EU economic competitiveness challenges

The euro area is lagging behind other regions in global competition. In his interview with Eurofi Magazine, the Governor of the Central Bank of Hungary notes that "the weight of the euro area in global GDP has fallen from 21.8 percent in 1999 with 12 member states to 14.7 percent in 2023 with 20 member states. The 12 founding countries achieved an average annual GDP growth of 1.5 per cent in the last 25 years, less than the over 2 per cent figure achieved by the United States of America".

The moderator of the session stated that competitiveness for Europe is not only about efficiency gains and wages but is also about being able to offer a social model that is simply unique in the world and one that makes Europe the most attractive place to live in the world. The panel identified the problem in terms of where this gap comes from and the solution.

All speakers acknowledged that Europe is falling further and further behind when it comes to innovation, especially when it comes to growth in intangible investment and productivity. At European level, priority must be given to completing the single market and implementing the CMU. There was little mention of reforms and national solutions to help Member States regain competitiveness.

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

1.1 This worrying observation for the future of Europe was shared by all the speakers

1.1.1 Our house is burning

An official stated that the number one priority for Hungary's presidency is the competitiveness issue. Former French President Jacques Chirac once said, 'Our house is burning, and we look away'. The bad news is that its house is really burning, but the good news is that it is finally not looking away.

In 2008, Europe was the biggest economy globally and had a 25% share of global GDP. This share has now decreased to 16%, while the US has increased its market share from 23% to 26%. The IMF has predicted that the lowest growth rates worldwide are going to be in Europe. The prediction is a growth of around 1.5% maximum, while other regions are all growing at much faster rates. An economy that is growing by 1% will double its size in 72 years, while one growing at 2% will double its size in 36 years.

1.1.2 Europe's startling income divergence from the US began around the turn of the century, coinciding with the onset of the tech boom in the US, and has deep firm-level roots

An official stated that it is an important time for Europe to focus on some of the problems that have been lingering for too long. The Noyer letter and the Draghi report are trying to address those, but it is also apparent that there is a clear diagnostic and there are solutions on the way forward.

Europe's per capita GDP is one third lower than that of the US. 70% of that gap is explained by productivity. Productivity development since 2005 in the tech sector improved by 40% in the US but was stagnant in Europe. Research and development (R&D) and innovation spending of these tech companies is twice as high in the US as in Europe. 10% of revenue generated by US tech firms is going into R&D, and 4% is in Europe.

The productivity gap is deeply rooted at the firm level. The market valuation of listed US companies since 2005 has tripled, while it has only increased by 60% in Europe.

1.1.3 The competitiveness gap is large, although whether Europe is seen as lagging or leading depends on the measure used

An official outlined that there were several ways of looking at the gap between the EU and the US. Looking at GDP at PPP, the gap between the US and the EU is now roughly a third. But if you compare GDP at PPP per hour worked, many EU countries have actually grown faster than the US. But the key issue is, as the IMF has pointed out, productivity in the corporate sector, especially innovative firms, where the US is much better than Europe. Weak innovative capacity is reflected in the trade balance, and the EU imports significantly more intellectual property and R&D services than it exports.

An industry representative noted that the Draghi report identified productivity and GDP growth, but it should not be forgotten that there are other social economic indicators where there is a lead in Europe. European economies exhibit consistently improving life expectancy rates, while US life expectancy has declined to the shortest in nearly two decades. Income inequality in the US is substantially wider than in any European economy.

1.1.4 Our way of life will be threatened sooner than expected if Europeans continue on a downward path

An official noted that the productivity and income gap between the EU and the United States has been widening for a long time. Although both economies were of the same size in 2011 with GDP in current prices of around $15 billion according to the IMF, the US economy is 52% larger today.

An official highlighted the issue of competitiveness and stated that the analysis has been there for decades. The

political agenda was focused on growth, whereas there is now more of a granular analysis, at least by the politicians. The major theme is how to convince political leaders to make decisions.

The Draghi report includes many ideas that have been discussed. Poland's prime minister proposed the energy union when Russia annexed Crimea 10 years ago. Poland also suggested that the EU needed to buy gas on the global market as the EU, and very little has been done. Poland has grown this year by about 3%. While it will grow by around 4% next year, it is not enough.

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

1.2.1 Europe lacks the productivity gains coming from innovative young firms that expand rapidly due constraints in scaling up

An official stated that Europe lacks the productivity gains that come from innovative young firms that expand rapidly and has an overabundance of very small firms that grow little. Firms with 10 employees at most account for nearly twice as much of employment in Europe as in the US. Firms that are under two years old represent 20% of all firms in the US versus only 8% in Europe.

Europe's weaker business dynamism reflects constraints to scaling up, and the main reason for these big differences in productivity gap is market size. A European firm cannot exploit economies of scale as a US firm does. When a company operates across country lines in Europe, the frictions and barriers are high compared to state lines in the US. Trade intensity in the US is twice as high as in Europe.

1.2.2 Access to finance is another key explanation of the lagging performance of European firms

An official highlighted that US listed firms access equity issuance at twice the rate of European firms. The available venture capital sector in the US is four times larger than in Europe. Even in terms of borrowing and debt issuance, small European tech companies pay interest rates that are two percentage points higher than in the US. When looking at the service sector, there is an issue of intangibles, which cannot easily be pledged as collateral. Equity also matters in order to give young, dynamic companies a start to grow. To scale up, market size matters. Europe needs to work on both of these issues.

1.2.3 The absence of a true single market

An official highlighted the incomplete nature of the single market as a problem. Fragmentation relates to national regulation, taxes and insolvency regimes. Barriers have remained particularly high in services trade, limiting economies of scale. Accordingly, intra-EU trade in services has barely grown during the past years and the EU has been unable to benefit from the global rise in services trade. This does not bode well for an advanced economy that generates 65% of its GDP from services.

Supply chain disruptions, coercive practices by trade partners and Russia's war in Ukraine have eventually exposed trade-related vulnerabilities. Strategic autonomy and economic security concerns have since reshaped the EU's policy agenda. The increase in energy prices is just the tip of the iceberg, yet the answer to vulnerabilities arising from political decisions elsewhere cannot be putting EU money at the service of external competitiveness. Political threats must be addressed by political means, even if this implies foregoing some of the benefits from trade.

European firms lack political support while the USA, which is their main competitor, introduced the Inflation Reduction Act in 2022. This allocates $400 billion in federal aid until 2030 to support clean energy, electromobility and the rebuilding of the US industrial base.

An official noted that the Draghi report says that one of the most important issues is to find an additional €800 billion for investment annually. Currently, the only available additional funds and initiative from the EU comes from the NextGenerationEU (NGEU) fund. The financing instrument has a total amount of €750 billion, but it is not an annual financing opportunity. Of the €750 billion, only 40% has been disbursed. One year ago, the same figure was 33%.

There is a common debt that is already borrowed from the market. It is in the accounts as €750 billion. In the last three and a half years, only 40% of this has been disbursed, and in the last year, only €50 billion has been at a time when there would be a desperate need for an additional €800 billion annually according to M. Draghi. This is a clear example of why there is a competitiveness issue in Europe.

2. At European level, priority must be given to completing the single market and implementing the capital markets union (CMU)

The EU strategies to strengthen competitiveness are well known but need to be pursued more rigorously. The single market should be prioritised over external competitiveness. The momentum regarding the CMU should be exploited to achieve a truly single, efficient and attractive EU capital market.

2.1 Policies can revive Europe's dynamism by strategic adaptation to technology and climate shifts

An industry representative predicted that there is going to be a very profound shift in demographic geopolitics, climate and technology. There are three areas to highlight in the problem statement: it is key to build the political consensus to implement some of the boldest plans; there is a question of how the EU will translate policy thought leadership into effective execution; and in areas where the EU has traditionally lagged, and in a time of even more rapid change, there is a question of how quickly the EU can reverse those legacy under-investments.

He added that Europe has an entrepreneurial artificial intelligence (AI) ecosystem, as evidenced by about 370 new AI companies in 2023; the US has nearly 900, i.e. the double. 61 states of the art AI models came out of the US

in 2023 versus 25 of Europe. The investment that is going into this space outpaced Europe by nearly sixfold in 2023. That starts to drive that gap. The speed at which this is happening is very different from, again, the policies that were in place in the past. What you see here is that, where you may be a fast mover, what you then contend with is fast implementers. This comes back to execution.

2.2 Implementing CMU

2.2.1 For a truly single, efficient and attractive EU capital market

An industry representative stated that European capital markets are fragmented across national lines and are not deep enough. There are not enough flows of savings that enter the capital market for financing the real economy. The CMU is an important concept designed to overcome this. Single supervision is extremely important to broaden the scope of the mandate of the European Securities and Markets Authority (ESMA), and there is a single rulebook. The bar for this has been lowered somewhat because of the successful experience of the European Central Bank (ECB) for the banking union.

A catalyst could be provided for further integration going forward. There are then the issues of harmonisation and convergence on structural issues, such as withholding tax procedures and harmonisation of the insolvency frameworks. This is important, although the hurdle here is probably higher.

To provide the right funding, it is a matter of changing the perception as well as the approach to capital markets: correct the preferential treatment for debt over equity and stimulate equity financing; encourage long-term equity financing from banks, insurance companies, institutional investors and households.

Private equity and venture capital are playing important roles. Easy, simple and transparent securitisation is positive. A review of capital requirements for securitisation tranches is necessary. Capital requirements for different tranches are sometimes higher than those on the underlying pool of assets, which does not make much sense. The securitisation liquidity regime also needs to be improved. Additionally, it is important to start creating a culture at the household level to promote financial literacy and increase the number of households that put their money to work and avoid leaving it stuck in their bank account.

The common safe asset is extremely important and politically very difficult. There is also a need to create the preconditions for this to be politically acceptable. There are two instruments. The first is delivering timely and effectively on NGEU investment. Secondly, Europe has a big issue, which is that disbursement needs to be linked to conditionality.

The main hurdle towards common debt is the lack of mutual trust across member states. Much has been said about setting up ad hoc funds for specific investment areas. To make this a bit more politically acceptable, Europe should look at Support to mitigate Unemployment Risks in an Emergency (SURE) bonds. However, over the medium to long term, there is a need for a big central capacity with a bigger role for the EU budget and more tax-raising capacity. The budget also needs to be given a larger amount of own resources to be able to meet the challenges of future investment.

2.2.2 Incentives, education and financial literacy should help to shift the mindset in favour of CMU

An industry representative likened CMU and all the important initiatives to greasing an engine in terms of making European capital markets more efficient. However, the engine needs to be fuelled. There is a question of how to mobilise the capital to get into equity markets and into debt markets, as well as how to change the culture of the willingness to accept risk for return in order to close a future pension gap.

Incentives and education/financial literacy can help to shift the mindset. A couple of European countries have already made good progress in terms of supplementary pension schemes, while Japan introduced a Nippon Individual Savings Account (NISA) investment scheme at the beginning of the year.

2.2.3 Improving securitization and facilitating capital flows from third countries to Europe are doable in the near term

An industry representative highlighted what is doable over the near term. Capital rules for banks related to securitisation are proving preventative. Equally, one could argue that the capitalisation rules under Solvency II for insurance companies to participate in the type of project finance that are needed to finance the energy transition are also preventative.

Some stakeholders in New York have expressed a high degree of scepticism as to whether the EU will be able to deliver on the CMU. Small items such as the securitisation market will help to create momentum that can be built upon.

Article 21c of Capital Requirements Directive (CRD) VI will go live in 2026 and is going to restrict the ability to provide banking services in the future, including lending from third countries into the EU.

2.2.4 The CMU requires a capital-funded pension base and is not, politically speaking, so complex

An official stated that all the details on securitisation regarding CMU are correct. The main difference in market structure is the availability of pension assets. Europe has a very dominant pillar 1, but if there is not a more dominant capital-funded pension base, it will not be possible to match this.

The Chair noted that the issue of pensions has been repeatedly highlighted.

An official stated that, politically speaking, the CMU discussion is not quite so complex. The economic model and the welfare state are threatened, and societies are threatened by the challenges that they are facing.

Decades ago, European leaders were able to agree that they would cease their national currencies. If people on the street were asked about a single supervision mechanism or CMU, they would laugh. Politically speaking, it is a non-issue. Therefore, for politicians, it is a 'low-hanging fruit'. Leaders need to determine how to tackle that and where the focus is.

The Chair summarised that the tasks to make CMU are not as politically difficult as they were 10 years ago.

2.3 To enable the corporate sector to flourish, the full forces of markets and capitalism need to be unleashed

2.3.1 Looking at the burning house

An official highlighted the issue of productivity. The reports sometimes ask for more state aids, subsidies, European champions or common debt, and all of this is going completely in the wrong direction.

The Draghi report includes many positive points, but the ones that focus on joint debt are disappointing. Productivity in Europe normally fluctuates cyclically with growth because European companies are normally very fond of labour retention. The support measures in the US during the pandemic focused on protection of income, whereas Europe focused on the protection of jobs. The protection of jobs leads to the protection of older industries that are less productive.

Europe is not too fond of 'creative destruction', so Europe does not have a tech sector like the US. There is a chance that, should Europe talk about items like safe assets and common debt, it will miss the point again and not look at the burning house. Such a focus on joint debt is utterly disappointing. If we want to implement such projects, we need to go into the technical details, on which all of these reports are extremely short: who is going to issue the debt? Who is going to decide which share of the debt goes to which country? How are we going to deal with the existing negative pledge clauses? There are many technical details that will lead to a situation where, if we start discussing this, even if everybody wanted it, it would take 10 to 15 years from the start to the implementation. By then we will not have solved any of the productivity issues.

2.3.2 The single market should be prioritised, and Europe should become more business friendly

An official suggested that the single market be prioritised over external competitiveness. EU funds should be used only for purposes with positive externalities, such as innovation or projects of common interest. The Recovery and Resilience Facility (RRF) can clearly not be a model, as it allocates the largest amounts of funds to the economically weakest spots. Similarly, pouring money into ailing firms will not generate the innovation needed to remain competitive on the world stage.

An official highlighted productivity as an area of focus. One solution is the single market, while another is CMU and the banking union. Pensions should be more portable because people need to move to where productivity is highest. Housing affordability needs to be fixed.

An official suggested that industrial policy is the wrong way to go. The EU has been benefiting from an open trade system, and that is something to support. Economic security and resilience lie in the single market. The single most important thing to do for economic security is make this market stronger and strengthen supply chains within that single market.

An official stated that much of the legislation that Poland has been implementing for the six months that the government has been in office has come from Brussels. He added that cheap and reliable energy is key for the competitiveness of European companies. Poland is working from day one on the structural reform of its innovative ecosystem that will be able to help tech companies from the energy sector, as well as those in biotech and AI, to access equity.

2.3.3 Incentivising the private sector to foster investment

An industry representative stated that it is not feasible for just the government balance sheet to bear the brunt of the reversal of the investments. There is a need to discuss changes to regulatory regimes, enable scale and productivity, and broaden and deepen capital markets to enable funding much further than the banking sector in Europe.

2.3.4 We must be able to protect ourselves

An official explained that Poland is spending 4.2% on defence this year and will need to spend 4.7% next year. Poland hopes to establish a pan-European fund.

An official stated that the Hungarian presidency is trying to tackle the recommendations in the Draghi report. Its primary goals are to reach a new competitiveness pact and to focus on setting up a common industrial strategy and a new R&D strategy.

There are three issues on which the Hungarian presidency does not see a real consensus among EU countries: the extended use of qualified majority voting, single supervision and the common issuance of new debt. Progress can be attained through securitisation, moving the deposits of the European banking sector into a long-term savings product, the deepening of CMU on the funding side and better leveraging of existing tools through the European Investment Bank (EIB) and NGEU.