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# Europe needs to step up its game

Lessons from the American playbook

# Executive Summary



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**In the 25 years since the foundation of the Euro, the economic gap between the US and Eurozone has almost tripled.** In 1999, the year the Euro was introduced, the US economy was 11% larger than the Eurozone in purchasing power parity terms; this gap has since widened to 30%. Even in per capita terms, the US is leaving Europe far behind: As of 2022, the average American enjoyed real income that was 35% higher than that of the average European in purchasing power parity terms, up from 27% just before the 2008 financial crisis.

**Admittedly, some of the driving forces of US dominance are its structural privileges: lower funding costs for the government (relative to growth), lower energy costs, a significant head start in tech and better demographics.** With a large and liquid sovereign debt market, the US government can spend its way out of downturns and prevent any scarring effects, while Eurozone countries have much smaller fiscal space, given the risks of sovereign default and redenomination. Power prices are also significantly lower in the US because of the abundance of natural gas resources, especially helpful in the current context of energy and geopolitical uncertainty. And though the US depends on foreign suppliers for certain key critical raw materials, it possesses abundant supplies of coal, copper, lead, iron, timber, bauxite and uranium, all essential for powering the green transition. The US also benefits from being home to the world's most dominant tech companies, which enjoy better access to early-stage financing and international talent, and is speeding ahead of most European countries when it comes to research & development and patent applications, giving it a larger competitive advantage.

**But Europe is mostly tripping over its own shoelaces: over-regulation and red tape are holding back productivity growth, while fragmented capital markets hinder efficient funding.** Rules covering everything from the curvature of cucumbers to the minimum diameter of clams impede innovation and make doing business in the Eurozone harder than in the US. In the World Bank's Doing Business rankings, EU economies outperform the US on only two indicators – getting electricity and trading across borders – and that too by a small margin. It is especially difficult to get credit in the EU, which hinders start-ups in particular, and companies need to navigate each country's separate laws and tax rules. At the same time, EU programs to support economic development are too complicated and fragmented, resulting in backlogs (eg. for NGEU funds), and they are not nudging the private sector to ramp up capital expenditure, unlike in the US. Finally, politics and national interests have blocked progress in creating a Capital Markets Union (CMU) that would boost cross-border risk sharing, reduce

the reliance on bank financing and improve capital allocation, promoting higher economic growth.

**There is one (green) silver lining: The EU is taking the lead in the green transition. Eurozone economies have significantly lower total and per capita CO2 emissions than the US.** The EU has also clearly taken the lead in green goods trade: Germany alone surpasses the US in green exports and 19 out of the 27 EU economies show a comparative advantage in green goods trade. In contrast, the US is slowly losing market share and its comparative advantage for green technologies has deteriorated over time. As the EU aims to accelerate its green transformation and reach net-zero emissions by 2050, the green economy will generate more jobs to compensate for the potential deindustrialization in declining sectors.

**To restore its overall competitive edge against the US, the next European parliament urgently needs to tackle the obstacles to higher productivity growth.** After the June EU parliament elections, the top priorities should be: I) reducing red tape and over-regulation, ii) re-igniting efforts to deepen the Capital Markets Union, iii) overcoming issues that hold back the speedy and timely absorption of EU funds and iv) pushing forward for a strengthened European industrial policy to mitigate the race to subsidies among EU countries.

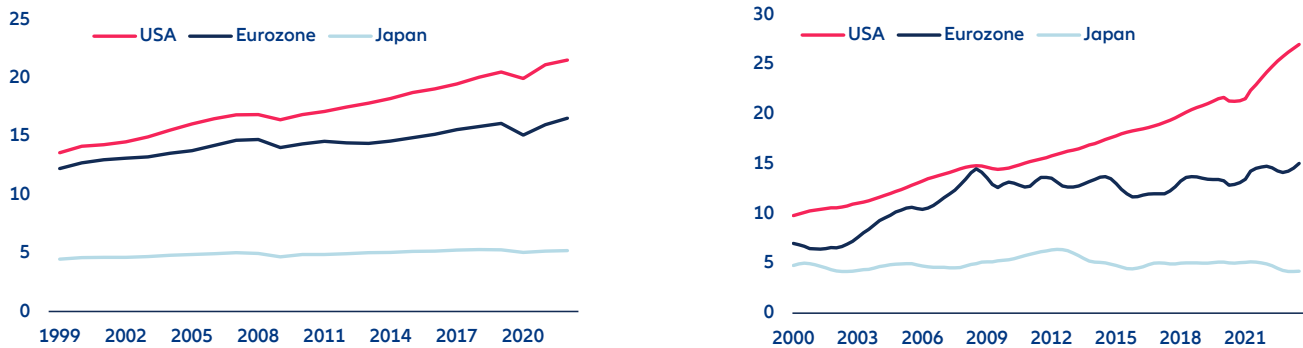


# Europe appears to be falling behind the US on many fronts

**The economic gap between the US and the Eurozone has almost tripled since the foundation of the Euro.** In 1999, the year of introduction of the Euro, the US economy was 11% larger than the Eurozone in purchasing power parity terms. After three major crises (2008 financial crisis, sovereign debt crisis and the Covid-19 pandemic), this gap has widened to 30%. If you compare both economies in nominal terms, the difference is even more staggering: While Eurozone nominal GDP is stuck at around USD15trn for the past 15 years, US nominal GDP has grown by an astonishing +80% to reach around USD27trn in that time period (Figure 1). Admittedly,

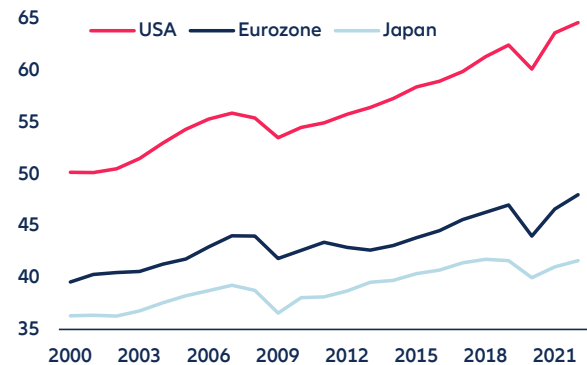
this also reflects the sharp appreciation of the USD versus the EUR over this time period. While some of the economic outperformance is based on demographic factors, the US also maintains its significant lead over the Eurozone in terms of GDP per capita in purchasing power parity (PPP), and this gap has also widened. In 2007, the average American enjoyed real income that was 27% higher in PPP terms compared to their European counterparts; this has since expanded to 35% by 2022 (Figure 2).

**Figure 1:** GDP in constant international dollar (PPP) and in current USD, trillion



Sources: LSEG Datastream, Allianz Research

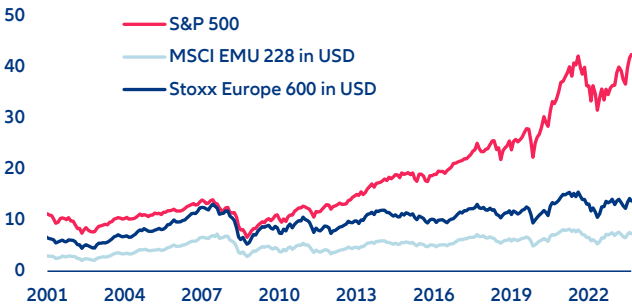
**Figure 2:** GDP per capita, in constant international dollar PPP, thousand



Sources: LSEG Datastream, Allianz Research

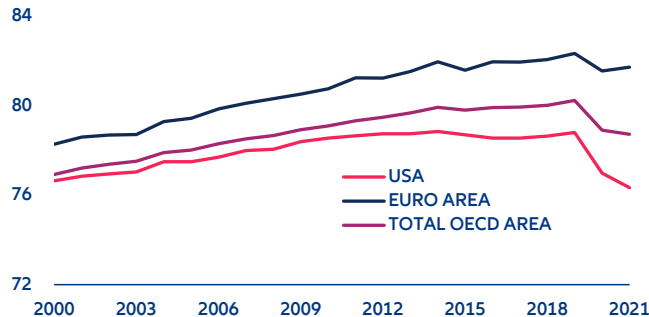
The divergence in economic strength is also evident through the substantial increase in the market value of American companies when compared to their European counterparts. In 2007, just prior to the GFC, the combined value, or market capitalization, of the top 500 US companies (as represented by the S&P 500 stock index) was USD14trn, nearly equivalent to the combined value of the largest 600 European companies at USD13trn (Stoxx Europe 600). However, fast forward to today, and the US figure has almost tripled to USD38trn, while Europe’s valuation has remained nearly unchanged. These numbers not only mirror past success but also reflect future expectations for these economic regions, as market capitalization can be interpreted as the discounted expected future cash flows from these companies (Figure 3).

Figure 3: Market capitalization of different stock indices in USD trn



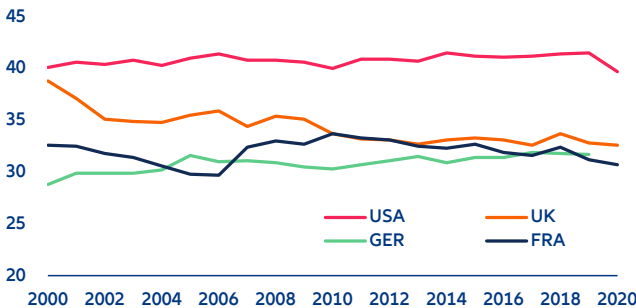
Sources: Bloomberg, Allianz Research

Figure 4: Life expectancy at birth and income inequality



Sources: LSEG Datastream, Allianz Research

However, not all that glitters is gold. In some metrics, the US is in a weaker position relative to Europe. Strong social and health indicators are also essential for long-term economic success. In this context, the significant decline in life expectancy in the US is particularly striking, compared to only a slight decrease in the Eurozone (Figure 4). According to the US National Center for Health Statistics, the reasons for the larger decline include not only the Covid-19 pandemic, which affected all countries, but also the increase in drug overdoses, accidental injuries, illnesses and suicides. Part of the explanation lies in the fact that the higher income in the US is distributed much less equally compared to Europe (Figure 4).

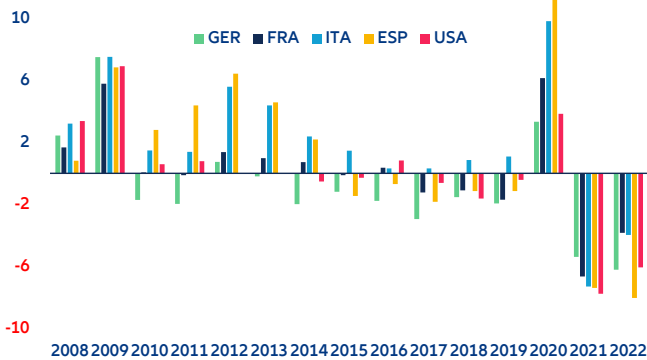


# Structural privileges behind the US-Eurozone economic gap?

The driving forces of US dominance are its structural privileges. First, the US government benefits from low funding costs (relative to GDP growth) owing to the appeal of its large and liquid sovereign debt market, making fiscal policy more cyclically active. With access to a large and liquid sovereign debt market, the US government can spend its way out of downturns and prevent any scarring effects, as seen during the Covid-19 crisis. In contrast, fiscal space is much more limited for most Eurozone countries (excluding core economies such as Germany) because of lower potential growth (the

ability to service debt is more challenging in a low growth economy). Moreover, the architecture of the Eurozone gives rise to sovereign default risk and redenomination risk, while the US can always print its own currency to avoid default. Eurozone countries have tried to combine fiscal firepower through initiatives such as the Next Generation EU fund (EUR750bn) and the RePowerEU plan (EUR225bn) but slow take-up has minimized the positive effects for now, particularly compared to the US where much more of the available IRA funds are already flowing into concrete projects.

Figure 5: Interest growth differential (pp)



Sources: LSEG Datastream, Allianz Research

Table 1: NGEU recovery package breakdown by instrument

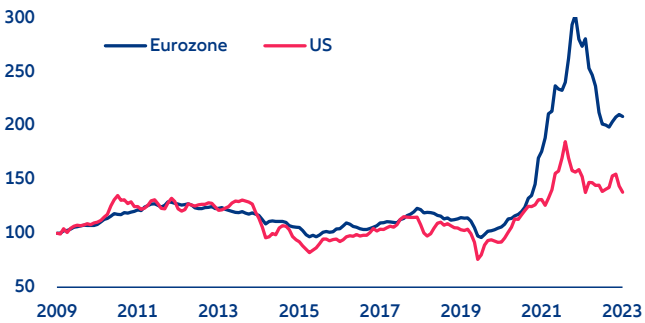
Instruments	Amount*
RRF - Grants	312.5
RRF - Loans	360
REACT-EU	47.5
Just Transition Fund	10
Rural Development	7.5
Horizon Europe	5
InvestEU	5.6
RescEU	1.9
<b>Total</b>	<b>750</b>

Sources: EC, Allianz Research. \* 2018 prices



**Second, the US economy has a big energy cost advantage, which has further widened over the past two years.** Power prices are much lower in the US because of its abundance of natural gas resources. For US businesses, electricity bills are 32% lower compared to those of their French counterparts (average 2008-22), 53% lower than those paid by Spanish businesses, 57% lower than those of Italian businesses and as much as 63% lower than those of German businesses. In fact, after remaining fairly stable for years, the energy price gap has widened sharply by a further 30% since 2021 (Figure 6)<sup>3</sup>. While it is not simple to calculate the effect on GDP, we can infer from the share of gas and electricity consumption in GDP that the power price gap has lowered the level of Eurozone GDP relative to the US by approximately -1pp. And the further 30% widening of the power price gap between 2021 and 2023 could have shaved an additional -1pp off the GDP level.

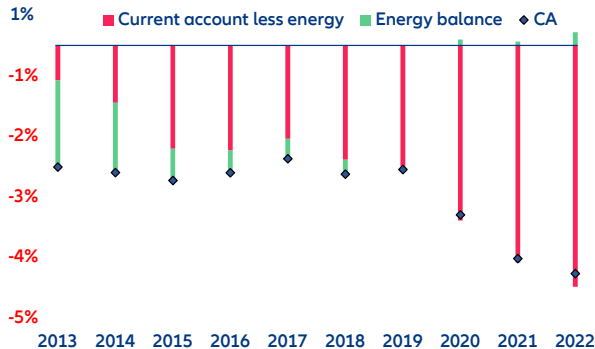
Figure 6: Production prices, energy sector (Nov 2009 = 100)



Sources: LSEG Datastream, Allianz Research

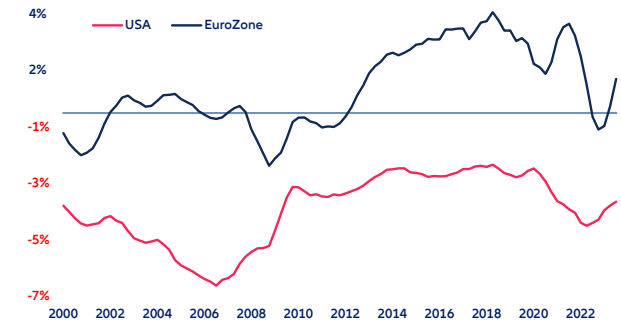
Escalating energy costs have also pushed the Eurozone’s current account into negative territory after a decade of surpluses and it is likely to linger below pre-pandemic levels. In contrast, the US has been a net exporter of energy since 2019, putting it in a more comfortable position in the face of various energy and geopolitical uncertainties (Figures 7, 8). While the US still grapples with a notable current account deficit, and the gains in the energy sector are largely insufficient to offset the negative impact of elevated imports, the outlook remains positive, both in terms of volumes and prices, buoyed by global demand for energy. Significantly, the terms of trade have shifted markedly in favor of the US compared to Europe (Figure 9). This crucial macroeconomic variable, key in currency valuation models, has played a substantial role in bringing the fair value of the euro lower.

Figure 8: US: energy balance and current account (% of GDP)



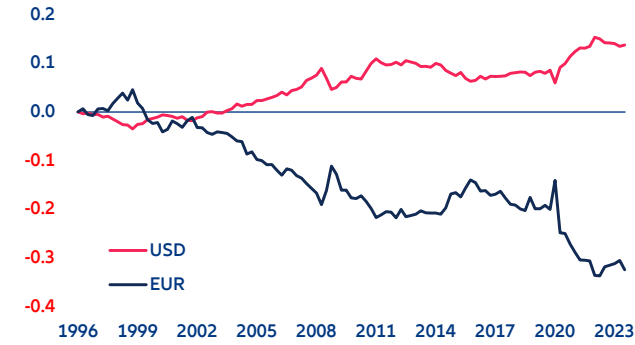
Sources: Refinitiv, ITC, Allianz Research

Figure 7: Current account balance (rolling sum 4 quarters as % of GDP)



Sources: Refinitiv, Allianz Research

Figure 9: Terms of trade (in effective terms, 1996=0)



Sources: Refinitiv, Allianz Research

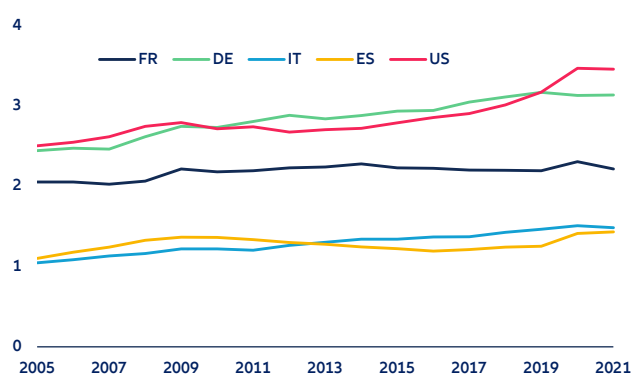


**The US also benefits from large reserves of industrial commodities, critical for re-industrialization.** Although the US is dependent on foreign supply for certain key critical raw materials, it possesses abundant supplies of coal, copper, lead, iron, timber, bauxite and uranium. As the green transition is powering ahead, and the re-industrialization agenda has moved up to the top of policymakers' agenda, access to these resources provides a strong edge for countries rich in natural resources. In comparison, European countries are poorly endowed with natural resources and therefore dependent on foreign supply for almost all industrial commodities and critical raw materials.

**Third, the US also got a major headstart with tech.** Most of the world's dominant tech companies are based

in the US, where they enjoy better access to both and early- and late-stage financing (Figure 11) as well as international talent. In 2022, the state of California alone attracted as much venture capital as the entire European continent. It is no surprise then that the US has more than three times the number of new start-ups than the largest EU economies. Moreover, in the Eurozone, much smaller national markets with diverse regulations are another obstacle, constraining the crucial early-stage user base needed for economies of scale in the tech industry. While Europe is catching up with the US in adapting digital technologies, lagging digital innovation risks creating technology dependencies. By market size, the major tech US companies represent 77% (in a sample of more than 500 listed companies) while European ones account for just 6% (Figure 11).

**Figure 10:** R&D expenditure, in % of GDP



Sources: OECD MSTI, Allianz Research



**Moreover, the US is speeding ahead of most European countries when it comes to research & development and patent applications, giving it a larger competitive advantage.** While Germany is particularly strong in patent applications (790.4 per million inhabitants), the US follows suit with 789.8. But France, Italy and especially Spain are lagging behind. Both Germany and the US have historically been very strong in research and development but German R&D expenditure has flattened at 3.1% of GDP due to a large backlog in investments triggered by high political and economic uncertainty. As a result, the US overtook the EU powerhouse with 3.5% of GDP since 2020 (Figure 10). R&D expenditure has remained stable in France, Italy and Spain at around 2.2% and 1.4% each, respectively. And while the US allocates 78% of its R&D investments to businesses, this number is only 62% across the four big EU economies.

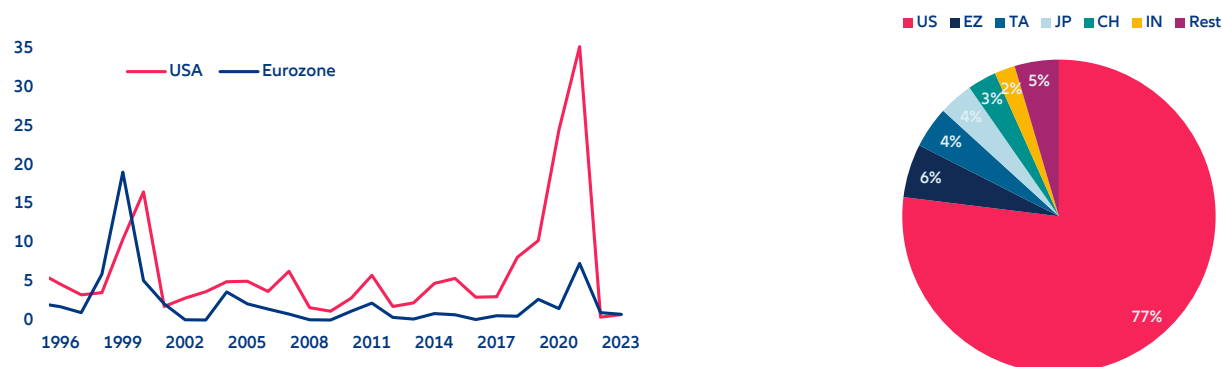
**Last but not least, the US has more favorable demographics.** Demographics (the growth of the working-age population) explains a big chunk of the US GDP over-performance (0.6pp on average per year between 2008 and 2023, see Figure 12), though both economic areas face growing demographic challenges ahead. Since the fertility rate in the US has been higher than that of most EU 27 countries until recently, the US has a much younger population<sup>1</sup> than the EU. In the US, the old-age dependency ratio, which measures the number of people aged 65 and older per 100 persons in age group 20 to 64, is expected to increase from 31% today to 42% in 2050, while in the EU 27 it is expected to surpass the threshold of 60% by mid-century.

**However, like the EU 27, the US economy depends on a continued influx of labor migrants.** If the migration balance was zero from now on, the US working-age population would decline from 197mn today to 183mn in 2050, which would correspond to an average annual decline of -0.3%. However, if this was the case in the EU 27, the decrease would be even steeper, with the number of people aged between 20 and 64 declining to 203mn or on average by -0.9% per year.

**In this context, both the US and Eurozone need to adapt their labor markets to the needs of an ageing workforce.** In the EU 27, the share of workers aged 50 and older in the labor force is set to remain above 37% in the long run, while in the US the share of this age group is expected to increase to around 33% from 2036 onwards. In fact, these shares might become even higher in the future due to increases in the retirement age<sup>2</sup>. In Germany, for example, the increase of the retirement age to 67 years is set to add 2mn people aged 65 and 66 to the working age population in 2050, pushing the share of those aged 50 and older in the workforce population above 40%.

Against this backdrop, the US-Eurozone demographics divergence has been somewhat lessened by the good performance of European labor markets offsetting the slowdown in working-age people. The Eurozone employment rate has indeed increased by around 7pp between 2008 and 2023 while in the US it has slightly declined.

**Figure 11:** Cumulative capital raised through IPOs in the tech sector since 1995 (USD bn) and major listed tech-companies by market size as a share of total\*



Sources: LSEG Datastream, Allianz Research. \* From a sample of 562 listed tech companies in the world.

<sup>1</sup> Here defined as age group between 20 and 64 years. Source for population data is United Nations, Department of Economic and Social Affairs, Population Division (2022). World Population Prospects 2022, Online Edition.

<sup>2</sup> In 2022, See OECD (2023).

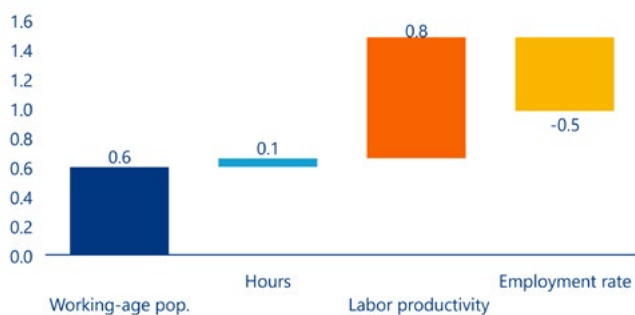
# The Eurozone is tripping over its own shoelaces

**The Eurozone has seen disappointing productivity growth.** Between 2008 and 2023, an outsized 0.8pp of the average annual 1pp US GDP growth overperformance stemmed from more dynamic labor productivity across the Atlantic (Figure 12). From a supply-side standpoint, GDP growth can simply be broken down into the growth of the working-age population, the employment rate (i.e. the number of people working as a percentage of the working-age population), the number of working hours per job and hourly labor productivity (output per working hour). We find that, on average per year between 2008 and 2023, US labor productivity grew 0.8pp faster than Eurozone productivity. Over time, this adds up to a huge gap that can explain the divergence between the US and Eurozone's income per capital since productivity is the single most important driver of the standard of living in the long term. The increasing divergence in productivity is all of the more striking since European countries are further away from the technological frontier and

therefore have, in principle, more productivity catch-up potential.

In fact, when we decompose the growth of hourly labor productivity between the contribution of capital deepening (the capital-to-labor ratio, i.e. the capitalistic intensity of production) and total factor productivity (the efficiency in which labor and capital inputs are combined to produce one unit of output), we find that most of the Eurozone under-performance is the result of lackluster total factor productivity growth rather than weak capital deepening growth<sup>1</sup>. In other words, it is not so much that the Eurozone invests too little in new capacity, but rather that the underlying rate of growth of technological progress and efficiency is underwhelming.

**Figure 12:** Breakdown of the US GDP growth over-performance vs the Eurozone, 2008-23 annual average (pp of GDP growth)



Sources: LSEG Datastream, Allianz Research

## Box 1: The ticking time bomb of demographics

**Pension and the health systems will face the challenge of covering the needs of an unprecedented high number of elderly people.** In the US, the number of people aged 65 and older is set to increase from 59.8mn today to 88.7mn in 2050; of this number, 34.2mn are expected to be aged 80 and older, compared to 13.8mn today. In the EU 27, there are going to be 130.6mn people aged 65 and older, of which 50mn or 30% will be older than 80. But the US pension system appears to be more sustainable than that of most EU 27 countries, given the importance of the capital-funded pillar and the increased retirement age. With respect to its adequacy, the US ranks upper midfield, reflecting the accessibility of financial services, private households' (net) financial wealth and the comparatively high acceptance of older workers on the labor market, which is reflected in the higher labor force participation rates in higher ages compared to most EU countries<sup>3</sup>. The US health system also receives more private financing than that of the EU 27, though there is still room for further improvement in coverage and access to health services.

**But US households are also wealthier than their European counterparts: In fact, in terms of net financial assets per capita<sup>4</sup>, US private households are among the wealthiest in the world by far.** In 2022, the net financial assets of the average American amounted to EUR253,450. In comparison, the EU 27 country with the largest net financial assets is Denmark but the average amount per capita was EUR 163,830. In the four major EU 27 economies, where pension systems are still mainly pay-as-you-go financed, the gap is even larger: In Italy, average net financial assets per capita amounted to a mere EUR69,340, in France to EUR67,500, in Germany to EUR63,540 and in Spain to merely EUR41,260. However, in the US, net wealth is more unequally distributed than in most EU 27 countries. In 2022, the Gini coefficient<sup>5</sup> was higher than that of the US only in Cyprus, Estonia, Greece, Ireland and Poland.

**Table 2: Allianz Pension Index 2023 (EU 27 countries and US)**

		API 2023	Basic Conditions	Sustainability	Adequacy	
2.0	Denmark	2.2	3.0	2.5	1.8	
	Netherlands	2.6	2.9	3.4	1.7	
	Sweden	2.6	3.1	2.9	2.1	
	United States	2.9	3.5	2.8	2.6	
	Belgium	3.0	3.9	3.0	2.4	
	Luxembourg	3.1	3.2	4.1	2.1	
	Portugal	3.2	4.8	2.7	2.8	
	Germany	3.2	3.9	3.3	2.8	
	Italy	3.3	4.7	3.1	2.7	
	Finland	3.3	3.8	3.5	2.9	
	3.0	Estonia	3.4	3.7	3.1	3.4
		Ireland	3.4	3.2	3.8	3.0
		France	3.4	3.9	3.7	2.8
		Bulgaria	3.4	4.7	2.9	3.3
		Austria	3.4	4.2	3.9	2.6
		Latvia	3.4	4.0	3.7	2.8
		Malta	3.4	3.8	4.6	2.1
		Greece	3.4	5.0	3.0	3.0
		Lithuania	3.4	4.2	3.2	3.3
		Spain	3.5	4.6	3.7	2.7
4.0	Slovakia	3.7	4.4	4.0	2.9	
	Croatia	3.7	4.5	3.5	3.5	
	Czech Republic	3.7	3.7	3.8	3.6	
	Slovenia	3.7	4.4	4.3	2.8	
	Hungary	3.7	4.2	3.8	3.4	
	Cyprus	3.9	4.1	4.3	3.3	
	Poland	4.0	4.5	3.7	3.9	
	Romania	4.3	4.4	4.5	4.0	

Source: Allianz Research

<sup>3</sup> Here we don't take into account the reasons for continuing work in higher ages, which can also be driven by the fact that retirement income is insufficient in old age.

<sup>4</sup> See Allianz Research (2023): Allianz Global Wealth Report.

<sup>5</sup> Here referring to the distribution of private households net financial assets. See Allianz Global Wealth Report.

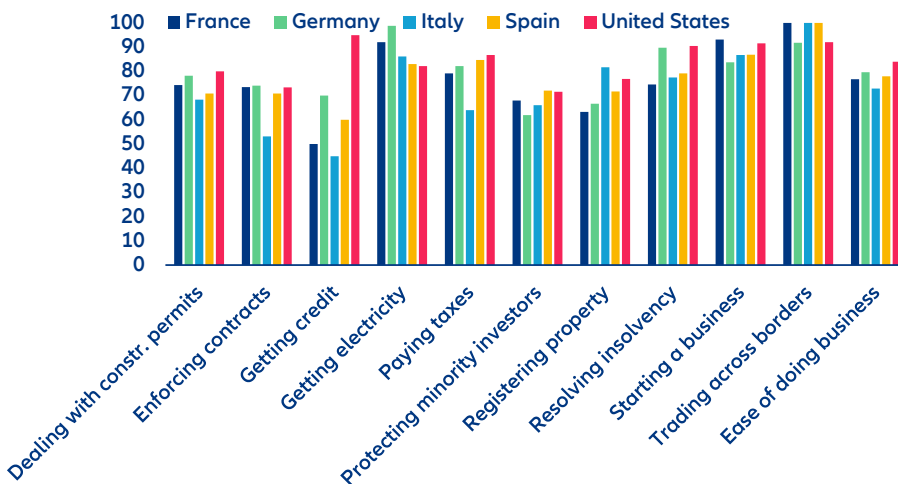
**The US benefits from a friendlier business environment, while over-regulation impedes innovation in the Eurozone.** Rules covering everything from the curvature of cucumbers to the minimum dimensions of clams make it harder to do business in the Eurozone relative to the US. In the World Bank’s Doing Business rankings, EU economies outperform the US on only two indicators – getting electricity and trading across borders – and that too by a small margin (Figure 13). It is especially difficult to get credit in the EU, which hinders start-ups in particular, and companies need to navigate each country’s separate laws and tax rules. While the bureaucracy and red tape between and across the 50 different states can also trip up businesses in the US, the relatively lighter approach to regulation leaves room for innovation, especially in critical fields such as artificial intelligence and genetics.

**Larger exposure to macro shocks, sovereign risks and over-reliance on bank funding also hamper the Eurozone.** Eurozone countries have been exposed to more repeated bouts of macro volatility than the US over the past 15 years, notably during the sovereign debt crisis of 2011-13. In fact, the five-year rolling standard deviation of Eurozone GDP growth has been consistently higher than the US since 2009. Larger volatility, which can be partly blamed on the flawed design of the Eurozone architecture and the doom-loop between sovereigns and banks, creates more uncertainty and tighter funding conditions for European corporates, which can hinder innovation.

**The existential threat hanging over the future of the European currency union and fragmented capital markets further constrain investment.** National interests stand in the way of creating a Capital Markets Union (CMU), hindering efficient capital allocation and contributing to persistently lower growth in the Eurozone compared to the US. A necessary prerequisite is a strong Banking Union, but progress has been sluggish due to the absence of European Deposit Insurance Scheme. Despite initiatives since the initial draft in 2015, legislative proposals remain under negotiation and implementation has been slow. If implemented, a CMU could boost cross-border private risk-sharing, reduce reliance on bank financing and enhance capital allocation efficiency, promoting higher economic growth and Eurozone integration.

**While the EU is spending big to support economic development, its programs tend to be too complicated and fragmented.** Industrial policy has become fashionable again on both sides of the Atlantic. Since 2021, total financial grants have amounted to USD40bn for Germany, USD59bn for France, and USD230bn for the US of which 71%, 59% and 15%, respectively, are classified as green subsidies. Overall subsidy levels have thus approximately tripled in the US, doubled in Germany and increased eight times in France compared to 2015 levels. Between 2021 and 2023, subsidy spending has amounted to 0.3% of GDP in the US, 0.35% in Germany and nearly 0.75% in France (Figure 15 and Box 2). In fact,

Figure 13: Components of Doing Business, 2020 (Index)

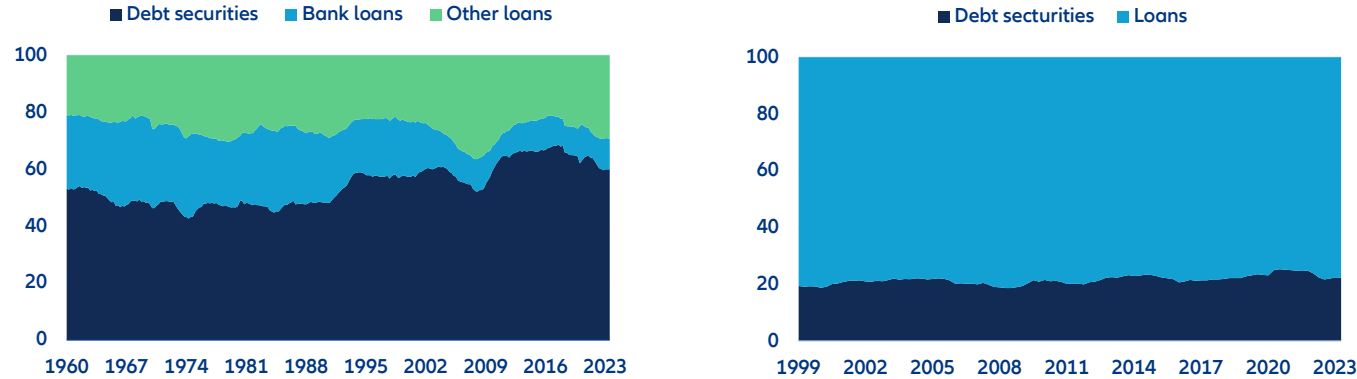


Sources: World Bank, Allianz Research

projected green subsidies in the EU are likely to be even higher than those offered by the US Inflation Reduction Act: USD880bn over 2022-2031 for the EU vs USD300bn-USD1,000bn over roughly the same time horizon in the US. But while US industrial policy is nudging the private sector to ramp up capital expenditures, the same can't be said for European policies. Investment in factories in the US has skyrocketed since the implementation of the Inflation Reduction Act and the CHIPS Act, despite higher costs and interest rates (Figure 16). In contrast, plant construction spending has fallen below 2010 levels in Germany, while in France it has barely increased over the past few years. The EU's programs have been criticized for being too complicated and detail-oriented, while the US's offer of uncapped tax incentives targeted

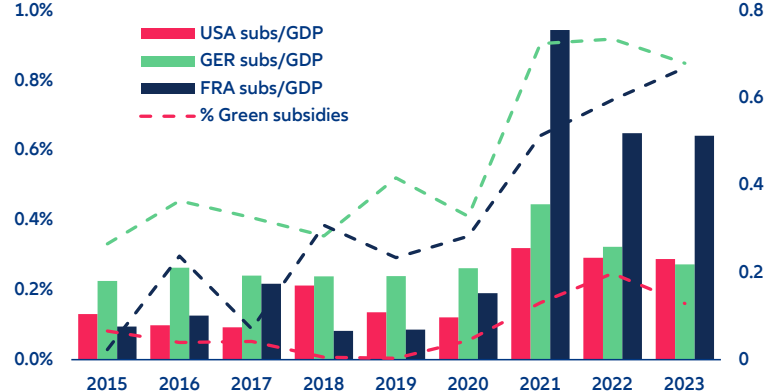
at manufacturers has been praised for its simplicity. Moreover, European governments implement their own tax credits at the national level, leading to variations from country to country. This highlights the challenges the EU and national governments face in establishing a convincing, consistent industrial policy amid a patchy regulatory and tax framework and complex processes for accessing funds (Box 3). In contrast, the US is leveraging its comparative advantages (including lower energy costs, size of the domestic market and higher potential growth) to spur more investments.

Figure 14: Sources of funding to the corporate sector



Sources: LSEG Datastream, Allianz Research

Figure 15: Subsidies as a share of GDP, in %



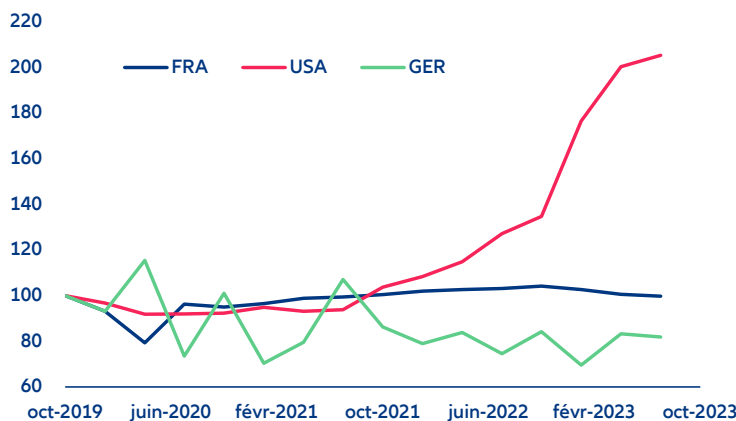
Sources: Global Trade Alert (GTA) Database, Allianz Research  
 Notes: As of December 2023. The analysis does not include corporate subsidies that  
 (1) affect almost all sectors as classified by GTA,  
 (2) related to public health concerns (including COVID-19),  
 (3) linked to the invasion of Ukraine. Bailouts and financial institutions are not considered. The total amount of subsidies that spread across several years has been equally divided across granted years if no other information was available. GTA corporate subsidies database has been enriched for 2022 and 2023 using the GTA latest state act section. Green subsidy classification incomplete for full year 2023.



**The outflow of investments from EU countries could be accelerated by the comparative advantages of the US and strengthened industrial policy, regardless of who wins the US elections in November.** Even before the IRA came into force, Germany struggled to contain investments due to high energy costs and a shortage of skilled labor. The gap between outbound investments by German companies and business investment into the country in 2022 was the largest on record: More than EUR135bn of foreign direct investment flowed out of Germany and only EUR10.5bn came in. Estimates signal that up to 70% of the European investment pipeline could migrate to the US as a result of new US incentives, including 80% of the pipeline of projects in Germany. Whoever wins the elections in November, US industrial policy is likely to be strengthened, a further headwind for European manufacturing. Under a Trump presidency, the

EV tax credit and the wind subsidies would most likely be repealed, although a Democratic-controlled House would be a bigger impediment. Under a GOP-dominated Congress, a wholesale roll-back of the IRA looks unlikely as most of the IRA subsidies happen to benefit Red States more than Blue States. Both a Trump and a Biden presidency would likely ramp up industrial subsidies, more across-the-board under Trump (funded by tariff revenues) while more focused in certain key sectors and technologies under Biden. US industrial policy could also extend its protectionist reach further by implementing a carbon border adjustment tax and expanding government mandates to favor domestic manufacturing.

**Figure 16:** Construction investments in manufacturing plants, Index Q4-2019 = 100



Sources: LSEG Datastream, Allianz Research

Notes: For the US: Total private construction spending: Manufacturing in the United States millions of Dollars, monthly, seasonally adjusted (US Census Bureau) price adjusted with the producer price index for intermediate demand "materials and components for construction" (Bureau of Labor Statistics). For Germany: Estimated costs, building permits for factory and workshop buildings (Destatis), price-adjusted with construction price index for commercial buildings, construction work on buildings (Destatis). For France: investment spending in structures, volumes.

## Box 2: Breakdown of industrial subsidy policy across main sectors

**A strong focus on establishing strategic sovereignty in the US and Europe due to the new geopolitical framework.** This means that the composition of goods and services produced domestically and imported from abroad should shift in the short term in favor of goods and services produced domestically or imported from abroad by friendly partners – in short, more „reshoring“ and „friendshoring“. In addition to energy and raw materials, this also applies to technical components such as computer chips and critical energy transition technologies such as batteries and solar panels. It is obvious that government support and industrial policy measures are required for such disruptive structural change processes – especially if it cannot happen quickly enough.

**The subsidies composition is changing in favor of more manufacturing and energy.** Consequently, subsidies in manufacturing have started to increase massively since 2021 in the US, Germany and France. In 2023, subsidies for manufacturing accounted for 62% of total subsidies in the US, 48% in Germany and 32% in France. Paris has already put more than half of its subsidies into renewable energy (including nuclear) since 2021, while the German share has remained flat around 16%. In the US, the share has increased as well to 19% of subsidies in 2023. In the past, Washington and Berlin both put a large chunk of subsidies (a quarter and nearly half of subsidies, respectively) in agriculture & food, but this has dropped dramatically to only 6% in Germany in 2023 while it was slightly reduced in the US to 18% as well.

**Green subsidies make up more than two-thirds of European subsidies while they were only 20% of total subsidies in the US as of 2022.** Strong benefits exist to subsidize green innovation both for global growth and for tackling climate change. And as investing in green industries helps to build up the new industries of the future, governments are trying to improve the performance of key business sectors ranging from energy to semiconductors. Across 2021-2023, the lion's share of green subsidies in the US went to energy (USD4.5bn, 37%) and manufacturing (USD6.9bn, 60%), while only 2% or USD0.2bn were put into transportation. But compared to European countries, green subsidies make up only 15% of total subsidies. The scenario is quite different in Germany where 71% of subsidies are classified as green over the last three years. Around 40% or USD3.6bn goes into manufacturing, even though the trend is declining, while USD1.8bn goes into energy. Green transport subsidies are negligible and have been down from nearly 80% of total transport subsidies in 2016 to 0.1% in 2021 to zero in 2023. France has gone from 2% of subsidies that are classified as green in 2015 to 60% in 2022. These basically split into more than 90% for energy (USD10bn) and the remaining for manufacturing.

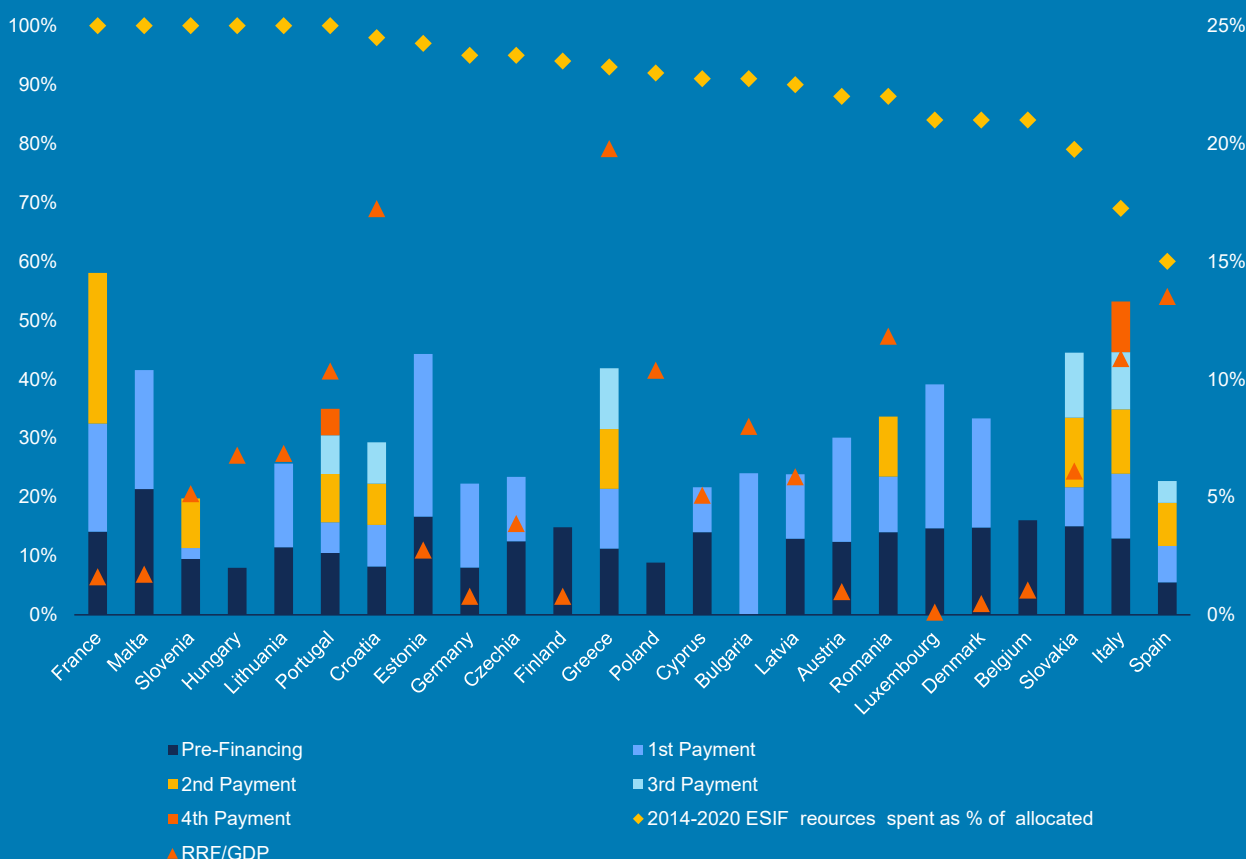
Box 3: What is going wrong with NGEU funds?

**As initially feared, NGEU spending has already encountered delays, significantly reducing the potential positive economic impact.** The big chunk of NGEU spending was initially for 2021-2023 to boost the immediate post-pandemic recovery. With disbursements dependent on qualitative milestones and quantitative targets (i.e. structural reforms), implementation delays have soon materialized. As of today, around 26% of Recovery and Resilience Facility resources (out of the EUR672bn between grants and loans) have been received by member states. By December 2023, most countries have received only the first payment (11 MS), few have seen the second and third disbursements coming in, while only Italy and Portugal have received four instalments (though accumulating around 50% and 35% of the total allocated resources respectively) (Figure 18). About one-third of member states are facing delays in planned reforms and investments, due in part to economic constraints and labor shortages but also to a lack of administrative and monitoring capacity to manage an unprecedented amount of resources in a short time period. This explains why the actual disbursements have been delivered later and are also sometimes smaller than initially requested. Consequently, the initial disbursement timeline has been shifted more towards 2025-2027 and the economic impact is likely to be lower than initially estimated and more spread out over time.

**This is not the first time European funding has taken a while to reach the economies that need it the most. European Structural Investment Funds (ESIF) have also seen spending delays (Figure 17).** In particular, during the 2014-2020 EU budget, Italy and Spain managed to spend as little as 10% of the funds in the first four years, trying to catch up at the end of the budget period. This reflected the lack of planning infrastructure and possibly difficulties in finding valuable projects to finance. The complexity of the tender procedures and coordination, inadequate technical expertise of public administration and insufficient monitoring remain key points to address.

**If structural issues are not negligible, global challenges have posed additional threats.** The high inflation environment led to upward revisions of planned costs of the projects and focused attention on the bloc’s energy dependence. Therefore, amendments to the original plans have been made to include the RePowerEU chapters, designed to address the 2022 energy shock, in particular to facilitate additional reforms and investments for phasing out Russian energy imports. The instrument is based on up to EUR225bn of unused loans from the RRF. Among other priorities, REPowerEU aims to address delays in wind and solar deployment in certain regions.

Figure 17: European Structural Investment Funds spending vs. disbursement status of NGEU funds.



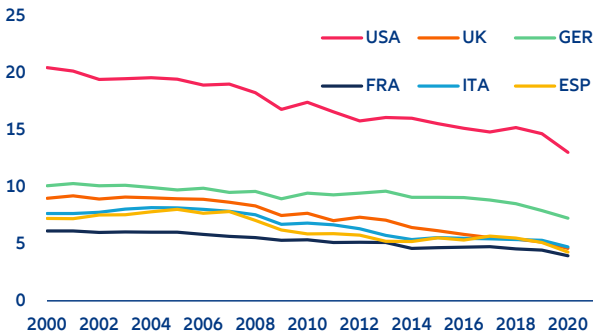
Sources: EC, Allianz Research

# The (green) silver lining

**Cheaper energy in the US comes at a (environmental) cost – the Eurozone produces lower CO2 emissions per capita.** The US’s economic outperformance over Europe comes at a substantial environmental price. Despite making some progress in the 21st century, the average US citizen still generates nearly three times the annual CO2 emissions of their European counterparts (Figure 18). This environmental gap extends well beyond CO2 emissions: If everyone consumed the same amount of natural resources as Americans, it would require 5.1 planets, according to data from the Global Footprint Network. For comparison, Germany and the UK consume the equivalent of 3 and 2.6 planets, respectively.

**European economies could benefit from the green window of opportunity.** The EU clearly has taken the lead in green goods trade. Germany alone surpasses the US in green exports while the US has become the strongest importer of green goods and technologies

Figure 18: CO2 emissions in tons per capita



Sources: World Bank, Allianz Research

besides the EU27 taken as a whole. The European comparative advantage in low-carbon economies is strong and has prevailed or even grown in recent years: 19 out of the 27 EU economies showed a comparative advantage (index above one) in 2021 (comparative advantage is calculated as the proportion of an economy’s exports that are environmental goods to the proportion of global exports that are environmental goods. A value greater than one indicates a relative advantage in environmental goods, while a value of less than one indicates a relative disadvantage). Slovakia is taking the lead due to a few specialized environmental products, particularly in the automobile industry, that account for a significant share of its exports, but Germany is following suit. At the same time, the US is slowly losing market share and its comparative advantage for green technologies has deteriorated over time (1.01 in 2021). As the EU aims to accelerate the green transformation and reach net-zero emissions by 2050, the green economy is expected to boost green job creation in the coming years and absorb some of the workforce displaced by potential deindustrialization in declining sectors. By focusing on the production and export of environmental goods, Europe can tap even further into growing global markets for clean technologies. In 2021, Germany alone generated about EURbn9.1 worth of revenue through energy efficient propulsion and control technology (0.3% of its GDP). This can contribute to economic growth and offset some of the negative impacts of deindustrialization. However, the EU’s green policies also include some ambitious standards and regulations that increase production costs, leading to leakages and the relocation of production to less regulated countries. The EU Carbon Border Adjustment Mechanism (CBAM) is designed to address this by levelling the playing field for EU companies. Yet, green energy production in the EU still struggles with competitive disadvantages.

# Where do we go from here?

It is clear that European countries urgently need to tackle the obstacles to higher productivity growth to improve the standard of living, regain a competitive edge against rivals and ensure the sustainability of their public finances in the face of both demographic change and the costly green transition. The top priorities must include:

**Reducing red tape and over-regulation, from the labor market to the business environment.** Simplifying rules and taxes across Europe would also help to strengthen the internal market. The current proposal for simpler tax rules within the EU to cut red tape for cross-border businesses pushes in this direction – but it remains to be seen whether this will be adopted. At present, 27 different tax systems exist across the EU. To comply with tax rules results in costs not used in productive activities and may be a disincentive to expand. With new simpler rules, tax compliance costs could drop by up to 65% for businesses operating within the EU internal market.

**Capital Markets Union (CMU): overcoming domestic and political interests.** Launched in 2015, the CMU initiative aims to develop and integrate capital markets in the EU in order to diversify business financing, increase investment opportunities and strengthen the resilience of the EU economy. However, EU capital markets lag behind the US and the UK and face challenges such as limited equity participation, fragmented market activity and persistent heterogeneity across member states. Two CMU Action Plans, adopted in 2015 and 2017, have struggled to achieve political consensus on longer-term objectives. Persistent fragmentation creates barriers to cross-border transactions and liquidity. Achieving a CMU will require political will to overcome resistance from vested interests. One source of resistance will be incumbents fearful of losing rents, possibly including local banking lobbies; local banks will need to be persuaded that part of the solution to structurally weak profitability lies in cautiously venturing into the capital markets business.

Another may be national authorities, some of whom may tacitly condone home bias; here the challenge will be to argue for the CMU as a way of encouraging a two-way flow of capital to the benefit of all. In a recent speech, Christine Lagarde identified two main reasons for the current stagnation in CMU progress. First, the lack of a unifying project on which to base the CMU. Second, the predominant reliance on a bottom-up approach to integration has failed to provide sufficient incentives for stakeholders to actively contribute to the development of a European market. To address these problems, the report advocates a top-down approach to the implementation of the CMU. This includes the creation of a European Securities and Markets Authority (ESMA) with enhanced powers for unified supervision and a single rulebook to reduce fragmentation in EU capital markets, as well as the need for consolidated market infrastructures. This could be a viable option.

**The vision of a truly integrated European financial union requires a well-functioning banking union and a vibrant CMU in healthy competition.** The CMU must complement banking, not replace it, so that the whole is greater than the sum of its parts. Reaping the economic benefits of both market-based and relationship-based finance requires appropriate public oversight. In capital markets, the regulatory approach must focus on facilitating effective market discipline, with intrusive prudential oversight of systemic actors.

Finally, progress in financial integration must be accompanied by fiscal responsibility and structural reforms. Efforts to complete the banking union and CMU must be part of a broader push to close productivity gaps and advance per capita income convergence across Europe, with countries pursuing fiscal adjustment as well as product and labour market reforms to improve their attractiveness as investment destinations. The CMU offers the promise of easier capital flows – but it is the



trade-off between risk and return that will determine their direction.

**Very linked to the CMU, the completion of the Banking Union is a crucial step for a stronger and more integrated European financial sector.** The agreement over the missing third pillar constituted by the European Deposit Insurance Scheme would definitely increase trust and market integration. The enhanced supervision and harmonized resolution of banks have already strengthened the sector which since 2014 has seen capital adequacy and balance sheets' quality improving, in parallel to the establishment of a credible safety net for the system.

**NGEU funds: spending timely and efficiently.** To maximize the benefits of the Next Generation EU initiative, member states should expedite their progress in achieving the targets and milestones outlined in their NRRPs as well as using the best infrastructure and resources available to them to allocate the funds. While the EU possesses robust public financial management and anti-corruption frameworks, it is crucial for NGEU funds to adhere to the highest standards of transparency and accountability. Given the size and complexity of the instrument, coordination between central and local functions should be strengthened and public administration should be adequately equipped.

**More targeted subsidies towards pushing the green transformation.** Economic convergence between member states is essential for the Eurozone. This is because economic imbalances increase the risk of instability in a monetary union. Unilateral or uncoordinated national industrial policy, which leads to further divergence within the Union, is therefore a considerable risk for the monetary union. It would therefore be better to have a truly European industrial policy. This means the same framework conditions and

funding conditions for industries in all member states. This would reduce the harmful subsidy competition between countries and put the spotlight on competition between locations. Misallocations would be reduced and the continent's potential maximized.

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