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Can Europe's economy ever hope to rival the US again?

Chronic underperformance is worrying EU policymakers who are searching for ways to inject some dynamism

Martin Arnold in Frankfurt, **Sam Fleming** in London and **Claire Jones** in Washington 3 HOURS AGO

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Claus Romanowsky reckons those who claim Europe's economy is falling technologically behind are out of touch.

The chatbot developed by his team at German engineering company Siemens will soon let factory workers anywhere talk to robots and machines without needing to know any code — potentially reaping massive gains in productivity.

“If you are a worker coming in to start your shift and a machine is not working, you normally have to wait hours, maybe days, for a programmer,” the Siemens executive says.

“But now with this chatbot you can just ask it what is wrong and fix it yourself much quicker . . . It is so easy to see the huge potential for this technology.”

If more European companies harnessed artificial intelligence in this way, it might help to address some of the deep-seated problems in the region’s economy, which is lagging behind the rip-roaring growth of the US. Europe remains badly behind in AI innovation and adoption. Siemens, for example, needed to team up with American tech giant Microsoft to develop its chatbot.

Europe’s economic underperformance has long worried policymakers. But it has surged to the top of their agenda now that the growth gap with the US has become even wider following the twin shocks of the coronavirus pandemic and Russia’s war in Ukraine.

French President Emmanuel Macron warned last month that Europe faces a “mortal” threat from economic decline, rising illiberalism and the war on its eastern border.

US gross domestic product has proved more resilient to these shocks and rebounded faster from them, rising 8.7 per cent above pre-pandemic levels by the first quarter of this year. That is more than double the 3.4 per cent rise in Eurozone GDP and even further ahead of the 1.7 per cent equivalent increase in the UK economy in the same period.

This transatlantic divergence has become so acute that it is creating a rift between the US and Europe on monetary policy. With growth and inflation expected to remain stronger in the US than in Europe, investors expect the Federal Reserve to cut interest rates fewer times this year than the European Central Bank or the Bank of England.

The combination of high European energy costs, now well above those in the US, and the attractive subsidies offered by Washington for green energy and semiconductor projects built in the country is tempting large numbers of European companies to shift activities there.

The scandal for Europe is not low growth, because unfortunately we are accustomed to this. The problem is how to keep a sufficient level of investment [to meet] these new challenges

Paolo Gentiloni, EU economy commissioner

The EU has asked Mario Draghi, Italy's former prime minister and ex-head of the ECB, to come up with ways of boosting the bloc's competitiveness. He is expected to recommend deeper integration of EU capital markets and greater centralised funding for defence and other areas from Brussels, warning recently that "without strategically designed and co-ordinated policy actions, it is logical that some of our industries will shut down capacity or relocate outside the EU".

Even the head of Norway's oil fund, one of the world's biggest investors, says it is "worrisome" how much more hard-working, ambitious and lightly regulated US companies and workers are than those in Europe.

Faced with an ageing population and a dearth of leading companies in the fastest growing areas of technology, European policymakers are searching for ways to inject dynamism into their economies.

Paolo Gentiloni, the EU's economy commissioner, says the question now is how to address the need for critical investments in areas such as the green transition and defence given the sluggish backdrop.

"The scandal for Europe is not low growth, because unfortunately we are accustomed to this," he says. "The problem is how to keep a sufficient level of investment, attracting private capital, and supporting with public investment the needs of these new challenges."

Europe's economy was riding high in the early 1990s, enjoying a boost from deepening the EU's single market before expanding it eastward following the end of the cold war.

But since then, the combined economies of the 27 countries that make up the EU today have steadily lost ground to the US, hit by a series of setbacks, particularly the Eurozone debt crisis a decade ago. More recently, the Covid-19 pandemic and Russia's war in Ukraine have both inflicted more economic damage to Europe than to the US.

Average per capita income levels in purchasing-power-parity terms in Europe have fallen to around one-third below those in the US, according to the IMF. What's more, per capita income in the US has overtaken all the major advanced economies of the EU and the fund forecasts this gap will only widen further over the rest of this decade.

Part of the problem for Europe has been a paucity of demand growth, weak investment and labour hoarding — where companies retain more workers than needed due to concerns they will struggle to hire them back once demand recovers.

Some of this stems from a lack of consumer confidence in Europe. House prices have fallen in many countries and governments are reining in spending. Faster US wage growth has helped its workers regain the purchasing power they lost due to high inflation sooner than their counterparts in Europe. US households have also benefited from investing more in equity markets, which have risen sharply in recent years.

"There are negative wealth effects in Europe," says Ana Boata, an economist at German insurer Allianz Trade. "If you don't expect to get more from public welfare or pension systems, you are likely to save more and spend less. Then you add in the uncertainty from wars and you have doom and gloom."

Wealthier and older households in the US have been insulated from higher borrowing costs by the country's predilection for 30-year mortgages, locking in interest rates at ultra-low pre-pandemic levels. European households have shorter term or variable-rate mortgages, which have eaten up more of their monthly income since rates shot up two years ago.

In the Eurozone, people are still saving more than 14 per cent of what they earn — well above the historical average. But US consumers have spent almost all the extra money they put away during the pandemic, reducing their savings to less than 5 per cent of their income.

People in Europe are also choosing to work less — a trend that has intensified since the pandemic — underlined by German train workers successfully pushing to reduce their working week from 38 to 35 hours by 2029 and steel workers demanding to be paid more for working only 32 hours a week.

The ECB estimated that at the end of last year the average Eurozone employee worked five hours less than they did just before the pandemic hit in 2020 — equating this to the loss of 2mn full-time workers a year — while the average hours of US workers have remained stable.

“There is a difference between the work-life balance in the US and in Europe,” says Markus Brunnermeier, a German-born professor of economics at Princeton University. “People’s preferences are very different. Europe’s labour shortages are made worse by this and by demographics. It can be compensated by immigration from eastern Europe, but younger people from this region are going back home or not moving at all.”

An extra burden for Europe’s economy stems from its ageing population and falling birth rates, which are already creating widespread labour shortages as the baby boomer generation retire.

Currently in the EU there are three working-age individuals for each person aged 65 years or older. But by 2050, the ratio is projected to be less than two working-age individuals for every older person. The US population will age more gently, from just under four working-age individuals for every person aged over 64 today to just under three by 2050, according to the census bureau.

Many EU countries are seeking to keep older workers in the labour force for longer, or to boost female labour force participation. But ageing societies mean that demographic trends are likely to make little contribution to medium-term growth, leaving Europe even more reliant on improvements in productivity.

Here too, the story is worrying. The US is seen as a more business-friendly and dynamic entrepreneurial environment, which has consistently proved more adept at channelling investment into high-growth sectors including IT.

Isabel Schnabel, an ECB executive, says the Eurozone has lost about 20 per cent of productivity relative to the US since the mid-1990s, attributing this to the continent's "failure to reap the benefits of digital technology developments" such as cloud computing and software applications. "It is not that this technological knowledge is not distributed across countries, but it is only a very small share of firms within countries that make efficient use of it," she says.

Schnabel adds that many European companies are too small and constrained by regulation to fully exploit new technology. Companies with more than 250 employees account for almost 60 per cent of private sector jobs in the US, but in the EU this falls to between 12 per cent in Greece and 37 per cent in Germany. "Larger firms invest more and are more productive," she says.

Europe's productivity lag is long-standing and enormously costly in terms of living standards. If the biggest five European economies — Germany, the UK, France, Italy and Spain — had matched America's productivity growth rate between 1997 and 2022, their GDP per capita would on average be nearly $13,000 higher in purchasing-power-parity terms, estimates from the McKinsey Global Institute show.

"In terms of the productivity gap between the US and Europe, what you've seen happening if you measure over the past four years is that [the US] has been mildly disappointing and [Europe's] been terribly disappointing," says Jason Furman, an economist at Harvard. "We're sort of the least ugly horse in the glue factory."

Part of the problem has been Europe's laggardly investment growth. Erik Nielsen, economics adviser at Italian bank UniCredit, says investment in the US had increased more than 8 per cent since the end of 2019 and was still growing strongly at the start of this year, while it remained "terribly weak" in the Eurozone at 4 per cent below pre-Covid levels.

The differences are stark when the largest companies are examined. The biggest publicly traded European companies with more than a billion dollars of annual revenue, including those in the UK, Norway, and Switzerland, invested $400bn less than their US counterparts in 2022, McKinsey has found.

Volkswagen was the only EU company that appeared in the top 10 in a recent European Commission report examining the world's top 2,500 R&D investors in 2023. Six of the top 10 were headquartered in the US and none were in the UK.

Jan Mischke, a partner at the McKinsey Global Institute, says the investment gap is particularly glaring in IT. The R&D spending of the so-called Magnificent Seven companies — Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla — amounted to more than $200bn last year, around half of Europe's total equivalent spending across all private and public sectors.

Europe, Mischke says, has been building and perfecting a model of "industrial excellence", but the world is now changing. "There is a massive technological disruption happening where an incremental approach doesn't cut it."

The mismatch in venture capital funding is stark. Last year VC investment in US companies was almost treble what those in Europe managed, according to KPMG research. VC funds in the US also raised almost five times as much as those in Europe over the past three years.

"With all the doom and gloom around Europe, this is the big lingering question: is adoption of new AI technology likely to be slower and less beneficial than in the US and China?" says Adam Posen, president of the Peterson Institute for International Economics. "Europe has an understandably cautious approach to regulating new technology but that will be a drawback here."

While ministers in the EU agree that growth needs to be bolstered, some question how sustainable the US's current trajectory will be.

"[It] is not a new issue for Europe and not a new issue for the Netherlands: growth has not been spectacular," says Steven van Weyenberg, the Dutch finance minister. But looking at the recent performance, he adds: “Part of this story is very loose fiscal policy in the US which may not be sustainable for decades.”

Most EU economies have started to shrink their budget deficits ahead of the reintroduction of binding fiscal rules this year. But US spending has continued to surge. That trend is expected to continue, whoever wins November’s US presidential election. The Congressional Budget Office projects deficits to remain around 6 per cent for each fiscal year over the coming decade.

“The question is how much longer can the US power ahead, when last year it was mainly driven by a large fiscal stimulus and a big increase in immigration,” says Kaspar Hense, portfolio manager at investor RBC Bluebay Asset Management. “But a Trump presidency could bring more fiscal largesse and we don’t think Biden would be much different.”

US productivity was boosted by the temporary surge in unemployment after the pandemic hit in 2020, which reshuffled people into new and more productive roles once activity picked back up. Europe instead chose to protect jobs with massive furlough schemes. “We froze our labour market,” says Boata at Allianz, adding that this resulted in “zombified jobs”.

Yet this pattern could reverse as the US boost wears off and if European companies stop hoarding labour. ECB economists wrote in a blog last week that there were already signs of “weaker tailwinds” in Eurozone job markets, “which in turn will support the increase in productivity” as vacancy levels fall, wages keep rising and hours worked increase.

The potential gains from AI — such as what Siemens is doing with its chatbot — represent “a substantial key driver and opportunity for Europe . . . to have the economic power to tackle some of its toughest problems,” says Ralph Haupter, Microsoft’s head of Europe, the Middle East and Africa. He estimates AI could increase productivity of programmers by 40-45 per cent and of office workers by 20-25 per cent.

The Eurozone economy showed tentative signs of rebounding from its recent stagnation with quarterly growth of 0.3 per cent at the start of this year. The

The potential gains

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UK economy grew at an even faster quarterly rate of 0.6 per cent, overtaking US growth of 0.4 per cent in the period. Some policymakers believe many of the region's problems could be fixed if there was less negativity about the future.

"There is a risk that the doom and gloom becomes self-fulfilling," says Schnabel. "Given the huge shocks we have had in Europe, the economic performance has not been as bad as many had feared, so we should stop talking ourselves down."

Data visualisation by Amy Borrett