

Weekly Perspectives

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A Weekly View of Global Economies

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In recent months, leading indicators of Eurozone economic activity have been heading higher and point to a pick-up in growth in the next few quarters. It seems likely that the economy may approach its trend growth rate, which is generally estimated to be in the range of 1.5 percent. Of course, there are different estimates of the trend growth rate, depending on the time frame chosen and the methodology used. But, quibbling aside, the above figure is a reasonable estimate of what the economy can pull off.

One thing that catches our attention about the Eurozone's trend growth is how low it is compared with that in the United States which can grow at a significantly faster rate. The main reason is that productivity and employment growth in the US have been higher than in the Eurozone. And, there are few indications of substantial changes underway in Europe to speed up its performance in the near term.

Europe lost ground in the nineties, as America pulled ahead. Earlier structural changes in the US bore fruit, while much of Europe failed to generate any dynamism. Currently, European output-per-hour-worked is often quite high in the manufacturing sector but, unfortunately, the productivity growth rate is low.

In addition, labour market participation is lower than in the United States and job creation has failed to keep up with the inflow of labour market entrants, resulting in high unemployment rates. Americans have successfully utilised technology to innovate and increase productivity, particularly in the service sector, an area in which Europe is relatively more inefficient than in manufacturing.

It should be noted that those countries that have implemented labour market reforms, such as the UK and some Scandinavian countries, compare more favourably with the US on many of the above measures than do the heavy-weights of the Eurozone economy: France and Germany. Labour mobility is a crucial factor, allowing a more efficient allocation of resources and better cost control. And, as some innovative countries in Scandinavia have shown, it isn't always necessary to remove the social safety net to achieve efficiency gains.

The structural problems are well known, but by their nature are difficult to solve. Over the years attitudes and practices have become embedded in organisational and institutional arrangements, and a consensus has been formed of what is, or is not, politically acceptable. And the word 'political' is to be understood in its broader sense, so that the above contentions are also relevant to private-sector firms.

This applies, for example, to the consensus system of decision making that was prevalent in German firms, involving the participation of labour unions. Such arrangements served a useful purpose in the immediate post-war years but have now become impediments to change, in an increasingly competitive and fast-moving global economy.

In many Eurozone countries there are sacred cows and delineated boundaries that preserve the interests of privileged and protected groups. Any attempt to bring about change involves a lot of risk. Inevitably, those under threat will fight hard to preserve their interests. As Machiavelli recognised long ago, those who seek change put their neck on the line and the safest bet is to go with the status quo.

So, European leaders tread carefully lest they step on this or that group's privileges. The redoubtable Margaret Thatcher is among the very few who have successfully challenged the status quo. In Britain, the post-war consensus system had been institutionalised to such an extent that even conservative governments contributed to shoring it up.

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The inefficiencies, inadequacies and privileges were obvious, but no government wanted to accept the challenge of bringing about change. And it must be noted that, in the beginning, even conservatives opposed Thatcher's reforms. She was confrontational and that didn't go down too well with the Tory old guard willing to buy peace at the cost of inefficiency.

We are not indulging in an accolade of Thatcherism. Just a recognition of how important it is to bring about change if the goal is higher efficiency, and how difficult to implement the necessary transformations. This contention is equally true of individual enterprises as of an economy. The reality of how a private firm operates is very different from the touted ideology. And, contrary to popular myths, small companies can be just as awful as big ones.

European growth performance lags the US and is even more dismal when compared with the record in non-Japan Asia. There is indeed some concern in government circles in Europe about what is happening in the east. On a present-day size comparison, Asian economies are still small relative to Europe, but their trend growth rate is very high which means that the balance of power will gradually shift eastward.

Europe is already uncompetitive in a range of products, but the response is often in the direction of seeking to obtain protection from Asian imports rather than of implementing adjustments that will enhance competitiveness. The dispute with China over textile imports is a case in point. European had plenty of time in the past few years in which to reallocate resources away from uncompetitive textile production, but failed to do so. However, we should note that the US and other countries are also guilty of implementing protectionist measures. It is just that Europe seems to have a greater proclivity for easy short-term solutions.

Structural change in Europe will be a slow process. The risk is that investors with high expectations may become too pessimistic about what is being achieved and underestimate the benefits of the reforms that are actually taking place.

In the meantime, a pickup in growth will start to close the output gap and cause concern at the European Central Bank of the potential impact on price pressure. Headline inflation is already running well above the target rate and is unlikely to come down in the near term. Meanwhile, M3 money supply growth is trending higher.

Exports are playing a big role in driving growth, but the ECB will be watching to see the extent to which recovery broadens from external to domestic demand. There are signs of a pick-up in the latter but it is too early to be sure of sustainable strength. So an early move by the ECB to stop inflationary pressure from taking hold carries the risk of making it responsible for compromising the recovery.

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