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Europe: Back To Domestic Growth¹

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Productivity, incomes, consumption, and investment have been structurally weak in Europe since the turn of the millennium and have significantly diverged from the US.

It was not always this way. After the second world war, Europe's labour productivity converged from 22% of the US level in 1945 to 95% in 1995. And for most of this period, domestic demand as share of GDP in the euro area stood in the middle of the range of advanced economies.

But from the mid-1990s onwards, relative growth in the US and euro area was pushed apart by two major shocks.

The first was the technology shock brought about by the internet, at which point EU productivity convergence with the US halted and then reversed. The productivity gap that has been emerging since then between the two economies is largely explained by the faster productivity growth of the US tech sector.

The second shock was the great financial crisis and sovereign debt crisis, following which the orientation of the euro area shifted away from domestic demand.

It is often claimed that globalisation was responsible for this swing, as it affected the EU economy much more than the US one. But the initial wave of globalisation did not have much effect on the euro area's current account surplus, which fluctuated between -0.5% and 1% of GDP from the mid-1990s to around 2008. The structural surplus of the euro area household sector was offset by fiscal and corporate deficits, supported by strong credit growth.

It was only when the "twin crises" hit that the economy fundamentally changed.

With investment stalling and fiscal policy becoming contractionary, both the corporate and government sectors shifted to being in surplus. As a result, domestic demand as a share of GDP in the euro area fell to bottom of the range of advanced economies.

And the relative gap with the US widened. Before the great financial crisis, domestic demand in the US grew around 1.4 times faster than in the euro area. Since then, the gap has been 2.2 times.

¹ This speech was delivered on December 15th 2024, at a dinner associated with the 3rd Paris Symposium of the Centre for Economic Policy Research (CEPR)

The relative stance of fiscal policy was an important driver. From 2009 to 2019, the collective cyclically-adjusted fiscal stance in the euro area averaged 0.3%, compared with -3.9% in the US. And if we look at primary deficits in absolute terms, measured in the 2023 euros, the US government injected 14 times more funds into the economy, 7.8 trillion euros in the US and 560 billion in the euro area.

The relative supply of private credit exacerbated this financing gap. After the crisis, the annual growth rate of banks loans to firms in the euro area fell to zero and only entered low positive territory again after 2016. In the US, bank credit returned to growth rates of around 5% from 2012 and remained there.

The net effect was that euro area became a structural exporter of capital, with the current account surplus regularly exceeding 3% of GDP after 2012. Outflows were partly driven by FDI in the aftermath of the crisis, but since then the main driver has been portfolio flows, attracted by a superior return on savings in the US.

One can exaggerate how much governments control their economic models, which in a market economy are the sum of private sector decisions. But it is hard to argue that this outcome was entirely accidental.

Governments made little effort to complete the EU's internal market and enforcement of its rules became weaker, while integration of capital markets hardly progressed. All these factors were an obstacle to productivity growth and to the flow of saving into domestic investment.

Moreover, European policies tolerated low wage growth as a means to increase external competitiveness, compounding the weak income-consumption cycle. Since 2008, annual average real wage growth has been almost four times higher in the US than the euro area.

And very large global trade imbalances produced downward pressure on real rates, which created fiscal space for all governments to lean against weak internal demand. But at least until the pandemic, in Europe they made a deliberate policy choice not to use this space.

Overall, policymakers revealed a preference for a particular economic constellation: one based on exploiting foreign demand and exporting capital with low wage levels. But this constellation no longer appears sustainable.

For some time now, the Chinese market has become less favourable for European producers as growth slows and local operators become more competitive and move up the value chain. Exports to China have stagnated since 2020.

The slowdown has increased our reliance on the US market, with EU goods exports growing by 13% in this period. But the new US administration looks unwilling to act as our buyer of last resort. We will have to contend with a deliberate US strategy to rebalance global demand and suppress trade surpluses in its major trading partners.

The challenge Europe faces now is that neither macroeconomic policies nor the structure of private credit are well placed to fill the gap left by external demand. And an important factor connecting these weaknesses is the lack of key reforms in the structure of goods, services, and financial markets.

When macroeconomic policies are working well, we should see a "handover" from fiscal policy to monetary policy to private credit that ensures a high degree of demand stability over time. If fiscal policy eases enough to push output above potential and raise inflation, monetary policy tightens and private credit creation falls. And then when the fiscal policy reverses, monetary policy eases and private credit expands to fill the gap.

We currently see this process playing out in the US at the moment, with fiscal policy – for now – becoming less expansionary, the Federal Reserve loosening financing conditions, and private credit creation starting to pick up and maintain the financial impulse.

But this interaction works because the “handover” takes place when growth is high, which enables private credit to take over. In the euro area, however, two structural factors make macroeconomic policies less effective, in turn hampering this process.

First, although the euro area is a large economy, it does not behave like one owing to its incomplete internal market. The IMF estimates that internal barriers within the single market are equivalent to an *ad valorem* tariff of around 45% for the EU manufacturing sector and a tariff on 110% for the services sector.² In the US, the implicit manufacturing tariff among states is three times lower.

These barriers effectively constrain the amount of fiscal space in Europe by keeping potential growth below what it could be, and thereby lowering potential government revenues and raising debt-to-GDP ratios. The IMF estimates that, if barriers were reduced to US levels, the level of EU labour productivity would be almost 7% higher after 7 years.³

These structural weaknesses increase the pressure on policymakers to rein in fiscal policy before recoveries are strong and self-sustained, which is a necessary condition for private credit to take over. For example, today we see the cyclically-adjusted fiscal stance in the euro area heading towards neutral even as growth remains weak and output below potential.

Internal barriers also reduce the potential size of fiscal multipliers. Compared with other large economies, the euro area is unusually open. Trade makes up around 55% of GDP, compared with 45% in Japan, 37% in China and 25% in the US. There is robust cross-country evidence that fiscal multipliers decrease with trade openness, as part of a fiscal impulse will be met by lower net exports rather than an increase in domestic production.⁴

But the sheer size of these internal tariffs means that, for price-elastic products, their abolition would create a powerful demand-diversion effect towards internal demand. Completing the single market would therefore likely bring the trade openness of the euro area more into line with other large economies and strengthen fiscal multipliers.

The second structural feature that affects demand stability in Europe is the lack of an integrated capital market.

When monetary policy eases in the euro area, the transmission to financing conditions is likely to be slower than in the US, owing to the greater weight of bank finance relative to capital markets. This in turn affects the speed at which private credit responds.

For example, ECB analysis finds that the repricing of corporate debt securities after a policy change is much faster than the repricing of bank loans. In the euro area, the change in market rates is fully transmitted to corporate bond yields within the same quarter, while for lending rates it usually takes about six months to one year.⁵

The transmission of policy changes to the mortgage market is also accelerated by a more capital market-based system with higher levels of securitisation, as the pricing of mortgage-backed securities has a direct influence on mortgage rates. This mechanism helps explain the much stronger transmission of rates to housing investment in the US.⁶

And equity markets typically react immediately to changes in market rates, reflecting both the change in the discount rate and growth expectations.

2 IMF (2024), “Europe’s Declining Productivity Growth: Diagnoses and Remedies”, Regional Economic Outlook Notes Europe, November.

3 IMF (2024), *op. cit.*

4 Ilzetzki, E., Mendoza, E. and Végh, C. (2013), “How big (small?) are fiscal multipliers?”, *Journal of Monetary Economics*, vol. 60(2).

5 Lane, P. (2022), “The transmission of monetary policy”, speech at the SUERF, CGEG|COLUMBIA|SIPA, EIB, SOCIÉTÉ GÉNÉRALE conference on “EU and US Perspectives: New Directions for Economic Policy”, New York, 11 October.

6 Battistini, N., Delle Chiaie, S. and Gareis, J. (2023), “Monetary policy and housing investment in the euro area and the United States”, *ECB Economic Bulletin*, Issue 3/2023.

The net effect of these structural constraints on macroeconomic policies is that the euro area experiences longer periods where the economy is operating below potential – and this inability to maintain demand pressure then feeds back into productivity growth.

There is strong evidence across advanced economies that R&D expenditures are procyclical⁷, and that higher R&D spending is associated with innovation.⁸ According to a CEPR discussion paper, 20% of long-run economic growth is driven by demand and its effect on firms' incentives to innovate.⁹ The implication is that an economy that is consistently underheated will ultimately produce less innovation and see slower productivity growth.

So, both structural policies and macroeconomic policies must change to raise endogenous growth in Europe. Structural reforms are necessary for macroeconomic policies to have full effect, and fully effective macroeconomic policies are necessary for structural reforms to yield maximum productivity growth.¹⁰

But what we mean by structural reforms today has changed. Ten years ago, the term largely meant increasing labour market flexibility and compressing wages. Today, it means raising productivity growth without displacing labour, but rather by reskilling people.

Many different measures were laid out in the report that can contribute to raising productivity. But Europe's single market and the capital market are foundational, as they underpin the basic mechanisms driving productivity growth.

Productivity growth is largely driven by a combination of innovation among large leading firms, mature lagging firms adopting those innovations, and new firms rising up and challenging both. But on all these fronts Europe is performing poorly.

IMF analysis finds that, among large listed firms, productivity growth in Europe is far slower than in the US, with the US tech sector growing almost 40 percentage points faster since 2005.¹¹ Europe also has an abundance of small mature firms that are not growing at all. And its most promising young firms rarely grow fast enough to influence aggregate dynamics.

According to one estimate, the collection of US companies valued at at least \$10 billion and founded from scratch in the past 50 years is worth almost \$30 trillion. This is 70 times as much as the set of EU firms that meet the same criteria.¹²

Unlocking the single market is key to tackle the problem from all sides: to create the scale for young firms to grow in Europe, to increase competitive pressures on large stagnant firms, and to encourage greater exit of unsuccessful firms so that resources can flow elsewhere.

But Europe also needs a financial structure that facilitates the growth of young, innovative firms, which its bank-based system cannot provide.¹³

Today, banks in Europe lend around six times more to real estate companies and over four times more to manufacturing companies than they do to ICT companies, and in the US real estate loans also make up around 45% of the total loans portfolio.

7 For a review, see Sedgley, N., Burger, J. and Tan, K. (2018), "The symmetry and cyclicity of R&D spending in advanced economies", *Empirical Economics* 57, 1811–1828.

8 See, for example, Hall, B., Lotti, F. and Mairesse, J. (2012), "Evidence on the impact of R&D and ICT investment on innovation and productivity in Italian firms", NBER Working Paper No. 18053.

9 Sedlacek, P. and Ignaszak, M. (2021), "Productivity, Profitability and Growth", CEPR Discussion Paper No. DP16205.

10 Over the past decade, R&D investment by European companies has been around 60% that of US firms, with the gap growing over time. See Panetta, F. (2024), "A European Productivity Compact", speech at the XX Spain-Italy Dialogue Forum (AREL-CEO-SBEES), Barcelona, 3 December.

11 IMF (2024), op. cit.

12 <https://geekway.substack.com/p/a-visualization-of-europes-non-bubbly>

13 For a more complete review of how to integrate Europe's capital markets, see Lagarde C. (2024), "Follow the money: channelling savings into investment and innovation in Europe", speech at the 34th European Banking Congress: "Out of the Comfort Zone: Europe and the New World Order", Frankfurt, 22 November.

Banks are simply not the right intermediaries to finance young firms building new technologies, who often have volatile cash flows, a high chance of bankruptcy and largely intangible collateral. But at present, European venture capital is not ready to fill this financing gap: the EU's share of global VC funds is just 5% compared with 52% in the US.

Shifting Europe's financial structure more towards equity will require an innovation environment that produces a pipeline of high-growth firms which can attract venture capital; a regulatory regime that allows institutional investors to channel finance towards those firms; and a tax regime that favours equity over debt and unified treatment of stock options.

But it will also require a fundamental change in mindset about how we want to generate growth. Today, EU institutional investors allocate much more to US equity markets than they do to European ones because returns are consistently higher. This is the counterpart to an export-led growth model with low wages and low domestic investment – and we will have to accept these low returns for as long as this model remains in place.

If these structural reforms were implemented, it would already go a long way towards delivering this change. Productivity would rise, the effectiveness of demand-side policies would increase, and that would spill back into still stronger productivity growth.

But we know it will take time before such reforms bear fruit. So we should also reflect on whether macroeconomic policies can be used more efficiently in the interim.

If the EU were to issue debt jointly, it could create additional fiscal space that could be used to limit periods of below-potential growth.

Research suggests that a European safe asset issued by the Union would benefit from a “convenience yield”, a premium that derives from the scarcity of high-quality safe assets denominated in the euro.¹⁴ If EU bonds traded like equivalent safe assets today, the convenience yield would push borrowing costs below growth rates.

This differential would allow the EU to issue additional debt – potentially up to 15% of GDP – and roll it over indefinitely without requiring payments from the Member States. But it would only work if we could assume – with a high degree of confidence – that real growth rates would indeed be higher than real interest rates on a sustained basis.

In other words, we could not start down this road unless structural reforms were *already* in motion that would lift potential growth rates over the medium term.

Without common debt, the sustainability of national budgets today will be a constraint on expanding national fiscal policies. Then, we will also have to shift our policy action from changing the stance of fiscal policy to improving its composition – increasing public investment – and coordination across Member States. This also creates scope to increase demand.

Most importantly, exploiting the fiscal space within the EU's new fiscal rules would create a large margin to raise investment. The ECB estimates that, if all countries were to make full use of the seven-year adjustment period, an additional €700 billion would be available for investment – a significant share of the required public investment needs.¹⁵

14 Ando, S., Dell'Ariccia, G., Gourinchas, P.-O., Lorenzoni, G., Peralta-Alva, A. and Roch, F. (2023), “Debt Mutualization in the Euro Area: A Quantitative Exploration,” IMF Working Paper No. 2023/059.

15 Bouabdallah, O., Dorrucchi, E., Hoendervangers, L. and Nerlich, C. (2024), “Mind the gap: Europe's strategic investment needs and how to support them”, ECB Blog, 27 June.

How much this investment would affect growth depends of course on the assumed multipliers. But the nature of the investment needs Europe is facing today imply that multipliers could be quite high.

Let me conclude.

Three factors are at the root of the economic model that Europe slid into over the past twenty years, based on weak domestic demand, low wages and investment overseas.

The first was the “unfettered” globalisation, which produced the environment where external demand could become a more important driver of growth.

The second factor was fiscal policy after the great financial crisis. In part because of the mercantilist paradigm that privileged foreign demand relative to domestic demand, and in part because it was constrained by an incomplete single market, fiscal policy turned unduly restrictive, suppressed domestic demand and cut public investment.

And the third factor was the lack of progress on removing barriers within the single market, especially for services, and on the integration of capital markets, even as Europe faced slowing productivity growth and profound technological change.

These factors compounded each other to depress potential growth and weaken the effectiveness of macroeconomic policies. The result was a level of domestic growth in Europe that was well below what we could have achieved.

And that setting likely contributed, in turn, to lower R&D, lower innovation and still lower productivity growth. Europe effectively trapped itself in a vicious circle.

The report on the future of European competitiveness highlighted the legacy of these policy choices across major economic sectors in Europe. Dysfunction at the macro level has translated into a relatively bleak picture at the micro level.

It would be comforting to believe that these problems are not as consequential as they seem and that, as a rich continent, Europe can enter a phase of comfortable, managed decline. But in reality, there is nothing comfortable about this outlook.

If the EU continues with its average labour productivity growth rate since 2015, given our ageing societies, the economy in 25 years' time will be the same size it is today. That means a future of stagnant tax revenues and fiscal surpluses to keep debt ratios from rising. Yet, we face spending commitments that will not scale down with GDP.

The costs of maintaining our social model will be immense: unfunded pension liabilities in EU countries range from 150% to 500% of GDP. And on top of these obligations, we have the massive investments necessary to carry out the multiple transformations we are facing.

The €750-800 billion per year that the Commission and ECB estimate will be needed for investing in energy, defence, digitalisation, and R&D do not even include important goals such as climate adaptation and environmental protection.

These are all investments that will determine whether Europe will remain inclusive, secure, independent, and sustainable.

We all want the society that Europe has promised us, one where we can uphold our values regardless of how the world around us changes, but we have no immutable right for our society to always remain as we wish it. We will have to fight to keep it.

ABOUT THE AUTHOR

Mario Draghi is an Italian economist, central banker, and public servant with a distinguished career in international finance and policy. He served as President of the European Central Bank (ECB) from 2011 to 2019, where he played a pivotal role in navigating the Eurozone through the sovereign debt crisis. Widely recognised for his decisive leadership, including his famous commitment to do "whatever it takes" to preserve the euro, Draghi's tenure at the ECB significantly shaped monetary policy and financial stability in Europe. Prior to his ECB role, he was Governor of the Bank of Italy and held senior positions at Goldman Sachs and the World Bank.

Draghi has also made significant contributions to academia and policy-making. He holds a Ph.D. in economics from the Massachusetts Institute of Technology (MIT) and has published extensively on macroeconomics, monetary policy, and financial regulation. Most recently, he served as Prime Minister of Italy (2021-2022), leading the country through economic recovery efforts during the COVID-19 pandemic. Known for his pragmatism and expertise, Draghi remains a prominent voice on global economic challenges, and recently authored a major report on the future of European competitiveness for the European Commission.

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