

European Integration and Global Competitiveness

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Facing the Global Challenge

David Jacoby

1. A micro-economic analogy

What can Europe learn from recent American corporate restructuring that will provide a useful framework for dealing with the forces of integration? From a micro-economic perspective, this paper compares recent corporate mergers in the United States with national mergers in Europe, and draws key inferences and implications for successful European integration. There are many important issues in the integration, ranging from social and cultural to economic and financial. This paper will address the economic dimension because global economic competition was the original impetus for Europe's renewed interest in integration.

Until the 1987 stock crash, many were worrying about "economic anemia" and "Eurosclerosis" as Europe tumbled into its eighth straight year of real growth below three percent and its fourth straight year of double-digit unemployment¹. Meanwhile, Japan's average real rate of growth of GNP per person rose by 4% per year between 1983 and 1987². Between 1985 and 1987, investors in Japanese equities earned a 98% return while yen-denominated investments in the United Kingdom earned only 16.8%³. In the United States, an inflation-adjusted Dow Jones industrial average rose over 200% between 1981 and 1987⁴, and real GDP grew at over 4% between 1983 and 1987.²

The investing public has recently acknowledged that European economic integration is a major step toward regaining economic competitiveness. Europe is "selling at a premium" on the world market. Belgian, French, and Swedish bourses have all registered increases on the order of 50% since last January, and most other European bourses have risen 20% or more⁵. Let's examine why this has happened and how we can increase Europe's "share price" even more.

2. Perspective from a corporate boardroom

Europe's economic restructuring is not very different from the corporate restructuring going on right now in America. In 1968, Jean-Jacques Servan-Schreiber sent out a warning signal that France was being taken over by American businesses⁶. Today, companies are targets for a takeover if they do not maximize streams of future operating profits. In the wake of the RJR Nabisco deal, America's "big deals" have now topped \$20 billion.

Countries' assets, if undervalued, are attractive targets for foreign investment. Europe must restructure to avoid being taken over. It must face "the global challenge"⁷ head on. When a company is in danger of a hostile takeover, the best defense is usually to

run the company as the takeover artist would: run a tighter ship to boost the stock price to the point where it is no longer "under-valued". There are several commonly-employed ways to "head raiders off at the value gap".⁸

Leverage

Equity financing was once considered a solid and secure means of funding growth. Today, however, companies will "leverage to the hilt" to reduce the cost of holding excess cash reserves⁹. If they don't do it, a takeover artist will. Every major European government has run budget deficits since 1980. The deficits of France, Italy, and Spain have risen by more than 200% over that period². However, Europe is not alone in leveraging to avoid competitive decline. Brazil borrowed (and defaulted) in the 1920s to sustain its commodity exports in the wake of depressed prices. Practically all of Latin America is now mired in a debt spiral which has ended up in negative net resource transfers to creditor nations¹⁰. Certainly, the United States has borrowed more extensively than most European nations to sustain its economic growth. Not to mention its federal budget and merchandise trade deficits, corporate debt now stands at 90% of corporate equity (the highest since World War II)¹¹ and consumer debt represents about 18% of aftertax income¹².

Divest

Often, companies could improve investors' perceptions of the stock's value by selling businesses which are cash drains. Companies like FMC are choosing to focus on core businesses and let the shareholders diversify for themselves¹³. For a country, divestiture can come in two forms. In one, the government can divest of nationalized companies through privatization. This has been going on in Britain and France for quite some time. It is divestiture as in a friendly takeover. The other form of divestiture is selling private or public assets to foreigners who have more capital or who can do a better job of running the company than private investors in the country can by themselves. In Spain foreign direct investment has increased by 300% over the past five years¹⁴. In 1987, the United Kingdom sold more assets to foreigners than it bought from them for the first time in the 1980s. Italy and France also went from being investment capital exporters in 1986 to investment capital importers in 1987¹⁵.

Acquire

Before being bought, a company may want to consider acquiring other companies which would complement its capabilities and raise investors' perceptions of its future profit potential. General Electric's stock price soared under Jack Welch while he went on a shopping spree during his first few years as CEO. One tactic used by takeover targets is to increase cross-control by making counter-bids for the aggressor's stock. This happened in the case of Bendix Corporation when faced with a takeover bid from Martin Marietta. The most direct political analogy is war. Today, however, economic power remains the only acceptable way to acquire assets internationally. In the race for competitive sustainability, the large capital-holders in some countries will rush for

undervalued assets of capital-holders in other European countries. Carlo De Benedetti's attack on Société Générale de Belgique represents an acquisition strategy. Many recent European mergers demonstrate that other companies are also out to buy before being bought - Philips (General Electric), Nestlé (Rowntree), and Thomson (Thorn EMI), just to name three¹⁶.

3. Measures of successful integration

W. Michael Blumenthal, Chairman of the successfully merged Sperry/Burroughs Corporation (Unisys), notes that the hardest part of a merger occurs after the bankers and the lawyers leave¹⁷. In an economic restructuring, companies or countries must successfully decrease costs, increase synergies, and deal productively with stakeholder groups. Mergers which do not produce these fundamental results are usually not successful. Some recent European corporate mergers which have failed on one of these dimensions include Groupe Bull/Siemens, Dunlop Holdings/Pirelli, and Hoogovens/Hoesch¹⁸.

Transactions Costs

R.H. Coase, in his landmark work on the theory of the firm, explains that a company grows until "the costs of organising additional transactions within the firm" rise instead of fall¹⁹. *Ceteris paribus*, this implies that mergers make sense as long as they reduce transactions costs. As the Community lowers internal barriers, it is reducing transactions costs. European Commission studies have quantified the cost of a non-Europe at 200 billion ECU, or about five percent of the EEC's Gross Domestic Product²⁰. But the savings are much more obvious than gross statistics can convey. Presently customs clearance for truck drivers can require about 70 national forms²¹, and one European firm estimates that its trucks spend an average of 30% of their time idling in customs duty lines²². Even the thought of reducing these unnecessary costs of doing business has done wonders for the confidence of European business.

Synergies

Synergies are value-added pieces of a puzzle that make the whole worth more than the sum of its parts. Firms maximize synergies all by themselves, given an unbiased economic system - one such as a unified Europe. Geographic locations may provide synergy or strategic value when meshed with existing operations elsewhere. However, opportunities like this are often blocked by regulations or disparate fiscal and economic conditions. Similarly, if one company has a good distribution network, and another has an exceptionally efficient production facility, then a merger would take advantage of strengths in both links of the value-added chain to produce an output more valuable than the sum of the two units separately. Procter & Gamble took advantage of both

geographic and functional synergies to make its entry into Germany by acquiring Blendax, a manufacturer of health care products, largely for its distribution channels. As the EEC establishes common standards of performance and safety, it enlarges the market, enabling companies to use their resources synergistically and to achieve economies of scale.

Transition

Opposition to change is inevitable in any restructuring situation. In a corporate environment, the opposition is likely to come from employees who will be laid off due to the change, shareholders who disagree about the profit potential of the investment, management of the company being bought, and the general public which may perceive an unfair redistribution of income due to economic consolidation. Many of the same opposition groups will surface in Europe. Employees who may be laid off form a significant group of stakeholders; increased competition was never a friend of organized or unskilled labor. Obviously, certain "shareholders" in Europe are not buying into the idea as much as others. Certain regions or sectors, previously supported by the state, may fear that they will be neglected in favor of higher-growth opportunities. Great Britain may refuse to let its hard-won domestic economic progress contribute to supporting depressed areas on the Continent. The 1992 project has already gained so much political legitimacy that insurmountable opposition to major components of it seems unlikely at this point.

4. Issues for the long-term

Culture/Language

No matter how many fewer papers a truck driver has to sign to cross a border or how equitable subsidies are, the most long-lasting transaction costs of doing business in Europe will be cultural barriers. Most social anthropologists agree that language expresses culture in a very complex way²³.

Most Europeans now learn three languages in school. Though language acquisition cannot be legislated, individual countries will probably begin to strongly encourage the teaching of a common third language. This is already the case among the business and political elite, who regularly communicate in English. However, the future may see strong efforts at expanding common linguistic capabilities as part of the standard European education. Individual countries will not shed any of their cultural heritage in this process; the harmonization of language acquisition may be analogized to the harmonization of value-added taxes.

Currency

Two significant factors influencing firms' ability to maximize synergies are the availability of factor inputs and the financial stability of foreign investments. Both will be impacted by the increasing use of a single ECU-type currency. Currencies have been used ever since 1971 as a buffer against the direct influences of trade fluctuations on domestic economies. However, the United States uses one currency for almost five times the land area of the EEC²⁴, so why can't Europe? The kingpins of the American system are flexible wages and mobile laborers. Regional recessions do not have to be buffered by fluctuations in exchange rates because they are reflected in prices. If the situation gets bad enough, labor moves. As the economic ball rolls faster and faster in Europe, the cost of not moving will increase, and labor will have to become more mobile to accommodate the growth. Swedish companies are now importing Norwegians by the busload to compensate for a shortage of skilled laborers²⁵. Moreover, an increasing number of intra-European business deals will require managers to relocate across national borders. Due to imperfect mobility of labor, however, the use of a common currency should be accompanied by interest rate stabilization and effective use of the European Regional Development Fund (ERDF) as a "shock absorber" for troubled regions or sectors²⁶.

EEC Membership

Opposition from certain stakeholder groups on issues of employment, subsidies, and foreign investment might lead to changes in the profile and composition of the EEC. Even though it seems to be the most active cheerleader of the 1992 movement, France has many protected markets and is bound to be hurt in some sectors. Although West Germany seems to be in a strong position, it faces inflexible labor costs and high taxes²⁷. Countries will specialize to profit from their comparative advantage of production, but not immediately. Every country will grow, but disparities of income may result between countries which are well-prepared for liberalization and countries which are not. Those countries not willing to support a market-driven economy will experience strained relationships with other member countries. They may eventually opt out of the EEC, choosing protectionism rather than integration.

5. Summary

Europe stagnated throughout the 1980s and avoided confronting what was described twenty years ago as "the global challenge." In order to maintain its position as one of the three poles of world economic power, Europe's 1992 plan finally puts a deadline on building the economic unity and competitive resilience envisaged in the 1957 Treaty of Rome.

The 1992 integration can be analyzed in the framework of the corporate restructuring occurring now in the United States. In both cases, undervaluation and poor business performance signaled a possible loss of control to outside interests. Each of the

standard defenses was enacted to varying extents: leveraging the future, divesting unprofitable operations, and acquiring for strategic strength. Global investors have acknowledged, by placing a premium on European stock prices, that this restructuring will create a more efficient business climate. Following the micro-economic example, Europe can make this restructuring successful by reducing transactions costs, increasing synergies, and coping with stakeholder opposition.

The language barrier may prove to be the most formidable transactions cost. More widespread use of a common currency will stir concerns about wage flexibility and labor mobility, factors which strongly affect firms' ability to maximize synergies. Growth will be uneven between member countries, creating tensions between stakeholder groups in the integration. The most substantial responses to integration may not develop for several decades. These may include a common third language, a common currency, and changes in the profile and membership of the EEC. 1992 is a preliminary deadline; as in corporate mergers or acquisitions, the most significant progress will be made after the paperwork has been completed.

Endnotes

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