Issue 6

Is your organization ready for Europe's "Collapse of the Middle"?

A Portfolio Approach

by Andros Payne

Each month, in the Human Resources files, CEO Europe shares its expertise with a synthetic presentation of a topic.

A Portfolio Approach.

"Human Capital" implies a human portfolio. And, not unlike its financial cousin, actively managing a portfolio of human assets (employees) is a pre-requisite for above-average financial returns. However, unlike financial assets, people are not legal property. And the skills they bring can not be acquired or divested as easily, or as quickly. These aspects make managing a human portfolio particularly tricky in turbulent times, like today.

It was easier in the past. In the industrial age, most employees performed manual, repetitive tasks in production or administration. Managing their productivity was done with a stopwatch. Long investment cycles and large spans-of-control meant that just a few employees were needed to do the thinking, and guide these firms through calmer waters. A few knowledge workers - managers, R&D scientists, marketeers - were responsible for recognizing and reacting to emerging market and competitive patterns at the front end of these businesses. And, relatively few employees were also needed at the end of the value chain, after production, to sell or deliver the product.

A Productivity Gap

However, the industrial age portfolio structure is now being turned upside-down in the developed countries. Customers are refusing to pay a price premium for a high-cost production worker to perform repetitive tasks with low creativity and/or little information content.

The result over the past 15 years has been employee portfolio rebalancing in the US and developed Asia. However, Western Europe (excluding the UK) has chosen workplace stability over adaptation in this same period; it therefore lags behind. "Old Europe" is still full of industrial-age businesses and employee portfolios with low productivity "production" jobs[1] , with low information content and requiring neither pattern recognition nor customer interaction skills.

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[1] Performance 2005: Productivity, employment and Income in the World's Economies, The Conference Board, R. McGuckin, Bart van Ark

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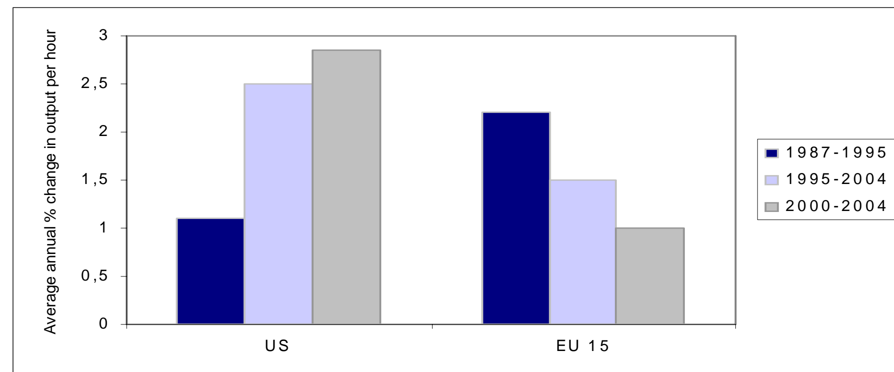
It's no wonder that a recently published study in the McKinsey Quarterly comes to the disturbing conclusion that "The real issue is the staggeringly large (32 percent) per capita output gap between Europe and the United States. That gap is mostly a consequence of Europe's poor productivity over the past 10 to 15 years." [2]



Another study by a team at the London School of Economics comes to a similarly troubling conclusion from a different angle. They linked higher productivity with modern management practices across 732 companies in the US, France, Germany and the UK, and found that "Management practices also display significant cross-country differences, with US firms on average better managed than European firms"[3]

McKinsey's conclusion: urgent action is needed in order to avoid a further erosion of relative prosperity. Europe is indeed at a turning point. Global economic and technological forces have put its companies and their employees on the verge of a major human portfolio shift, which will close the productivity gap and likely challenge deeply held social values along the way.

The Perfect Storm
Force 1: EU Expansion

George Schultz, Reagan's Secretary of State commented in 1991: "Western Europe either allows the former communist countries to send their products to the west, or they will send their people." He was right, and Western Europe responded.

The EU now includes ten former East Block countries with a combined population of 102 million - a 25% enlargement of the original EU12. However, the income footprint of the new members is indeed quite different from that of the rest of Europe. Per capita GDP in Central Europe is still less than 1/3 of the Western European average.

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[2] McKinsey Quarterly, Nr. 2, 2007, Heino Fassbender
[3] Center for Economic Performance Discussion Paper No. 716
"Measuring and Explaining Management Practices Across Firms and Countries", N. Bloom & J. Van Reenen

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In this way, the new EU member states have given Western European firms immediate and close access to a deep pool of low cost and flexible labour for many years to come.

Short-term, EU expansion poses the greatest immediate threat to employees caught in the middle – the production workers in western European factories. The option of moving their lower value, repetitive tasks east became credible with EU expansion and the economic rationale for doing so, more pressing.

However, it is still early days in Europe. There are other driving forces at work which will accelerate and amplify the impact of EU expansion on western European companies.

Force 2: Services Deregulation

Europe's many coun¬try-based rules and regulations have hin¬dered competition as an underlying driver for productivity improve¬ment in the past. Deregulating and opening-up the service sector to competition is therefore a second major force for change. The passing of the EU Service Directive in December 2006 marks a turning point at which the previously sheltered service sector is being pushed into the high seas of competition.

The Directive aims to increase competition by removing legal and administrative barriers to the development and delivery of service activities between member states. By unifying requirements, even previously protected professional employees in the legal and medical trades will be challenged.

According to Charlie McCreevy, European Commissioner for Internal Market and Services, "the Services Directive is an essential element to boost the European economy and unleash the potential for the internal market for services." The impact on productivity will indeed be large.

Injecting competition into Europe's underdeveloped service sector will not only boost productivity growth within sector, it will also accelerate growth of the sector as a whole. Since the productivity of service jobs at the customer interface is on average higher than that of manual factory workers, the resulting portfolio rotation out of factories and into services will compound gains within the sector to further lift average productivity.

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Force 3: Information Technology

Information technology is the third force driving shifts in employment and productivity across Europe. Specifically, the internet, broadband communications and Moore's Law[4] are contributing to a collapse of information processing and transmission cost – that is, the cost of any information transaction broadly defined. Like any other economic shock, the rapid decline in the real price of information (or transactions) is driving compensating changes throughout the rest of the economic environment.

Competitive and market rigidities have previously hindered this adaptation in Europe, and its impact on jobs and productivity. However, barriers have now largely been removed so that the benefits of technology can be realized.

As the cost of information collapses, the economic logic for co-locating activities in order to minimize communication and transaction cost evaporates. The glue holding activities together in European companies is finally coming apart.

At the same time, the fall in information cost is reducing entry barriers and enabling new competitors to gain scale in ever smaller niches. Back-office secretarial service specialists like E-Buero in Berlin answer calls and provide secretarial services to companies across Europe. Activities and processes in the value chain are being taken apart in European companies and being put back together in increasingly specialized (higher productivity) new firms, sometimes in Bangalore or St. Petersburg.

This bodes well for increasing efficiency since, as the venerable economist Adam Smith noted in 1776, productivity growth is based on increased specialization.

The future has already happened, it is just unevenly distributed

Simultaneously opening Central European markets, deregulating services and technology-driven specialization: Where will Europe's ship land after this perfect storm? Thankfully we don't need to look very far to see what the future holds. And, it could be a sunny island, if the European ship can stay on course.

A similar "triple play" of forces buffeted the US economy in the '90s. NAFTA, the North American Free Trade Agreement was implemented in 1994. It removed trade barriers between Canada, the United States and Mexico. Similar to EU expansion, this agreement gave US businesses nearby access to a deep pool of cheap labor in Mexico. Lower value-add, manual tasks, primarily in manufacturing, rapidly moved south of the border and injected new competition into US labor markets. Together with an open market for services and the IT revolution, NAFTA was a catalyst for productivity

[4] The empirical observation made in 1965 that the number of transistors on an integrated circuit for minimum component cost doubles every 24 months. It is attributed to Gordon E. Moore (born 1929), a co-founder of Intel.

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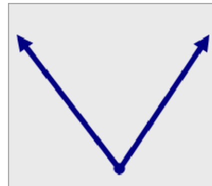
growth. US productivity accelerated from 0.7% p.a. ('90-'95) to 1.5% p.a. ('95-'05). A similar pattern is emerging in Europe, with similar results. Productivity growth has begun to pick up recently.

However, before European's get their place in the sun, considerable change and re-structuring lies ahead.

Collapse of the Middle



In July 2004, only weeks after EU enlargement, Daimler negotiated unprecedented favourable labour contract conditions for its Mercedes division, including a net reduction in pay and longer working hours in return for a guarantee not to move production and jobs until 2012. Germany's strongest union, IG Metal, representing Mercedes' 160,000 strong work force, was characterized as "shamelessly capitulating" by its own insiders. More recently, Verdi, Germany's largest service union capitulated to Deutsche Telekom. Despite loud protest from its members, the union agreed to spin-off 50,000 workers into a service company, where they will work 12% longer and for 6.5% less pay. These are early signs for the larger storm to come.

Value is migrating from the "production" workers in the middle of the value chain to the extremes. On the one hand, it is shifting to those employees at the beginning of the value chain, the managers and researchers, who are responsible for recognizing emerging market and competitive patterns, and for creating products and services to satisfy new needs (innovation). And, it is also migrating to employees who work directly with customers to deliver unique solutions which satisfy their specific requirements (customer ownership).

This bifurcation, or Collapse of the Middle in Europe, is at the heart of today's employee portfolio shifts, and it explains otherwise contradictory headlines in the business press. Even in today's tightening labor markets, hardly a day passes without announcements of lay-offs, redundancies, plant closures or re-locations. Companies in Western Europe are shedding the "production" employees in the middle.

At the same time, there is a lack of skilled, knowledge workers on the continent. An aging population is exacerbating competitive challenges at both extremes of the Collapse of the Middle. The fight between firms over the most valuable (often younger) employees who are creating and managing new products & services, and those delivering them to customers (the knowledge workers) will only intensify. It is in this light, that calls for managers to become leaders, and for salesmen to become customer relationship managers, make sense.
Clearly, the approaching wave of human portfolio shifts in Europe will demand both re-structuring, and re-training.

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How to succeed

What should European corporate leaders do to take advantage of the approaching Collapse of the Middle for the benefit of their customers, employees and shareholders?

First, they should face reality. It is normal for humans to avoid conflict with their fellow man. Managers are no exception. In the short term, it is often harder to face reality and downsize, parting with long-time colleagues, than to endure slowly deteriorating financial performance. However, acknowledging the coming Collapse of the Middle, means facing difficult organizational choices and making tough decisions that will improve performance, but also surely cause conflict.

Managing the Collapse of the Middle demands a fact-based understanding of the current human portfolio. How many employees do we have? What skills do they possess? Which tasks are they performing? What is their productivity versus other internal and external benchmarks? Sound economic decisions about the organization are based on having good information about people.

Human portfolio optimization also requires a fact-based view of individual performance. High performers can often be re-trained to perform new tasks, or to perform their current tasks at a higher level.

As the scarce resource increasingly shifts toward knowledge workers at the extremes of the Collapse of the Middle, many companies will have to learn how to better manage this new majority of their human portfolio. Old business and human resource practices that worked well for managing dependent production workers in the past will require a fundamental rethink. The leadership and HR processes to manage independent knowledge workers at the extremes, look very different from those used to manage the shrinking few in the middle.

Finally, the time delay between making employee portfolio changes, and realizing their positive effect, makes anticipation and early action important. There are many benefits to beginning early. It minimizes risk by giving management more time to find good solutions for departing employees, and on the other hand, time is needed to build the new skills required in the future.

Successful firms and leaders will anticipate the needed changes and take action before they are forced to do so by the financial circumstances. The time to start is now.

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