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Accelerating Europe: Competitiveness for a new era

Turbulent times have highlighted new fragilities in Europe's economies. Addressing them could be the catalyst for a new wave of competitiveness and growth.

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At a glance

- Europe is one of the world's leading regions in terms of sustainability and inclusion. But its per capita income remains 27 percent lower than in the United States. Closing that prosperity gap depends on accelerating growth by becoming more globally competitive.
- We have entered a new geo-economic era that makes competitiveness more urgent and more challenging for Europe in seven arenas that matter for the future, from energy to technology and supply chains.
- Shoring up competitiveness in these areas is critical. We estimate that about €500 billion to €1 trillion of value added could be at stake annually by 2030. For perspective, this is three to six times the incremental annual investment needed to achieve net zero. Addressing these issues will determine the region's ability to unlock future growth while preserving its unrivaled sustainability and inclusion model.
- To thrive in this new era, Europe needs an integrated agenda for competitiveness, with business leaders and policy makers working hand in hand toward ambitious new goals. Critical choices and potentially uneasy trade-offs lie ahead.
- Sharply higher goals could include: doubling innovation-related private and public spending in areas such as artificial intelligence, with a differentiated approach for adoption vs. development; doubling the average scale of Europe's leading firms, perhaps by introducing a "28th regime" of common business rules; cutting power and gas prices in half by developing and accessing new sources of energy; accelerating reskilling, labor redeployment, and talent attraction to enable technology adoption; adding \$400 billion of annual corporate investment and doubling the inflow of greenfield FDI; securing access to critical materials; and rethinking regulation and industrial policy.

Europe is a global leader on sustainability and inclusion but needs to revive its competitiveness

Sustainability, inclusion, and growth reinforce—or undermine—one another. Together these three elements can deliver a prosperous and green future.¹ Thus far, Europe has a strong record on the first two (Exhibit 1). It leads the world in reducing carbon emissions. It also leads on most dimensions of economic inclusion and social progress, including income inequality and life expectancy.

But Europe has not fared so well on the growth part of this equation. Europe's per capita GDP (at purchasing power parity, or PPP) was 27 percent

below that of the United States in 2022.² About half of this gap reflects productivity differences, while the other half is due to societal choices to work fewer hours per capita across a lifetime.

Unless Europe can reenergize growth, its leading position on sustainability and inclusion could be compromised, eroding Europeans' standard of living. Accelerating growth requires becoming more globally competitive, even in the face of mounting pressures.

This article, part of an ongoing research series by MGI, presents a fresh perspective on these issues. It delves into the factors that will define

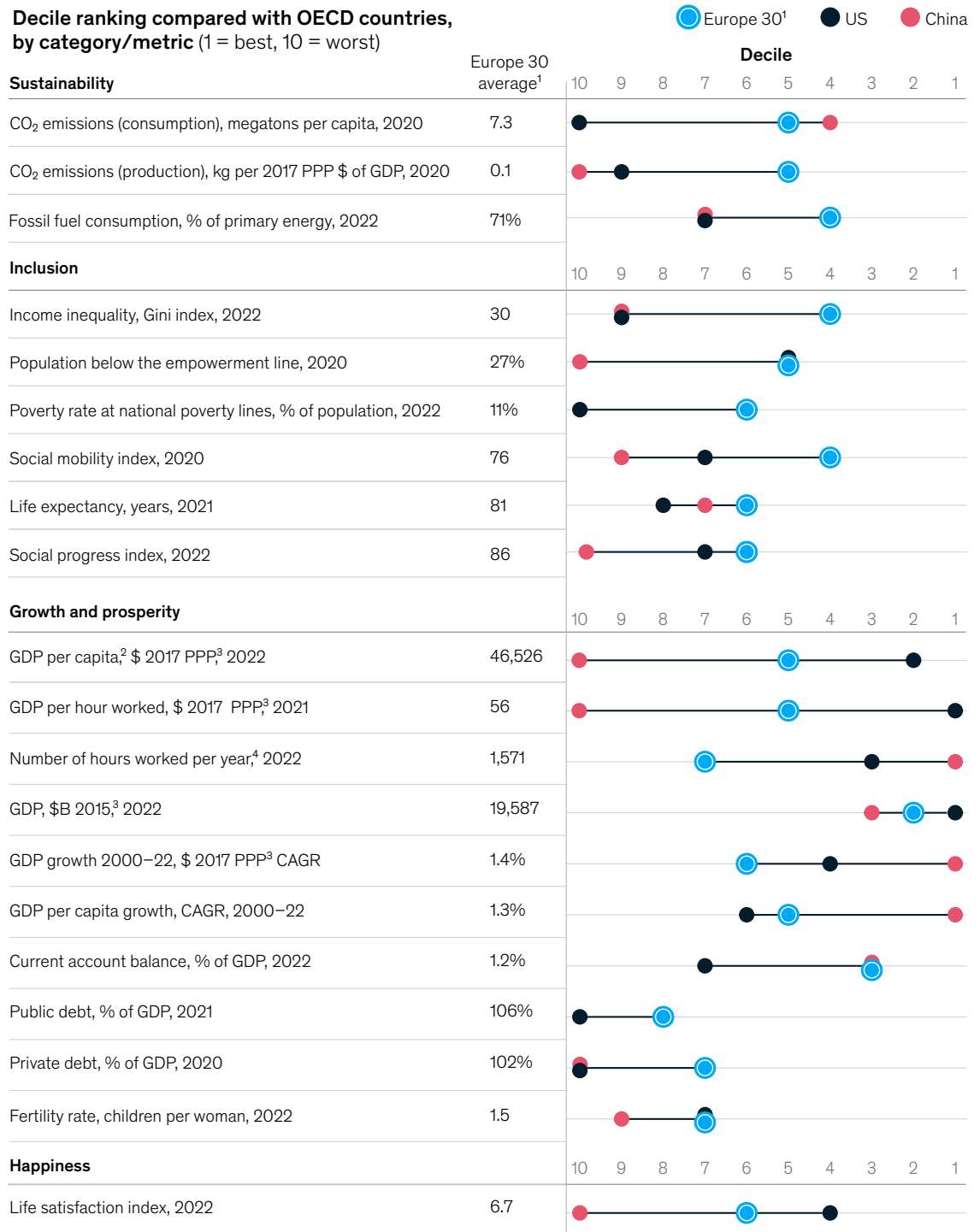
¹ *From poverty to empowerment: Raising the bar for sustainable and inclusive growth*, McKinsey Global Institute, September 2023.

² OECD.

Exhibit 1

Europe leads on sustainability and inclusion, but lags behind on growth and prosperity.

Decile ranking compared with OECD countries, by category/metric (1 = best, 10 = worst)



¹Europe 30 includes the European Union plus Norway, Switzerland, and the United Kingdom. ²Excluding Ireland and Luxembourg. ³World Bank and OECD. ⁴EU-27.

Source: Our World in Data; World Bank; Eurostat; World Economic Forum; Socialprogress.org; OECD; McKinsey Global Institute analysis

competitiveness and economic performance in the years ahead across 30 European economies (the 27 member states of the European Union (EU) plus Norway, Switzerland, and the United Kingdom. We deliberately steer away from examining the governance structures of the EU, choosing instead to focus on the economic dynamics. In the months ahead, we will publish a comprehensive report exploring these themes in greater depth.

A new geo-economic era disrupts Europe's economic model

Europe's competitive strength has long been based on industrial excellence: its continuous innovation of industrial products and processes; the world's most sophisticated and connected supply chains; exceptional stability and broad-based skills in the workforce; affordable energy; and widely available low- and medium-risk capital.

Europe is home to iconic high-growth, high-profitability champions in almost all sectors. But even before new challenges came into the frame, signs were beginning to flash that its competitiveness was eroding. In aggregate, Europe's largest companies already trailed their US counterparts in multiple measures. From 2015 to 2022, they spent roughly half as much on R&D as a share of revenue and invested less (even adjusting for their smaller size). In turn, they grew at two-thirds the pace and their return on capital was four percentage points lower. In 2022, total market capitalization was 2.5 times higher in the United States than in Europe, and the scale of US firms was almost double (Exhibit 2). The issues appear to be systemic rather than cyclical.

Now, new fragilities are coming to light, and Europe faces even more pressure on seven fronts that will define future competitiveness:

1. ***Innovation: Accelerating tech disruption challenges Europe's historical industrial model.*** Disruption is challenging established sectors that are highly exposed to global competition; these include areas such as automotive, aerospace, and pharmaceuticals in which Europe has had a strong record as an industrial innovator. The competitive edge now increasingly comes from the application of ten frontier technologies. But our past research has found that Europe leads on only two of them (next-gen materials and clean technologies), while lagging in areas such as artificial intelligence (AI) and quantum computing.³ Take generative AI (gen AI) as just one example. ChatGPT reached 100 million new users in just two months—the fastest any technology has ever reached this milestone.⁴ Yet in 2023, Europe invested \$1.7 billion in gen AI, compared with \$23 billion of US venture capital and private equity that went into these technologies.⁵ As of November 2023, 35 gen AI companies had scaled up in the United States, but only three in Europe.⁶
2. ***Energy: Europe's import dependencies have been exposed, particularly hitting energy-intensive industries.*** For decades, European industry benefited from access to affordable energy, but Russia's invasion of Ukraine, which cut off access to Russian gas, starkly highlighted the dangers of Europe's dependency on overly concentrated energy imports. In 2021, Europe imported 55 percent of the energy it needed. By contrast, China imported 25 percent, while the United States was a net exporter of energy.⁷ Moreover, Europe obtained its energy from a limited number of suppliers; one-quarter of its imports came from fewer than three countries in 2021.⁸ Industrial power and gas prices doubled

³ *Securing Europe's competitiveness: Addressing its technology gap*, McKinsey Global Institute, September 2022.

⁴ Krystal Hu, "ChatGPT sets record for fastest-growing user base - analyst note," Reuters, February 2, 2023.

⁵ PitchBook.

⁶ Privately held companies with a valuation of \$1 billion or more; PitchBook.

⁷ *EU imports of energy products*, Eurostat, December 2023; and *U.S. energy facts explained*, US Energy Information Administration, August 2023.

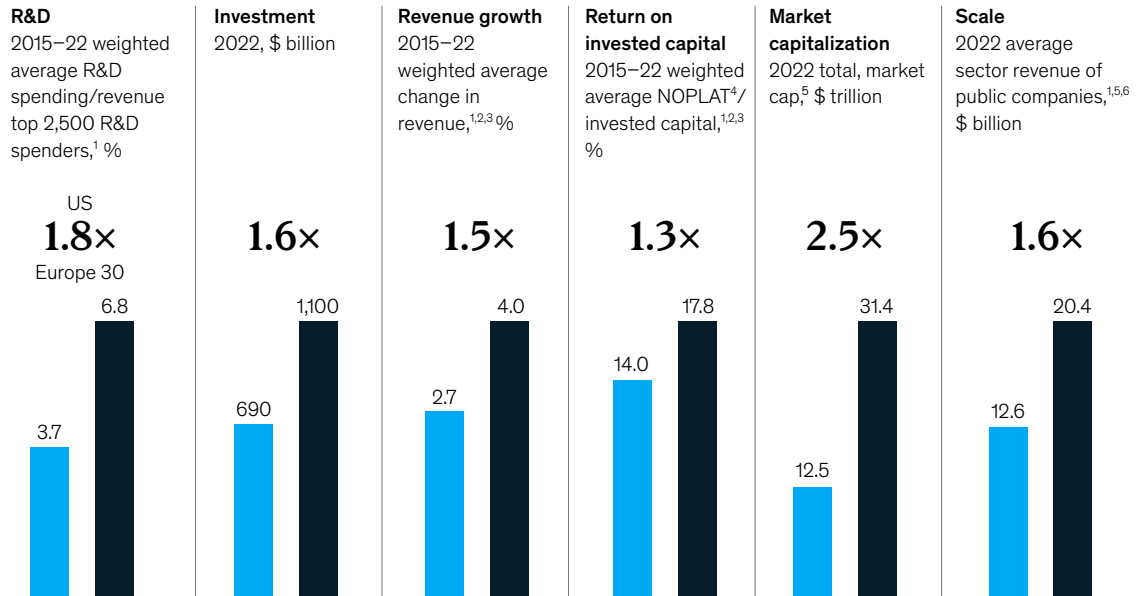
⁸ McKinsey Global Trade Explorer; and *Global flows: The complication of concentration in global trade*, McKinsey Global Institute, January 2023.

Exhibit 2

European corporations lag on scale and performance.

Public companies with revenue of >\$1 billion in Europe 30 vs US

■ Europe 30 ■ US



¹Excludes financial services and real estate companies. ²Inflation adjusted (2014 as base year) based on eurozone (Europe 30 sample) and US inflation (US sample); US data in \$, Europe data in €. ³Excludes companies without complete revenue, net operating profit less adjusted taxes (NOPLAT), capital expenditure, or invested capital time series in 2014–22. ⁴Net operating profit less adjusted taxes. ⁵End of 2022 for public companies with >\$1 billion available market capitalization and revenue. ⁶Average based on in-sector revenue.
Source: McKinsey Corporate Performance Analytics; S&P Global; Eurostat; IMF; McKinsey Global Institute analysis

McKinsey & Company

between the first half of 2020 and the second half of 2022 as Europe sought to replace Russian gas imports with a combination of efficiency measures and liquefied natural gas imports.⁹

3. **Capital: The rising cost of capital exposes Europe's lower returns and investment gaps.** For many years, interest rates have been low, and capital has been abundant. Under these conditions, there was less downside to European firms delivering about 20 percent less return on capital than US companies. But rates

have increased at a time when significant capital is needed for the net-zero transition and to support innovation. European corporations may need to reevaluate their investment portfolios.

Europe has had a persistent gap with the United States in net investment. It attracted \$90 billion of greenfield foreign direct investment (FDI) in the first three quarters of 2023, while the United States drew \$300 billion; this widened a longstanding historical gap to one percentage point of GDP.¹⁰ Capital expenditures by large European companies declined slightly between

⁹ "Electricity price statistics," Eurostat, accessed December 26, 2023; and "Natural gas price statistics," Eurostat, accessed December 26, 2023.

¹⁰ World Bank and fDi Markets (excludes intra-Europe 30 FDI).

2015 and 2022 after adjusting for inflation, while investment by their US counterparts grew by 30 percent due to rapid investment in the tech sector. By the end of that period, investments by large US corporations were 60 percent higher than those of their European peers. Last, European capital markets are not as deep as those in the United States. In 2022, their private equity assets under management were 50 percent lower and venture capital financing was 75 percent lower.¹¹

4. ***Supply chains: Rising geopolitical tensions are affecting Europe's historical trade patterns.*** Europe has long been outward looking on trade. According to International Monetary Fund data, Europe is 30 percent and 70 percent more open than the United States and China, respectively, and has 30 percent and 20 percent fewer trade restrictions.¹² Yet geopolitical turbulence is bleeding over into trade relations, giving rise to more disputes and prompting companies to reconfigure supply chains.¹³ The number of new trade and foreign direct investment (FDI) restrictions affecting EU countries almost tripled between 2012 and 2022.¹⁴ For instance, China, which accounts for 80 percent of the global supply of graphite (a key component in electric vehicle batteries), restricted exports of the material in December 2023.¹⁵ Disruptions to supply chains, particularly for critical goods such as semiconductors and minerals, could bite hard. In 2021, the United States held 35 percent of the semiconductor value chain, while Europe had only 10 percent.¹⁶ Europe is home to 2 percent of global mining and processing of

ten critical materials, while China conducts 14 percent.¹⁷

5. ***Talent: Making smoother and faster worker transitions is challenging with Europe's labor market rules.*** A new labor market challenge is emerging. Where the region once had an abundance of workers to fill positions, labor markets have become tight in many European economies. The job vacancy rate in the eurozone stood at an all-time high of 3 percent in September 2023.¹⁸

Looking ahead, automation and the net-zero transition are likely to set off some of the largest labor market shifts in history. The latter alone could create 11 million jobs but eliminate six million others through 2050 in Europe.¹⁹ Europe's current labor market structure will make these shifts more difficult to manage. For instance, job switching is twice as common in the United States as in the EU.²⁰ Europe has also lost some focus on the skills of the future: In 2021, the EU had about 20 percent fewer STEM graduates per thousand inhabitants than the United States and 45 percent fewer than South Korea.²¹ Demographic headwinds will pose another structural challenge: due to aging and low birth rates, the EU's working-age population is expected to decrease from 64 to 58 percent of the total population by 2040.²²

6. ***Size: Scale matters more than ever, but Europe remains fragmented.*** Europe's integrated economy is comparable with the size of the US and Chinese economies (about \$21 trillion versus \$25 trillion and \$18 trillion, respectively,

¹¹ Preqin.

¹² Chikako Baba et al., *Geoeconomic fragmentation: What's at stake for the EU*, International Monetary Fund working paper number 23/245, November 2023.

¹³ Pinelopi K. Goldberg and Tristan Reed, "Growing threats to global trade," *Finance & Development*, International Monetary Fund, June 2023; and *Geopolitics and the geometry of global trade*, McKinsey Global Institute, January 2024.

¹⁴ Chikako Baba et al., *Geoeconomic fragmentation: What's at stake for the EU*, International Monetary Fund working paper number 23/245, November 2023.

¹⁵ *Graphite facts*, Government of Canada; and "China, world's top graphite producer, tightens exports of key battery material," Reuters, October 20, 2023.

¹⁶ *State of the U.S. semiconductor industry*, Semiconductor Industry Association, 2022.

¹⁷ International Energy Agency.

¹⁸ Eurostat and Haver Analytics.

¹⁹ *How the European Union could achieve net-zero emissions at net-zero cost*, McKinsey Sustainability, December 2020.

²⁰ Orsetta Causa, Nhung Luu, and Michael Abendschein, *Labor market transitions across OECD countries: Stylised facts*, OECD Economics Department working paper number 1692, December 2021.

²¹ "Going Digital Project," OECD, accessed December 26, 2023.

²² "Age dependency ratio (% of working-age population)," World Bank, accessed December 26, 2023.

as of 2022).²³ Smaller countries have appeared to benefit from being part of a powerful bloc.²⁴ But it has been more difficult for European corporations to scale, which matters at a time when many markets have winner-take-most dynamics. In 2022, the combined revenue of all listed companies with more than \$1 billion in revenue was \$12 trillion in Europe, compared with \$18 trillion in the United States.²⁵ For companies in telecommunications, airlines, and defense that operate on a national rather than European scale, this translates into 30 percent less revenue per company than US peers. In 2022, the market-to-book ratio of top European companies was 60 percent that of their US counterparts—meaning fewer available financial resources and a higher chance of being M&A prey. Finally, economies need to have the ability to generate the large firms of the future. While European companies such as Northvolt, Doctolib, and Bolt have scaled up rapidly in recent years, Europe is currently home to 13 percent of the world's unicorns (on par with China), while the United States has produced 50 percent.²⁶

7. ***Competition and markets: Regulation and industrial policy are becoming stronger tools of competitiveness again worldwide.*** Europe has benefited from its adherence to open trade and its limits on state aid support to drive competition.²⁷ But the world is changing. Many

governments have reintroduced or increased tariffs as well as engaging in more active industrial policy. The US Inflation Reduction Act, for instance, provides nearly \$400 billion of energy and climate funding, most in the form of tax credits; to claim many of those credits, manufacturing must occur on US soil. China funds industrial policy to the tune of 2 to 5 percent of GDP, while the EU averages about 1 percent.²⁸ Europe has taken some policy steps, such as the 2021 Recovery and Resilience Facility, which devotes about €250 billion out of €723 billion to support the green transition with funds and loans. It was followed by the Green Deal Industrial Plan and the EU Chips Act in 2023.²⁹ State aid rules have also been overhauled to help fund decarbonization. But the global playing field remains fluid.

These seven priority areas will likely define European competitiveness in the new era. Looking across them, we estimate that about €500 billion to €1 trillion of value added could be at stake annually by 2030.³⁰ To put that in perspective, this is in the range of 5 to 10 percent of Europe's 2022 GDP in private industries excluding real estate, three to six times the incremental annual investment needed to achieve net zero, or 12 to 24 percent of Europe's social protection expenditure in 2022.³¹ To safeguard its future growth and prosperity—as well as the unrivaled sustainability and inclusion

²³ World Bank.

²⁴ David Skilling, *How are the small countries doing?* Global Brief, 2016.

²⁵ McKinsey & Company Corporate Performance Analytics. Financial services companies are excluded from both the Europe 30 and the United States.

²⁶ "Unicorns," Dealroom, accessed December 26, 2023.

²⁷ Thomas Philippon, *The great reversal: How America gave up on free markets*, Belknap Press, 2019; and Philippe Aghion, Céline Antonin, and Simon Bunel, *The power of creative destruction: Economic upheaval and the wealth of nations*, Belknap Press, 2021.

²⁸ *China's industrial policy*, CCA-SCCEI Roundtable Summary report, Asia Society Policy Institute, January 2023; and Michael Landesmann and Roman Stöllinger, *The European Union's industrial policy: What are the main challenges?* Vienna Institute for International Economic Studies, January 2020.

²⁹ "NextGenerationEU," European Union, accessed December 26, 2023.

³⁰ We triangulated the value at stake for Europe based on several approaches. First, we aggregate analysts' consensus estimates for the revenue and profit growth of large European firms compared with their US peers in each sector, finding a gap in this order of magnitude. Second, we corroborate these findings with sector outlook reports from industry associations as well as our own first-order and expert estimates of the shocks to particularly exposed sectors. Third, we examine GDP projections, particularly in highly traded sectors, to compare Europe to the United States and other regions. Finally, for those traded sectors, we expand the range by calculating cascading or multiplier effects. This analysis provides an order of magnitude for the corporate value at stake. But note that this is not a precise GDP estimate. The link between corporate value and GDP is complex, not least as multinational firms have presence and contribute to GDP around the world; it is hard to judge ex ante what will emerge in the long run if some sectors and firms come under pressure; and the use of multipliers (for the upper range) can be subject to debate. The following sources were used in the analysis and applied to 2022 GDP: Capital IQ, Cefic, European Commission, International Civil Aviation Organization, OECD, Oxford Economics, Statista, US Department of Agriculture, and the World Bank.

³¹ The net-zero comparison is based on an estimate of €180 billion average annual incremental investment needed for the EU to reach net zero by 2050; see *How the European Union could achieve net-zero emissions at net-zero cost*, McKinsey & Company, December 2020. The social protection comparison is based on expenditures for old age, sickness and social protection healthcare, disability, survivors, family and children, unemployment, and housing, derived from Oxford Economics and the European Commission.

delivered thus far—Europe cannot afford to risk losing ground.

Making Europe more competitive for the future involves critical choices and higher goals

Europe remains ambitious, but what will it take to meet the mounting challenges? Some of the groundwork has been laid, with multiple recent initiatives meant to sharpen its competitive edge. But capturing the full potential value at stake requires focusing on all seven dimensions outlined above. The analyses and benchmarks throughout this article suggest that goals can and should be set far higher (Exhibit 3). But strategic choices have to be made, many involving uneasy tradeoffs.

Within an effective policy framework, corporations can play vital roles: investing strategically in pivotal areas, creating and supporting growth-oriented ecosystems, nurturing a skilled talent pool, and forming partnerships or joint ventures with industry peers or across industries. Business leaders will need to look beyond their immediate interests and the boundaries of their industries, collaborating with each other and with policy makers to tackle any systemic barriers and gear up for long-term competitiveness.

1. Innovation: Can disruptive technologies such as AI be scaled up by doubling corporate R&D budgets?

Europe could aim to double its corporate R&D budgets to lay the foundations for future growth, pulling ahead of US levels. This would involve going from 3.7 percent of revenue today to 7.4 percent (vs. 6.8 percent for the United States today). Investing strategically could enable Europe to win a fair share of new arenas of competition, such as autonomous driving or AI in healthcare.

In AI, for instance, Europe can adopt a differentiated approach for technology adoption

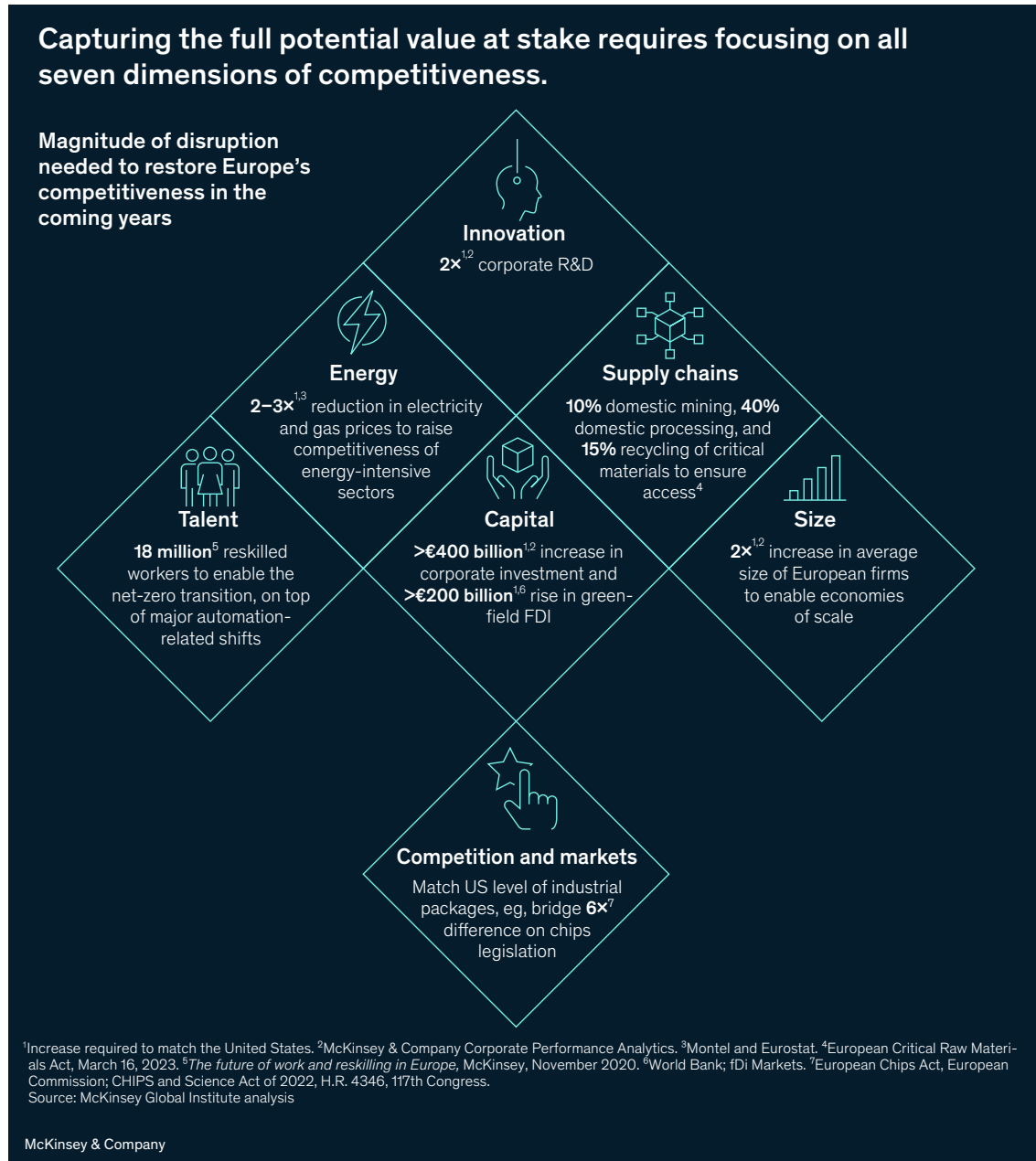
vs. development. For either to succeed, Europe will need its regulatory framework to allow for continuous experimentation, attract talent, and ultimately incentivize the founding, retention, and attraction of tech companies. On adoption, Europe has a chance to go “all in” with its natural strengths: a sophisticated industrial base, an edge in design, and access to structured data. It’s also worth noting that for Europe, gen AI itself can be a unique tool for partially overcoming some of the negative aspects of fragmentation such as differences in languages and legacy IT architectures. When it comes to AI development, the strategic play would be making big bets only where Europe is well-positioned to win. For example, since ASML is based in Europe and holds a unique position in the global semiconductor value chain, working on specialized chips is a natural adjacency. Europe could also focus on developing specialized foundational models, new forms of banking (including blockchain), or B2B applications. Whether in AI or other frontier technologies, funding also needs to be addressed. As noted above, there is a sizable and persistent gap between Europe and the United States in venture capital and private equity investment.

Europe could explore whether a joint European fund—or fiscal capacity—could support financing of precommercial innovation in areas including energy, healthcare, industry, and defense. The EU’s Important Projects of Common European Interest (IPCEI) instrument could be a useful vehicle. In December, the European Commission approved up to €1.2 billion of state aid over eight years to support R&D in cloud and edge computing. Yet, for context, this is equal to about 4 percent of Amazon Web Services’ total investments in 2022 alone.³²

Clear choices and more technological and regional focus will also be needed; not every cluster can be successful in every technology. In areas where the gap with China and the United States is so large that it may not be realistic for Europe to compete in

³² Commission approves up to €1.2 billion of state aid by seven member states for an Important Project of Common European Interest in cloud and edge computing technologies, European Commission, December 5, 2023; and Amazon annual report 2022; Amazon Web Services’ total investments include both R&D and infrastructure investments.

Exhibit 3



development, Europe could concentrate on rapid adoption and examine ways to attract some of the high-value activities of foreign firms, developing domestic clusters around them.

The private sector could contribute by sharing R&D on productivity-enhancing technology with

fellow players across Europe, perhaps through joint research programs and joint procurement initiatives. One current example of this approach is the \$330 million joint investment of the Iliad Group, Schmidt Futures, and CMA CGM to launch a gen AI research lab; it aspires to develop enhanced

algorithms to strengthen the capacity, reliability, and efficiency of large multimodal models.³³

2. Energy: Can Europe diversify and develop domestic sources of energy to secure sufficient power supply at half the current cost?

Europe needs sufficient affordable energy if it wants to maintain energy-intensive tradable industries such as agriculture, chemicals, steel, or shipping to match other regions. To make truly bold strides, it can set the ambitious goal of cutting the cost of power and gas in half.

Europe is making real headway in deploying more renewables; the EU-27 generated 22 percent of electricity from wind and solar in 2022, up from just 6 percent in 2010.³⁴ But there are still a number of barriers to overcome. Renewable solutions need to continue scaling up, but progress is hampered by several factors, such as long permitting processes, “not in my backyard” issues, and opposition to building critical connectors and transmission lines. Other alternatives also come with complications. Contracting with new suppliers of energy could create new dependencies.³⁵ Revamping domestic extraction of fossil fuels (such as coal, gas, oil, and shale gas) would not be in line with Europe’s environmental commitments.³⁶ Nuclear fusion is not yet commercially available.

Given all this, what energy sources can Europe align on and then move to deploy rapidly? And what funding can bridge newer alternatives to commercial viability? Recent MGI research has outlined measures to address net-zero ambitions, energy affordability, stability, and competitiveness—simultaneously. Beyond the vital scale-up and buildout of renewables capacity, they include a focus on lower-cost energy sources, investment in innovation to drive down costs, and

the parallel management of emerging and existing energy systems.³⁷

The private sector can contribute to the financing and expertise needed to develop reliable infrastructure for energy supply. For instance, Ingka Group has committed to investing €7.5 billion in clean energy projects by 2030.³⁸ It has contributed investment in offshore wind projects in Sweden that have the potential to produce 38 terawatt-hours, or more than 25 percent of Sweden’s current electricity use, once operational.³⁹ Another example is the commitment of 33 private and publicly owned players, including Enagaz, GRTgaz, and Gassco, to a vision for a 40,000-kilometer hydrogen pipeline infrastructure across Europe by 2040, accelerating the development of the European hydrogen market.⁴⁰

3. Capital: Can Europe activate an additional \$400 billion annually in corporate investment?

Europe will need more (and more patient) risk-seeking capital to support efforts on sustainability and competitiveness. Matching what large US corporations are doing would mean boosting corporate investment by about \$400 billion a year over 2022 levels (an increase of more than 60 percent). But it will take higher returns to attract that capital; currently, returns on invested capital are 14 percent in Europe and 18 percent in the United States. How could European leaders trigger a virtuous cycle to enable business dynamism and larger scale, thereby enabling higher corporate returns that could attract more capital?

On the supply side, Europe needs a capital market structure that delivers sufficient pools of funding—funding that is prepared to take the necessary burden of risk and invest for the long run, such as

³³ “Launch of Kyutai—Europe’s first independent research lab dedicated to AI open science, co-funded by the Iliad Group, CMA CGM and Schmidt Futures,” CMA CGM, November 17, 2023.

³⁴ Yearly Electricity Data (2023) and European Electricity Review (2023), Ember; *Statistical review of world energy*, Energy Institute, 2023.

³⁵ *Geopolitics and the geometry of global trade*, McKinsey Global Institute, January 2024.

³⁶ “The European Green Deal,” European Commission, https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal_en.

³⁷ *An affordable, reliable, competitive path to net zero*, McKinsey Global Institute, November 2023.

³⁸ “Ingka Group’s EUR 7.5 billion commitment to support the transition to a renewable future,” Ingka Group press release, November 30, 2023.

³⁹ “Ingka Investments buys 49% of three Swedish wind projects,” Ingka Group press release, August 29, 2022.

⁴⁰ GRTgaz.

venture capital. Accelerating completion of the capital markets union is a critical step. Europe could also trigger pension fund consolidation and review regulations on their investment portfolios to enable more allocation to growth funding. Pension fund investments account for only 8 percent of venture capital fundraising in Europe, compared with 20 percent in the United States.⁴¹ Today, Europe's venture capital assets under management are only one-fifth the size of those in the United States.⁴²

Some private players have already struck partnerships to deploy more capital. In 2021, for instance, Stellantis, TotalEnergies, and Mercedes-Benz secured €7 billion in joint funding for their supply of batteries, combining their mutual expertise to develop a leading European battery manufacturer.⁴³

4. Supply chains: Can Europe diversify toward a resilient global supplier base and unlock new domestic sources?

In a potentially more fragmented world, Europe may need to work harder to ensure access to a secure and sustainable supply of strategically important materials.⁴⁴ This effort could involve complex trade-offs. One approach could be to further diversify global suppliers, although this requires acting with caution if they are from markets that are not geopolitically aligned.⁴⁵ Another option would be to unearth new domestic supply, but environmental concerns surround the extraction of some critical minerals such as lithium, cobalt, and graphite.

Policy makers have taken action to strengthen supply chains. The EU launched the Global Gateway Initiative in 2021, aiming to bolster economic relationships with trade partners, particularly those supplying essential materials. Subsequently, the Critical Raw Materials Act of 2023 set forth a framework to ensure that by the decade's end, at

least 10 percent of the EU's annual consumption of these materials will be extracted domestically, at least 40 percent will be processed within the EU, and a minimum of 15 percent will be recycled. While these goals are clear, implementation will be harder. For instance, processing of critical materials in Europe tends to be less competitive given higher costs of energy. But new policies could facilitate the scale-up of supply by, for example, streamlining permitting procedures for new asset development.

Private actors have strong cards to play here. McKinsey's 2023 supply chain survey reveals a dramatic increase in resilience measures.⁴⁶ Two-thirds of respondents reported that they are planning to obtain more inputs from suppliers located closer to their production sites over the past 12 months—double the share of companies reporting such nearshoring strategies in the prior year. The biggest reported increases in nearshoring came from the automotive and consumer goods industries. Beyond the trend toward nearshoring, the shift from global to regional supply networks continues to gain momentum. Almost two-thirds (64 percent) of respondents reported that they are currently regionalizing their supply chains, a trend that is most prominent in Europe and Southeast Asia.

Forging supplier relationships is critical when it comes to strategically important materials. For instance, in 2022, BMW secured lithium supplies from US company Livent for €285 million.⁴⁷ H2 Green Steel and Mercedes-Benz have struck a partnership to deliver 50,000 tonnes per year of green steel by 2025.⁴⁸ Beyond such deals, companies can pursue a number of strategies to make their supply chains more resilient, including building in redundancies and reducing the number of unique parts they need. For large companies with dense, multitiered supplier networks, end-to-end

⁴¹ *Securing Europe's competitiveness: Addressing its technology gap*, McKinsey Global Institute, September 2022.

⁴² Preqin.

⁴³ "About us," Automotive Cells Company, accessed December 26, 2023.

⁴⁴ "Critical raw materials: ensuring secure and sustainable supply chains for EU's green and digital future," European Commission press release, March 16, 2023.

⁴⁵ *Geopolitics and the geometry of global trade*, McKinsey Global Institute, January 2024.

⁴⁶ "Tech and regionalization bolster supply chains, but complacency looms," McKinsey.com, November 2023.

⁴⁷ "BMW Group steps up sustainable sourcing of lithium for battery cell production to ensure rapid e-mobility expansion," BMW Group press release, March 30, 2021.

⁴⁸ "Mercedes-Benz and H2 Green Steel secure supply deal," Mercedes-Benz press release, June 7, 2023.

transparency and sophisticated risk management tools have become top priorities.⁴⁹

5. Talent: Can Europe benefit from tighter labor markets to accelerate reskilling and rotation—and thus technology adoption?

A critical ingredient in hastening technology adoption and the net-zero transition is the rapid reskilling and redeployment of workers as the economy evolves. Some 18 million workers will need to move into new roles as part of the net-zero transition alone. Automation and other technology trends are poised to create even bigger shifts in roles and work activities—and these shifts need to occur for Europe to realize the full productivity-enhancing potential of new technologies.

As labor markets are tight and unemployment is low in most regions, could now be the time for Europe to activate the “flexicurity” concept outlined by the European Commission? Flexicurity protects workers rather than jobs in order to hasten rather than delay these transitions.⁵⁰ The challenge for policy makers would be to ensure that the security of employees is preserved even while flexibility increases.

Beyond reskilling, developing and attracting top talent remains critical, particularly in cutting-edge fields such as AI. Could Europe’s decision makers also consider expanding free trade to “free talent movement agreements” with other regions, or tax incentives for immigrating as well as returning talent?

Corporate players can collaborate with educational institutions and policy makers on reskilling programs and the creation of new career pathways, focusing in particular on mid-career workers who need to or want to prepare for new lines of work. For instance, more than 20 automotive companies, including Renault and Volkswagen, have collaborated on a “pact for skills” that aims

to help more than 700,000 automotive workers add the skills they need for opportunities in the green transition and innovation. The overall joint commitment is expected to amount to €7 billion.⁵¹ Companies could also help forge a new deal for education—independently or in collaboration with universities—to cultivate the talent of the future, broadening access for students from diverse backgrounds. An example of this approach is France’s Ecole 42, which offers free, teacherless peer-to-peer learning; it welcomes students of all backgrounds without prerequisite qualifications.

6. Size: Can Europe operate more at the European level while preserving national priorities, potentially doubling the size of firms?

A growing number of competitive arenas have “winner-take-most” dynamics, with a few giant companies accounting for disproportionate market share and profits. Europe’s large corporations would need to almost double in scale on average to match their US peers. This would require cross-border consolidation as well as deeper European integration, which implies the transfer of more competencies to the EU.

Completing the single market is an evergreen goal. According to a survey of members of the European Round Table for Industry, the European single market is only about 75 percent complete.⁵² The remaining trade frictions within the EU have been estimated to reduce EU GDP by 5 to 10 percent.⁵³

Could a bolder and faster option for decision makers be to create a “28th regime” of common, simplified business rules, giving companies the choice to opt in? That kind of regulatory framework could cover areas such as product market regulation, employment rules (including professional qualifications), VAT, competition rules, and more.

⁴⁹ *Risk, resilience, and rebalancing in global value chains*, McKinsey Global Institute, August 2020.

⁵⁰ The European Commission defines flexicurity as an integrated strategy for enhancing flexibility and security simultaneously in the labor market.

⁵¹ “About us,” Automotive Skills Alliance, accessed December 26, 2023.

⁵² *Economic confidence among Europe’s industrial leaders cools as supply chain issues, inflation cloud the horizon*, European Round Table for Industry, November 2021.

⁵³ José V. Rodríguez Mora and David Comerford, *The gains from economic integration: The EU has still a long way to go*, Centre for Economic Policy Research, January 2019; and Chikako Baba et al., *Geoeconomic fragmentation: What’s at stake for the EU*, International Monetary Fund working paper number 23/245, November 2023.

Private actors can be on the lookout for cross-border M&A opportunities that would help them achieve globally competitive scale, where antitrust rules allow. One example of such an approach to M&A was DSV's €5 billion acquisition in 2019 of Panalpina, a provider of supply chain solutions, to create one of the world's largest transportation and logistics companies.⁵⁴

7. Competition and market frameworks: Can Europe redesign rules to compete effectively in the future?

A competitive race is on around the world to forge a lead in dynamic new growth arenas such as AI and clean tech. Other economies are already designing and implementing policies to attract investment and spur innovation in these areas. To keep up, Europe may need to revisit its stance on funding, regulation, and administration.

On funding, will Europe's free-market principles give it the competitive edge over other markets that deploy decisive government support to domestic firms, or will Europe need to match and exceed them in industrial policy support? On regulation, should

Europe continue to take a precautionary approach or enable more risk-taking with an eye toward capturing fast-moving opportunities, as happened during the development of the BioNTech COVID-19 vaccine? And how can Europe reduce the burden and timelines of administration and permitting, freeing firms to move more quickly?

On all seven of these dimensions of competitiveness, Europe faces new challenges. Addressing them will require an integrated agenda built around much more ambitious goals. It will also require public and private leaders to make strategic choices and weigh some difficult tradeoffs. There is always a cost involved in achieving bold goals, whether in capital, risk, or what else may be deprioritized. Corporate Europe needs to play its part and look beyond company and sector boundaries, working hand-in-hand with policymakers to agree upon and then reach those goals. The challenge for Europe is to use this testing moment to act decisively, as it has done in crises of the past.

⁵⁴"DSV completes acquisition of Panalpina," DSV press release, August 19, 2019.

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