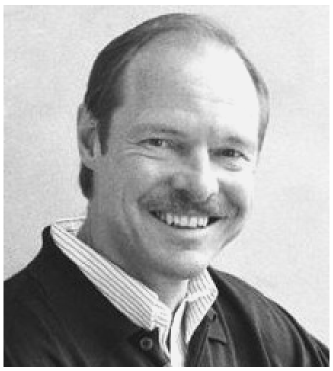
July 13, 2004

Cavelti

Perspectives



Europe's Descent into Irrelevance

The trouble with Europe is that it's far too large to ignore. While the old continent's political and social decisions are increasingly less relevant to the world, negative economic surprises are still capable of impacting the global economy.

The latest disappointment is Europe's inability to kick-start a decent recovery. To be sure, the continent's economy is once again growing, but the rate of growth is anemic. This comes at a time when China's engine is finally stalling, once again leaving the burden of pulling the world out of recession with the US.

Long-Lasting Busts and Short-Lived Recoveries

Why is it that Europe keeps hovering between long-lasting busts and short-lived, modest recoveries? There are tangible economic reasons, such as the structural impediments imposed by an interventionist, restrictive government culture. Others are psychological: the continent seems unable to take the kind of bold and decisive action the Europeans are fond of calling cowboy capitalism. When the two combine, as they did during the most recent recession, things get ugly.

In the US, corporations responded to the slowdown by slashing inventories and aggressively cutting costs, both on the human resources front and by eliminating excess manufacturing capacity. The transition was painful; the pay-off to come is immense. Many European companies looked at their American counterparts with a mixture of bewilderment and envy. Bewilderment because doing what's needed speedily is offensive to European tastes; envy because those few managers wanting to take resolute measures couldn't, because Europe's rigid laws wouldn't allow it.

The result? The US has enjoyed GDP growth close to 8%, which is now slowing to a more sustainable 3.5% - 4.5%, while most European economies are barely growing and are slated to return to only 2.0%.

Most intellectuals are still star-struck with by the promise of the European Union. Despite overwhelming evidence that the EU is in utter disarray, many of my friends in academia keep hoping that the dream of a continent united in vision and committed to high social values will yet be realized. The world's business community, on the other hand, is getting increasingly disenchanted. "The world is in the process of giving up on Europe," conclude Morgan Stanley's analysts after spending weeks with a broad cross section of investors, executives and policy makers from around the world. "The subject of the European economy almost never comes up," says Stephen Roach, the company's chief economist and Director of Global Economic Analysis. "This attitude is strikingly reminiscent of the treatment Japan received over the past decade. Just as the world learned to live without Japan, it now appears increasingly resigned to yet another outbreak of 'Eurosclerosis'."

Neither Mr. Roach's team not many others expect things to change. The EU bureaucracy keeps growing, duplicate government structures proliferate at the national level and, increasingly, individual nations are at each others' throats over topics ranging from balanced budget, to foreign policy to what the European Union should or should not be. Alarmingly, many fact finding missions reveal that European executives themselves have lost faith, a development which I can certainly confirm. Many of the continent's business leaders are reluctant to target their own economy with new investment. Instead, China, the US and a host of emerging nations are favored.

Gap Likely to Grow Further

In the end, of course, this trend will translate into a sharp decline in the European standard of living. Germans are already familiar with the experience: the absorption of East Germany and ongoing huge transfer payments to other EU nations have converted Europe's once proudest economy into one of the G-7's poorest performers. A similar fate appears in store for most of the rest of the continental economy.

Looking twenty years down the road, it's mind-boggling what challenges lie in Europe's way. Companies will further curtail their continental presence and invest elsewhere, and young professionals will desert Europe for venues where taxes are lower and opportunities greater. In addition to such economic considerations, there is also Europe's rapidly deteriorating demographic profile. Fertility rates in much of "Old Europe" (Italy, France, Spain, Germany) are dangerously low, which means that the continent's vast social security system will have to be supported by fewer income earners, just at the time when the number of benefit recipients explodes. All in all, not a pretty picture.

Some will say that my musing are based on the current situation and that the future may simply turn out differently. To be sure, any assumptions carry the risk of being overthrown by unexpected developments. But take a look at the most likely generator of future surprises, research and development spending, and you'll find it as negative for Europe as the topics I've already covered. Consider these facts:

-The US spends more than anyone on research and development. In 2002, reports The Kiplinger Letter, the total was $276 billion, of which 30% came from government. Japan, which was in second place, spent a third as much.

-Many of Europe's largest firms have headquartered their research facilities in America. In the life sciences field, arguably the most attuned to coming technological breakthroughs, the exodus to the US is particularly large.

-Three quarters of the world's Ph.D. graduates attend part of their post-doctoral education in America.

-The US continues to be faster than any other nation in converting R&D efforts into measurable cost-savings.

-America is far ahead of anyone in the three areas which will dominate global change in the coming decades: information technology, molecular biology and nano-technology.

Basking in Isolation

For the moment, the central problem is that Europe's conversion into a union has left it firmly under the control of the civil servant class. And a civil servant, by nature, is the antithesis to an entrepreneur. Politicians come and go; some will be liberals and others conservatives. The civil service doesn't much care about such distinctions: its sole goal is the preservation and, ideally, expansion, of the bureaucracy. Until the European people vote for change, which will be many years off, things will get worse.

As I am writing this article, a quote comes my way--a quote that captures the essence of Europe's problem better than any words I could come up with. It's by Jean-Claude Trichet, the new head of the European Central Bank, who had this to say a few days ago: "We are not influenced in any respect by what has been decided across the Atlantic, or what has been decided in the past across the Channel, or what has been decided elsewhere in the world. The US is the US, the Euro area is the Euro area. We are in different universes, with different fundamentals, with different episodes in the business cycle." What Mr. Trichet confirms for all us Euro skeptics is this: Europe's leadership is indeed on a different planet, accountable to no one, least of all to Europeans. ☐

Publisher: Cavelti & Associates Ltd., Toronto, Canada.