NextGenerationEU And The Capital Markets Union Can Boost Europe's Dwindling Productivity

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This report does not constitute a rating action.

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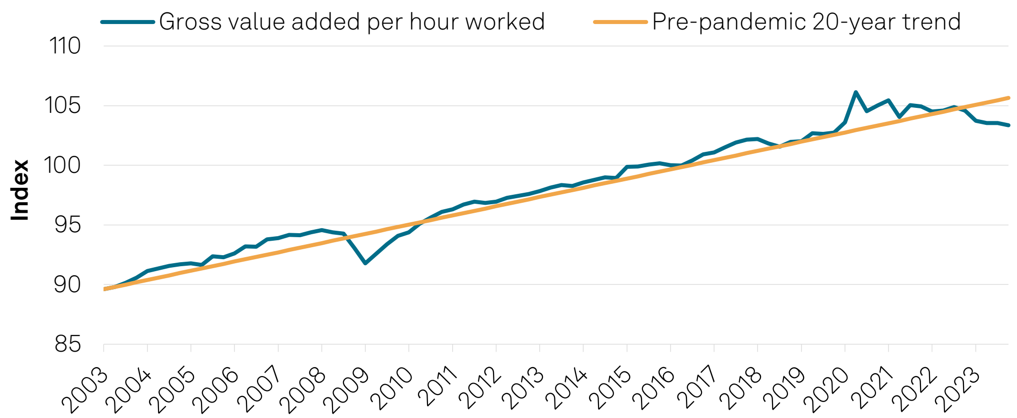
Chart 1

GDP per hour worked has fallen below the pre-pandemic long-term trend

Eurozone total economy



Source: S&P Global Ratings.

Even though Europe has avoided a recession and almost reached full employment, it's not out of the woods yet. An unusual decline in productivity casts a dark cloud over the European economy. GDP per hour worked, which fell below the long-term trend and contracted by 1% in 2023 (see chart 1), decreased in four of the eurozone's five largest economies, including the Netherlands, France, Germany, and Italy.

The decline in labor productivity--which affected several sectors, such as industry, construction, transportation, retail and wholesale services, financial services, and public services--is even more surprising as it coincides with business investments that are historically high relative to GDP. In other words, it may not just be labor productivity that's declining but also total factor productivity.

Economists Fall Into Two Camps

It's going to be ok

Especially in France, where the productivity drop has been most pronounced (see "Comment expliquer les pertes de productivité observées en France depuis la période pré-Covid?," Banque de France, published on March 22, 2024), economists have come up with different reasons to explain the significant productivity slowdown. Those with a slightly more positive outlook suggest that it's reversible, with productivity resuming to rise once the double shock of the COVID-19 pandemic and the energy crisis has abated. They argue that the productivity drop reflects an:

- Increase in the employment rate that is linked to public policies, which aim to promote apprenticeships and the regularization of informal employment;
- Economic shift toward services, especially personal services, after the pandemic; and
- Increase in absenteeism and sick leave after the lockdowns, recruitment problems, which lead companies to hoard labor, and rising energy costs in the industry sector.

Is it though?

Economists that err on the pessimistic side, however, believe that permanent factors will hamper a rebound in productivity. For example, the Bundesbank considers that unfavorable demographics impair productivity as it reduces the number of new companies (see "Monthly Report – March 2024," Bundesbank, published on March 19, 2024). There's nothing we can do about it: Europe is ageing. KfW, the German development bank, pointed out that the average age of Mittelstand entrepreneurs increased to 53 in 2022, from 45 in 2002, and that only 36% of the oldest entrepreneurs are planning investments, compared with 57% of the youngest (see "A boost in investment for the transformation – what exactly is needed?," KfW Research, published on Nov. 2, 2022).

Additionally, it's not guaranteed that absenteeism, sick leaves, or production costs, particularly energy costs, will return to pre-crisis levels in the short term. European Central Bank (ECB) economists expect GDP per capita will rebound by 0.1% this year and 1.2% in 2025, which is not enough to bring productivity back on track by the end of 2025. Sustained below-trend productivity could confront companies with a dilemma that either sees them lay off workers to reduce labor costs or raise selling prices to maintain margins. This would result in unemployment or inflation. Sustained low productivity could also force governments to consolidate their budgets even more to meet their debt-to-GDP targets.

Hold Your Horses

That said, such pessimism might be premature. Data suggests that productivity has picked up at the start of 2024. The production-to-employment ratio in the S&P Purchasing Managers' Index rose by 2 percentage points in the first quarter of the year, while the record trade surplus that the eurozone recorded in January suggests that the European economy is gradually recovering from the terms-of-trade shock.

And then there's AI. It may well be able to solve the problem of low productivity in Europe one day but we shouldn't get our hopes up just yet. It will take time for AI to gain a foothold in work processes and workers' daily routines. Even though AI seems to be ubiquitous these days, the growth figures, especially in Europe, don't match the hype. The effect of AI on employment, and even more so on productivity, remains uncertain (see "Les enjeux économiques de l'intelligence artificielle," Trésor-Eco, published on April 2, 2024).

Time To Refocus

Instead of waiting for AI to save the day, the EU should complete the NextGenerationEU plan to tackle the productivity drop. The plan has fallen behind schedule, with the European Investment Bank (EIB) estimating that only 44% of the milestones and targets set for the third quarter of 2023 have been met (see "EIB Investment Report 2023/2024," European Investment Bank, published on Feb. 7, 2024). This resulted in a €127 billion spending gap and a 0.7% decline in the EU's GDP growth in 2023.

Another solution to the productivity problem could come from the Capital Markets Union, which has the potential to stimulate investments in growth (see "Statement by the ECB Governing Council on advancing the Capital Markets Union," European Central Bank, published on March 7, 2024, and "Statement of the Eurogroup in inclusive format on the future of Capital Markets Union," European Council, published on March 11, 2024).

Needless to say, a significant rebound in productivity only has benefits. It would help mitigate the effects of the material rise in unit labor costs and inflation, open the door to ECB rate cuts, and make recently created jobs more sustainable.