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EUROPEAN BUSINESS: OVERCOMING UNCERTAINTY, STRENGTHENING RECOVERY

MAY 2017

EXECUTIVE SUMMARY

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EUROPEAN BUSINESS: OVERCOMING UNCERTAINTY, STRENGTHENING RECOVERY

MAY 2017

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IN BRIEF

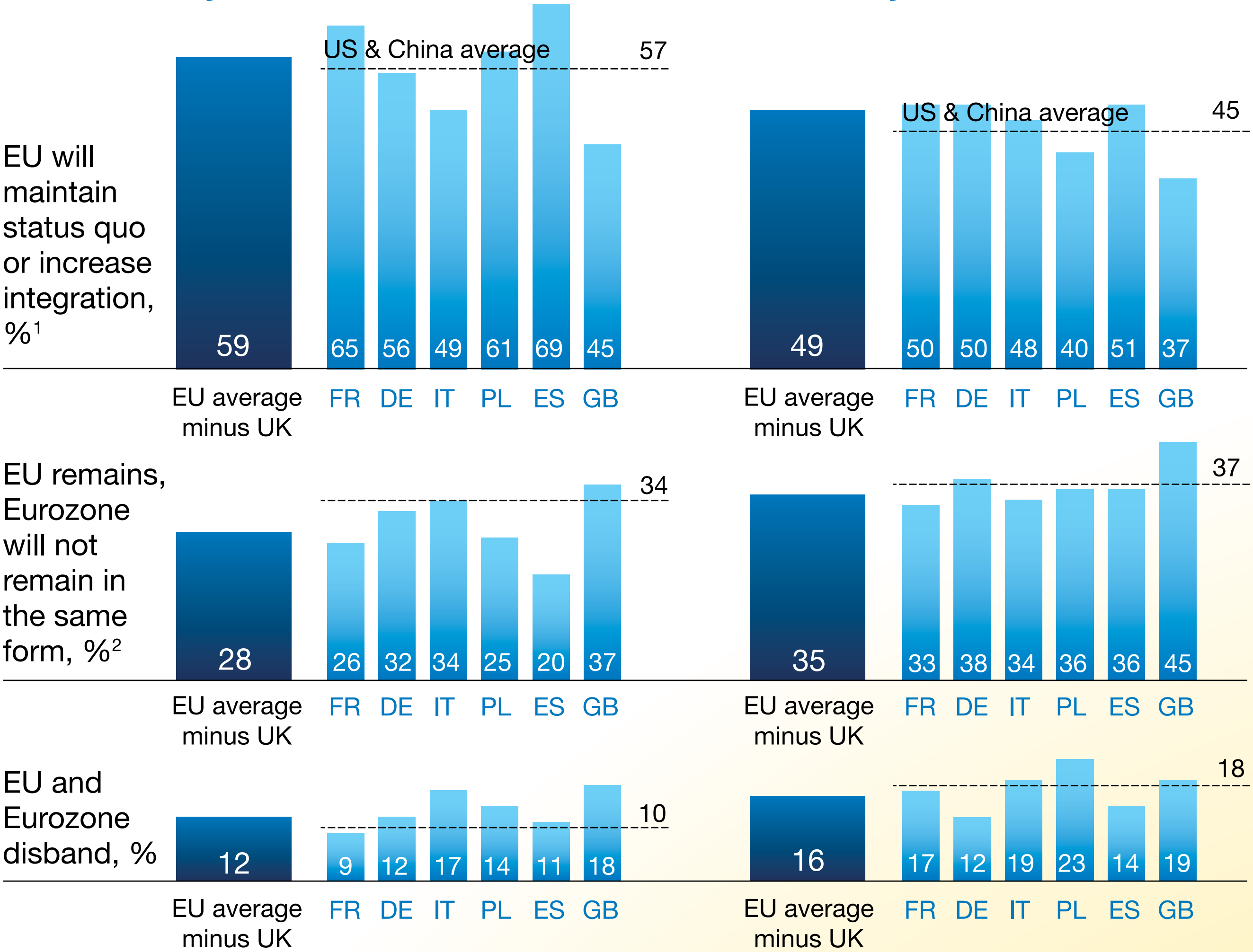
EUROPEAN BUSINESS: OVERCOMING UNCERTAINTY, STRENGTHENING RECOVERY

The European economy is on the road to recovery and business confidence has picked up after one of the toughest decades in the postwar era. While companies around Europe are more optimistic about the outlook, the majority remains nervous, perceiving some global trends as headwinds to their business and concerned about risks to the European Union (EU) itself. A survey of 2,000 C-suite executives we conducted in France, Germany, Italy, Poland, Spain, and the United Kingdom highlights their desire for "more Europe" in the form of more integrated policies across the EU, but also their divergent opinions on the trends and pressures on the EU they expect in the future.

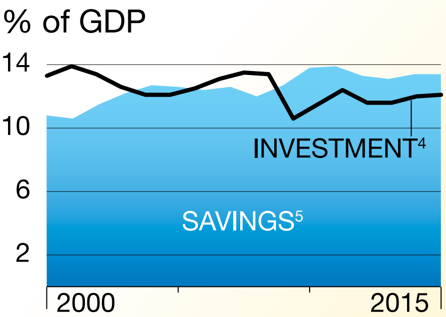
- European businesses are more optimistic than economists' forecasts and are expecting EU GDP growth of 2 percent annually over the next five years. They also expect average revenue growth of 2.1 percent in the coming year. About one in five companies predicts revenue growth above 5 percent, while about one-third of firms expect revenues to stagnate or decline in the year ahead. Larger, internationally focused companies are most likely to expect future revenue growth. US and Chinese firms we surveyed project even higher EU GDP growth than their European competitors on average, of almost 3 percent and 2.3 percent respectively.
- Businesses see opportunities to invest, even as they amass cash to insure against a range of risks and uncertainties. Gross corporate savings rose to almost €2 trillion in 2015, and firms are divided between those that say they are saving to fund future investment (48 percent) and those building reserves for future crises (47 percent). Uncertainty rather than weak demand, lack of opportunities, or access to finance is cited as the main barrier to investment.
- Most company leaders surveyed are positive about the effect of digitisation and the rise of emerging economies on their businesses, but more negative about other global trends. A positive view of digitisation, where the EU currently trails the United States, correlates with a more optimistic outlook for investment, while concerns about income inequality, rising populism, and antiglobalisation sentiment correlate negatively.
- Just over half the companies surveyed think the EU has had a beneficial effect on their business, and the most successful companies are the most positive. Smaller, less globalised companies tend to question the benefits of Europe and are less eager to invest in the future. Businesses generally are supportive of the EU Commission's policy priorities, but are less positive about the way they have been executed.
- Eighty-five percent of surveyed companies say they think the EU will remain intact, and just under half anticipate that the status quo will prevail or that greater integration will take place. However, 51 percent expect the Eurozone to shrink or disband in the years ahead. After Britain's decision to leave the EU, one in three respondents said a decision by any other countries to follow suit would be negative for their business.
- Reducing uncertainty should be high on the European agenda; restored productive investment could boost the EU's GDP by as much as €1 trillion. The EU will need to address lingering areas of fragility, including remaining financial risk, the direction of the Eurozone and, where possible, geopolitical concerns such as migration and populism. One way to bolster confidence in the EU would be to develop a new narrative showing that the forces in favour of cooperation are stronger than those opposing it.

European business between hopes and fears

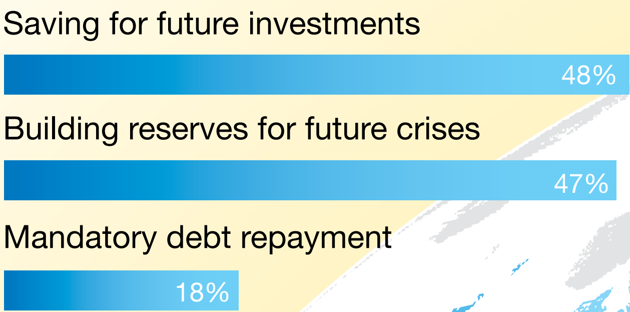
Q: Which of these scenarios is most beneficial for your business? / Q: Which of these scenarios is most likely to occur?

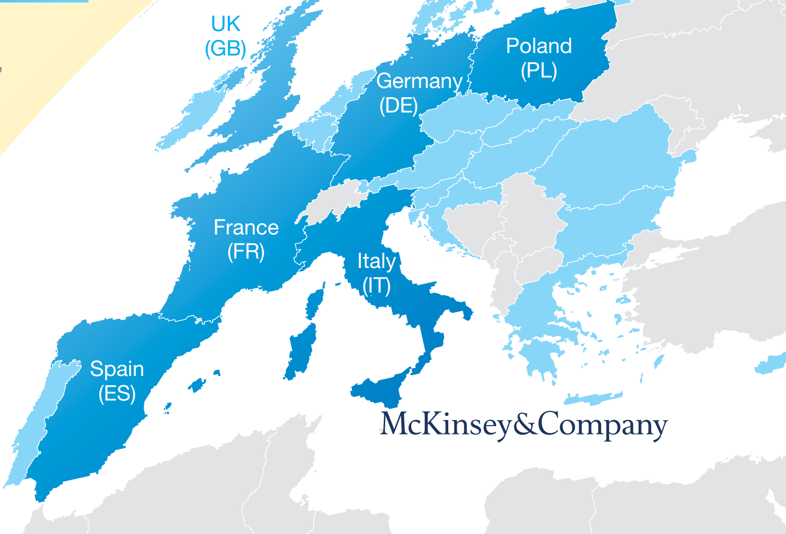


Cash position of EU firms



Q: Why did your company increase its cash position?[3]





1 Includes all responses with “EU and Eurozone remain intact with current responsibilities” or “EU responsibilities expansion” as top choice.
2 Includes all responses with “Eurozone breaks up, EU intact” or “Eurozone shrinks, EU intact” as top choice.
3 Asked only of companies that indicated cash position had increased; companies were allowed to choose up to two responses.
4 Gross capital formation.
5 Gross corporate savings.
SOURCE: AMECO; McKinsey Global Institute Business Survey, 2017; McKinsey Global Institute analysis

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La Défense business district in Paris
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EXECUTIVE SUMMARY

The European economy is on the road to recovery after one of the toughest decades in the postwar era, marked by the 2007–09 financial crisis and the double-dip recession in 2012–13. The stronger outlook is cheering the European business community: a survey of 2,000 C-suite executives we conducted in France, Germany, Italy, Poland, Spain, and the United Kingdom shows that executives are on the whole more optimistic about the overall EU economy and about their own business outlook. However, the brighter mood is tempered by concerns over lingering risks and areas of fragility, including worries about another financial crisis, the rise of populism and antiglobalisation sentiment, and the future shape and role of the European Union itself, all of which are weighing on companies' investment behaviour.

2%
Expected annual GDP growth over the next five years

A FRAGILE RECOVERY

Our survey suggests that European businesses are expecting EU GDP growth of 2 percent annually over the next five years, higher than the 1.7 percent forecast by some economists for 2018. They are also more upbeat about their own business prospects: overall, the companies we surveyed expect weighted average revenue growth of 2.1 percent in the coming year, considerably higher than 1.5 percent annual forecast by economists and 1.6 percent average annual rise seen in the past three years.[1] About one in five companies is predicting revenue growth above 5 percent, while about one-third of firms expect stagnant or declining revenues in the year ahead. Larger, internationally focused companies are more likely to expect strong revenue growth. Survey respondents also expect to raise headcount over the next three years by an average of 2.4 percent cumulatively, triple the 0.8 percent forecast for employment growth (Exhibit E1).[2]

As part of our survey, we also polled US and Chinese companies that operate or invest in Europe for their views of the GDP outlook for Europe. They were even more upbeat than European companies, with US companies expecting growth of almost 3 percent, and Chinese firms anticipating growth of 2.3 percent.[3]

€200B
Decline in investment from 2007–09 in Europe

COMPANIES AMASS CASH EVEN AS INVESTMENT OPPORTUNITIES RETURN

How much of this restored optimism is mood, and how far does it extend into business decisions? Business investment patterns provide some revealing indications. Investment was one of the biggest casualties of the past decade, with corporate investment falling by €200 billion between 2007 and 2009. While business investment has crept back to 2007 levels in absolute terms, investment as a share of GDP remains at historic lows, most notably in southern Europe.[4]

Business investment tends to follow demand and demand expectations.[5] Indeed, those European respondents to a *McKinsey Quarterly* survey who have increased their investment budget predominantly cite increasing demand expectations (43 percent) and increasing demand (40 percent) as the key reasons for doing so.[6] And in line with the downturn and recovery of the economy, a large majority of businesses believe they have been investing at the right level.

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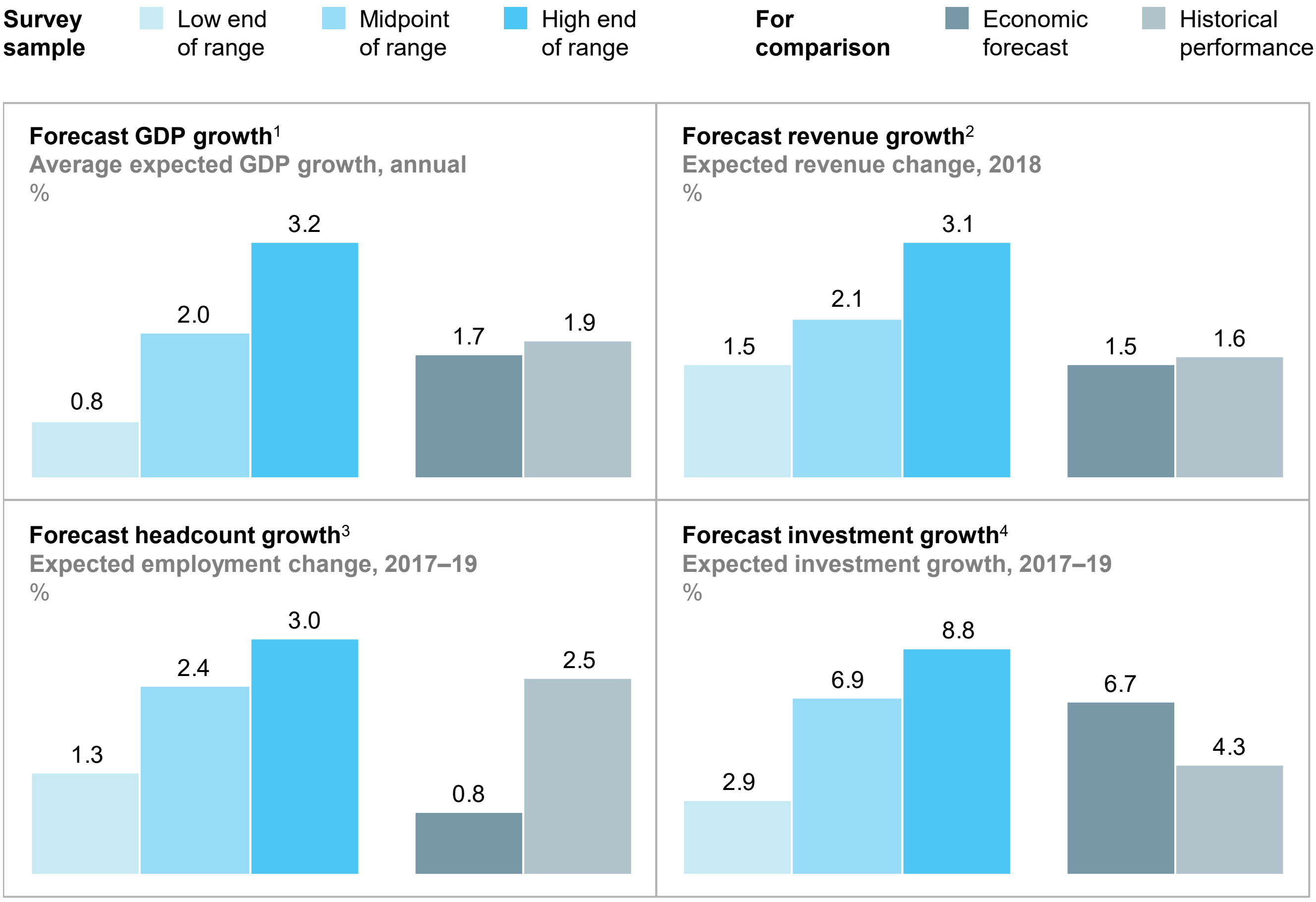
1 IHS Global Insights database.
2 IHS Global Economy database.
3 A full list of survey questions and more detailed analysis of the results can be found in the technical appendix.
4 European Commission macroeconomic database (AMECO).
5 See *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.
6 *McKinsey Quarterly* survey, March 2017.

Exhibit E1

European businesses are more optimistic than industry forecasts across four indicators (after weighting to more fully represent the business community within the six member states)



1 Forecast is IHS forecast GDP growth for EU-28 (2018). Historical performance is Eurostat historical real GDP growth for EU-28 (2016).
2 Forecast is IHS forecast real GVA growth for average of 6 countries' total economies (2018). Historical performance is IHS historical real GVA growth for the average of 6 countries' total economies (2016).
3 Forecast is the % change in employment for the total economy of the 6 countries (2017–19) from IHS. Historical performance is the % change in historical employment for the total economy for the 6 countries (2014–16) from IHS.
4 Growth is the unweighted average of expected investment growth over 2017–19 across respondents as we do not have a breakdown of private investment by enterprise size to provide a total economy weighting. Forecast is the % change in investment in non-residential construction, metal products and machinery, and other investment from the European Commission's AMECO database. It estimates 3-year total growth based on the 2015 annual growth rate. The data for 2015 is the latest available for forecasting and assessing historical performance. Historical performance is the % change in investment in non-residential construction, metal products and machinery, and other investment from the European Commission's AMECO database over 2013–15. The data for 2015 is the latest available for forecasting and assessing historical performance.

NOTE: Not to scale. GDP and revenue growth are response averages weighted by GVA contribution of different company size groups within each of the 6 countries. Forecast headcount growth is a response average based on share of employment for different company size groups within the 6 countries.

SOURCE: MGI Business Survey, 2017; IHS Global Economy database; IHS World Industry Service; European Commission SME Performance Review; Eurostat; AMECO database; McKinsey Global Institute analysis

Going forward, as the recovery continues, businesses in our survey see their investment rising by an average of 6.9 percent over the next three years cumulatively. Notably, as of today, almost 80 percent of European respondents to our global survey say they also have sufficient opportunities to invest or even more than they can fund.

Yet uncertainty appears to be holding investment back and leading to increases in cash flow positions instead. Forty percent of European respondents to our global survey say risk aversion is the key reason for not investing in all opportunities, and uncertainty about future relevance of investment (29 percent) and political uncertainty (17 percent) also feature highly. In our European survey, the top cited risks are the possibility of another financial crisis as well as European political trends such as the rise of populist parties.

Uncertainty appears to have shifted business preferences towards funding investment internally, and hoarding larger cash buffers. European companies continue to grow their cash: gross corporate savings rose to almost €2 trillion in 2015, €410 billion more than in 2009, turning companies into net lenders to the economy. Of the companies increasing their cash flow positions, 48 percent of our survey respondents say they are doing so in order to save for future investment, and 47 percent to equip them better for future crises. Forty percent of European respondents to the *McKinsey Quarterly* global survey who have not invested in all available opportunities cite risk aversion as a key reason not to do so; uncertainty about future relevance of investment (29 percent) and political uncertainty (17 percent) also feature highly. In our European survey, the top cited barriers to investment are regulatory burdens, regulatory uncertainty, and other concerns around possible risks.

GLOBAL TRENDS AND EUROPEAN CHALLENGES: BETWEEN OPTIMISM AND ANXIETY

55%
Share of executives who see technological change as positive for business

In our survey we asked European business leaders for their perspective on global forces and trends potentially affecting business, from ageing to rising populism, and on their views of the European Union. For the trends, business leaders were eager to embrace digitisation and automation, with 55 percent of executives saying that advancing technologies will have a positive impact on their business. They also broadly welcomed the rise of emerging economies. However, between 35 and 40 percent of firms surveyed see rising populism, geopolitical disruption, and rising inequality as having a negative impact on their business. One-third also view any country beyond Britain leaving the EU as a negative for business, although one in four says the impact could be positive.

Most European businesses see benefits from EU membership and want "more Europe"

Fifty-four percent of European companies surveyed think the EU has had a positive impact on their business, and the better a company's expected future revenue growth, the stronger the approval rating. The benefits of EU membership most cited by companies are maintaining peace and security, enabling ease of business, and providing free market access.

Some 57 percent of respondents said they have received benefits from the single market for goods and for services, while about 55 percent have seen benefits from the free movement of people that is enshrined in the single market, and from a unified currency. Asked about the challenges of EU membership, companies cited the loss of national sovereignty (19 percent) and complex and burdensome regulations and processes (13 percent).

The responses from British companies about the impact of the EU on their business were on the whole less favourable, although not significantly more negative than in the other countries we surveyed. For example, the 42 percent of UK business respondents saying the EU's impact on their business had been "moderately positive" or "very positive", was not far behind the 46 percent of Italian companies that felt the same way. Indeed, a slightly larger proportion of Italian firms said the EU's effect had been negative (22 percent vs. 21 percent).

The results of our business survey are in line with views expressed by consumers: in one recent survey, some 70 percent of the German and Spanish public wanted more political and economic integration, as did 50 percent of French respondents, while less than half the Britons polled did.[7]

Across the six countries we surveyed, 60 percent of businesses say they want "more Europe", including more centralised authority and spending—a proportion that rises to

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[7] Catherine de Vries and Isabell Hoffmann, *Supportive but wary: How Europeans feel about the EU 60 years after the Treaty of Rome*, Bertelsmann Stiftung, January 2017.

65 percent when the replies from UK businesses are excluded.[8] However, some of the policy desires contradict one another, and no one size fits all. Our survey also suggests that while many European businesses are supportive of EU Commission policy priorities, they have more mixed views about the way these policies have been executed.

European businesses see the EU remaining intact, but think the Eurozone could shrink or even disband

Some of the biggest uncertainties for European business are related to the future of the European Union itself. Now that the countdown for Britain's exit from the European Union has officially begun, at a time of economic and political divergence among the remaining 27 member states, what will be the future shape and direction of the EU itself? We presented companies with five possible scenarios and asked them which they thought were most likely to happen, and which they thought would be best for their businesses. The results highlight the gulf between hopes and expectations: nearly 85 percent of surveyed companies say they think the EU will remain intact, and just under half anticipate that the status quo will prevail or that greater integration will take place. However, just over half expect the Eurozone to shrink or disband in the years ahead.

The scenarios we suggested were:

- **Increased integration.** "EU responsibilities expansion: Both the EU and the Eurozone maintain their current structure, with core countries remaining in place (with only the UK leaving the EU). The EU gains new responsibilities and sets up new institutions such as common defence, external border protection, and partially common fiscal policy".

- **Maintaining the status quo.** "EU and Eurozone remain intact with current responsibilities: Both the EU and the Eurozone maintain their current structure and levels of responsibility, with core countries remaining in place (with only the UK leaving the EU)".

- **Eurozone shrinks.** "Eurozone shrinks, with the EU intact: Peripheral economies exit the Eurozone and return to their national currencies, while core countries retain the euro. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU)".

- **Eurozone breaks up.** "Eurozone break-up, with the EU intact: Core countries exit the Eurozone, and all countries return to their national currencies. The EU maintains its current structure and levels of responsibility (with only the UK leaving the EU)".

- **EU and Eurozone disband.** "EU and Eurozone erosion: Core countries exit both blocks, and both the EU and the Eurozone disband completely".

Exhibit E2 shows the results from business leaders when we asked them what they expect to happen. About one in three expects the Eurozone to break up or shrink, and 16 percent even expect the European Union to disband, along with the Eurozone. It also shows the survey results when we asked the business leaders what they thought would be best for their businesses. A larger proportion—almost 60 percent—want the EU and the Eurozone to integrate more closely or maintain the status quo, up from 49 percent who expect that to happen, while the share of those hoping the Eurozone will shrink or disband falls to 28 percent, and only 12 percent say they want the European Union itself to disband.

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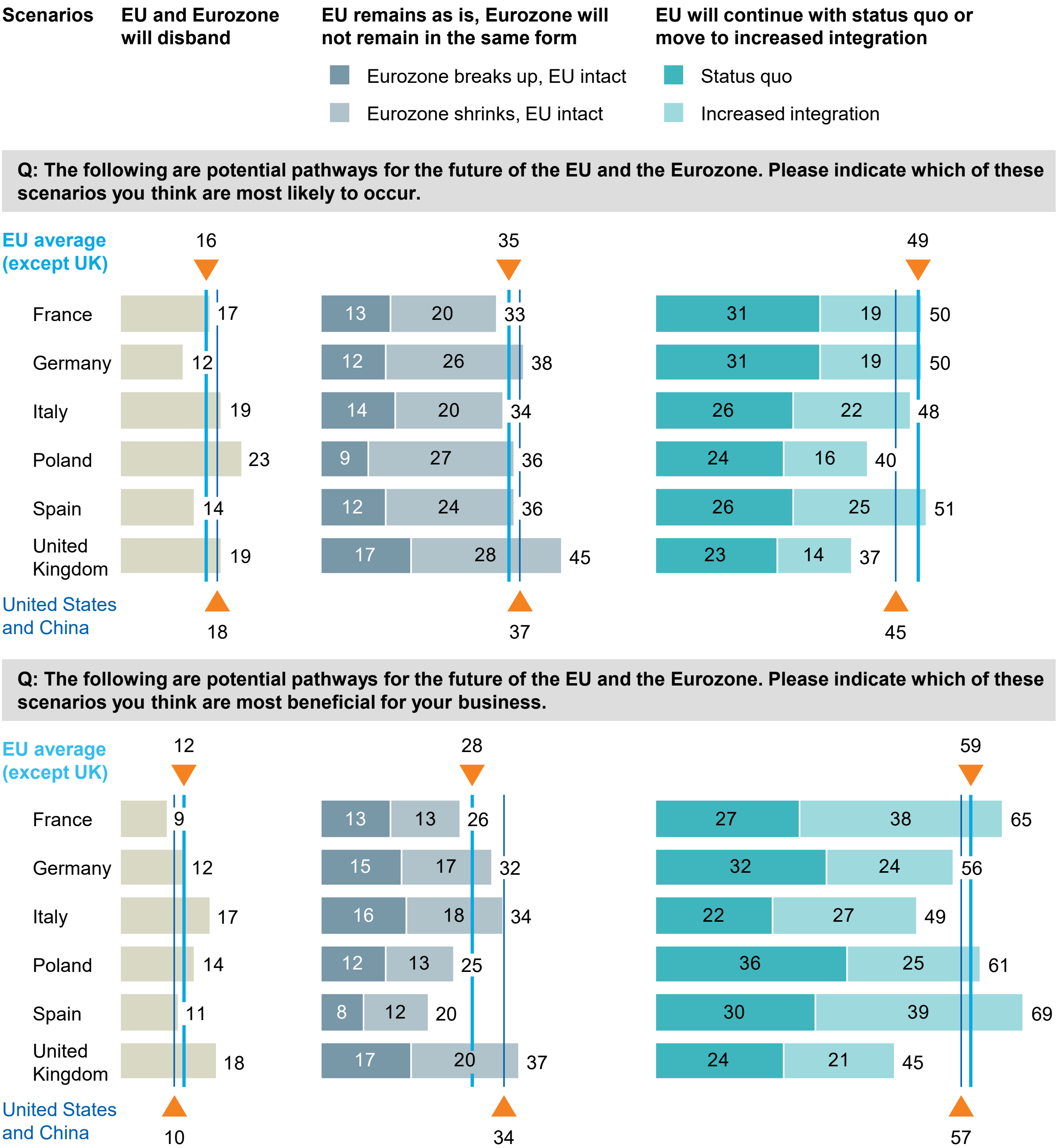
8 The questions about "more Europe" in our survey referred to more policies set and enforced at EU level; "less Europe" referred to more policies being set by individual member states. Follow-up questions then probed views on specific policies, including on trade, migration, and financial and monetary measures.

Exhibit E2

Respondents from all countries have split expectations for the future of the EU

Expected and most beneficial scenarios for Europe
% of EU respondents



NOTE: All top-ranked scenarios. Numbers may not sum due to rounding.

SOURCE: MGI Business Survey, 2017; McKinsey Global Institute analysis

€1T

Potential boost to EU GDP from restoring investment to pre-crisis level

STRENGTHENING CONFIDENCE AND STABILITY

How can Europe further strengthen confidence within the business community and thereby boost investment? Our 2015 report on Europe's economic prospects provided detailed suggestions for ways to close the output gap, return to sustained 2 to 3 percent GDP growth, and create millions of jobs through a combination of national structural reforms and pan-European measures to stimulate demand.[9] A subsequent prize essay contest we held in 2016 sought to crowdsource ways to implement reforms so that they would be palatable to European policy makers and the public alike.[10] In our concluding section, we mainly take our cue from European businesses themselves, large and small, successful and struggling, across the six EU nations we surveyed, with a discussion of three paths forward: further stimulating recovery and investment; addressing key areas of fragility; and developing a new narrative for the EU.

Further stimulating recovery and investment

We used McKinsey & Company's Global Growth Model to test scenarios of what could happen to the European economy if investment were to return more strongly.[11] Our analysis found that EU GDP could rise by 5.7 percent in 2030, or the equivalent of an additional €1 trillion for the EU economy.[12] For context, that would be approximately equivalent to the combined GDP of the Czech Republic, Denmark, and Sweden.[13]

Our survey provided pointers on what policy options businesses would prioritise to achieve higher investment. Respondents are divided: more accommodative monetary and fiscal policy (23 percent) and additional economic stimulus (16 percent) were two of the top three most commonly cited ways to increase investment, while lower taxes and less spending by EU or national governments was the second most frequently cited (21 percent of respondents).

Some 80 percent of respondents also see a case for raising public investment—notably in energy and green investment, information and communications technology, and R&D—although the majority would not be prepared to pay higher taxes to finance those investment.

Addressing key areas of fragility

A number of key measures will need to be taken to address the lingering areas of fragility that are weighing on the corporate environment. They include:

- **Solidifying financial stability.** The EU has put in place the first phases of a banking union that include provisions for recapitalising struggling banks and "bail-ins" for those that are failing. However, the continued high level of non-performing loans in a few countries suggests more strenuous action may be needed to clean up bank balance sheets proactively—and restore investor confidence—be it at the national or at the European level. Difficult decisions will also be needed to defuse concerns about elevated sovereign debt levels.

- **Laying out and communicating a credible plan for the future of the Eurozone.** Given the significant proportion of business leaders who doubt the Eurozone's durability in its current form, EU and national government leaders will need to sketch out—and find the political consensus on—a plan that resolves the unstable equilibrium between

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9 *A window of opportunity for Europe*, McKinsey Global Institute, June 2015.

10 *An opportunity for Europe? The McKinsey Global Institute 2016 Europe Essay Prize: Key themes and winning entries*, McKinsey Global Institute, October 2016.

11 McKinsey's proprietary Global Growth Model is an advanced macroeconomic tool that provides growth and GDP outlooks for different economic scenarios. For details, see *Shifting tides: Global economic scenarios for 2015–25*, McKinsey & Company, September 2015.

12 In 2010 prices, based on raising investment to pre-crisis levels by 2020.

13 AMECO.

monetary interdependence and fiscal and economic policy sovereignty, which has led to moral hazard and unaligned policy mixes.

- **Finding answers to global political challenges.** Most businesses see global trends as creating more risk and headwind than benefits. Political debate around migration and refugees and geopolitical tensions that are fuelling a rise of populism stand out as influencing businesses' perceptions about the EU and its benefits. Some of these issues are not within the control of EU institutions, especially without consensus among member governments, which has proved elusive on some key topics. Nonetheless, if the EU were to come up with solid pan-European answers to some of these issues, our research suggests that support from companies for "more Europe" and confidence in the EU could benefit.

A new narrative for Europe going forward

Successfully addressing these fragilities is no mean feat, and will require bold action by the EU and EU member states' elected leaders. Many individual steps have successfully been taken to "muddle through" and help overcome—for now—the worst financial and economic crisis in the EU's existence. But they have not put an end to uncertainty. The EU will need to demonstrate that the forces in favour of cooperation are stronger than those opposing it.

One way to move ahead and rally support for bolder moves forward would be to work on creating a new narrative for the European Union for the coming years. The EU's founding fathers did this convincingly in 1957 in the Treaty of Rome, outlining a clear and compelling vision of peace and prosperity and "ever closer union" (even if turning that union into practical steps proved highly complex already in the early years). The creation of the single market starting in the mid-1980s was another moment of reinvention, as was the momentous step towards establishing a single currency, which set off a decade of moves to bring about closer economic convergence. Today, the EU needs a new vision, one based on realism about the present, but also aspirations for the future.

•••

For all the challenges it faces today, the EU is no stranger to adversity. Since its origins, it has had to tackle a seemingly endless succession of crises and threats to its integrity, from France's "empty chair" policy in the 1960s in a dispute with Germany over agriculture, to the global energy crisis in the 1970s, the complex restructuring of its coal and steel industries in the 1980s, and waves of currency turbulence in the 1990s before—and after—the creation of the euro. While the forces arrayed on the horizon, and increasingly in its midst, may seem formidable today, and are feeding some pessimism within the business community, resilience has been one of the EU's enduring strengths, and could prove invaluable again in today's turbulent world. But resilience needs a goal that can be articulated, and that can inspire a return to confidence. As our survey of European business indicates, that restoration of faith is needed.

A greenhouse in Almería, Spain

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