Why Europe won't grow
(and what to do)

By

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A future without growth

We are in the grip of a nightmare. Like all nightmares, the rationale behind it is terrifying.

What is growth?

First of all, it's demographic growth: 0.3% per annum in Europe[(1)] for the next 10 years.

It's growth in the proportion of the working population[(2)]. This will rise from 44% to 45% of Europe's total population between 2010 and 2020. Therefore, the working population will increase by 0.5% per annum.

It's the increase in productivity and value added created by the working population, not just in absolute terms, but in relative terms vis-à-vis other countries.

Productivity increases more or less automatically (for any given product mix) in a market economy. However, since all of the big developed and emerging countries achieve this same improvement in productivity (indeed, far more so in the case of the emerging economies), the end result is an increase in volume, but not necessarily in value.

Increasing value added is conditional upon improving the product and service mix that the population is assigned to. This mix can only improve if a significant portion of the population and capital is regularly reallocated from one sector to another, from low value-added sectors to higher value-added sectors, but without exit or transfer costs (administrative regulations, restructuring costs, environmental costs, etc.) becoming so prohibitive that they slow down or halt these developments. An increase in value added requires a sufficiently free-flowing economy. In the absence of demographic growth, an economy in which nothing is moving cannot grow.

A free-flowing economy also presupposes that governments do not subsidise (or over-subsidise) old sectors and that they promote the optimal allocation of resources across the economy to allow it to develop. Another requirement is that the countercyclical buffer measures taken by these same governments are not such as to prevent natural industrial concentration, or decline in the case of some sectors, or improvements in the average competitiveness of businesses; nor should such measures result in a public debt burden that stifles the potential growth cycles that naturally follow crises. Without economic cycles, it is difficult to eliminate competitors and marginal sectors. There is therefore no reason to increase average productivity and value added[(3)].

Value added can only increase sustainably if European firms in growth sectors are competitive at an international level and can invest in order to gain market share as a result of appropriate strategies as well as the competitiveness of wage costs and the levies of all types that they contribute for the benefit of the community (the compulsory contributions burden is 40% of GDP in Europe and 26% in the United States).

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(1) European Union (27 countries).

(2) Active population (excluding unemployed). Assuming a constant unemployment rate of 10%

(3) Except where there is high population growth.

Little surprise, therefore, that there was no increase in productivity and value added (combined) in Europe between 2000 and 2010. Over the same period, the increase was 0.8% per year in the United States and 9% per year in China (see Table 1).

The mechanism is not quite that simple. There are, of course, other factors.

There is the fact that the education and training system gives a population the means to work competitively in increasingly sophisticated new industries – and not just in service jobs that create little value added or in low-skilled blue-collar jobs – in direct competition with workers in emerging countries, where, all things being equal, costs are bound to converge in the medium-to-long term.

If the population is expanding through immigration alone, there is the fact that the value, education and integration system enables immigration to contribute to improving average value added over time.

There is the fact that the inactive portion of the population does not consume an excessive share (healthcare, retirement, etc) of the wealth created by the active population. If the average age of (actual) retirement increases in Europe, this share can probably be kept at 55% of the total population in 2020[4] despite the unfavourable changes in the demographic mix. It cannot be lowered significantly within this time frame. In terms of unemployment (10% of the active population), the important thing is for minimum wage and employer contribution costs not to be so high that they structurally exclude a significant portion of the population from the labour market.

There is the fact that the few functions or investment decisions that need to be centralised by the community in order to benefit from scale effects or long-term prospects – and they alone – are indeed centralised; and that the costs of administrative coordination and political representation of the whole population are optimised.

There is the fact that a large enough minority of individuals are willing to engage in entrepreneurial ventures and take risks, and are encouraged to do so by their education, the value system and the profits that they are able to derive.

Last but not least, there is the collective willingness to grow, which involves acceptance of the conditions and consequences of growth in terms of job mobility, a cyclical economy and the risks concerning new technology and the inequality of individual achievements.

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Now let's stop and wake up; it is obviously just a bad dream. This train of thought is absurd. *It would lead to growth of 1.5% per annum in Europe (at constant exchange rates) for the 10 years ahead (and close to 2.5% per annum in the United States), compared with average growth worldwide of 4% per annum (at constant exchange rates) and Chinese growth in the order of 8% (see Table 1).*

It would follow on from 0.8% growth per annum between 2000 and 2010 and would imply that we are in for at least 20 years (2000-2020) of economic stagnation.

In reality, of course, all of these parameters can be altered. All that is needed is a willingness to do so. In fact, Europe is set to rebound as a result of the recovery and will grow by 3% or 4% per annum over the long term, depending on the country (at constant exchange rates). The lack of growth over the last decade is nothing more than a blip.

But why should the next 10 years differ substantially from this structural historical reality? Why have all the conditions for growth described above not been met or not sufficiently met? What can really be changed in the short-to-medium term?

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[4] At constant unemployment rates

Inside the box

This macroeconomic "box" is very much part of the day-to-day reality for firms. It is highly restrictive and very hard to get out of.

Most of the major sectors that have driven European economic growth over the past 50 years have been plateauing for 10 years and are likely to go into decline in the coming decade. These include the automotive sector, consumer products, computer services, fixed telecommunications, infrastructure, basic industries, etc. (see Table 2). And the anticipated new, major sources of growth associated with new behaviours (energy efficiency, etc.) seem highly uncertain when you examine their economic rationale and factor out government subsidies or else they simply constitute transfers of resources and jobs between sectors with no overall value creation.

What can we do?

It is hard to envisage any alternative strategies for the European economy as a whole in the short-to-medium term. *Alternatives exist for individual companies however.*

For large and medium-sized companies, this will involve geographic redeployment, with a significant portion of sales and investments in regions of the world experiencing strong long-term growth.

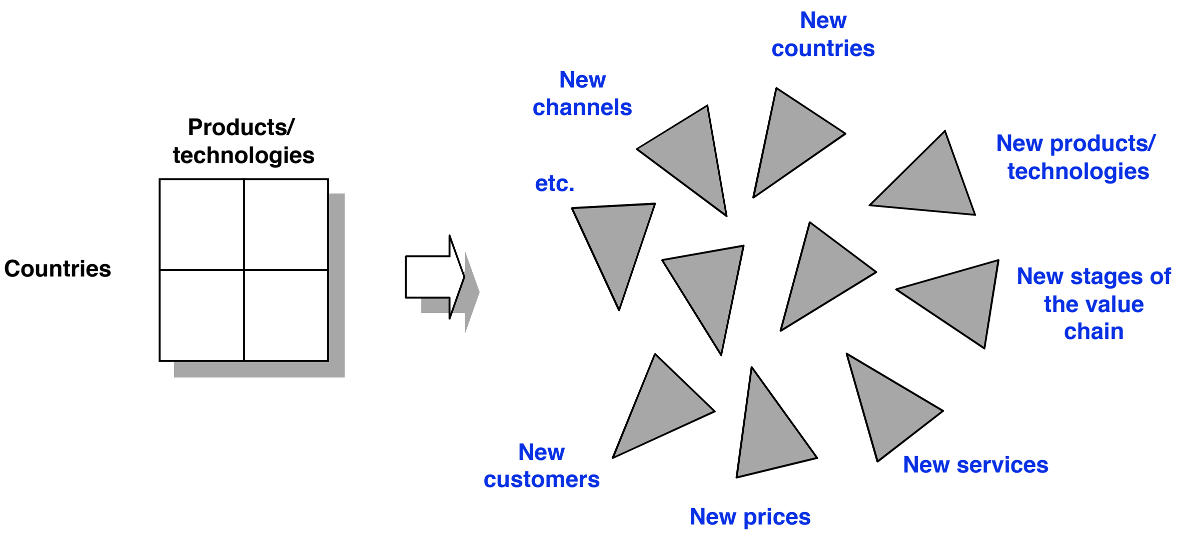
It will also involve a reassessment of core business portfolios and possible diversification into the few remaining or emerging sectors experiencing strong growth in Europe (digital economy, e-commerce, low-cost products and services, ultra-luxury segments, products and services related to the ageing population, industrial or service activities upstream of the value chain that are directly or indirectly driven by the growth of emerging countries or commodities, etc.).

Finally, it will involve challenging the business models that define current activities at the heart of European markets in order to discover new pockets of growth (see Table 3).

- Table 3 -

Need for a new perspective

Multiple segmentation and differentiation drivers exist in wealthy and mature countries and they continually create pockets of growth



Increased differentiation (facilitated by the growing heterogeneity and sophistication of wealthy and mature markets), microsegmentation, migration to new stages of the value chain, changes to the range of customer access channels and regular innovation are factors that may enable firms to refocus on areas of business that are growing at a time of overall sluggishness, adopting a different approach to each individual country.

The latter option is possible for medium-sized companies and activities. Regular repositioning and the periodic reinvention of the business model in order to capitalise on growth niches will provide significant additional revenues relative to the size of the company or the activity.

For large groups that make up the core sectors of the economy, this option is necessary but not sufficient. The additional revenues generated by this sort of strategy are often marginal relative to the size of the group. They do not create significant growth. They may even create instability and costly complexity, reducing the cash flow generated without securing the anticipated growth.

A classic strategic question is to decide how far to try to grow an activity, in all its forms, even if it means radically altering it, and at what point it is better to extract maximum short-term and long-term resources from the business to finance other, more obvious developments. That is the question that most large European groups must answer today for each of their businesses operating in flat markets. It is something that needs to be assessed on a case-by-case basis and the answer is seldom obvious. In many cases, growth, although modest, is still possible provided there is a *change in strategic focus* and sensitive and flexible management (see Table 3). In other cases, reinventing businesses is merely a more complex way of maintaining the status quo.

Migration, diversification or reinvention, these are the options open to each individual European company. But the struggle to capture these sources of growth will be fierce because the macroeconomic "box" will be firmly closed for the next 10 years. At the collective level, there is no more growth in Europe. The worst thing a company could do is base its strategy on illusions.

May 2011

Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analysing and improving the value of their investments.

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- Table 1 -

Past and future GDP growth

Annual growth rates (in local currency)

	Europe [(1)]		United States		China	
	2000-2010	2010-2020	2000-2010	2010-2020	2000-2010	2010-2020
Annual population growth (as %)	0.4%	0.3%	0.9%	1.0%	0.7%	0.6%
Growth in the labour force participation rate (as %)	0.4%	0.2%	-0.2%	-0.2%	0.3%	-0.2%
Improvement in productivity (as %)	0.0%	1.0%	0.8%	1.6%	9.0%	8.0%
GDP growth at constant prices (as %)	0.8%	1.5%	1.5%	2.4%	10.0%	8.4%
Inflation (as %)	2,1%	1.5%	2.5%	1.5%	4.1%	3.0%
GDP growth at current prices (as %)	2.9%	3.0%	4.0%	3.9%	14.2%	11.4%

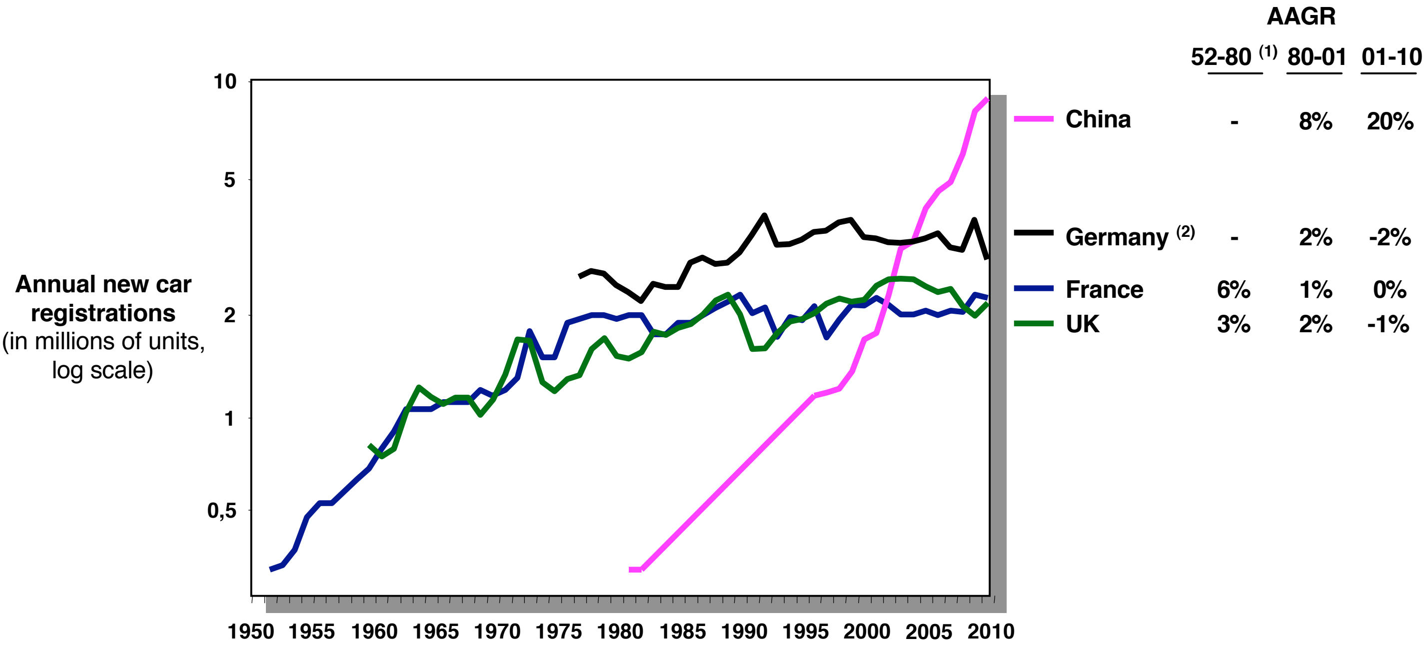
(1) European Union

Source: IMF, Eurostat, OECD, US Bureau of Labour, Estin & Co analyses and estimates

- Table 2 -

New car registrations in Europe and China

1950-2010



Note: New cars for passenger transport (excluding trucks)
(1) Or first year of available data; (2) West German growth rate applied to reunified Germany in 1990
Source: ACEA, Datamonitor, Comité des Constructeurs Français d’Automobile, Ward’s auto, ST Louis Fed, Estin & Co analyses and estimates