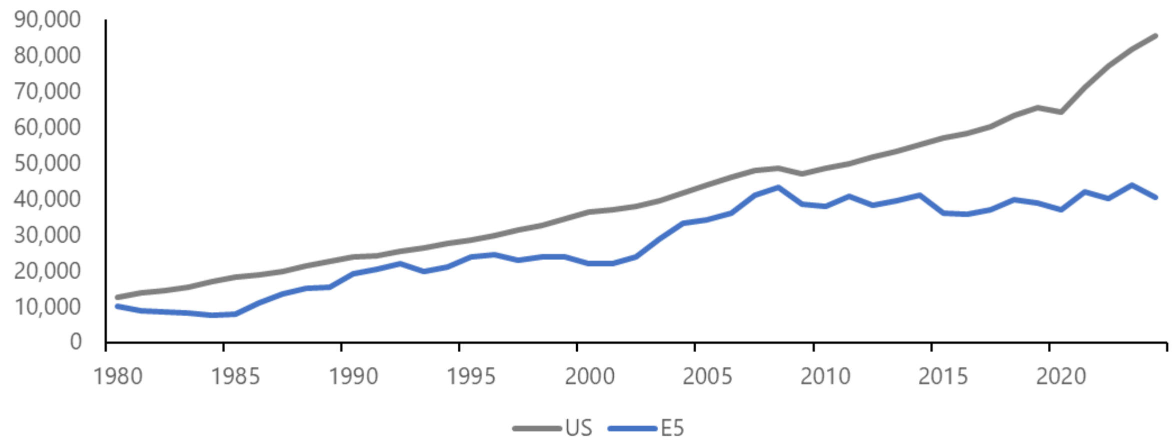
August 2024

Europe's Capitalism Problem

Europe's leading politicians and thinkers are increasingly worried about falling behind the United States—for good reason. Since the great financial crisis of 2008, per capita income has grown at an annual rate of almost 4 percent in the United States while stagnating in the five leading European economies (Germany, France, the UK, Italy and Spain—the E5 in chart 1). While per capita income in the US was similar to that of the E5 in 2008, now it is more than twice as high. Capitalism is fueling popular frustration worldwide, but it has gone more wrong in Europe.

Chart 1. GDP Per Capita (US Dollars)



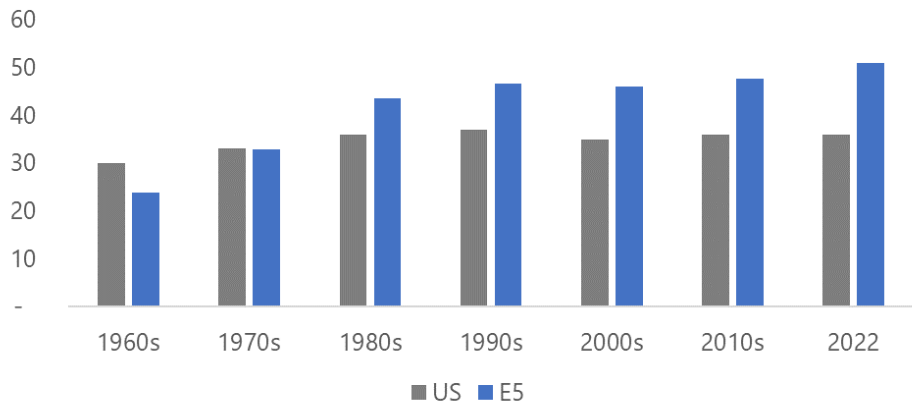
Source: IMF, Breakout Capital Calculations. E5 represents the equal weighted average across UK and the European Union's 4- big economies – Germany, France, Italy and Spain

Government Failure

What's the problem? One answer, we believe, is that beyond a certain point, bigger governments slow growth—and governments have grown both bigger and more active in Europe. Public spending was lower on average in the E5 than in the US until the 1980s, but since then has grown significantly faster—and is now much higher (Chart 2).

Over that period, public debts of the E5 nations rose threefold to almost 100 percent of GDP on average, as constant deficit spending shattered old habits of restraint, at least outside crises. Since its records go back farther than the others, the UK is a particularly interesting case in point: starting in the 1690s, the UK never ran a peacetime deficit until the 1970s. It then ran a deficit in all but five of the next 50 years.

Chart 2. Government Spending to GDP (Percent)



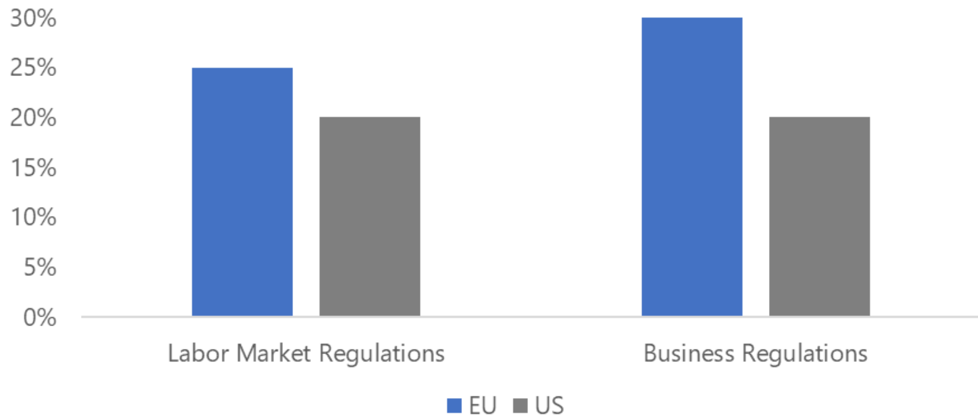
Source: National Sources, Haver, IMF, World Bank, Breakout Capital Calculations

The "Global Regulatory Hegemon"

Except for the UK, since Brexit, the E5 were also burdened by a second layer of continental government, over the national one. Since the European Union does not have taxing and spending authority, it channeled its considerable energies into creating what one scholar[1] has called a "global regulatory hegemon." Following the lead of largest and most active states—Germany and France—the EU is imposing its tight standards on any global firm that wants to do business in Europe, which is all of them.

It is no surprise that Europeans are more likely than Americans to cite regulation as a major obstacle to their investment decisions (Chart 3). Many medium-sized German companies say they are considering shutting down, citing "too much red tape and higher taxes."

Chart 3. Share of Firms Reporting that Regulations are a Major Obstacle to Investment Activities



Source: Europe Investment Survey

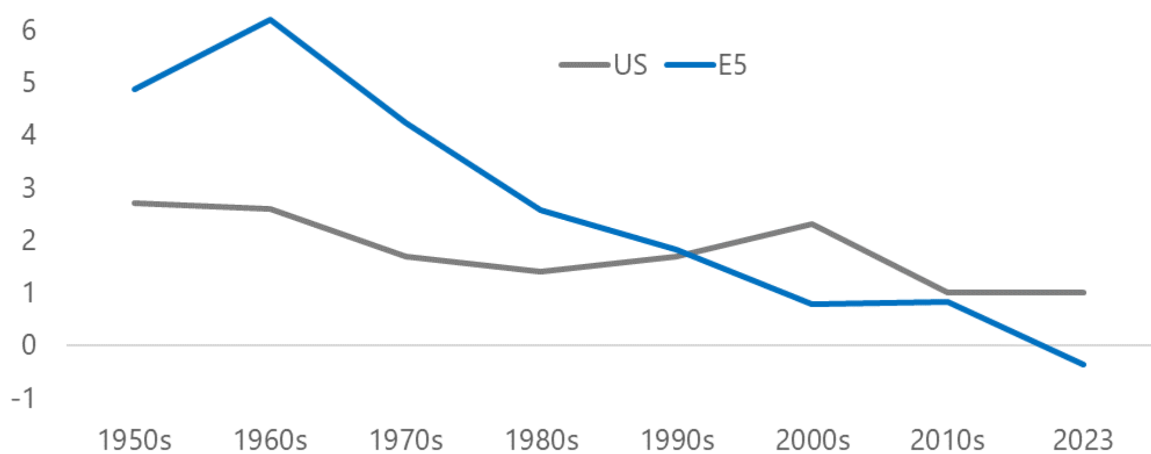
[1] Bradford

Productivity Growth has Declined Sharply

The expanding scale of E5 governments left less room for private competition and initiative. The growing tangle of red tape created an environment friendly to large companies, which can afford to navigate the maze, and hostile to small firms and startups. Over the last two decades, as central banks joined with governments in an effort to prevent recessions, and juice up recoveries, the business cycle started to flatten out. More deadwood survived each crisis. A new breed of zombie firms—which survive on a constant diet of new debt—rose across the developed world, with high concentrations in Europe, particularly as central banks joined governments in a campaign to eliminate business cycles.

The rise of oligopolies and collapse of business dynamism weighed on productivity growth, especially in Europe. From 1960s postwar peaks near 6 percent in Europe and 2.5 percent in the US, productivity growth collapsed to around 1 percent in the US and less than zero in Europe (Chart 4 below). And productivity is of course the key to prosperity—the force that makes strong, inflation free growth possible.

Chart 4. Productivity Growth (Percent, Calculated as Decadal Average)



Source: The Conference Board, National Sources, Breakout Capital Calculations

Trading Places

The twist: under President Joe Biden, who turbocharged the long expansion of government in the US, America is replacing Europe as the land of the most troubling spending habits. In coming years, the US budget deficit is expected to remain north of 6 percent of GDP, almost double the average deficit of the E5. This is particularly worrisome for the US because it is happening at a time when the US dollar is significantly overvalued as compared to its trading partners and fundamentals (Chart 5). We expect this trend to break and, in a sharp deviation from the past 15 years, for the dollar to remain weak versus other currencies.

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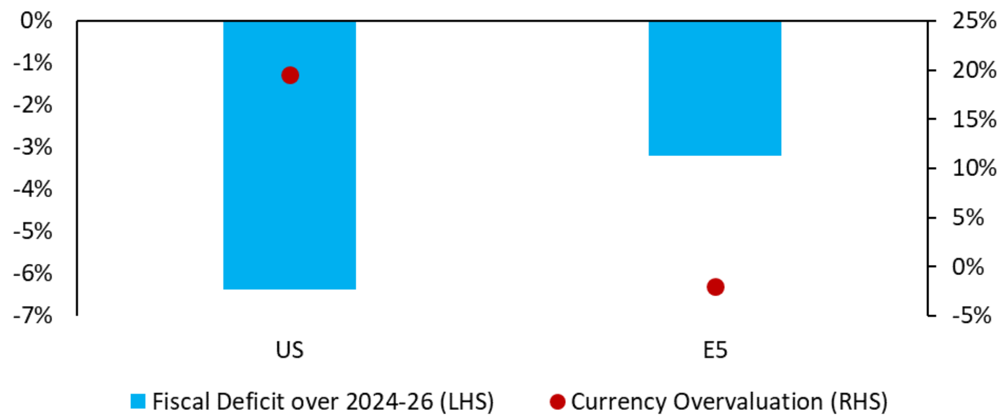
Chart 5. Fiscal Deficit and Currency Valuation
(Percent)



Source: Bloomberg, IMF, BIS, Breakout Capital Calculations

Why it Matters

We have expected the era of American financial dominance to end for some time, and there are signs that break is now emerging, both in the weakness of the dollar and the shakeout in global tech stocks. And for over a decade now, US outperformance has been so extreme, it doesn't even need to retreat very far for the rest of the world to gain. That means Europe, and emerging markets as well.

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