FEDERAL RESERVE BANK OF DALLAS

Issue 5 September/October 2000

Southwest Economy

The New Paradigm in Europe: Is Goldilocks Going Global?

Since the mid-1990s, the U.S. economy has experienced a combination of high growth and low inflation that has made it the envy of the world. Some argue we have entered a new era, one in which the old rules no longer apply. Others argue the country has benefited from a series of favorable supply shocks that have simultaneously lowered inflation and unemployment. While commentators may disagree over what is and isn't new about the New Paradigm, the fact remains that the U.S. economy is experiencing a combination of output growth, inflation and unemployment not seen since the onset of the productivity slowdown in 1973.

What *is* new about the New Paradigm is the proximate cause of the high growth and low inflation experienced over the past five years—rapid technological innovation. But given the ease with which technology can be transferred between nations, the question arises of why only the United States seems to have benefited from the computer revolution. Despite its large domestic market and highly educated workforce, Europe hasn't exhibited the same performance. There's

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A Common Currency for the Americas?

As part of the Federal Reserve Bank of Dallas' ongoing efforts to support effective economic policies, the bank hosted a conference in March 2000 entitled *Dollarization: A Common Currency for the Americas?* The question mark in the conference title signaled attendees that both sides of the dollarization debate would be represented.

Dollarization

When a nation officially dollarizes, it abolishes its own currency and formally adopts the U.S. dollar as legal tender. Advocates argue that dollarization helps establish fiscal and monetary credibility because inflating the currency to cover fiscal deficits is no longer an option. For the same reason, dollarization helps maintain price stability. Accordingly, dollarization can lower transaction costs for trade and investments. It also eliminates the devaluation

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Special Issue Focusing on International Economics and Monetary Policy

reason to believe, however, that the process of European integration—as manifested most recently in the European Union's (EU) single-market initiative and the launch of economic and monetary union (EMU)—is setting the stage for the emergence of the New Paradigm in Europe.

U.S. Economic Strength

The United States is enjoying its longest economic expansion ever. Over the past five years, GDP growth has averaged 4 percent a year, while inflation has averaged less than 3 percent. But robust growth and low inflation don't tell the whole story. Unemployment rates are at a 40-year low, and, unlike the pattern of previous expansions, productivity growth has increased over the course of this one. Stock market gains have boosted the wealth of millions of households, and burgeoning surpluses have allowed the federal government to start paying down the national debt.

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So far, only the United States has simultaneously experienced the combination of rapid GDP growth, low inflation, low unemployment and high productivity growth. While some European countries may exhibit one or more of these features, none has them in the same combination. For example, while inflation in the EU is lower than in the United States, unemployment is higher and GDP growth is lower. The UK is experiencing low inflation and low unemployment but has not grown at the same rate as the United States. And Ireland, dubbed the Celtic Tiger, has grown at rates far in excess of the United States' but is experiencing its highest inflation in 15 years.

Table 1 compares key economic indicators for the United States and Europe.[1] Average annual GDP growth over the past five years was 1.6 percentage points faster in the United States than in Europe. In fact, Europe experienced a mild growth recession in recent years, due in part to fallout from the Asian crisis. Inflation was low and falling in both the United States and Europe from 1995 until last year. Indeed, for most of that period, Europe posted the better inflation performance, as candidates for EMU strove to bring inflation rates down to German levels. Inflation rose in both the United States and Europe over the past year and a half, primarily as a result of higher oil prices. Inflation in Europe has also been adversely affected by the euro's decline against the dollar.

Table 1

U.S. and European Economic Performance, 1995–2000

	United States (percent)	Europe (percent)
GDP growth	4.0	2.4
Unemployment	4.8	10.0
Inflation	2.6	1.9
Productivity growth	1.9	1.5

NOTES: All numbers are annual averages. European productivity growth is for the 11-nation euro area only. GDP is through first quarter 2000. Inflation is through July 2000. Unemployment is through June 2000. Productivity is through first quarter 2000.

SOURCES: Eurostat; Bureau of Economic Analysis; Bureau of Labor Statistics; European Central Bank.

Some have argued that the struggle to meet the stringent Maastricht criteria for EMU participation was a key contributor to Europe's sluggish output growth and high unemployment in the latter half of the 1990s. However, it seems more likely that labor market rigidities were the main factor keeping unemployment high. European unemployment has been declining since 1997, but the jobless rate is still more than twice that of the United States.

Europe has done well in terms of productivity, at least in the industrial sector, where productivity growth has been consistently positive and solid since 1994. While cross-country comparisons of productivity are difficult, some past measures have shown manufacturing productivity in France and Germany exceeding that of the United States.

But even with strong productivity performance in the industrial sector, Europe has been outperformed by the tech-fueled American economy through much of the 1990s and into the new millennium. Chart 1 shows the trends in overall labor productivity growth for the United States and Europe.[2] During the first half of the decade, these trends were not all that different. But since 1995, there has been a persistent and growing gap between U.S. and European productivity growth. The acceleration in U.S. productivity lies

at the heart of the New Economy, making it possible for rapid growth, low unemployment and low inflation to coexist.

Many factors have contributed to America's robust economic performance. Adoption of new technology—particularly information technology—has allowed many businesses to become more efficient. Deregulation and crumbling trade barriers have exposed U.S. firms to intense competition, spurring innovation and leaner production systems. The U.S. labor market remains one of the most flexible in the world, making it easier for businesses to respond to rapidly changing conditions. Mature financial markets have provided the capital needed to develop new ideas and move discoveries from the laboratory (or garage) to the marketplace. Finally, relatively low capital gains taxes and use of stock-option-based compensation have encouraged entrepreneurship and risk taking, which in turn have sustained growing business activity.

Until very recently, the prospects for Europe participating in the New Paradigm looked decidedly weak. A long history of government intervention reinforced market rigidity, propping up Industrial Age corporations with subsidies and delaying much-needed restructuring. Heavy reliance on bank lending as the primary source of business capital worked against new business development. Laws intended to promote job security discouraged hiring and promoted a rigid labor market. Conflicting and confusing regulatory regimes across European borders increased uncertainty and inhibited interstate commerce. "Eurosclerosis" was the diagnosis, and the condition seemed terminal. But things may be changing.

Europe

With America experiencing its longest expansion ever, many European leaders are looking across the Atlantic in search of the recipe for the "just right," Goldilocks economy. While it is unlikely Europe will be able, or even want, to replicate every aspect of the U.S. experience any time soon, the prospect of the New Economy emerging there is no longer just wishful thinking. A variety of market and political trends are creating the institutional infrastructure that may transform Europe from its current torpor to a more dynamic environment.

Competition. One of the key factors that contributed to the New Economy's emergence in the United States is the intense competitive environment American firms face, both from within and from overseas. For example, the overall level of tariff protection is lower in the United States than in Europe. In 1996, the average tariff on all products in the United States was 5.2 percent, while the

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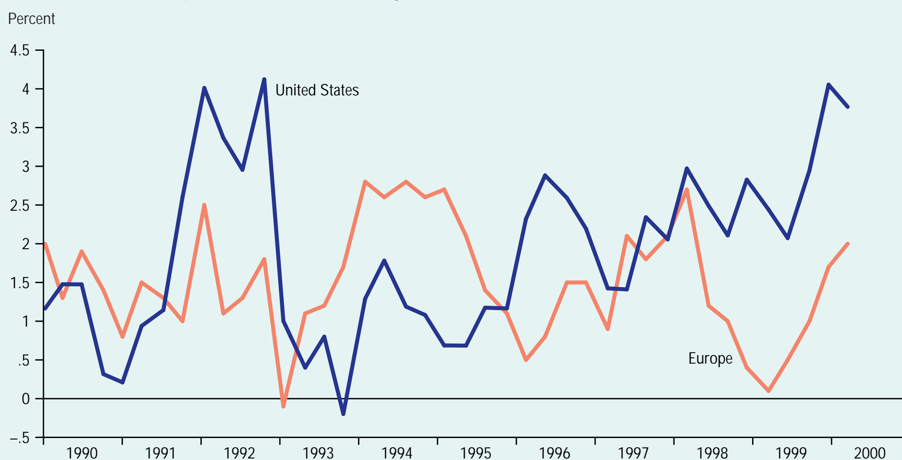
Chart 1

U.S. and European Productivity Growth, 1990–2000



NOTE: Data for 2000 are through the first quarter.

SOURCES: Bureau of Labor Statistics; European Central Bank.

Many consider Europe's financial system another obstacle to realizing New Economy growth in the Old World.

average in the EU was 7.7 percent. Government bailouts of ailing firms are rare in the United States, and the federal government has never been deeply involved in the day-to-day activities of business, as has often been the case in Europe. Fierce competition in the U.S. marketplace has forced American firms to raise performance levels. To stay viable, they have had to boost productivity, become more efficient and pursue myriad business innovations.

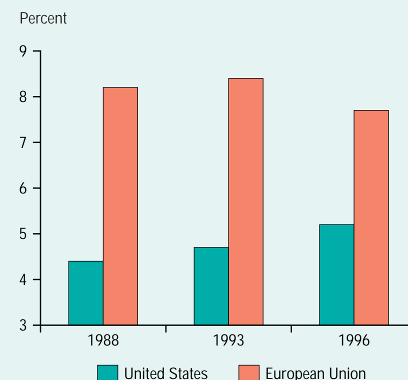
European integration, which began with the Common Market's creation more than 40 years ago, has gradually intensified the competitive pressures firms in Europe face. The first step was the elimination of formal tariff barriers to trade, which was rapidly accomplished. A more radical step was taken in 1986 with the passage of the Single Market Act, which required the elimination of nontariff barriers to trade by 1992. These moves toward greater openness (at least vis-à-vis other EU members) have been accompanied by privatization of nationalized industries and deregulation. Combined, these measures have enhanced the competitive environment in Europe, although as Chart 2 shows, firms there are still less exposed to global competition than their U.S. counterparts.

Entrepreneurship. It seems obvious that entrepreneurship is central to economic growth. Yet surprisingly little effort has been devoted to studying entrepreneurship or understanding what policies best promote it. One recent study found that variations in rates of entrepreneurship may account for as much as one-third of the variation in economic growth across countries. The same study found that at any given time, 8.5 percent of the U.S. population is involved in starting new businesses, the highest percentage of any country.[3]

Historically, Europe has been a less friendly environment for entrepreneurship. High taxes on profits, dividends and other types of capital gains have discouraged risk taking and constrained business initiative. In France, two-thirds of profits from stock options are taken in taxes. Excessive bankruptcy penalties have long stymied entrepreneurial initiative, with legislation erring on the side of protecting creditors. Failed entrepreneurs rarely get a second chance.

Chart 2

Production-Weighted Average Tariff Rates



SOURCE: *OECD Economic Outlook*, June 1999, Organization for Economic Cooperation and Development, Paris.

Cultural norms have generally been incongruent with those that allow entrepreneurial spirit to thrive. The high value European countries traditionally place on social cohesion has as a corollary an unwillingness to accept high levels of income disparity. Many Europeans would be glad to see a homegrown equivalent of Microsoft but unwilling to accept the concentration of wealth that would accompany it.

However, there are signs the entrepreneurial environment in Europe is changing. Most important, many countries have cut taxes to encourage capital formation and new business initiatives. Germany recently announced one of the most dramatic tax reforms, which will see the top income tax rate fall from 53 percent in 1999 to 47 percent in 2003. France is following suit, with proposals to cut the corporate income tax rate for small and medium-sized enterprises from 36.6 percent to 33.3 percent. In 1998 the European Commission proposed a variety of measures to foster entrepreneurship, including simplifying the process for starting a company, improving access to seed capital and fostering "the spirit of enterprise." Different attitudes about risk taking, new technology and new products are taking hold. Entrepreneurs are viewed more favorably, and outdated regulations restricting competition are slowly being dismantled. Venture capital alternatives and equity markets, both essential to facilitating entre-

preneurial activity, are increasingly gaining ground.

Financial Markets. Many consider Europe's financial system another obstacle to realizing New Economy growth in the Old World. Traditionally, debt financing has been the primary vehicle for funding European business ventures, putting powerful European banks in total control of financing. As a result, start-up firms with little in the way of tangible assets to offer as collateral often had difficulty raising capital. Additionally, a variety of regulatory barriers have impeded institutional investing in venture capital and private equity markets.

In contrast, the American financial system has been well equipped to handle the technology-driven demand for seed funding. Regulatory and structural changes in the late 1970s cleared the way for pension funds, insurance companies and mutual funds to invest in venture capital and private equity funds. This deregulation made it much easier for entrepreneurs to take their ideas from the drawing board to the marketplace. The difference in financial systems is underscored by the fact that real business investment in America increased almost twofold between 1990 and 1999 but rose only 16 percent in Europe.

Despite these past difficulties, the outlook for Europe's financial markets now appears much brighter. The euro's much-anticipated unveiling in 1999 began the development of a single European capital market. The unifying force of the new currency will make capital markets more efficient in the long term.

Another sign of strengthening European financial markets is the growing popularity of venture capital funding. European venture capital funding increased significantly in 1999 and is expected to double or triple over the next few years.[4] To complement the maturing venture capital market, Internet and other technology incubators are springing up throughout Europe. In some cases, new businesses have rushed to go public, bypassing venture fund opportunities altogether. The creation of Le Nouveau Marché in France and the Neuer Markt in Germany has further broadened the funding opportunities for start-ups.

Yet another encouraging trend can be seen in European equity markets. Share ownership is becoming more common, and a shareholder culture is emerging. The seeds of this culture were planted by the privatization of nationalized industries, such as airlines, telecommunications firms and utilities. Much of the deregulation and privatization is being driven by directives from the European Commission.

The development of a shareholder culture is likely to lead to a shakeout in many industries. Management will increasingly have to answer to shareholders and not to broader state interests or stakeholders. The understanding that firms belong to shareholders and not bosses or society will replace the existing paradigm, and European managers will begin feeling the kinds of pressures their American counterparts have long endured. Return on equity and earnings growth targets will force firms to become more efficient and productive.

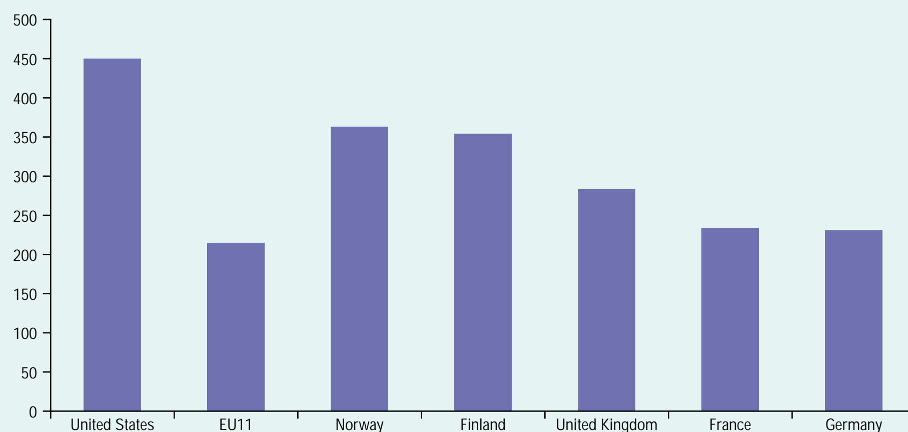
Technology. New information technologies have been key to the recent rise in U.S. productivity. Large investments in information technology in the early '90s paved the way for higher output growth in the latter half of the decade. In general, the use of computers, the Internet and mobile telephones is lower in Europe than in the United States. More than 90 percent of U.S. white-collar workers use a PC, compared with only 55 percent of Europeans. The United States has one PC for every two people, while the ratio is one for every four in Europe's big industrial economies (*Chart 3*). However, some individual European countries exceed the United States in Internet and mobile telephone use, in particular, the Scandinavian countries. Finland and Sweden are home to leaders in mobile telephony (Nokia and Ericsson), and by most accounts Europe is leading the mobile Internet revolution.

About one-third of Europeans own a cell phone for personal use; in Finland and Sweden, the figure is closer to two-thirds. The number of people connected to the Internet via a wireless device is expected to grow dramatically in coming years. Furthermore, Europe has already adopted a single digital cellular telephone standard, while the United States continues to rely on multiple, incompatible standards.

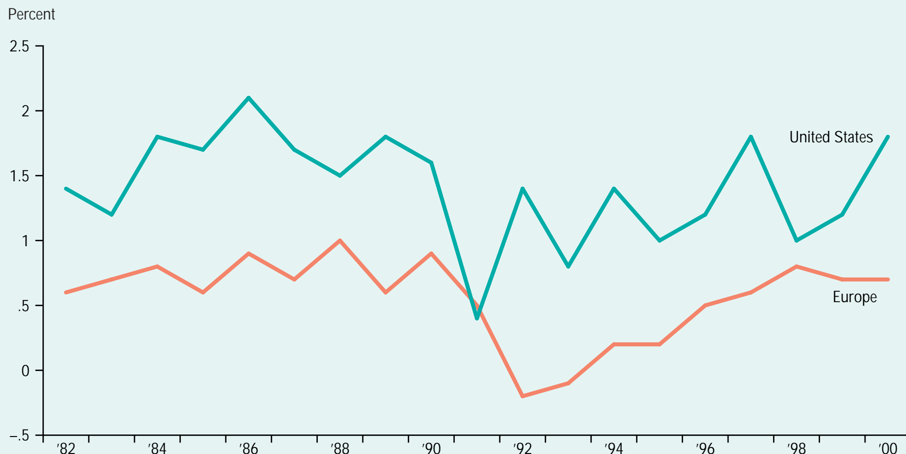
Labor Markets. Even with large productivity gains from business innovation, it's unlikely technology alone can lead to sustained rapid output growth across Europe. Low labor force growth means that it would take productivity growth rates well in excess of those in the United States to propel comparable output growth in the euro area. As Chart 4 shows, since the early 1990s labor force growth in Europe has been running at about half the U.S. pace. To realize New Economy levels of output growth,

Chart 3

Use of Computers, 1997



SOURCES: *Fostering Entrepreneurship in Europe: The UNICE Benchmarking Report*, 1999, Union of Industrial and Employers' Confederations of Europe, Brussels.



NOTE: Data for 2000 are OECD projections.
SOURCE: *OECD Economic Outlook*, June 2000, Organization for Economic Cooperation and Development, Paris.

Europe would have to draw deeply on its pool of unemployed workers and attract more workers into the labor force.

In Germany the labor force has shrunk in five of the past eight years. Ireland has been one of the few European countries posting rapid labor force growth, but it is too small to have much effect on areawide aggregates. Labor force participation rates remain much lower in Europe than in the United States. According to recent estimates, slightly more than two-thirds of Europe's working-age population participates in the labor force, compared with nearly four-fifths of America's.

Cultural and language differences across borders have been a deterrent to European labor mobility. It's the Continent's rigid labor markets, however, that have long drawn reformers' ire. In the past, powerful labor unions systematically averted efforts to increase businesses' flexibility to hire and fire workers. The absence of this flexibility has undermined global competitiveness by hampering firms' ability to respond to changing market conditions. The downsizing of U.S. firms a decade ago created room for companies to exploit new market niches. The use of flexible work contracts and other forms of temporary employment—more common than in Europe—have also enhanced the efficiency of America's labor market, freeing workers to move from industries in decline to those growing rapidly.

Current trends, however, suggest that Europe's labor markets are becoming less rigid. As rules become less strict, more workers have been hired on fixed-term contracts or as part-timers, reducing labor costs. Policy changes in Italy, Spain, Germany and France have further mobilized labor markets. These "friction-free" policies have reduced the social cost of dismissing workers and made it more attractive to hire younger and lower paid workers.

Some European countries have also adopted "making work pay" policies, such as tax incentives for entering employment. These policies have stimulated employment in France and the Netherlands. While the dynamic effects are still uncertain, it is commonly agreed that the efficacy of such policies depends on flexible labor markets and the easing of hiring constraints.

The Future

Europe is increasingly trusting market solutions and resisting the temptation to legislate commerce. UK-based Vodafone AirTouch's hostile takeover of Germany's Mannesmann is a good example. Hostile takeovers were once taboo in Germany, and when the bid started to materialize, many expected the German government to kill the deal. In the end, though, the state backed down and allowed the massive transaction.

There is still room for improvement. It is far more expensive to start a business in Europe than in America, and some regulations continue to stifle firms and discourage job creation. Gaps in the law result in insufficient protection of intellectual property. Prohibition of stock options in France continues to impair entrepreneurship and new company growth.

However, as the countries of Europe become more integrated, sharing a common currency and a market bigger than the United States by about 100 million people, the competitive pressures firms and governments will face cannot but lead to greater efficiency and higher growth.

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Notes

[1] The data are for the European Union (EU), which consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. The euro area (EU11) consists of all these countries except Denmark, Greece, Sweden and the United Kingdom. However, starting January 1, 2001, Greece will also adopt the euro.

[2] The data for Europe refer to the 11-nation euro area only.

[3] Paul D. Reynolds, Michael Hay and S. Michael Camp (1999), "Global Entrepreneurship Monitor," 1999 Executive Report, Babson College, Kauffman Center and London Business School, p. 3.

[4] Reynolds, Hay and Camp (1999).