply chain bottlenecks peaked during the pandemic, this Council should further work to keep supply chains secure, diversified, and resilient into the future. Both geopolitical and economic benefits are at stake: having secure supply chains *vis-à-vis* China is key in some fields such as medicine and semi-conductor, and avoiding supply chain disruptions such as those suffered during the pandemic will minimize inflationary trends.

6.4.2 The IRA already proved very attractive for both US and foreign companies

As written by G. Moëc⁶⁹, "the Inflation Reduction Act (IRA) is one of the ingredients of the current resilience of the US economy – showing up for instance in the already visible rebound in manufacturing investments projects – in stark contrast with the increasingly dismal readings on the European economy."

CHART 72.

Private real investment in non-residential structures, index Q4-2019 = 100



Source: DeStatis, US Bureau of Economic Analysis

Note: last observation from 2024-Q1; data are seasonally adjusted and expressed in real term

Private non-residential investment in the manufacturing sector, a measure of the number of factories and industrial equipment acquired by private companies, has significantly diverged between the United States and Germany since 2022. Chart 72 shows the boom in private investment in non-residential structures on the US territory, while Germany – the industrial heart of the European Union – experienced a declining trend. Between Q4-2019 and Q1-2024, the volume of private investment more than doubled (+108%) in the United States, while it only increased by a mere 6% in Germany.

Given the conditions to benefit from the IRA mentioned above, the latter seems to be undeniably successful at attracting investors from all around the world.

68. "La Maison-Blanche se transforme en tour de contrôle des chaînes d'approvisionnement", *Les Échos*, 28 November 2023.

69. G. Moëc, "In defense of Europe's net zero strategy", AXA Macrocast, 20 November 2023.

6.4.3 The EU seems to be distanced by the US in the race to clean energy, competitiveness, and industry

Even if NGEU, was launched two years before the voting of the IRA, and even if the EU has since then launched other initiatives such as REPowerEU and the GDIP, the EU seems to fall behind the US in the race to clean energy, competitiveness, and industry. This part shows that both external and inherent features of the EU can explain why the latter is lagging behind the US: the current global context is more favourable to the US than to the EU, and the American instruments seem also more efficient than in the European Union. The second half of this part focuses on recommendations for the EU to improve its competitiveness and its overall economic health to fully reap the benefits of NGEU.

6.4.3.1 Global context is more favourable to the US than to the EU

Different elements of the global context are undeniably hampering the reindustrialization of Europe and undermining the effects of the massive investments under NGEU.

The EU has suffered from importing energy at very high prices; the EU has few raw material resources. Europe's aging population is not attractive for companies⁷⁰. The workforce is cheaper, better skilled and more productive in the US than in the EU (see Chapter 1). High public debt and fiscal deficits in the EU hamper the competitiveness and effectiveness of companies. The overall economic and fiscal health of certain EU Member States are further hurdles to their reindustrialization and attractiveness. Indeed, as long as no structural reforms are steered, high public debt as well as important fiscal deficits are limiting the possibility of the most highly indebted countries to help reindustrialization through public funding.

Furthermore, Germany, the manufacturing pillar of Europe, is being forced to review its growth model built on low-cost energy imported from Russia and dependent on its exports, particularly from China.

All in all, European firms face cost explosions in terms of energy, skilled labor, tax law, and environmental regulations, while simultaneously, the US and China fight to attract industrial activities and employment.

6.4.3.2 The US employs instruments that are more efficient than the EU, and qualitative differences in the approaches are also observed

The IRA is very attractive for firms worldwide, and its success relies on various elements. First, the focus is on the market, firms' and private investment. The US benefits from a genuine single market that enables companies to achieve economies of scale. The focus of NGEU is on EU Member States and public investment rather than the single market. Moreover, the IRA resorts to massive tax credits, which cannot be implemented in the EU because tax policies remain national.

Besides, the US has a genuine industrial policy: the IRA includes Local Content Requirements (LCRs) that automatically favour the US over international competitors and attract companies that want to benefit from IRA subventions. In that regard, the US has already favoured its national economy for almost a century with the *Buy American Act* of 1933 which requires the US government and third parties to prefer US-made products in its purchases, with legal requirements changing according to sector, price and competition.

This is in profound contrast with the European approach regarding industrial policy: for decades, the EU has favored competition policy and free trade over having a genuine industrial policy with a community preference. This absence of EU industrial policy is reflected in the current struggles in the progress of NGEU.

Additionally, one of the main differences between the IRA and NGEU is that the former massively grants subsidies and tax credits to private companies and citizens, while the latter follows a bureaucratic intermediated procedure where the Commission distributes grants and loans to national public authorities which then award it to private sector agents.

This burdens the efficiency and the speed of fund allocation and disbursement, even if it is true that the disbursement by the Commission is made upon evidence that milestones and targets – e.g. signature of contracts/ grant awards – have been fulfilled and thus that Member States have supported private companies and citizens. While everything is centralized in Europe, IRA funds swiftly and efficiently flow through over a dozen federal agencies, with 5 main agencies handling 96% of the funding.

Furthermore, available IRA funds are spent almost immediately while halfway through its lifetime, only one-third of NGEU funds have been spent. Indeed, the Member States – which have never before benefited from so much money – seem to be struggling to absorb all the funds made available to them.

70. Demographics in the Eurozone are less dynamic than in the US, leading to a future decline in labor force that will reduce potential production, tax revenues, etc. Additionally, Europe's ageing population does not make it very attractive to establish new industrial production capacity, especially as it gives rise to structural recruitment difficulties.

6.4.3.3 Highly indebted Member States need to review the composition of public spending and favour quality over quantity in order to have new margin to increase productive public investment

This Macroeconomic Scoreboard shows that EU countries with the highest level of government expenditure as percentage of GDP are those with the least competitive firms and that excessive levels of public debt do not fuel productivity growth and employment. In such a context, it has become urgent to achieve sufficient fiscal discipline in all parts of the EU.

In that respect, D. Cahen and J. de Larosière made some recommendations⁷¹.

6.4.3.4 The EU needs to design and implement a genuine industrial policy

The EU needs appropriate competition rules to boost its industry

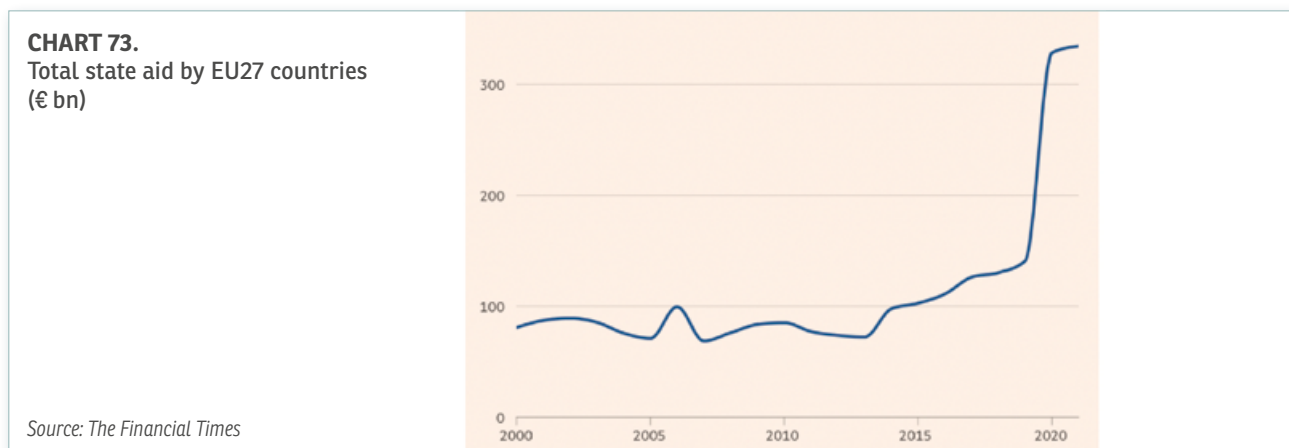
A paper of the European RoundTable⁷² (ERT) reminds us that the EU's competition policy is an essential pillar of a comprehensive industrial strategy for the Union. The Commission should assertively deliver a competition policy that reinforces the role of open markets and incentivizes European firms to compete effectively, both across the internal market and on the global stage. Such a policy should also foster the emergence of European industrial and financial champions able to compete on the international stage: merger decisions should seek the benefits for the entire single market, not only the markets of individual Member States, and should be assessed regarding global competition and trends.

An effective industrial policy could also rely on state aid for early-stage innovations for the digital and green transitions as well as for key strategic sectors when market forces alone are insufficient. The EU must offer faster and more efficient procedures to entice European companies to invest at home rather than being lured away by attractive and unbureaucratic incentives in the US and elsewhere.

State aid rules must be carefully relaxed insofar as they could jeopardize the Single Market because Member States have diverging fiscal capacities

In the EU, tax policy remains the prerogative of Member States, so it has relaxed rules on state aid to deter companies from redirecting investment to the US⁷³. Indeed, the Temporary Crisis and Transition Framework (TCTF) of March 2023 can be seen as a European response to the financing gap between the EU and the IRA.

In the wake of Covid-19 and the Russian invasion of Ukraine, Brussels decided on economic emergency measures and abandoned the single rule book: rules on the conditionality of state aid and national subsidies were lifted and EU oversight of its members' deficits and debts were suspended. But the FT reminds us that **"the EU's state aid rules were drawn up to protect poorer states with less fiscal firepower from the richer states that would otherwise be able to pump cash into their national champions and give them an unfair advantage."** That, say some officials from mainly southern and eastern countries, is exactly what has happened.



Governments in countries such as Germany and France, in the name of economic stability for the entire bloc, have given their own companies the financial clout to outcompete their EU rivals, trampling on the safeguards of the single market in the meantime⁷⁴. Indeed, France and Germany accounted for half of the €733 bn in state support

71. D. Cahen & J. de Larosière, "Reforming the Stability and Growth Pact", Eurofi Regulatory Update, April 2023.

72. "Securing Europe's place in a new world order", ERT Vision Paper, 2024-2029, 26 October 2023.

73. "Industrialists call for deeper political union in the EU on energy", Financial Times, 14 November 2023.

74. Op. Cited FT.

that Europe approved between March 2022 and August 2023. The state aid explosion shown by Chart 73 has thus given Member States, particularly richer ones, the incentive to keep the rules as they are, but this situation also brings about fundamental disequilibria insofar as fiscally sound Member States can afford to provide financial assistance to their economies, while fiscally weak countries cannot, which worsens the existing heterogeneities within the Union. Therefore, without adequate safeguards and limits, a relaxation of risk control could fragment the Single Market.

6.4.3.5 IPCEIs are key to Europe's industrial future

Important Projects of Common European Interest (IPCEIs) are useful instruments that enable Member States and the EU to support certain industries without going against international competition rules.

IPCEIs were created in 2014 and allow firms to receive state aid under the EU state aid rules in complement to private funding in order to promote innovation in strategic industrial sectors. They rely on a bottom-up approach insofar as private companies have been involved in the projects since their beginning, and Member States remain the drivers of the projects all along.

IPCEIs are also supported as part of the NRRPs. Since IPCEIs are supported by national budgets, Member States are in the driving seat to form an IPCEI, identify the scope of the projects, and select participating companies and projects. A central EU IPCEI fund does not exist, but IPCEIs require the approval of the European Commission under state aid law.

IPCEIs have experienced increasing success since 2018: at least one IPCEI has been approved each year by the Commission, with significant amounts engaged. Moreover, the increase in the number of participating Member States and companies observable in the chart below shows a positive trend. Since the start of the first integrated IPCEI in 2018, the participation ratio of SMEs has steadily increased from 7% in the IPCEI Microelectronics 1 to 64% in the IPCEI Med4Cure in 2024.

The approved state aid along with the expected private investments into research and development of the 10 IPCEIs so far add up to almost €91 bn. This level of investment is comparable to the EU's Horizon programs.

CHART 74.
Approved IPCEIs

	Participating companies	Participating projects	State aid approved (EUR billion)	Expected private investments (EUR billion)	Participating Member States
First IPCEI on Microelectronics (2018)	29	43	1,9	6,5	
First IPCEI on Batteries (2019)	17	22	3,2	5	
Second IPCEI on Batteries - EuBattIn (2021)	42	46	2,9	9	
First Hydrogen IPCEI - Hy2Tech (2022)	35	41	5,4	8,8	
Second Hydrogen IPCEI - Hy2Use (2022)	29	35	5,2	7	
Second IPCEI on Microelectronics and Communication Technologies (2023)	56	68	8,1	13,7	
IPCEI on Next Generation Cloud Infrastructure and Services (2023)	19	19	1,2	1,4	
Third Hydrogen IPCEI - Hy2Infra (2024)	32	33	6,9	5,4	
Fourth Hydrogen IPCEI - Hy2Move (2024)	11	13	1,4	3,3	
IPCEI Med4Cure (2024)	13	14	1	5,9	
Total	283 247*	334	37,2	66	22 Member States, UK and Norway participated in at least one IPCEI

Source: European Commission

Nine of these IPCEIs concern predominantly research and development as well as projects of first industrial deployment (microelectronics, batteries, and hydrogen value chains). One IPCEI is dedicated to infrastructure, to enhance the territorial integration of the EU.

IPCEIs are a way forward towards a European industrial policy and enhance the competitiveness of the Union at a time when it most needs it. As P. Gentiloni told *Le Monde*⁷⁵, the EU “will not win the race to competitiveness only with regulations”. IPCEIs are a promising way forward and could be extended to other strategic sectors such as health, solar panels, and even a European cloud. But uncertainty remains around the financing of such initiatives: is more common debt the key? Only the reimbursement of NGEU will tell if a European fiscal union can emerge, or if it is doomed to remain a pipe dream.

The EU needs to accelerate the single market while re-establishing a community preference

With the Single Act of 1986, the EU abandoned community preference, and this limitless openness of trade undoubtedly contributed to the weakening of industries in certain EU countries. However, experts such as French Nobel Prize of Economics M. Allais warned in the early 2000s about the threats of unregulated economic globalization and the detrimental effects it would have on the various regions of the world, with a focus on the European Union.

He advocated in his work **the need to build a European community based on a democratic political structure as well as on a community preference and an appropriate protection of the community's single market**. He also suggested that the European Treaties, specifically Article 10 of the Treaty of Rome, should be revised in order to introduce a reasonable level of protectionism that would always put the best interest of the European community first. His proposal was the following: “In order to safeguard the harmonious development of world trade, a reasonable community protection must be ensured regarding imports from countries whose exchange rate wage levels are incompatible with the abolition of all customs protection.”

Furthermore, the potential of the single market has not yet been fully tapped. Indeed, the IMF estimates that further integration of the single market would enable the EU to gain up to 7 pp of GDP. In that respect, the ERT⁷⁶ made some recommendations to remove single market barriers: “the European Commission must spearhead an ‘encompassing program’ to shape a common market across all policy areas, including energy, digital, capital, environment, and defense. It should proactively compel EU Member States to promptly remove unlawful or unreasonable barriers and burdens *via* mechanisms like the European Semester, guaranteeing the free circulation of goods, services, people, capital, and data. There should also be a concerted effort to harmonize and simplify the implementation of EU Regulations, Directives, and Delegated Acts, as fragmentation makes it difficult for businesses to compete fairly across the single market.” A collaborative and genuine single market would be beneficial for the overall union and to secure Europe's place in the new world order.

The growing inequalities both at regional and global levels as well as the fierce competition that puts pressure on workers and the environment are increasingly observable. Re-establishing a community preference in Europe would also reinforce the development of a European industrial policy, the multiplication of IPCEIs, and the emergence of European industrial companies. It also seems to be an adequate response to the LCRs at the heart of the American IRA.

To conclude this section, it is worth highlighting several important points:

To date, the main issue in the EU is not essentially one of financing, but of carrying out investments that could consequently give rise to a need for financing.

With €370 bn of excess savings in 2023, Europe has significant financial resources to engage in the green and digital transitions but lacks adequate investment projects despite the different EU plans that have been launched over the past years. In other words, the additional financing needs assumed according to the Commission's calculations for additional investments in the climate transition (+€350 m/year) and digitalization (+€150 bn/year), have not materialized, as investments have remained stagnant.

Concerning the ecological transition, all public and private reports confirm that the EU is still a long way from the levels of investment required to meet commitments (FF55). Roughly speaking, to successfully achieve the transition, the investment efforts should be multiplied by 2 to 3. For this to work, a positive investment-financing feedback loop would have to be triggered. This is what the US has achieved with the IRA. What is puzzling is that they have even attracted European companies to their territory – all the more since energy prices are cheaper on the other side of the Atlantic.

75. “L'Europe a un problème de compétitivité”, *Le Monde*, 17 November 2023.

76. *Op. Cited ERT Vision Paper 2024-2029.*

The multiplication of European investment plans over the past years underlines the EU's standardization effort. In addition, the RRF is a well-designed innovative performance-based instrument that combines reforms and investments, emphasizing the effort of the Commission to get results. Nonetheless, external factors tend to limit the speed and the impact of the program. The solidarity and ambition demonstrated in NGEU are undermined by the Recovery and Resilience Plan being fragmented along national lines. Indeed, 27 national plans have been submitted to the Commission with no enhanced cross-border dimension, even though Member States have similar needs regarding the digital and green transitions.

Furthermore, the RRF offers one more advantage to Member States: expenditure financed by RRF grants does not add to national debt and deficits and thus provides important support to high-quality investments and reforms without subtracting from the available fiscal space.

When qualitatively comparing NGEU and the American IRA, one thing is striking: the American funds are easily and quickly accessible and work as an incentive to achieve the adopted objectives, whereas national and European bureaucracies make the process of spending NGEU funds cumbersome and rely heavily on prohibitive rules. In that respect, some experts also pointed out to the fact that the EU does not have the fiscal means of the US, and therefore needs to rely much more on the approach of ETS combined with a well-designed subsidy/industrial support.

The speed of deployment of the IRA and the whopping number of companies that have announced investments on American soil testify to the success and the simplicity of the IRA one year in. By contrast, the deployment of NGEU has been slower, impeded by the lack of skilled workforce and the burden of bureaucracy.

Furthermore, NGEU does not reap the full benefits of the European single market. This is less attractive for investors than the vast and unified American single market which offers significant opportunities and economies of scale. As a result, only a third has been spent halfway through the lifetime of the project. Additionally, some European companies have been attracted by the IRA and have thus shifted investment to the US, including Total Energies, MBW and Northvolt.

Conclusion

For a more dynamic economy in the Eurozone

The euro has weathered almost a quarter century of crises and storms without sinking. But the euro's successes cannot mask its vulnerabilities.

Monetary union alone does not create economic convergence. This Scoreboard underlines that economic disparities and differences in living standards between Euro area countries have widened considerably since the launch of the euro. As we have observed, many Member States have relaxed their macroeconomic discipline over the past twenty-five years, and those who played the fiscal vigilance card have emerged as the winners. The Covid-19 crisis and the energy crisis, exacerbated by the war in Ukraine, have exacerbated these existing heterogeneities among EU member states.

Over the past two decades, several EU Member States have opted for an economic model that is detrimental to the supply-side of the economy. This economic policy stance has contributed to a loss of economic dynamism in Europe, which now finds itself well behind the United States in terms of growth, productivity, and investment. Indeed, productivity gains have faded in Europe since the 2008 Global Financial Crisis, as most Member States have systematically focused on stimulating private demand through public spending. Indeed, fiscal policies have most often sought to preserve household consumption at the expense of productive investment. The ECB's permanent accommodative monetary policy until 2022 – in the form of negative interest rates and asset purchase programs that have pushed its balance sheet up to 70% of EA GDP – has facilitated the financing of these public deficits, discouraged structural reforms, and massively favoured the expansion of debt not to finance productive investment as a priority, but speculative and real estate purchases (without creating new value).

As long as it is not sufficiently understood, especially in the highly indebted countries, that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe. Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define a common interest in Europe, encourages a policy of "every man for himself" and creates a climate of mistrust between Member States that hinders any progress in terms of public and private risk sharing and weakens the Euro area.

A monetary union can only work if a minimum of fiscal discipline is guaranteed by all states, which has not been the case for 25 years. Ultimately, the fate of the euro will depend on the political will to achieve genuine cooperation within the zone. If the fiscal and economic drift in the Eurozone continues, the 'virtuous' countries will end up paying the price. That would be the definition of an uncooperative game, in which most players try to evade their obligations by passing on the costs to those who respect them. We must therefore take control of the Union's destiny and not let it drift. If we do, the logical consequence could well be another inevitable crisis in the Eurozone.

It is economic growth that ultimately solves debt problems. The only way to promote robust and sustainable growth in the EU is to implement fiscal discipline and ambitious supply-side structural reforms in all member states. "This means fostering competition, increasing labour and product market flexibility and promoting innovation. It also means a judicious use of scarce public resources to support the economy's adjustment to the new realities."⁷⁷ Any demand-driven stimulus financed by increasing deficits and taxes in highly indebted countries can only harm business competitiveness.

If Europe and the Eurozone are to correct their growth disadvantage relative to the United States and China, a considerable investment effort in research and development, in industrial equipment, in decarbonization, in digital technology, in improving equity financing, the education system and the skills of the population, in promoting selective immigration of "people" who can occupy sufficiently skilled jobs, will therefore be necessary. Furthermore, scale matters more than ever and the completion of the single market must be a permanent objective progressively based on an EU industrial policy.

We must understand that our future – non-inflationary – depends on the elasticity of supply and therefore on sufficient investment and a well-trained workforce. Anything that encourages savings to be channeled into liquid assets at the expense of long-term capital investment must be opposed.

As explained by Jacques de Larosière⁷⁸, "One day we will have to understand that the narrowing of the output gap between potential and observed growth cannot be reduced to the mere fight against the restoration of production

77. BIS, Annual Economic Report, June 2024.

78. J. de Larosière, "Putting an end to the reign of financial illusion", Odile Jacob, September 2022.

chains, but requires the activation of all the sources that ultimately constitute our eco system: productive investment – penalized for 20 years by lasting very low interest rates – , the development of training, the recovery of the share of wages in income, the revitalization of competition... To revive productive investment, refrain from administratively setting (“or guiding” the market) long term interest rates and accept to let the market remunerate savings in the medium and long term according to supply and demand without which there can be neither productive investment nor productivity gains.”

Monetary policy can erase spread differentials but cannot address structural issues, notably the lack of confidence and the persistence of structural discrepancies, which explains the limited capital flows from North to South. Europe benefits from a large pool of savings which could contribute to financing long-term investments, especially those related to the green and digital transition, provided that such savings are not taxed but remunerated.

However, these savings leave the EU and finance the rest of the world (in particular the United States). Indeed, since the EU sovereign debt crisis (2011-2012), Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in countries with lower GDP per capita (Spain, Italy, Portugal, Greece). This is due in particular to the interest rate differential between the US and Europe, the higher returns on US equity markets, and, more generally, to the capital invested compared with the EU (risk-taking is more rewarded in the US than in Europe).

These limited cross-border capital flows in the Euro area highlight the lack of a genuine Banking Union and integrated financial markets as well as persistent doubts of some investors in Northern Europe about the solvency of states and companies in other countries.

Consequently, the Eurozone must embark on the right course: more fiscal responsibility and more supply reforms geared to increase productivity. It must fight persistent inflation, as well as take the necessary steps to complete the Banking Union and implement the Capital Market Union. But these steps are only conceivable if sufficient discipline is applied to reverse the trend of ever-growing economic heterogeneity among member states.

•

Ultimately, the paradox of the Euro is that a single currency and national economic policies coexist without a strong cement of coordination. Ultra-accommodative and asymmetric monetary policies have been used to overcome the contradictions of this paradox, but the price of this permanent rescue is costly. To make the euro sustainable, it is essential to ensure the convergence of fiscal and structural policies.

To be viable, the Eurozone needs:

- **National budgets under control in all parts of the Union.** No responsible state can be expected to finance durably current public deficits generated by other Eurozone members of the Union that do not follow the rules of the Union. The future – and notably the solution to market fragmentation – depends on a consolidation of present weak fiscal positions (primary surpluses) and a shift towards quality of expenditure and investment. We do not need more redistributive expenses. We must rein them in and allow adequate space for public investment.

We have to recognise that the shift towards more investment will require a substantial political effort; at present, public investment accounts for only about 4% of GDP, while current – unproductive – expenditure accounts for almost all public spending. As much as we need to tackle unproductive spending, we can encourage the financing of infrastructure spending (including research). The implementation of the revised Stability and Growth Pact is of paramount importance in this respect. Unfortunately, the agreement reached by the Ecofin Council in December states that countries subject to the excessive deficit procedure (total public deficit above 3% of GDP) will be exempted from the rule requiring them to reduce their public debt by an average of 1% per year until their deficit falls below 3%, which is not the best way to encourage the worst performers to reduce their debt to GDP ratio!

- **Domestic structural measures aimed at enhancing business dynamism and increasing growth potential should be encouraged and monitored.** We have seen that the economic and financial model based on monetary abundance, the under-remuneration (taxation) of savings, the financialization in response to structural insufficiencies, the systematic short-termism, and the increase in the – essentially speculative – valuation of financial assets, does not meet the needs of our society. These needs require long-term investment, a response to climate and digital challenges, and an adequate return on savings and wages. Without such a reorientation of our policies, it seems difficult to achieve the “common good” and to correct

the major current imbalances.

Raising potential growth requires increasing in the productivity of the system, which requires more competition and long-term investment.

- **To combat persistent inflation.** The most pressing monetary policy task is to restore low and stable inflation and to sustainably rebuild monetary buffers. According to the BIS Annual Report of June 2024, key interest rates should remain high for as long as necessary to restore price stability. "A premature easing could reignite inflation pressures and force a costly policy reversal – all the costlier because credibility would be undermined." The reappearance of spreads should not dominate the decision-making process. The history of high inflation episodes tells us that if central banks loosen too quickly before the problem is really addressed, then we get another inflation wave, and then another wave of interest rate hikes, which would be a worse scenario. Last but not least, it is necessary to refrain from fixing administratively ("or directing" the market) long-term interest rates and to accept that the market should reward medium – and long-term savings – according to supply and demand – without which there can be no productive investment or productivity gains.
- **An active banking and integrated capital market in Europe.**

Finally, it's high time to return to a more pragmatic conception of Europe, by thinking about strengthening it, giving it **strong groups worldwide, not neglecting the community preference advocated by Maurice Allais** in his day, and working for "projects in Europe" and not for "a greater Europe".

Most of the necessary remedies are within the power of the Member States and the European Union to implement: fiscal discipline, expansion of SMEs, CMU, BU, design of selective Community preference. But this requires political will, leadership, impeccable intellectual support, with a sensible supporting EU programme. In sum, members of the Monetary Union must act together to make it work, and not behave as passive individual bystanders hoping that things will turn out fine. Ultimately, the fate of the euro will depend on the political will to achieve genuine cooperation within the Euro area.

Notes

A series of horizontal dotted lines for writing notes.

Notes

A series of horizontal dotted lines for writing notes.

euromfi

www.euromfi.net

