Europe [un]Limited

What do companies in Europe need to grow faster?

GE European Policy Center

GE imagination at work

Europe (un)Limited
A global company's view on what Europe needs to grow faster

In an effort to contribute to kick-starting growth in Europe, a group of GE experts reflected on the obstacles to growth that will linger long after the dust has settled on the Eurozone crisis.

We conducted this study to contribute to the European growth debate, because we feel that companies should express their views on the policy changes that are required to drive economic growth. An international team of GE economists and policy experts analysed the broad array of problems that businesses face in Europe and looked for responsible solutions that do not require raising debt or taxes.

Our conclusions fall into three areas: unclogging bottlenecks that will unleash demand, making it easier to do business (i.e growth-oriented public services and better regulation), and guaranteeing the quality and cost-effectiveness of key production factors.

Since many of these policy changes will take years to implement, we believe leaders should start today and adopt a holistic approach rather than attempting to solve problems one at a time or waiting for the end of the financial crisis before starting structural reforms. While strengthening the European financial system and its single currency is essential, it would be a mistake to wait until the end of the sovereign debt and financial crisis to undertake long-term reforms. Neither should we be trapped in a 'growth versus austerity' dilemma: governments should reduce inefficiencies and excessive current spending as quickly as they can. If additional public spending is needed to sustain growth, temporary additional public investments are a much better option than maintaining unsustainable current spending levels.

This effort was led by Vincent Champain in Paris, Hendrik Bourgeois in Brussels, Wolfgang Dierker in Berlin, and Alessandro Coppola in Rome.

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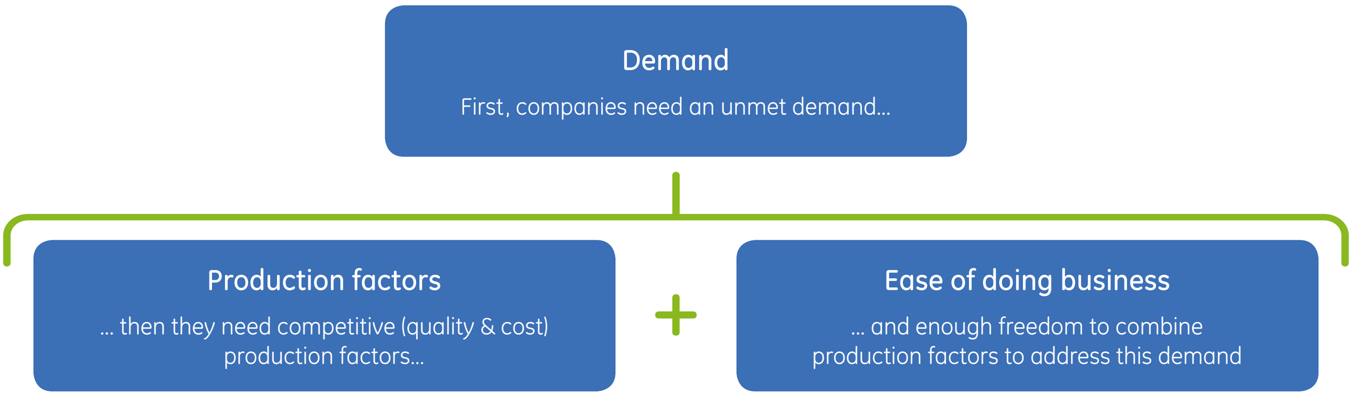
Methodology: looking at growth from the point of view of companies

In this research, we did not want to produce yet another macroeconomic study that other organisations publish on a regular basis. Instead, we wanted to produce a study based on the point of view of companies to answer the question: what do companies need in order to grow in Europe? Even if the details vary, the overall results are the same for a multinational company as they are for the neighbourhood bakery:

- Firstly, companies need customers willing to buy their products, i.e. strong and steady **demand**. This demand may come from consumers, other companies, or government (domestic or foreign).
- For companies to operate successfully in Europe they also need competitive **production factors** (e.g. capital, staff, materials, energy, communications infrastructure and equipment). Capital cost and availability is a key short term issue in Europe, but our study also raises questions regarding the availability and competitiveness of energy, infrastructure and talent.
- Companies also need a **business-friendly environment** to turn these production factors into products they can sell. Market access (national or export) must be simple, and regulatory burdens must be reasonable. Public services to business (enforcement of contracts and the rule of law, predictability, a solid education system, training systems etc.) are also key contributors to growth.

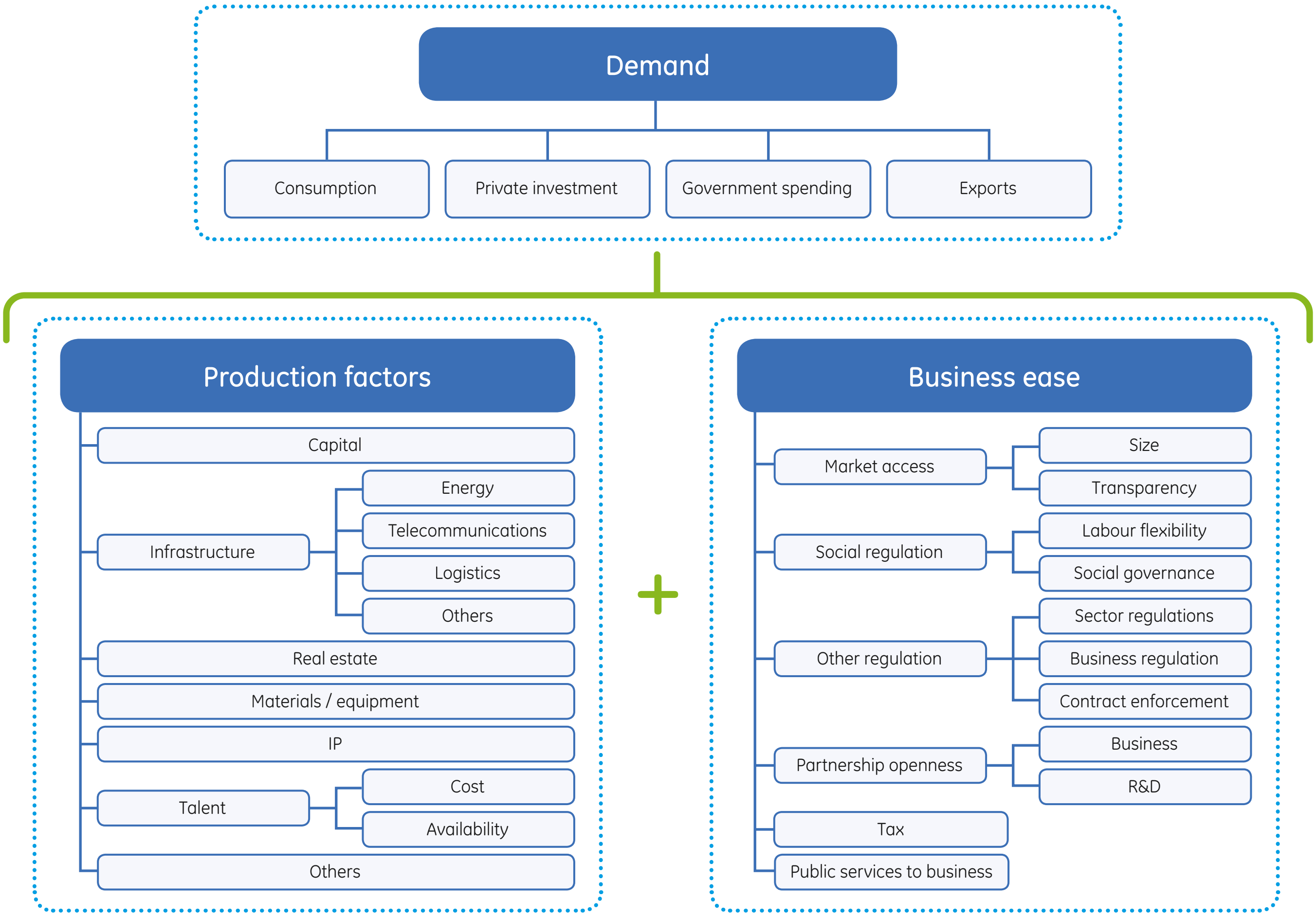
Growth decomposition



We took a closer look at each of these growth components, looking for potential bottlenecks. Using publicly available sources, we quantified the direct impact on growth of these bottlenecks. For each one, we tried to define acceptable solutions - i.e. solutions addressing root causes at a low additional cost compared to the value these solutions would unlock.

This study does not address social or political issues and can only be non-exhaustive. This report aims at providing only a framework to analyse ways to promote business growth.

Detailed decomposition



Europe (un)Limited: what do companies in Europe need to grow faster?

Demand analysis: short and long-term bottlenecks

As everyone knows, global demand declined during the recent economic crisis. However, European weakness in demand has deeper roots:

- *In comparison to the US economy, household consumption has been a particular weak spot of the European economy. This appears to be linked to consumer confidence and access to credit, and could be addressed by a number of policy measures.*
- *With the exception of Germany, European current account imbalances have worsened in the last few years, and investments have declined. Part of the reason why Germany has been able to export more during this period, is because it imports components from low cost countries, making its products more competitive. For this reason, an open and active trade policy, and more integrated export support and financing services for European products are key to reducing European current account imbalances.*
- *Government spending in Europe is high, but in comparison to US government spending, a lower proportion is spent on investments which is likely to have a negative impact on future European growth. European governments could reduce current spending and at the same time increase future-oriented spending, and thus escape the 'growth versus austerity' dilemma.*

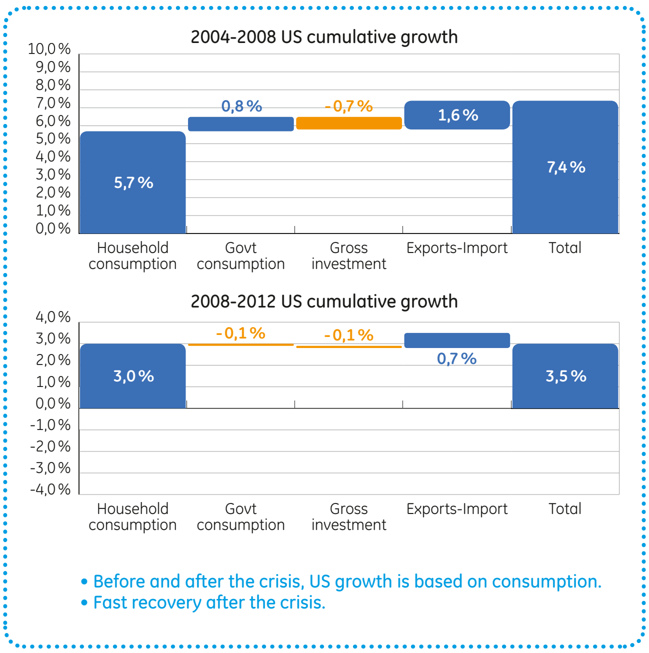
Consumption, Europe's weakest spot

Growth is derived from consumer spending, government spending, investments, or net exports.[1] European public spending is unlikely to accelerate in the next few years due to deficit reduction efforts. Corporate investments will grow again, but only after companies see the first signs of increased demand. In the short term, this leaves consumer spending and net exports as the main levers for growth.

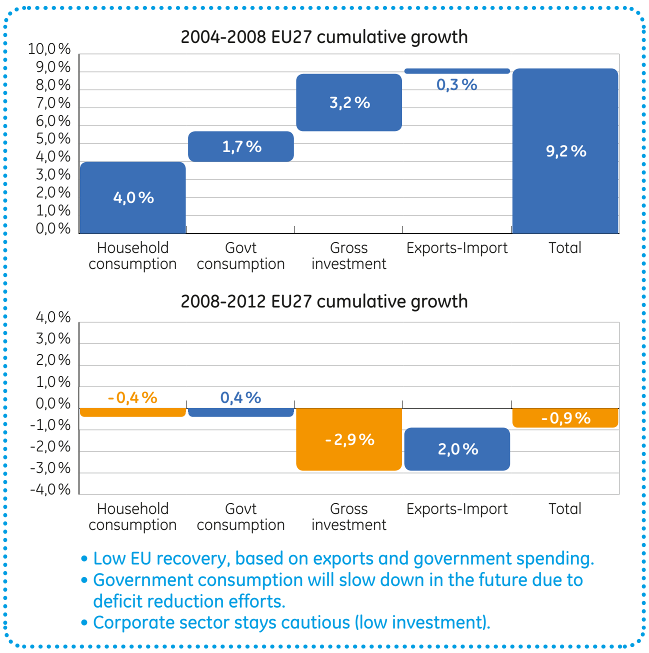
However, in comparison to the US economy, consumer spending has always been weaker in Europe, and the gap has widened during the current economic crisis. While US household consumption represented 3 points of US cumulative growth in the period between 2008 and 2012, and was a net contributor to its economic recovery, it stood at -0.4 % during the same period in the EU. After the financial crisis, the swift recovery seen in the US was based on consumption, whilst the dependence of EU growth was on government spending and exports which led to a slower recovery.

US growth has been based on consumption whilst the EU relied more on government spending

US cumulative growth



EU cumulative growth



Source: Eurostat, 7/15/2012

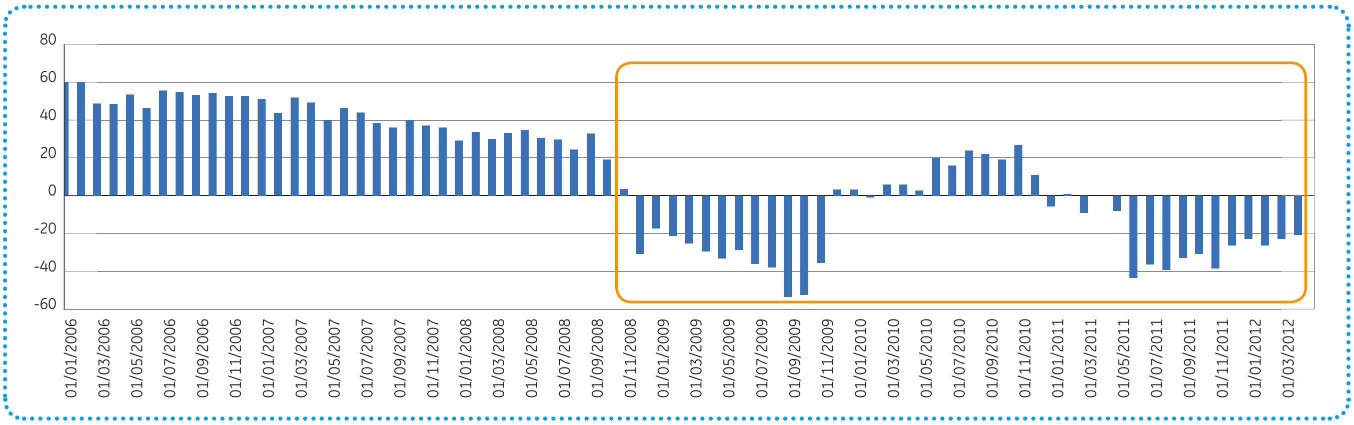
[1] Net exports is equivalent to the value of total exports minus the value of total imports.

Household consumption relies on three main variables: ability to buy (revenues and credit), willingness to do so, and demographics.

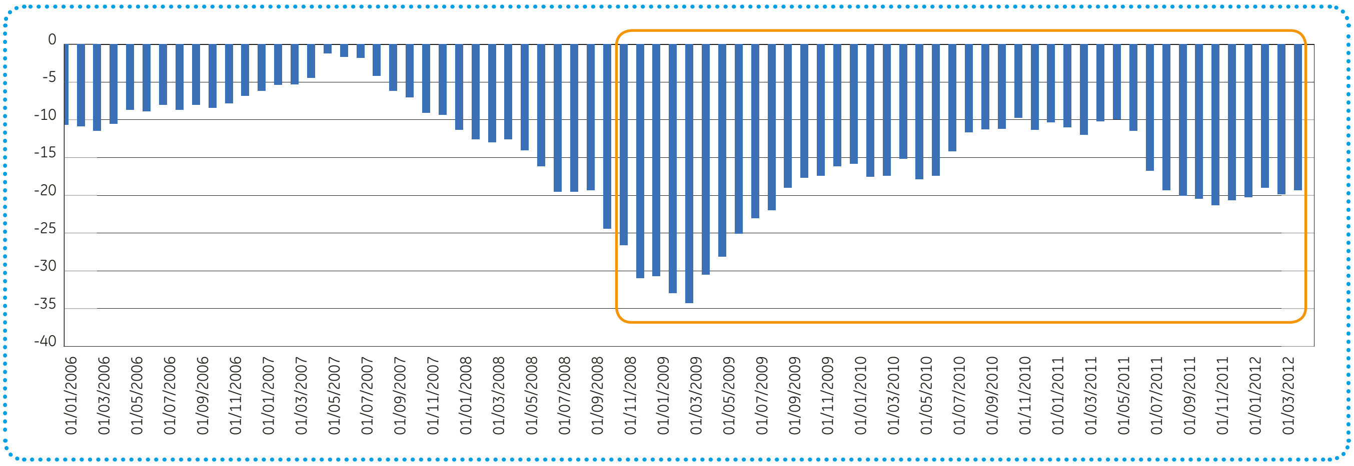
- **Revenues and credit** determine household's ability to consume. Currently, household revenues are affected by the economic crisis and the increase in unemployment. To maintain current levels of consumption and if we assume economic growth will return in the next few years, households will need financial credit to sustain their consumption in spite of the current low growth. However, in times of economic instability and financial turmoil, banks might be more reluctant to issue loans, and increased regulatory requirements could further reduce the availability of credit.
- **Willingness to consume** depends on household confidence: rich but insecure consumers spend less and postpone important purchases such as cars and household equipment. Currently in Europe, unemployment combined with existing doubts about the sustainability of social protection systems create a climate which is unfavourable to consumption. Hence reforms geared towards increasing the sense of security would impact positively on consumption and growth.
- **Demographics** determine the number of individuals who can consume goods and services. In the middle to long term, European population growth is expected to decrease, which will lead to a reduction in consumption growth. In the period between 2010-2025, the population of the Eurozone is expected to grow by 2%, while in the US this figure is expected to be 12%. Unless demographic projections or immigration policies change, this trend will negatively impact Europe's growth prospects.

Consumer credit and confidence are currently low

Credit for consumption, Eurozone outstanding stock yearly increase (bn €)



Household confidence in Eurozone



Source: ECB; OECD - Household confidence (Eurozone)

Short-term solutions to increase household demand include 'trust building' reforms (pensions, social safety net sustainability, etc.), together with pan-European programmes to reduce unemployment through adapted policies, training and labour mobility. In addition, efforts should be made to ease credit and sustain demand. Long-term solutions should address demographic issues via family and migration policies.

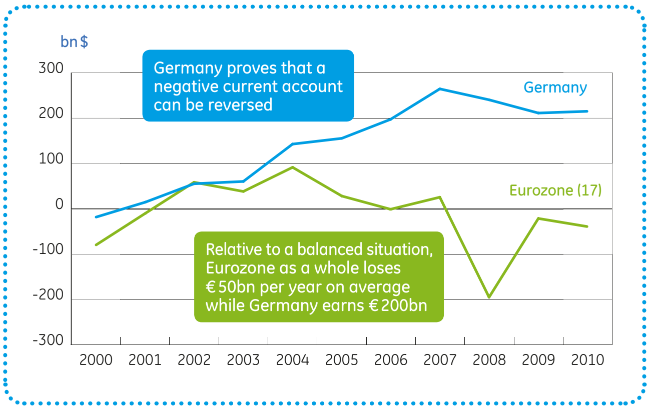
Current account balance: where growth meets trade policy

In a period where global growth is significantly higher than that of Europe, increasing exports should be one of the quickest levers to foster demand.

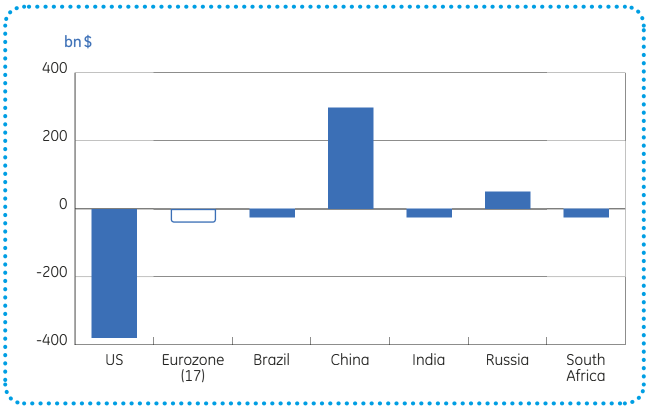
For example, Germany's exports have significantly contributed to its growth since 2000. However, in the last few years the rest of Europe has had a negative current account balance,[2] with no sign of sustainable improvement. When compared against a balanced current account, Eurozone GDP loses € 50bn a year whilst Germany earns € 200bn.

Eurozone's current account balance worsened with the economic crisis, despite Germany's contribution

Current account balance - US$ billion



Current account balance 2009 - US$ billion



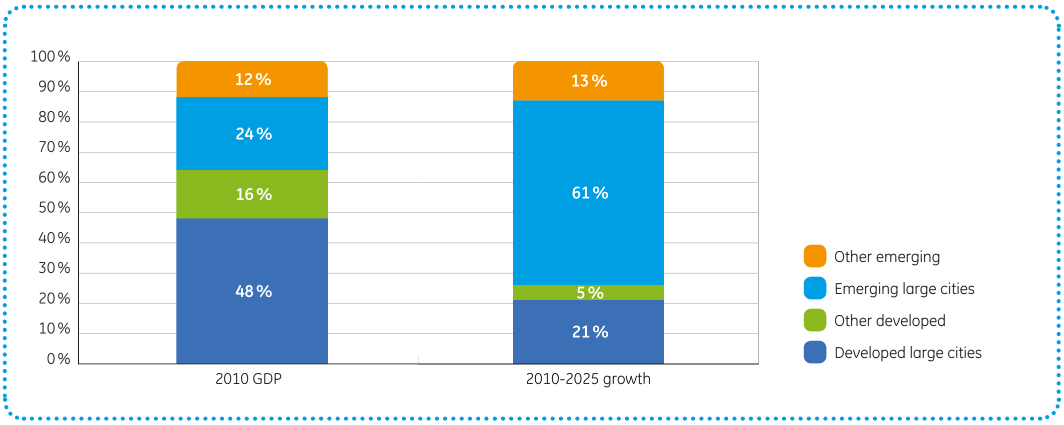
Source: OCDE - Balance of payment (MEI), current account balance

Germany is competitive on export markets because its industry focusses on manufacturing the parts of the value chain where it has significant competitive advantages, whilst importing the rest from other countries.[3] Export competitiveness goes hand in hand with trade openness and the ability to import components that can be produced more competitively elsewhere. To put it another way, the winning strategy is not to develop exports and reduce imports (the so-called 'Buy European strategy'), but rather to adopt positive current account strategies and 'import competitiveness', which includes increasing imports of technologies or materials that will help companies be more competitive and export even more.

Moreover, in the long-term, growth will mainly be in emerging markets (see next chart). To benefit from these growth opportunities, European companies will need trade policies that ensure significant access to these markets, rather than policies which could spark 'trade wars' (such as closing markets to foreign companies, or 'buy national' policies).

Future GDP growth will be increasingly in emerging countries

Share of 2010 GDP & 2010-2025 growth



Source: McKinsey Global Institute Cityscope 2.0

[2] Current account balance statistics represent the sum of balance of trade (i.e. net earnings on exports minus payment for imports), foreign trade balance (earnings on foreign investments minus payments made to foreign investors) and cash transfers.

[3] This phenomena is detailed in 'Globalisation: a European perspective', by Professor John Sutton.

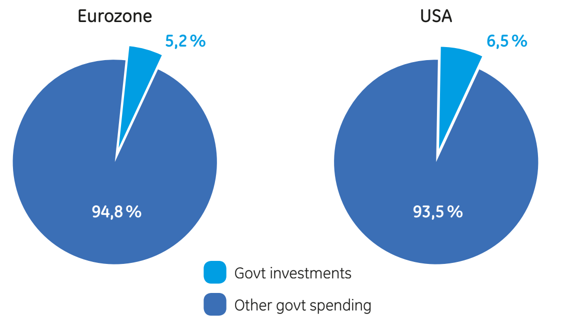
In the short and long term, facilitating exports and trade should be among Europe's top priorities for stimulating growth. Policies should focus on the current account, rather than exports only - i.e. promote exports, but also imports that help making exports more competitive. We also need trade policies which will help increase trade with key partners, and better coordination of export financing or support from export agencies (particularly for products made from parts coming from various European countries).

Government spending should be more future-oriented

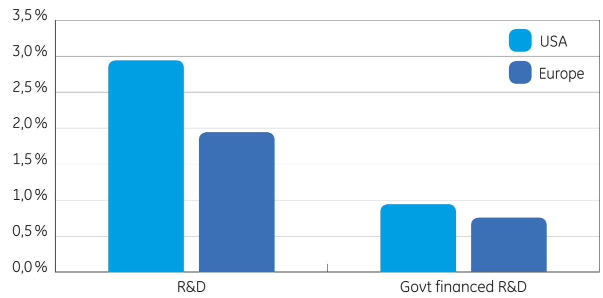
Public spending accounts for a large share of Europe's GDP. However, this spending is mainly current spending, rather than investments. In 2011, according to the OECD, governments in the Eurozone spent 5.2 % of their budgets on investments, compared to 6.5 % in the US. This gap represents € 72bn less public investment each year in the Eurozone, and the need to reduce public spending is likely to make things worse, as it is usually, from a political perspective, easier to cut investments rather than current spending.

Government spending structure

Investments represent a smaller share of public spending in Europe



R&D spending is lower in the EU than in the US (% of GDP)



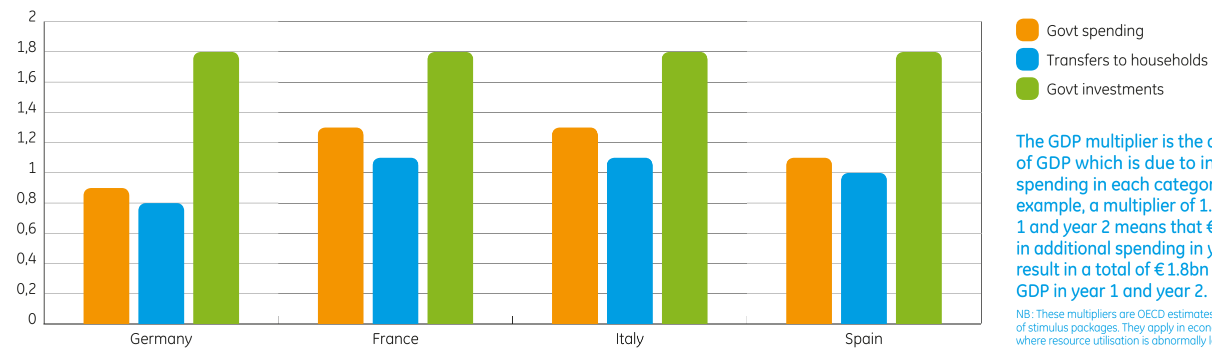
Source: OCDE

Nevertheless, there are several reasons why doing exactly the opposite, i.e. reducing current spending while preserving or even increasing public investment should be encouraged:

- The impact on economic growth of government investments is usually much higher than for current spending, as shown in the following chart;
- Future-oriented spending creates public assets,[4] such as new infrastructure, which increases future growth potential;
- One reason governments need to reduce deficits lies in the difficulties they face in financing their debt, but investments are easier to finance than current spending, as public assets can be used to secure loans.

Investments have the highest impact on growth

Public spending GDP multipliers (year 1 + year 2)



The GDP multiplier is the amount of GDP which is due to increased spending in each category. For example, a multiplier of 1.8 in year 1 and year 2 means that € 1bn in additional spending in year 1 will result in a total of € 1.8bn additional GDP in year 1 and year 2.

NB: These multipliers are OECD estimates of the impact of stimulus packages. They apply in economic conditions where resource utilisation is abnormally low.

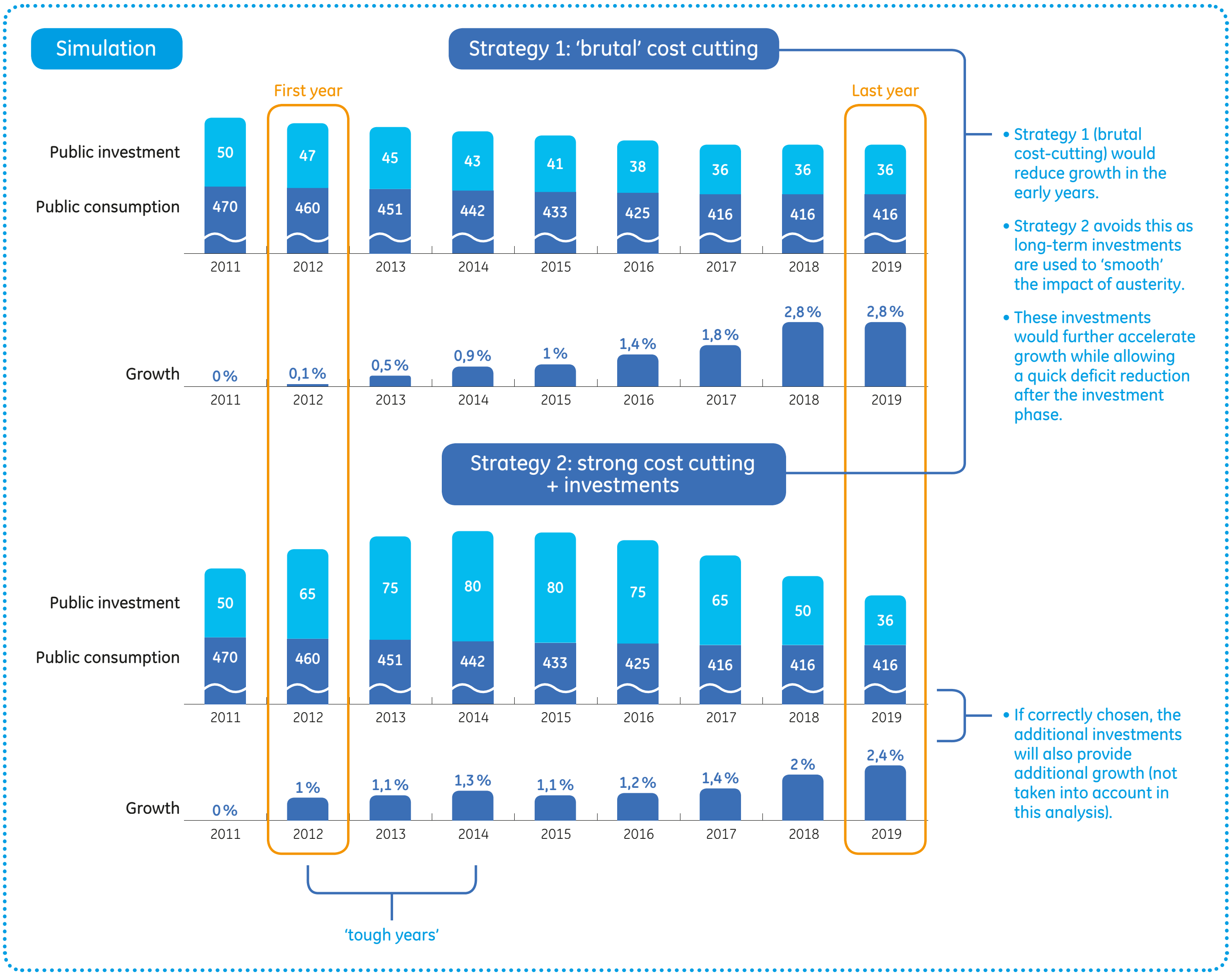
Source: OECD estimates for stimulus packages

[4] Future-oriented spending is the share of spending, like investment or spending on R&D or education, that creates durable physical (infrastructure) or intangible (intellectual property) assets.

For all these reasons, the 'growth versus austerity' dilemma could be resolved by reducing current spending whilst temporarily increasing investments. This would both sustain total government spending in the short term - avoiding a negative impact on growth - and ensure a quick deficit reduction in the mid-term, because once these additional investments are expensed, the total spending level will automatically reduce.

Solving the 'growth versus austerity' dilemma: reducing current spending whilst temporarily increasing investment increases growth in the 'tough years'

Simulation of a €50bn spending cut on the GDP of a large European country



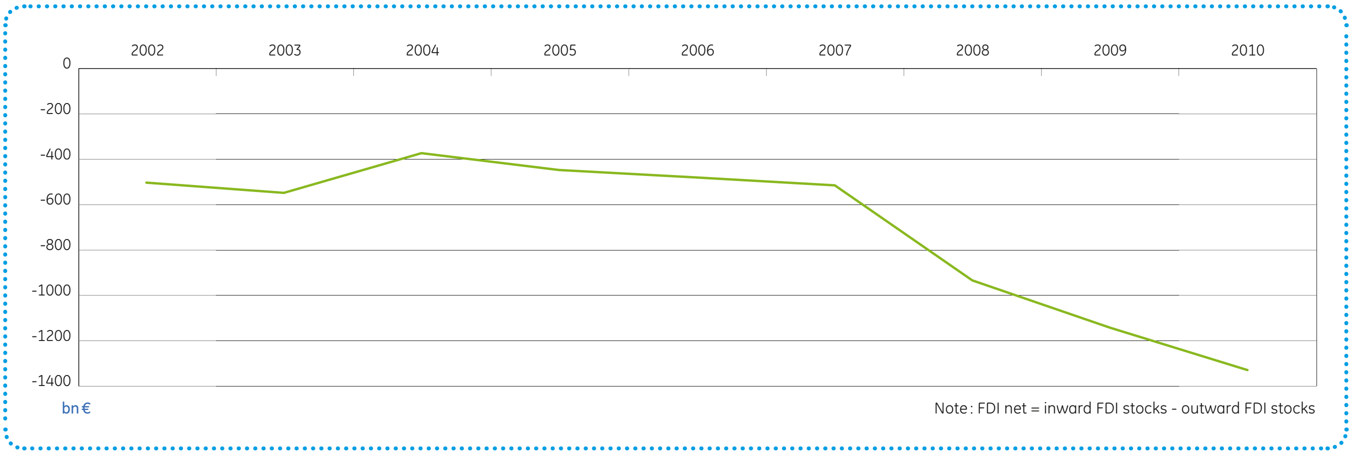
Whilst discussions often focus on government spending and deficit **levels**, spending **structure**, in particular the proportion dedicated to public future-oriented spending, is also an issue. Europe should select industries to invest in based on their growth potential as well as on their capacity for job creation (examples of industries which meet these selection criteria include: R&D, intensive industries, transportation infrastructure, energy technology and healthcare IT infrastructure). This could be done directly (by monitoring the mix between current and future-oriented public spending) or through common institutions and programmes such as the European Investment Bank (EIB) and project bonds.

Investments: attracting foreign money

Investments in Europe have declined since 2007. This reduction in investment is particularly pronounced for net foreign investments, which have been declining since 2004 and worsened with the economic crisis.

Net Foreign Direct Investments

EU Net Foreign Direct Investments (bn €)



Source: OECD - Stock of FDI inward/outward

How can this decline in net foreign direct investments be addressed? To invest in a country, companies need both positive growth expectations and sufficient confidence in the business climate (reasonable tax rates and a robust and predictable legal system, for example). Conventional wisdom dictates that whilst Europe's growth rate is significantly lower than that of emerging countries, it benefits from a favourable investment environment. However, Europe does not need the growth rate of emerging markets to generate the magnitude of absolute growth in GDP to attract foreign investment. What is needed is a favourable foreign investment context, a more coordinated 'Invest in Europe' communication, and a continuous dialogue with non-European companies to ensure main attractiveness criteria are met.

- The magnitude of 'absolute growth' will likely be the same in Europe and in China. In the medium-term, China will have a much greater growth potential than Europe. However, Europe has a much larger economy. Because of this, the magnitude (as measured by the additional billions of GDP created each year) by which Europe and China's GDP will grow in the medium-term is expected to be the same.
- Europe's investment attractiveness could seriously be hurt by the Eurozone crisis, corporate tax increases and initiatives such as calls to 'Buy European'.

Ease of doing business: making public sector a real 'growth catalyst'

The public sector is a key 'growth catalyst' and provides key public services to businesses such as support for education, training or fundamental research. For this reason, its performance has a strong impact on growth.

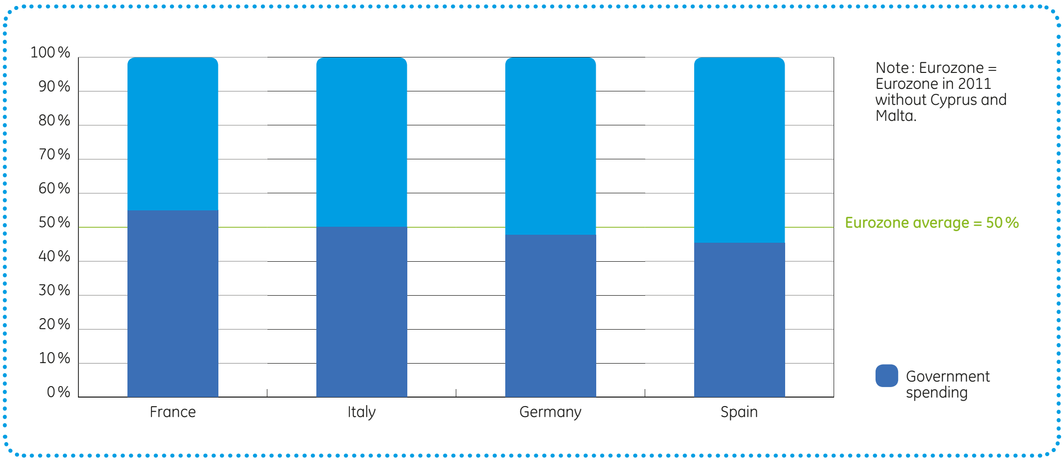
Unique markets and competition have helped foster productivity in the European private sector. However, non-market services, such as the public services, have not benefited from this. To improve the productivity of non market public services, more evaluation, transparency and benchmarking of best practices across Europe are needed. In addition, European regulations and tax choices should be as growth oriented as possible.

Public services to business: key growth catalysts

The public sector not only represents 50 % of European GDP, it also regulates the other half, and provides key public services to business through support for education, training and fundamental research. For these reasons, the public sector is a key 'growth catalyst': economic growth depends partly on its efficiency and benefits are derived from a pro-growth approach to the public sector.

Europe's public sector covers half of European GDP

Government spending as a % of GDP in 2011



Source: OECD; Team analysis

Public services to business are strong contributors to growth (examples)

Services

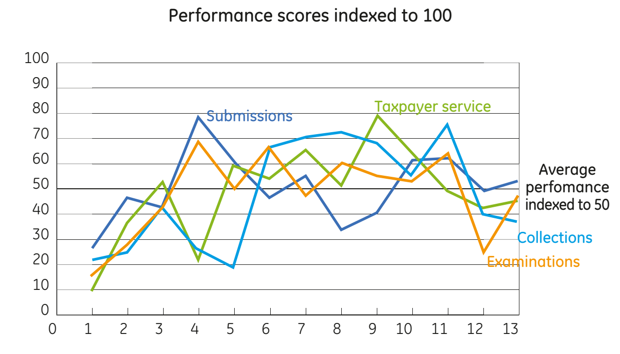
	Employment services	Education and higher education/research	Export support
How it contributes to growth	• Provide companies with the HR they need • Help managing transitions from declining industries to new ones	• Provide companies with adapted qualifications and attitudes • Partner with companies to innovate	• Help companies enter new or complex markets • Ensure effective market openness
Typical limitations	• Services to employers are not a priority • Low ability to adapt workforce to needed qualifications & attitudes	• Adaption to employers present and future needs not a priority • 'Soft skills' (attitude, job readiness) not taken into account	• Limited support for very large transactions • Complex support for multi country transactions
Consequence (est. economic cost)	• 1,7 million of vacancies which cost € 48bn yearly to EU27		• € 50bn lost compared to a balanced current account situation

In Europe, the scope of services provided by the public sector is wider than anywhere else. And the 'price' of these services (i.e. taxes) is also higher than in other parts of the world. In light of global competition, these high taxes can only be sustained if public services to business are efficient, productive and fitted to the needs of households and business.

In reality, there are large performance improvement opportunities across Europe. For example, the allocation of public sector employee resources differs widely: in France 30 % of employees perform back-office tasks compared to less than 20 % in UK. The level and scope of services also vary greatly, some countries set goals to ensure employment services provide companies with the staff they need, while others focus mainly on welfare.

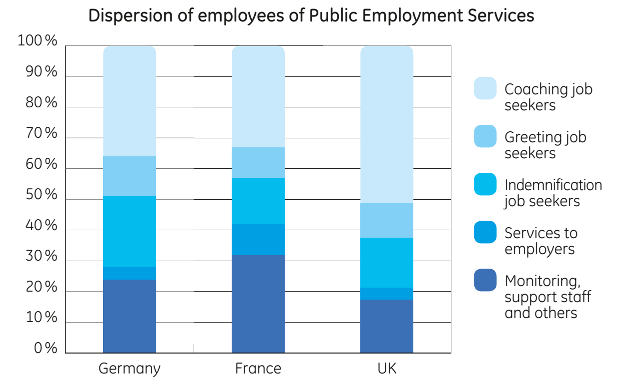
Public sector performance varies across Europe (examples)

Tax agencies in different countries vary in their performance levels



Source: McKinsey tax benchmarking study (includes analysis of 13 countries: Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden and the United States)

Public Employment Services differ significantly in terms of their back office/front office mix

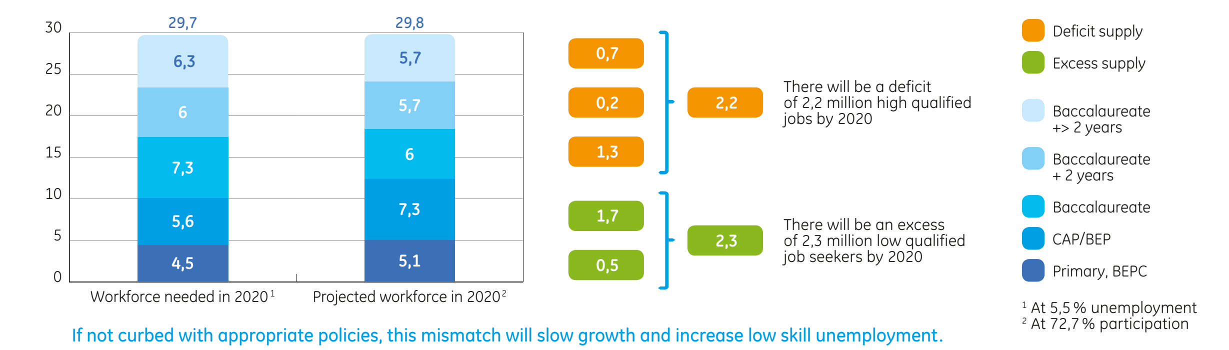


Source: French National Audit Office, European employment services benchmark report, 2011

Another key dimension of public sector performance is its ability to anticipate the future needs of the private sector. In some countries, there are significant and increasing mismatches between skills demand and skills supply: a recent study[5] in France showed that these mismatches could lead to a shortage of 2.2 million high-skilled workers and an excess of 2.3 million low-skilled workers in the coming years. This means that the education system's output is not adapted to business needs, which will cause an increasing number of both jobs vacancies and jobless youths.

Skill mismatches: an example of the challenge the public sector faces anticipating long-term needs

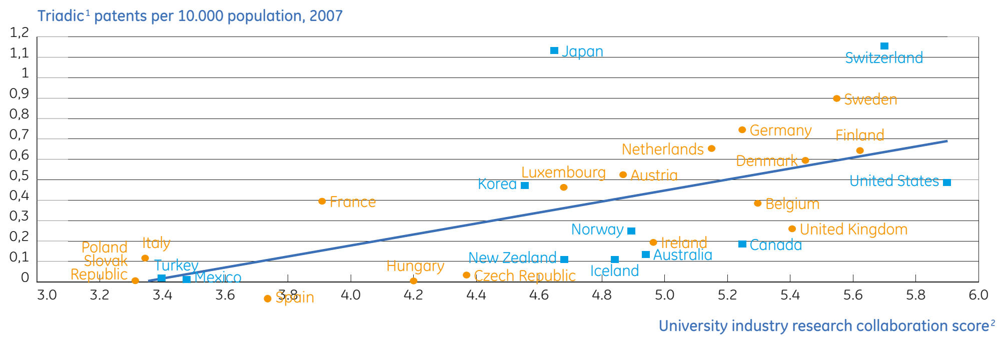
Skills supply and demand, 2020 (millions)



If not curbed with appropriate policies, this mismatch will slow growth and increase low skill unemployment.

Public sector partnerships with the private sector to develop growth opportunities are also very important. But, for example, the way in which universities cooperate with companies to increase Europe's stock of intellectual property varies greatly across the continent. As a consequence, it is likely that many innovation opportunities are being missed.

Collaboration between business and universities: lost innovation opportunities



¹ Patents filed at the European Patent Office (EPO), the US Patent and Trademark Office (USPTO) and the Japan Patent Office (JPO). ² Based on responses from 13 000 business leaders on a scale from 1 = minimal or non existent to 7 = intensive and ongoing. ³ Sample of 30 OECD Countries.

Source: OCDE, WEF, MGI

[5] 'French Employment in 2020', McKinsey Global Institute.

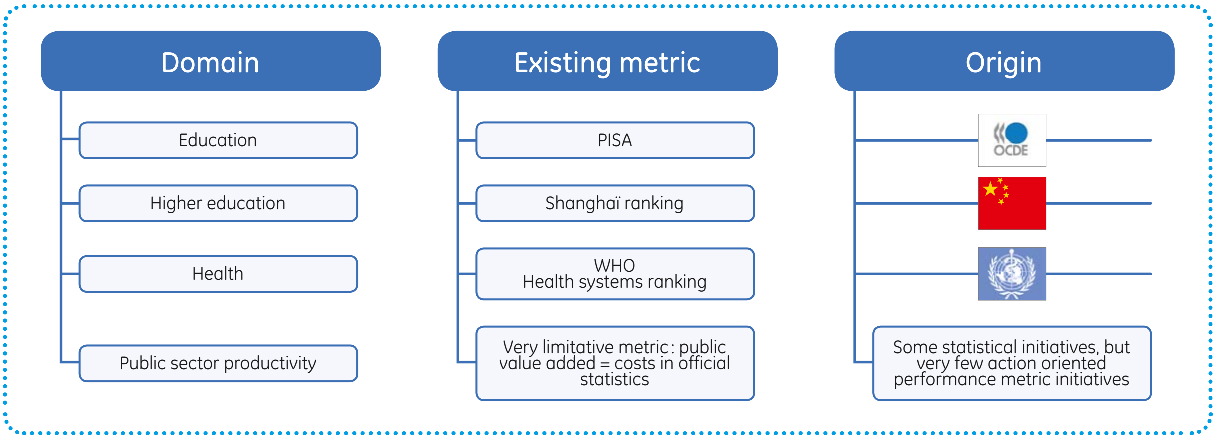
Improving the performance of the public sector: Europe's next frontier?

One key idea behind the European single market was that an integrated market would increase competition and foster productivity and growth. This recipe worked well, but it is mainly applicable to products or services traded on a market. For the most part, public services remain national and are not traded on markets, for legal or structural reasons.[6] To improve the productivity of these 'non-market public services' evaluation, transparency and benchmarking of public sector performance is needed.

The first step in achieving this objective is to design key public service output metrics which can be applied to all European countries. In practice, initiatives of this sort are more the exception than the rule. Public sector costs, deficits and taxes are precisely known, but there is very little information available on the value added by the public sector or on how public services fit the needs of citizens and companies. This makes it difficult to communicate Europe's attractiveness to foreign companies for it is as if European public services were a luxury brand able to communicate only its prices but not its value!

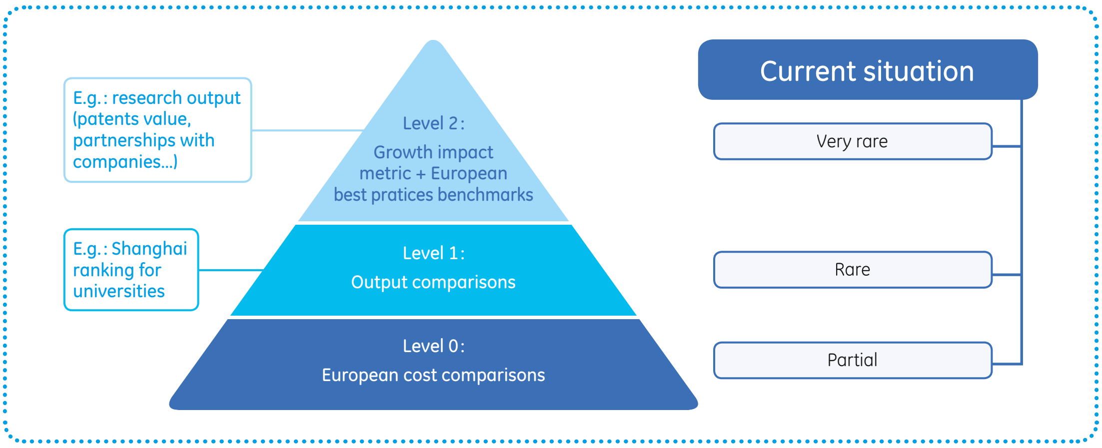
This is also a performance management issue, as the absence of value-added metrics for the public services reduces the ability to monitor the increase of this value-added! And where such metrics do exist, such as Pisa (for evaluating education systems), Shanghai (for research) or Doing Business (for business regulation) they mostly come not from European institutions, but from international organizations such as the OECD, Shanghai University, the World Health Organization, the World Bank and the World Economic Forum.

The origin of key public sector metric initiatives



Of course, the role of the public sector cannot be reduced to metrics or its contribution to growth. For example, schools also provide a common civic education and ensure equal opportunities for every child. However, given that we are starting from a situation where the public sector's contribution to growth and adaptation to business needs are neither measured nor benchmarked across Europe, there is certainly scope for improvement.

How to optimise the contribution of public services to growth



[6] For example, some infrastructures enjoy what economists call 'natural monopolies', i.e. situations where monopoly is the best option.

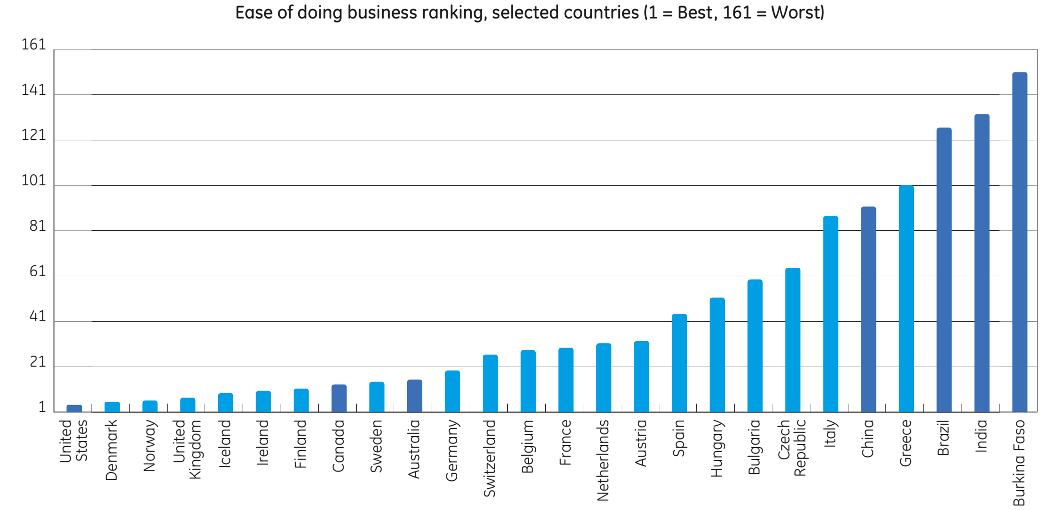
A pan-European initiative to better assess the value added by public services to businesses is needed more than ever to optimise its contribution to growth and benchmark best practices across Europe.

Growth-oriented regulations

Overall, European regulations are of relative good quality compared to many other countries. However, the *business impact* and the *application* of common regulations can still be improved. While some countries such as the UK feature at the top of the rankings both in terms of the business orientation of its regulation and transparency of its application, countries such as Bulgaria are at the lower end, and perform worse than China on regulatory transparency.

Ease of doing business varies across Europe

World Bank Ease of Doing Business Ranking

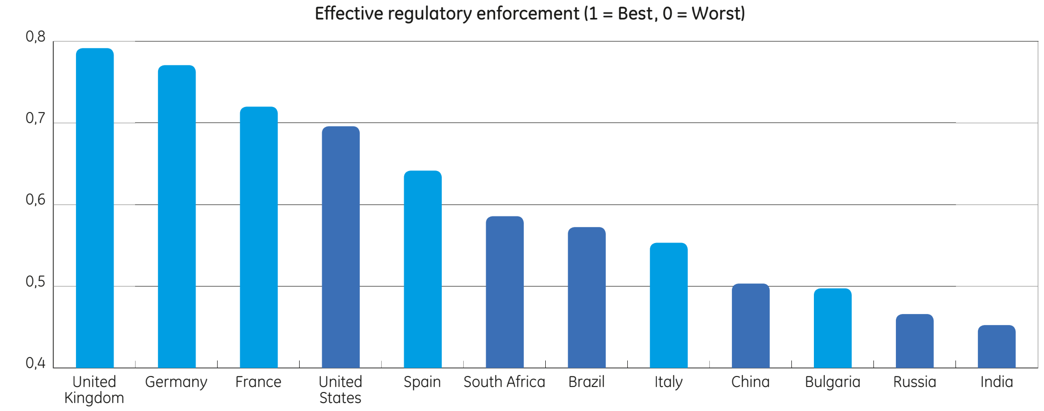


Examples: Starting a business takes 7 days in Norway, but 28 days in Spain. Paying taxes takes 76 hours in Ireland and 285 in Italy. Two documents are needed to import in France, 7 in Hungary.

Source: World Bank Ease of Doing Business Database 2012

Regulatory enforcement varies across EU

World Justice Program - Rule of Law Index



Note: Effective regulatory enforcement = Government regulations are effectively enforced, Government regulations are applied and enforced without improper influence, Administrative proceedings are conducted without unreasonable delay, Due process is respected in administrative proceedings, The Government does not expropriate property without adequate compensation.

Source: WJP Rule of Law Index 2011 Database

The regulatory environment often comprises several layers of both national and European regulation.

An example of this is public procurement: EU initiatives to improve efficiency in this area such as green purchasing or lifecycle cost procurement can generate complexity and reduce transparency, because public sector rules require contracting entities to describe detailed technical specifications in advance. For complex products or services, these specifications can be very difficult to establish without deep domain expertise. Contracting entities end up relying on specific players, or consulting firms linked to specific players, to define these specifications. In many situations, this favours 'insiders' while depriving the public sector of better or more adapted technologies. To avoid this, the solution would be to rely more on 'open specification', i.e. designing the specification step in a way all the potential bidders can contribute and give contracting authorities an exhaustive view of the possible specification options, and their consequences on the lifecycle cost.

However, efforts to reduce regulation complexity can also create growth bottlenecks, if not done properly. Confronted by complex regulations, governments sometimes choose to reduce the regulatory or tax burden for SMEs, rather than reduce them universally. Whilst this might help some SMEs in the short term, this approach also creates strong disincentives for growth as growing companies will be confronted by an increasingly high regulatory or tax burden, and to avoid this they may prefer to halt their growth and stay small.

Helping SMEs: negative incentives to growth should be avoided

Good ways to help SMEs

- Using SMEs' difficulties as indicators for public procedures which need simplification (e.g.: the complexity of public tenders)
- Help SMEs to become more productive/innovative (e.g.: training, support, clusters)
- Promote partnerships where multinational companies can help SMEs to reach global markets (e.g.: partnership between Apple & application developers)

Less productive ways to help SMEs

- 'Peter Pan effect', i.e. size thresholds for low taxes/social costs, giving negative incentives to being big or getting bigger
- Excluding big companies from public strategies (e.g.: limit R&D partnerships to SMEs), which deprive labs and supplier SMEs from a global size approach

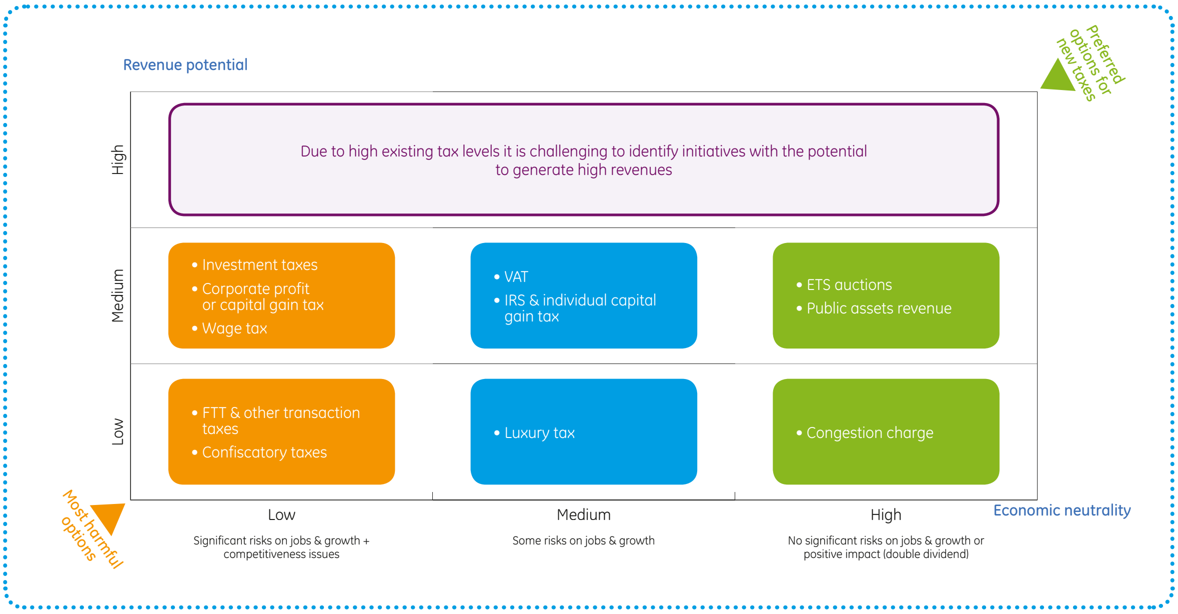
The impact of regulation on business, and the transparency of regulation in Europe could be improved. One way of doing this would be to increase open cooperation with companies, for example, by favouring 'open specifications' in complex public procurement (inviting all companies to take part in a specification dialogue) or launching focused 'simplification' initiatives where companies and administration cooperate to find the most efficient ways to deliver the objectives of regulation and improve its enforcement across Europe.

The tax dilemma: finding public money without hurting growth

Many governments will have to reduce their deficits in the coming years. To do so, they will have to choose between many options, which differ in their impact on growth and competitiveness.

Measures to reduce the deficit should prioritise on the following basis: improving public performance and reducing costs, increasing non-tax revenues, and, increasing 'double-dividend taxes' (i.e. taxes which deliver wider benefits such as ETS auctions which bring in public revenues while contributing to reducing greenhouse gas emissions) and low distortion taxes (such as VAT, which do not reduce competitiveness).

Public revenue increases should favour medium / high economic neutrality options (examples)



In addition, taxes should be designed in a simple and predictable way. In practice, complex or unpredictable tax options act like 'virtual additional taxes': the increased complexity has the same negative impact on growth as a tax, but brings no additional public revenue. For example, wage taxes in one large European country used to be so complex that polls showed companies largely overestimated the amount they paid and behaved as if taxes were much higher than their actual level. This resulted in the country having all the negative consequences of higher taxes (lower employment and economic activity), without the benefits (higher tax revenues).

Tax structure is also important

Good tax principles

- Tax bases coherent with international standards
- Simple & predictable compliance process
- Tax law predictability (no retrospective change in the middle of the year)

Bad tax principles

- Nonstandard bases or principles (ex: limitations to interest deductions)
- Complex or changing rules
- Confiscatory effective rates
- Discriminatory taxes or control processes

Production factors: former strengths, future weaknesses?

Quality and availability of key production factors (such as human resources, capital, energy, logistics and IP) are usually superior in developed countries. But it should not be assumed that this will be the case in the long term:

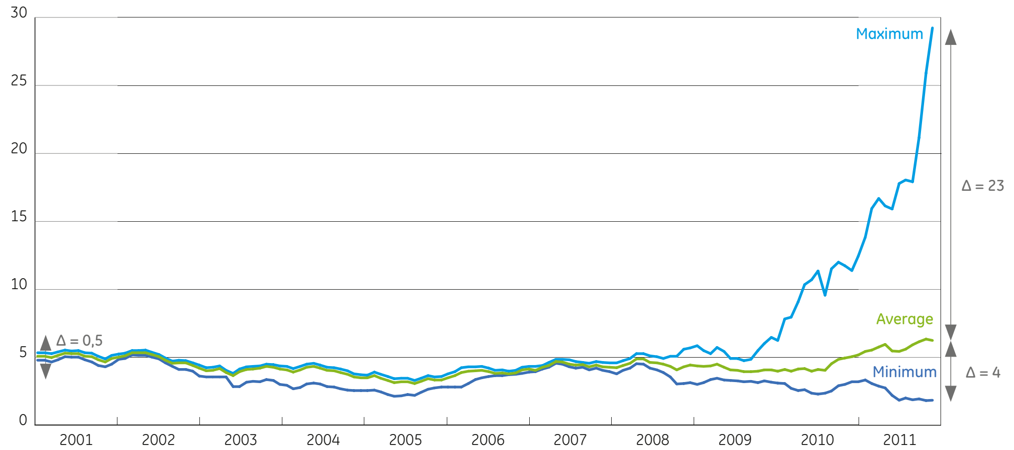
- *With the economic crisis, capital availability is an issue in Europe for many companies, including a large number of SMEs;*
- *Europe's talent pool is still very competitive but its ageing population and failure to adapt qualifications to business needs may change this situation in the years to come;*
- *Energy costs and availability will depend on whether investments can match future evolutions in demand and environmental constraints. Europe could become less competitive in this area if the wrong decisions are made.*

Financial crisis made capital scarce, particularly for SMEs

Capital is a key production factor for companies. Whilst multinational companies have access to global capital markets, national companies and SMEs depend more on the European capital markets to find the resources they need to grow. Before 2008, the Euro successfully lowered the cost of capital, particularly in southern Europe, and reduced interest rate differences across Europe. However, the financial crisis reversed this and dramatically increased the cost of capital. This has huge consequences: the Eurozone now pays several hundred additional billion euros each year in interest compared to before the economic crisis.

Eurozone cost of capital increased significantly with the crisis

Long term interest rates in the Eurozone (2001-2011) - %



If average debt cost was at Germany/France average level, Eurozone would save 310bn €/year.

Source: ECB - Long term interest rates in the Eurozone

At the same time, capital available to companies has drastically decreased:

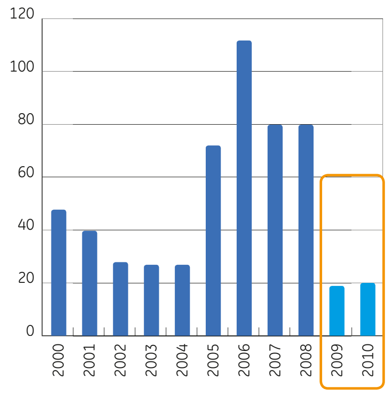
- Outstanding loans to non-financial companies in Europe stagnated in 2008. Before the economic crisis, outstanding loans were growing by € 600bn each year. Growth in outstanding loans is now close to zero, which means that European companies are missing out on an additional € 600bn each year. This is not a trend which is expected to change for some time, as Europe has entered a deleveraging period, which means banks will have to reduce their risk exposure for several years.[7]
- The volume of IPOs in Europe has dropped, leading to a € 40bn shortage every year in the economy.
- Capital raised by EU private equity funds has plummeted since 2008. This represents a € 60bn yearly hole in the European economy.

All these changes mean that it is now much harder for companies to finance their investments, R&D and growth.

[7] Debt and deleveraging: The global credit bubble and its economic consequences, McKinsey Global Institute, 2011.

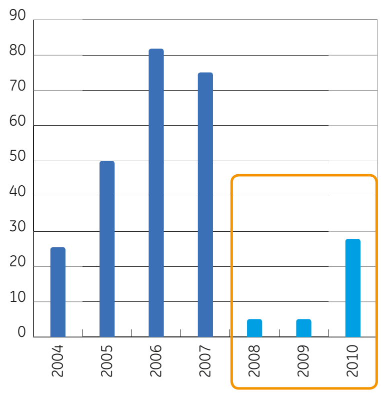
Debt, IPOs and private equity decreased with the economic crisis

EU private equity fund raised (bn €)



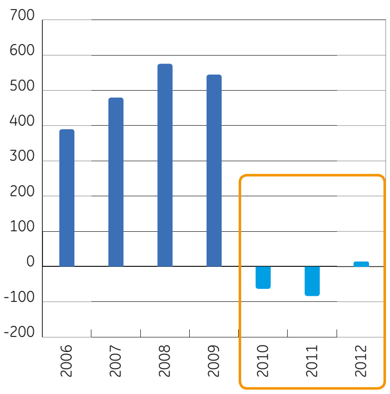
Compared to pre-crisis levels, EU is currently losing € 60bn inflow/year.

EU IPO (bn €)



Compared to pre-crisis levels, EU is currently losing € 40bn inflow/year.

EU Loans to NFCs (outstanding stock increase, bn €)



Compared to pre-crisis levels, the EU is losing € 600bn/year.

Source: EVCA - Industry statistics: incremental closings during year (2011); Ernst&Young; ECB

During the economic crisis, secured forms of financing like accounts receivable (AR) financing[8] remained a source of fresh capital for European companies, when other sources were decreasing. It provided companies and even SMEs with no tangible assets, with the working capital they need to operate their business and grow, and AR's annual net inflow is now comparable to private equity and IPOs.

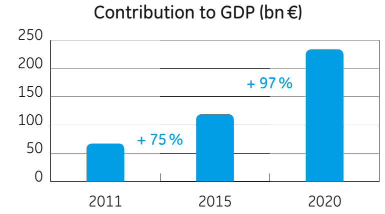
AR financing, an example of growing secured financing

AR benefits

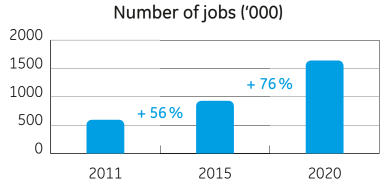
- AR can provide financing to SMEs even if they have no other access to credit.
- As a secured form of lending, AR financing risks are lower than traditional credit.
- But awareness of AR financing as an alternative source of SME finance is still low.

Impact (estimate in Germany, France, Italy and UK)

Contribution to GDP (bn €)



Number of jobs ('000)



AR financing increased by 17 % between 2008 and 2010 in EU27.

How to develop AR financing

- Raise awareness of AR as an alternative source of financing, in addition to traditional debt and equity.
- Develop simple products like 'jefinancemapme.com'.
- Develop public reverse factoring.

Source: GE 'AR factor', EU Federation of Factoring and AR finance

Secured financing's growth potential stays high: research has shown that wider use of AR financing across Italy, France, UK & Germany could boost GDP by an additional € 17bn per quarter by 2015.[9]

> Considering the capital inflows lost by companies, financial stability and growth oriented financial policies should be a priority to restart debt and capital markets. However, in the short and medium term, secured financing is likely to be a significant and growing source of fresh capital, as the deleveraging of the financial sector limits the growth of classical loans. This growth could be accelerated at no cost for governments by increasing awareness for secured financing, and by developing tools targeted to SMEs (similar to jefinancemapme.com one-click factoring service) or public suppliers (via public reverse factoring programmes allowing public suppliers to be paid immediately at a reasonable cost for them, and no cost for the public customer).

[8] AR finance allows companies get new funds against invoices or accounts receivables, or through selling those invoices to a third party.

[9] The AR Factor, GE Capital Report, 2011.

Human resources: fighting unemployment and developing talents

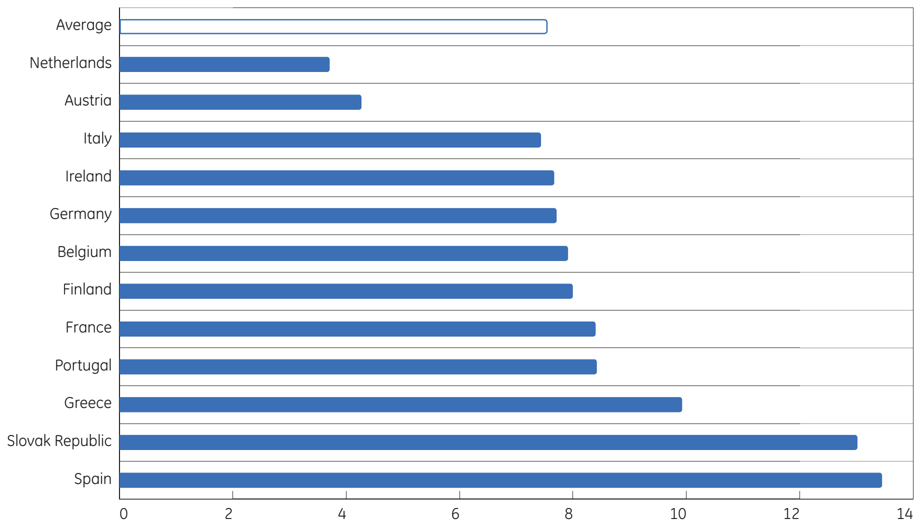
Unemployment is at its highest level in many countries across Europe. This is a key social issue that hits the most vulnerable segments – low income households, youths and seniors. This is also a major economic issue as human resources are being under used.

The causes for this high unemployment are numerous and complex, and this report does not intend to address them all. However, if we focus on this issue from the perspective of companies, we can identify several causes that could be addressed by focused policies:

- The first cause is low economic demand - greater demand would mean more growth opportunities, and more jobs. However, waiting for a return to growth is not the only solution, as resolving employment bottlenecks would also lead to additional jobs, which would increase household demand and increase growth.
- Structural rigidities explain a significant share of the unemployment in many countries. OECD structural unemployment rates vary significantly across Europe: 14 % in Spain, but only 4 % in Austria and the Netherlands.[10] These differences are partly explained by rigidities in the labour markets or goods markets as well as country-specific causes. These rigidities were often created to protect jobs, whereas, in the long term, they end up having the opposite impact. Complex regulations make hiring or creating new products in these countries too complex, and increase unemployment. These regulations also create 'dual labor markets' keeping for example, young people in a state of perpetual job insecurity and unable to develop their skills.

Structural unemployment differences in EU

Structural unemployment rates in Europe (%)



- Structural unemployment has many causes, but inappropriate labor regulation is an 'usual suspect'.
- If Eurozone had Netherland's structural unemployment, it could create 6 million additional jobs which would represent about € 150bn per year.

Source: OECD - 2008 Structural unemployment

The solution here is not to eliminate all social regulation, but to try and find a better balance between workers' security, jobseekers' opportunities and making it easier for companies to do business and grow. Studies have shown the benefits of the flexicurity model (lower legal constraints, stronger coaching and training services), which involve reforms in the employment and training services.[11] Active career management (i.e. the way companies allow their employees to adapt to new challenges and new ways of working) is another promising way to improve companies' ability to grow while preserving employees' jobs opportunities.

[10] Defined as the minimal unemployment rate a country can reach without increasing prices.

[11] See OECD employment outlook for 2007 for example.

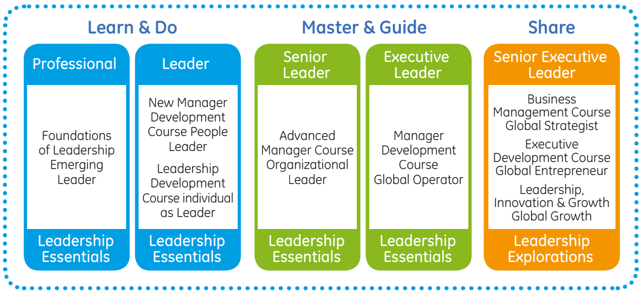
Active career management: how companies develop their employees

World's Best Companies for Leadership

2011	2010	2009	2008	2007	2006
General Electric	General Electric	General Electric	3M Company	General Electric	General Electric
Procter & Gamble	Procter & Gamble	Southwest Airlines	Procter & Gamble	Procter & Gamble	Procter & Gamble
IBM	Intel Corporation	3M Company	General Electric	Johnson & Johnson	PepsiCo
Microsoft	Siemens	Procter & Gamble	Coca-Cola	Unilever	Citigroup

What they do

- 95% of senior leaders take time to actively develop others. Only 48% of leaders at peer companies do this
- 94% are prepared to run unprofitable projects to try new things. Only 49% of all other respondents will do this
- 90% of Best Companies for Leadership let employees bypass the chain of command with an excellent idea, a practice that only 63% of peers tolerate
- They know collaboration is important and reward it accordingly. 100% take action when a leader is not collaborating vs 59% of peers
- And they see setbacks as learning opportunities. 95% see difficulties this way, compared to 50% of peers



What they get

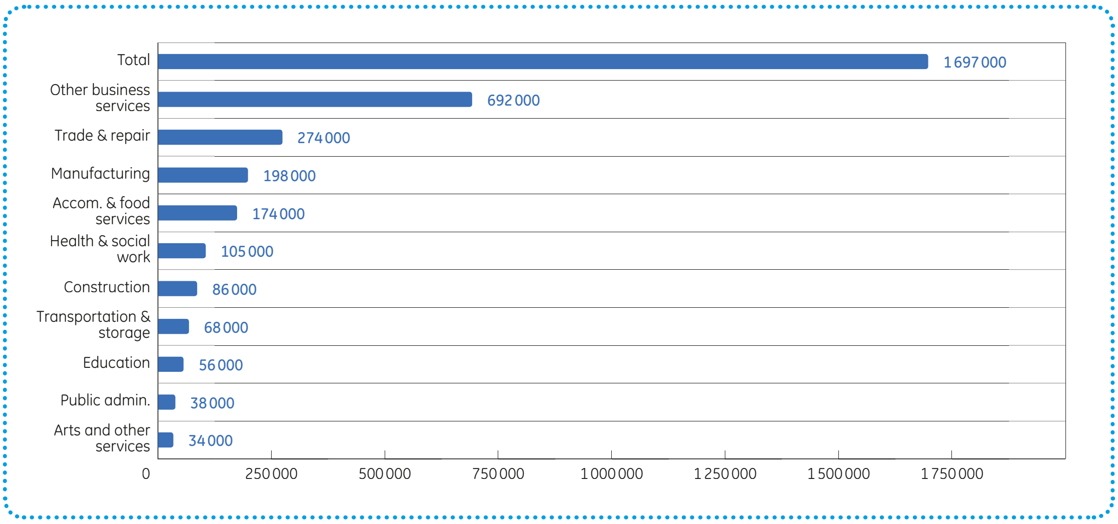
- More diversity: in Europe 59% of the best companies actively recruit cultural minorities vs 27% of peers
- More mobility: the best companies in Europe are twice as likely to use international opportunities to develop leaders
- More growth: growth within the best companies in the last 10 years is double that of the S&P 500

Source: The HAY Group

Unfilled positions due to companies being unable to find people with the right skills to fill vacancies is another cause of low growth. There are currently about 1.7 million job vacancies throughout the EU27 in service sectors as well as in industrial jobs.

Europe does not fully leverage its jobs potential

Job vacancies by economic sector in the EU



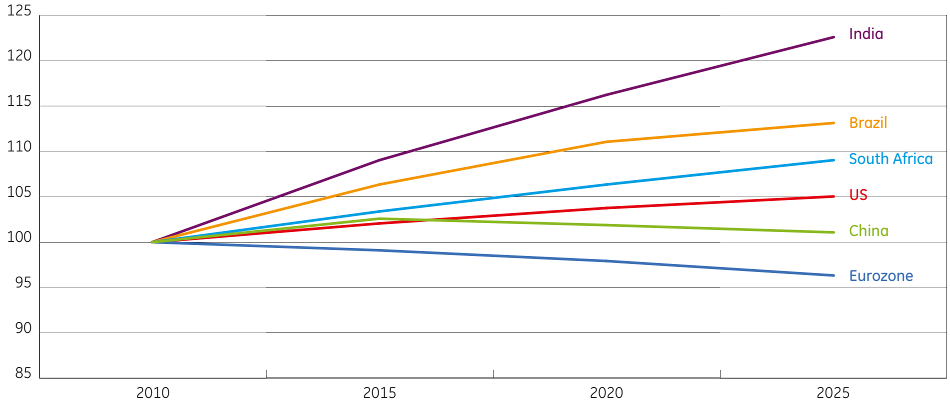
Source: OECD

Skills mismatches are likely to worsen in the years ahead,[12] unless there is a dramatic reform in the way education and training services take into account the needs of companies. Europe's shrinking workforce will make these reforms even more necessary.

[12] As shown is the public services section of this report.

Eurozone's workforce is shrinking

Labour force (15-64 years) - Base 100 = 2010 level



By 2025, difference between US and EU countries will represent a GDP loss of $677bn each year for EU.

Source: HNPstats - World Bank - OECD

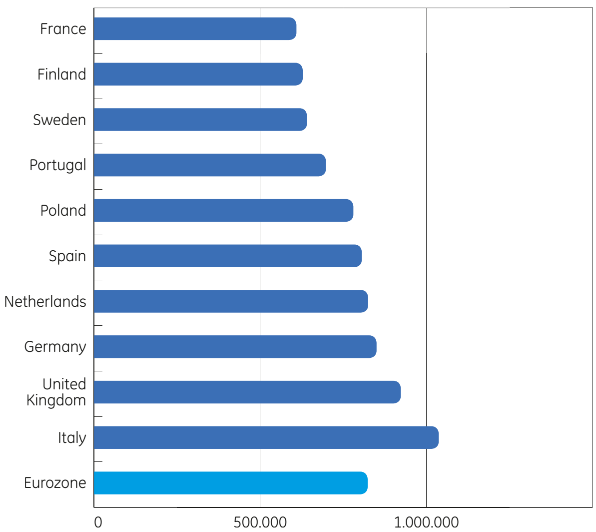
The active career management initiatives of companies should be shared across Europe. A fact-based approach to regulation and policies based on an assessment of their long-term impact on jobs should also be developed, and improvements to coaching and training services for job seekers should be implemented.

Energy prices: it's about demand, supply and networks

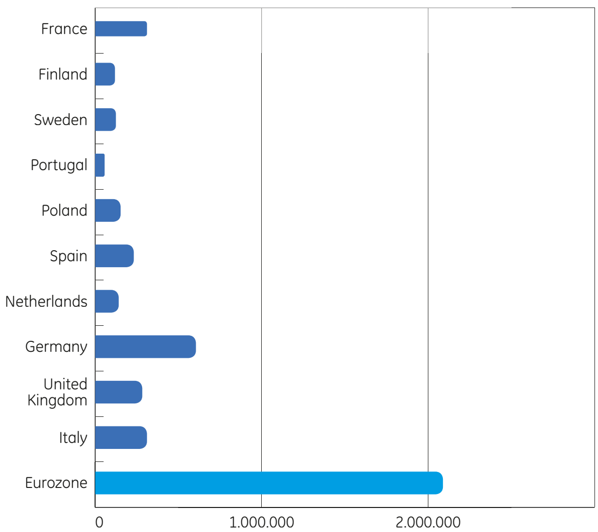
Energy supply is a highly debated policy issue - be it the mix between nuclear energy and renewables, greenhouse gas reductions or decisions to develop smart metering. Although discussed less frequently, decisions about energy supply also have a significant impact on competitiveness as the difference between a situation with all companies in Europe paying the highest energy prices, versus a situation with all companies paying the lowest price in Europe results in a difference in cost of almost € 90bn / year.

Electricity price is a competitiveness issue

Price (1000 TEP) - Euros (average)



Manufacturing consumption (1000 TEP) - 2010



Note : 1 TEP = 11 630 kWh

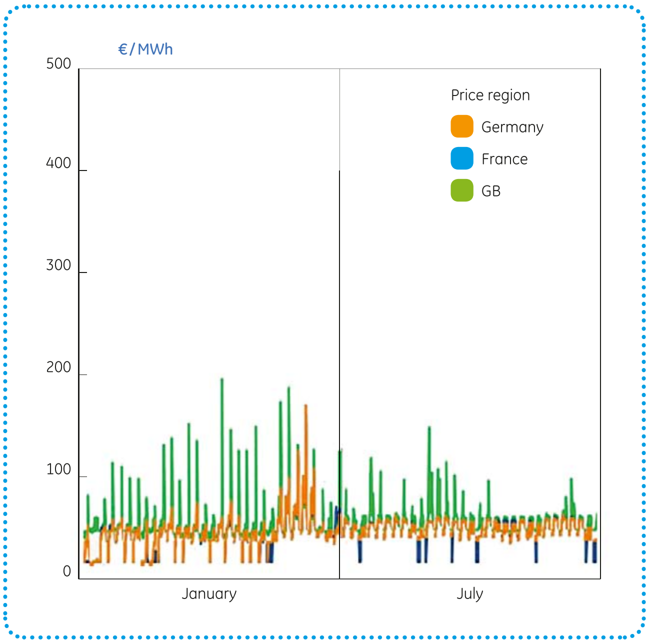
Europe would save €44bn/year if it had the lowest price (France) and lose €45bn with the highest price (Italy).

Source: OECD - 2008 Structural unemployment

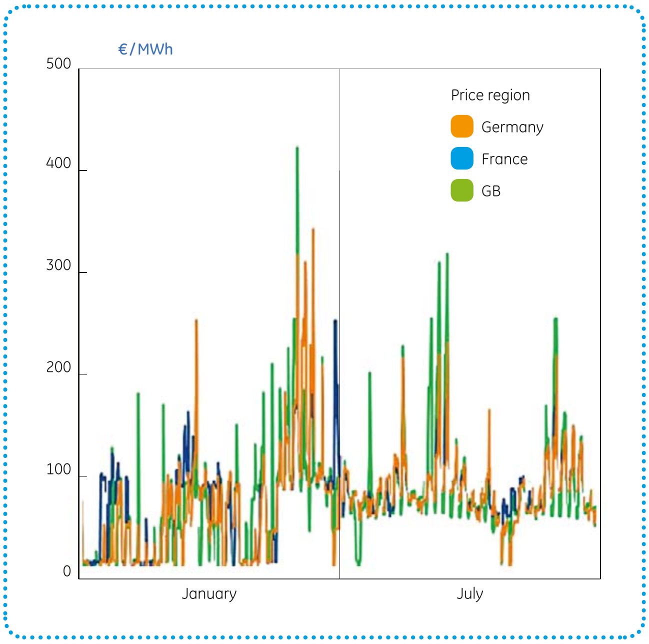
However, average prices evolution is not the whole story. Businesses will also be confronted by increasingly variable spot prices, since new renewable production capacities like wind or solar are more variable electricity sources than existing sources.

Increasing renewables in the energy mix will increase price volatility

Hourly wholesale prices - 2010



Hourly wholesale prices - 2030

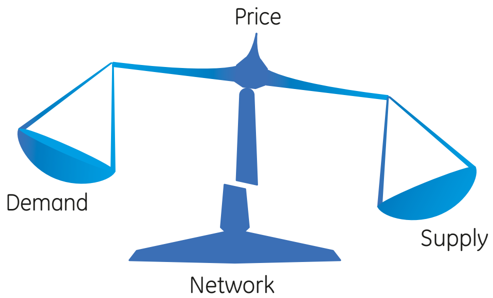


Note : Example from NEWSIS (North European Wind and Solar Study) 2011, showing hourly wholesale prices from one historical weather pattern.

Source : Poyry Institute - 2012

The decisions needed to keep energy supply and prices competitive in Europe are complex, and should address supply, demand and networks issues. Many options are interdependent, both technologically (for example, more renewables calls for flexible production options such as 'flexefficient' gas turbines) and geographically (price volatility 'injected' somewhere in the European network spreads to other countries). These issues cannot be addressed by waiting for crises and solving them in a piecemeal fashion: a holistic European strategy, covering both supply, demand and networks issues, is needed.

Energy prices result from imbalances

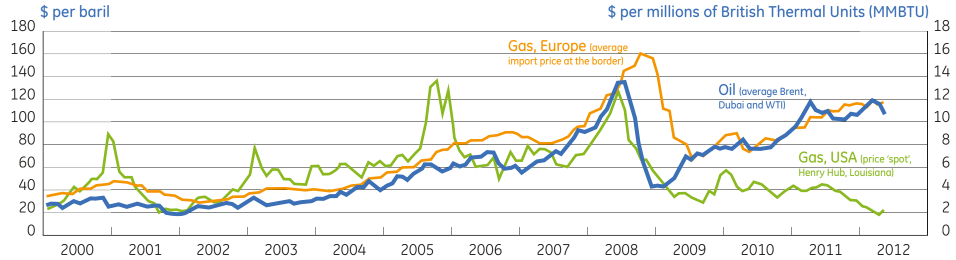


	Demand	Network	Supply
Main issues	• Increasing demand level	• 'Dumb' network • Lack of interconnections • Ageing network	• Renewables cost • Development of unpredictable production (renewables) • Oil and gas cost • CO_2 and nuclear constraints
Possible solutions	• Local production capacities • Energy management • Energy savings	• Grids modernization • Interconnection investments • Network investments	• Flexible production • New energy sources • Storage

Exploring new energy options - such as ways to extract unconventional gas safely and with minimal leakage of greenhouse gases - will also be key to minimising price increases and ensuring Europe takes a winning position in the global competition for energy.

Shale gas significantly reduced prices in the US

Oil and gas price comparison between US and Europe



Impact of shale gas prices on US total consumers' purchasing power: +0,1 point.

Source: INSEE - International development 2012

An holistic strategy is needed to avoid future increases in European price levels and volatility:

- Energy efficiency and smart energy management should be promoted to reduce waste and ensure that demand regulation options are correctly used.
- The development of renewables will make the implementation of more flexible energy sources necessary. Efficient production capacities such as CHP (Combined Heat and Power) will also help ensure target to reduce greenhouse gases are achieved. Safe and efficient access to shale gas will also be a key question for the coming years.
- To connect smart demand to smart supply, smarter networks will be necessary. Cross-border infrastructure and modernization of networks will also be needed.

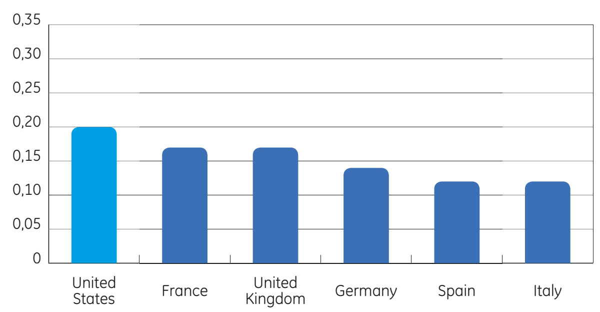
Logistics: connecting Europe

For many products, companies rely increasingly on 'fragmented value chains', where the production is split between different sites, to ensure each component is produced where its cost and quality will be optimal. For this reason, Europe needs first-class transportation networks to ensure that it is the best place to locate the largest possible share of industries' value chain, and that it offers cost efficient access to non-European locations.

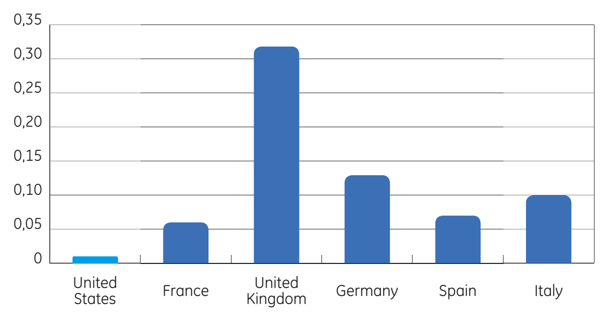
Europe has a well-established tradition of good transportation infrastructure such as railways and motorways. However, significant improvements are needed to facilitate trade and production across Europe especially for rail freight costs which remain significantly higher than in the US.

Contrary to road costs, rail freight costs are higher in EU than in the US

Road costs (EUR / tkm)



Rail costs (EUR / tkm)



If EU countries had the same cost than US for rail freight, it could save € 23bn / year.

Source: European commission

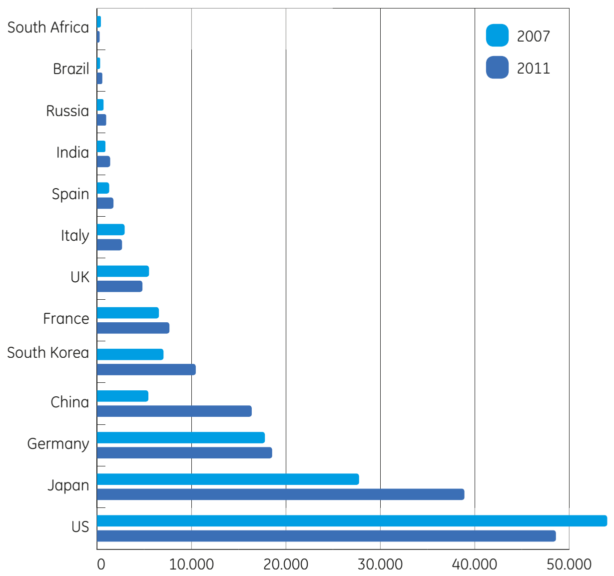
Logistics costs could be lowered by reducing European freight costs, for example by optimising the use of European rail freight corridors, developing high-speed freight trains and adopting common regulations, for example on freight train size.

Intellectual property: emerging countries are catching up

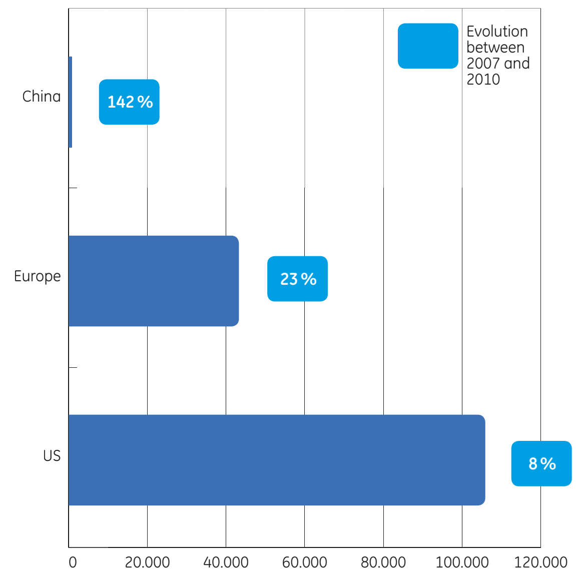
Europe's intellectual property and large pool of skilled researchers have long been decisive factors in locating and growing activities in European countries. Although still true today, the situation is rapidly changing: between 2007 and 2010, revenues from patents grew by 23 % in Europe, but by 142 % in China.

Patents: China is catching up

Number of patents by country



Patents and licenses royalties



Note: European Countries = Germany, Spain, Italy, France, UK; calculus = difference between patent royalties/GDP

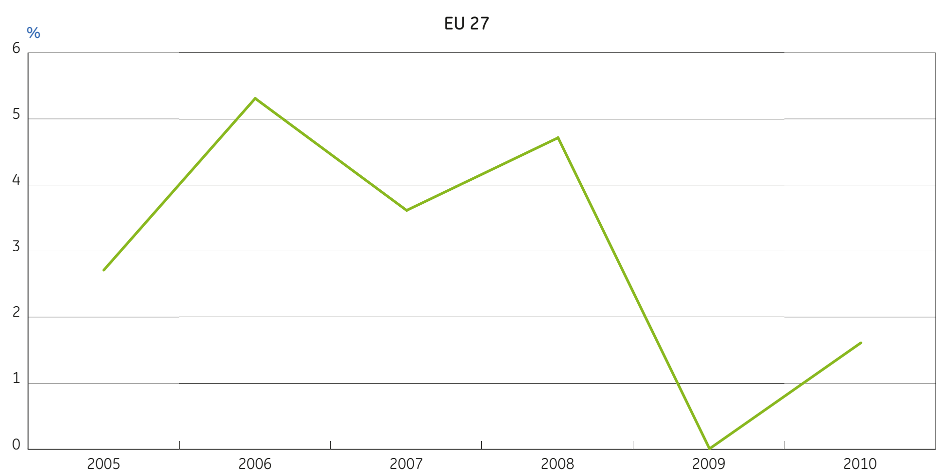
Source: World Intellectual Property Organization (PCT); World Bank - Patent royalties

If we want to accelerate Europe's intellectual assets' contribution to growth, we must answer two questions:

- Firstly, how can investment in R&D be sustained in Europe? As is usual when there is a decline in economic growth, R&D spending decreased significantly during the economic crisis. However, Europe's innovation potential could be seriously damaged if this situation continues for more than a few years.

R&D spending decreased during the crisis

Gross domestic expenditures on R&D – compound annual growth rate



Source: HNPstats - World Bank - OECD

- Secondly, how can research efforts be turned into revenue? This requires turning research into patents, then turning patents into products, and finally the ability to scale up, address large markets and engage in global competition whilst remaining cost efficient.

Getting more revenue out of research efforts

Main steps: Research → Patent → Venture → Scaling

Key issues

- Ability to turn R&D into patents
  - National & european R&D orientations
  - Researchers' patent awareness
  - Universities/companies cooperation
- Ability to turn patents into ventures
  - Entrepreneurship
  - Big companies innovation ability (intrapreneurship)
  - Large partners & suppliers network
- Ability to address large markets
  - IP protection
  - Market access and export support
  - Big companies/SMEs partnerships
  - Ability to build a competitive value chain

Innovation policies often favor innovating SMEs. But in many markets, particularly those where a critical size is needed (for example, the highly regulated and technology intensive global healthcare imagery systems market) scalability poses a significant challenge for SMEs, unless they partner with a larger entity - as for the example in the Discovery IGS730 partnership.

Discovery IGS730: a partnership between a SME and a large company to reach global markets

Goal: Joining imagery (GE) and robotics (BA Systèmes)
- Allows complex endovascular procedures
- $2bn global market

Solution: A new technology
- First mobile imaging device
- Allows a larger scope of interventions

Share designs by BA Systèmes
BA Systèmes : 90 staff, € 12M turnover

Gains for BA Systèmes
- A share of the global sales
- Access to the global imaging market, very regulated and difficult to access for a SME
- A unique experience of a global partnership with a multinational company

Competitive intellectual property regulations are also needed to strike the right balance between levels of protection, keeping regulation simple and averting the risk of 'patent trolls' using regulations against innovative companies.

Reform strategy: let's start now!

Will the economic and financial crisis make Europe stronger in the long term? This is possible as the crisis has helped to raise fundamental questions about European governance and better economic policy coordination, and this study shows that Europe has many of the assets it needs to grow faster.

However, to reach this goal, reforms are needed to restore short-term financial stability, to improve the efficiency of markets, and to build social systems that are both protective, fair and competitive. Since many of these policy changes will take years to implement, it is important to start implementing all these reforms as soon as possible, rather than waiting for the end of the financial crisis, or addressing bottlenecks to growth one after the other.

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GE imagination at work