Europe's Comeback: More Than a Dead Cat Bounce?

By Olaf Gersemann
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Europe is back—or so it seems. For years, Europe presented itself to the outside world in a dismal state, both politically and economically. From the perspective of the United States and emerging Asia, the continent lost significance both as a competitor and as a partner. Europe was laughed at, belittled, written off. Those times seem gone. “Growth escalates in Europe” read the headline of an analysis that investment bank Goldman Sachs published in May 2007. “The truth is that Europe is back and very much so,” wrote Michael Heise, chief economist of Germany’s insurance giant Allianz, in an op-ed piece for the Boston Globe. “Indeed, Europe suffered from inertia, coasting on educational and industrial achievements of the past, and living off its accumulated wealth,” Mr. Heise admitted. But, he added, “this mindset is now largely a thing of the past.”

European optimists like to point out that, for the first time since 2001, economic growth in the Euro area is set to be stronger than in the U.S. in 2007. Indeed, this kind of news tends to be celebrated in Europe; the looming out-performance of the U.S. seems to be even more important than the long-awaited and much-needed economic recovery itself.

From an American point of view, this kind of attitude might be hard to fathom. However, for years politicians and other opinion leaders in Europe have struggled to defend the so-called “Rhineland model of capitalism.”

Often the claim is made that while Europe might not do all too well, the U.S. is doing worse. The U.S. is said to be suffering from what Germans call “amerikanische Verhältnisse,” or “American conditions.” Leading figures from every single major political party, as well as trade union leaders and prominent executives, claim that “American conditions”—allegedly unbearable high income inequality, wide-spread poverty, and many other social problems—are a price far too high to pay.

On the other hand, it became ever-more difficult to convincingly make this point. After all, it was increasingly obvious that, at least in the modern era of globalization and rapid technological progress, American-style “cowboy capitalism” seems to be able to produce more productivity growth and job growth and, thus, higher gains in per-capita incomes than continental Europe’s “comfy capitalism.” According to data compiled by the International Monetary Fund (IMF), France, Germany, and Italy in 1980 had reached per-capita incomes of between 79 and 84 percent of the U.S. level (based on purchasing power parity). Since then they have slipped back quite steadily—to between 70 and 71 percent in 2007.
To sell Europe as the superior economic model certainly becomes far easier in times when the continent actually seems to be getting stronger economically and, more to the point, stronger than the U.S. The policy implications are potentially huge. Attempts to move economic policies closer to Anglo-Saxon standards might be stopped in their tracks. Deep-rooted reforms might be abandoned in favor of minor adjustments to the over-burdened systems.

But has the tide indeed been turning? Is there a sustainable turnaround of economic fortunes in Europe? How much of this is based on cyclical and other short-term factors? Will Europe continue to outperform the U.S. economically?

This paper tries to answer these questions. It starts out by looking back at the situation in Europe a mere two years ago when Euro-pessimism was rife. It then looks at the present situation and tries to clarify what has changed—and what has not.

Special attention is given to Germany, for several reasons. First, it has never been correct to portray the whole continent as economically sick. Denmark and Ireland, for instance, have been economic success stories for many years now. Like these examples, the countries with economic growth are typically rather small. Indeed, Denmark and Ireland each make up for only something like 1 or 2 percent of Europe’s entire population.

Secondly, while most eastern European countries have joined the European Union (EU) by now, they remain in an exceptional situation. After the near-collapse of their economies in the early years of transformation from communism, they bounced back more or less strongly. While their sustained above-average economic growth performance is certainly good news, anything less would have been a profound disappointment.

A similar point applies, thirdly, to countries like Greece and Portugal where per-capita incomes are still, on average, considerably lower than in western Europe.

Fourthly, there is the special case of Great Britain, whose economic model features elements of both America’s “cowboy capitalism” and the “comfy capitalism” that is typical for continental Europe.

Therefore, if one attempts to compare the economic performance of cowboy and comfy capitalism, the most appropriate group of countries on the European side is the Big 3 on the continent: France, Germany, and Italy.

Among those, Germany stands out not only as being the biggest by a significant margin, but also as the one whose comeback is allegedly most astonishing. For years, Germany has been considered the sick man of Europe. Now, it is supposedly back from the brink. Der Spiegel already believes “Wirtschaftswunder 2.0” has arrived in Germany. Furthermore, Peer Steinbrück, the country’s finance minister, has detected “many indications” that Germany is experiencing a “long-lasting recovery.”

What is more, the continent was, politically, deeply divided. Most eastern European countries supported the American-led invasion of Iraq while many western European governments openly rejected it. There was a rift even among those countries which, decades ago, formed the core of what has now become the EU.
EUROPE IN 2005: A DIVIDED AND DEPRESSED CONTINENT

Economically, most major countries in continental Europe have fallen behind the United States and other Anglo-Saxon countries such as Australia, Canada, and Great Britain. France, Germany, and Italy, to name just the most striking examples, were plagued by mass unemployment, high public debt, huge welfare systems, and fast-aging populations. At the same time, their economies did not grow nearly fast enough to help to overcome these problems.

Even more significant in the long-run is the fact that it is far from obvious what Europe—or the EU—stands for. This became all too clear when European leaders tried to create a European “constitution.” If they had developed any vision for or any positive definition of Europe, it vanished somewhere in the several hundred pages of the document they came up with.

Thus, it remains an unanswered question of if the EU is supposed to be much more than a single market in which goods, (some) services, capital, and—if it is not cheap and from eastern Europe—labor are allowed to move around freely.

In the meantime, European leaders often define Europe in a negative way: as the region in the western industrialized world that is not America. The famous Lisbon Agenda, for instance, does not aim to provide a framework that would enhance human prosperity as much as possible. Rather, the EU Heads of States and Governments agreed in March 2000 to make the EU “the most competitive and dynamic knowledge-driven economy by 2010”—the implicit target, in other words, is simply to overtake America, rather than making Europeans better off. At least theoretically, this target could be reached with the EU making no prosperity gains at all.

The definition of Europe as the anti-America feeds upon the widespread view that somehow Europe is superior to the United States. This view may have been reinforced by the foreign policies of the administration of U.S. President George W. Bush. However, it would be a mistake to believe that Europe’s attitude toward the U.S. will fundamentally change after the Bush presidency ends. Indeed, “amerikanische Verhältnisse” had become a derogatory code word long before Mr. Bush came into power.
Europe in 2007: new signs of life

Many things in Europe did not change at all. Among them is Anti-Americanism. As Die Zeit, a German weekly, wrote in April 2007, “Everything American has remained politically radioactive in (western) Europe: whoever gets in touch with it too closely or for too long is contaminated into unelectability.”

Still, what a difference two years can make. In countries such as Germany, there is the widespread feeling that the reforms conducted over the last five to ten years have finally paid off—and that no further steps are necessary. Almost equally pervasive is the belief that all the talk about the need for far-reaching structural reforms in Europe was ill-founded. This talk, it is held, was the work of doomsayers who failed to see that Europe’s long malaise had been caused by non-recurring factors such as, in Germany’s case, the cost of reunification; the consolidation in the construction industry; and fiscal and monetary policies that were allegedly excessively tight.

Growth forecasts for a number of European countries—and for Europe as a whole—have been revised upwards repeatedly since 2005. In early 2007, the Euro-zone’s economy was growing even faster than America’s; even Germany might enjoy faster growth than the U.S. in 2007. If these forecasts turn out to be right, Germany might enjoy three consecutive years with real economic growth above 2 percent; that would be the first time for Germany to achieve this much growth since the brief boom that followed the country’s reunification in 1990. In France, there are also encouraging signs. For instance, the official unemployment rate fell to 8.2 percent in April of 2007, the lowest level in twenty-five years.

Government finances also look much better than a mere two years earlier, with countries like Germany possibly being able to run a fiscal surplus by the end of the decade. The Euro, meanwhile, came close to an all-time high vis-à-vis the dollar in 2007. There was much talk about London surpassing New York as the capital of the financial world. Finally, there was much fuss about Europe’s equity markets eclipsing those of the United States.

This kind of good news, while often recited on both sides of the Atlantic, does not provide the whole picture:

- True, economic growth in the Euro-zone is likely to outstrip that of the United States in 2007 for the second year in a row. However, cyclical factors clearly play a major role here. In 2007, the Euro-zone enjoyed an economic upswing, helped by strong import demand from a booming world economy; the U.S., by contrast, experienced a housing-induced deceleration of economic growth. Finally, when Goldman Sachs economists celebrated “escalating” growth in Europe, they were referring to a revision of the 2007 growth forecast from 2.4 percent to 2.7 percent—hardly numbers that would draw more than yawns on the American side of the Atlantic.
Yes, unemployment in many European countries in 2007 was far lower than it used to be just years earlier. However, in most countries it still remained far above the level America has gotten used to. The standardized unemployment rate in the EU-15, as compiled by the Organization for Economic Cooperation and Development (OECD), stood at 7.8 percent in 2006—a level that the United States has not seen in many years (see Table 1).

Budget numbers currently do indeed look better in many European countries than in the United States. It is also true that Social Security and Medicare will come under major strain once the baby boomers start to retire. However, the problem is far greater in most European countries. Much lower fertility rates and lower immigration rates, combined with far more generous entitlements for the elderly, will leave the public finances of most European countries in an even more dire state than that of the United States.

True, market capitalization in Europe, according to Thomson Financial, has surpassed America’s market capitalization, if only temporarily. However, this is to be expected, given Europe’s considerably larger population. What is more, the statistics include a country that is not a member of European institutions such as the EU or the European Monetary Union and does not aspire to be; a country that does not really consider itself to be European: Russia. Indeed, the Russian stock market is dominated by Gazprom and a handful of other companies that enjoy government protected monopolies.

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Table 1: Standardized unemployment rates, in percent
Source: OECD

While these points put fashionable claims and comparisons in perspective, they surely do not prove the comeback hypothesis to be wrong. For that, a more in-depth analysis seems necessary.

Prosperity depends on economic growth which, in turn, is determined by employment and productivity: by the amount of work that is done and the efficiency with which it is done.

Europe undoubtedly suffered from massive underemployment for years. Unemployment rates, including long-term unemployment rates, have come down in many countries. Labor force participation rates for women, young people, and elderly persons have risen, albeit slowly. As the IMF states in its most recent “World Economic Outlook,” “Europe has made progress in strengthening labor utilization; in fact it has reduced the differential with the United States on this front as unemployment rates have been progressively lowered—but the gap with the United States nevertheless remains substantial, particularly in conti-
It won’t be easy for many European countries to close this gap even farther. Serious mismatches between the supply of and the demand for labor persist. Even in eastern Germany where underemployment remains stubbornly high, employers complain about the difficulties of finding any personnel whatsoever. In particular, college graduates such as engineers are short in supply, according to industry associations. Vladimir Spidla, the EU’s Commissioner for Employment and Social Affairs, predicts that in the years ahead there will be a shortage of labor “in most areas” of the German economy.

Theoretically, solving these problems might not look that difficult. For instance, in the German case it is rather obvious that work requirement rules for recipients of unemployment benefits are either not strict enough or are not, in practice, applied according to law. What else could explain that people from the Northeast of Germany do not migrate to the country’s Southwest? After all, in the Southwest only one in twenty people is unemployed—while in the Northeast the ratio is one in six (officially, that is. If properly calculated, the ratio would be far higher.)

Much more difficult to tackle will be aspects of the labor market mismatch that relate to professional qualifications rather than regional migration. In any case, if the political will to enact more thorough reforms was lacking in the crisis years during the first half of this decade, it seems doubtful that political will will show more appetite in the near future.

Far more importantly, for Europe’s comeback to be real and sustainable, higher labor utilization will not suffice. Rather, Europe would have to stop, and turn-around, the long-lasting decline of labor productivity growth rates.

Labor productivity growth is the key driving factor that determines a nation’s material prosperity. That is because employment can be increased only by so much. Labor utilization rates, for instance, cannot exceed 100 percent, and the work day cannot be longer than twenty-four hours, even in the very short run. It is only productivity that can, in theory at least, be increased without limits. Two hundred years ago in western European countries, some 70 percent of the work force had to work in agriculture in order to feed the nation. Today, the job is done by 2 percent. The reason behind that is not that those 2 percent work harder; rather, it is thanks to modern machinery and fertilizers, among other things, that they are vastly more productive.
By the mid 1980s, real oil prices were back at their pre-crisis level. At that time, a technological revolution was underway: the rapid pace of innovation in information and communication technologies (ICT). However, falling oil prices failed to lift productivity growth to its old levels. As Nobel Laureate Robert Solow famously quipped, the computer age could be seen “everywhere except in the productivity statistics.”

Finally, the U.S. saw another turnaround. Starting in 1995, labor productivity growth accelerated again. In the decades that followed, its pace was about twice as fast as it was in the two decades before; indeed, Yale economist William Nordhaus has shown that productivity growth—regardless of how one measures it—in the post 1995 period has even been faster than between 1959 and 1973.

Long-time Morgan Stanley chief economist Stephen Roach recently called this development one of the three most important “macro milestones” of the past twenty-five years (the others being disinflation and globalization). After all, stronger productivity growth had made possible faster economic growth and lower unemployment without igniting inflation.

While at first there was a fierce debate among economists on whether this revival was more than a cyclical event, there is now a broad consensus that it was the ICT revolution that finally paid off. As Mr. Nordhaus puts it, “The 1970s productivity slowdown has over the last decade been overcome by a productivity growth rebound originating primarily in the new-economy sectors.” Even Mr. Roach, well known for his enduring pessimism, now acknowledges that he “failed to appreciate the breath, depth, and duration of the IT-enabled transformation of the U.S. economy—as well as the broader productivity leverage that ultimately would flow from the new technologies of the Information Age.”
Economic growth is the product of hours worked and output per hour. Hours worked have grown slowly in many European countries. In Germany, the total number of hours worked has actually declined for a long time. Between 1970 and 2004, it has, on average, declined by 0.4 percent annually. By definition this means the economic growth in the last decades has been entirely due to rising productivity.

However, for years productivity growth has been markedly slower in Europe than in the United States. Between 1995 and 2005, the only EU-15 country that mastered higher productivity growth than the U.S. (population: 300 million) was Ireland (3 million).

Indeed, at the time America enjoyed its revival of productivity growth, gains in Europe continued to diminish (see Table 2). “In sharp contrast with opposite developments in the U.S.,” a study by economists of the European Central Bank states, there was “a decline in average labor productivity growth observed in the Euro area since the mid-1990s.” This decline was a fate shared not only by struggling countries such as Germany and Italy, but by most western European economies.

The divergence between Europe and America is particularly strong in the private sector. “When looking at the market economy only, the forging ahead of the U.S. becomes even more pronounced,” declared the economists who, with the financial assistance of the European Commission in Brussels, wrote the so-called Klems Report on productivity growth.

The difference, it is widely believed among experts at institutions like the ECB and the IMF, is likely connected to information and communication technologies. First, Europe’s ICT-producing sector is smaller. Secondly, its companies have invested less in ICT. And thirdly, ICT investments in industries such as wholesale, retail, banking, and other industries in the service sector did not, for whatever reason, increase productivity in Europe by as much as in the United States.

It seems obvious that the level of ICT investment and the potential for productivity gains are linked. After all, the ICT revolution is likely to have at least as profound an impact as the spread of electricity one hundred years ago. Indeed, the prices for ICT equipment plummeted more steeply than those for electrical power. What is more, ICT has the potential to enhance efficiency in almost anything companies do—including companies in the service sector where, in the past, productivity gains had proven to be much harder to realize than in manufacturing.

It seems equally obvious that it is not good enough to just buy computers or software. Rather, the new equipment has to be put to an efficient use. This involves a learning process that can take companies and their employees years to finish; it often also requires the will and the ability of companies to adjust their work organization.

Less obvious at first sight might be the role of the ICT-producing industries themselves. However, the price
of computing power, for instance, continues to fall sharply: in the order of magnitude of 10 percent annually. This translates into large gains in output per hour worked in the ICT industries.

It is here where the difference between the U.S. and Europe is most visible. In 2003, ICT’s share of total value added in the business sector was, according to the OECD, 6.9 percent in Germany and Italy. By contrast, the share was 10.5 percent—one and a half times larger—in the United States.

The difference is even more striking if one looks at the leading companies in the industry. According to Business Week magazine’s most recent Info Tech ranking, 49 out of the top 100 leading IT companies in the world are headquartered in North America (see Table 3). Another thirty-three are from South or East Asia. A mere eleven, by contrast, are from EU member states.

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*Table 2: Annual labor productivity growth, percent*

Source: Gomez-Salvador et al.
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<th>Country</th>
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<td>Canada</td>
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<td>Hong Kong</td>
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<td>Germany, Luxembourg, Mexico, Netherlands, Russia</td>
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<td>Other EU member states</td>
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Table 3: Number of companies in Business Week’s Info Tech 100 ranking
Source: www.businessweek.com
EUROPE AND THE UNITED STATES IN 2008: WILL THE PENDULUM REALLY SWING BACK?

The first post-war era of high productivity growth in the United States ended as abruptly in the early 1970s as the new productivity miracle started in the mid-1990s. Both turnarounds came as a surprise—at least they were, according to the forecast of mainstream experts, not in the cards.

This alone should be enough to prevent one from extrapolating recent developments too far into the future. “Recent history tells us that the pendulum of competitive prowess can change much more quickly than we might think,” Morgan Stanley’s Stephen Roach wrote in the spring of 2007. “That’s something to keep in mind in the years immediately ahead,” he added, referring to indications that the tide might be turning once again.

There are indeed signs that labor productivity growth in Europe is accelerating, while it lately dropped in the United States. In 2006, productivity growth in Europe actually exceeded growth in the U.S.

So what happened? Is this a change of fortunes on both sides of the Atlantic? Or is what we see an entirely cyclical and, therefore, temporary phenomenon?

Without a doubt, cyclical factors do play a role. In the U.S., economic growth has slowed while, according to official statistics, the labor market is doing well, an indication that underlying productivity has actually weakened. These kinds of developments are to be expected in the late phase of a business cycle. Then, firms tend to get overly optimistic and hire more people than justified by actual orders, thereby pushing productivity below trend growth (i.e., the maximum rate of economic growth an economy can sustain without getting overheated sooner or later).

Goldman Sachs economist Jan Hatzius estimates that the recession in the residential housing sector has subtracted more than one percentage point from non-farm labor productivity growth. This matters a great deal since, as Hatzius puts it, the housing recession is “a purely cyclical development that says nothing about longer-term secular trends.” Excluding residential housing, productivity still seems to be growing at a rate of 2.5 percent or more. Therefore, angst about a slowdown might well be exaggerated.

It is also possible that the statistics do not capture the whole picture. Between mid-2006 and mid-2007, residential construction activity has plunged while official employment in the industry barely fell. Actual employment might have fallen much more, perhaps due to illegal immigrants whose exit was not noted because they were not included in the statistics in the first place. If this were the case, the decline in hours worked is understated, implying that the decline of productivity growth was overstated.

On the other side of the Atlantic, in Europe, the rather strong recent economic performance provokes the question whether this portends a sustained improvement. In the eyes of IMF economists, “it is too early to
assess definitely to what extent the present expansion may have reflected improving underlying conditions as well as a cyclical upswing."

In Germany, for instance, the quarter over quarter growth of output per hour was negative as early as 2004. In 2005, the average rose to 0.5 percent. Last year, it continued to climb and reached 0.725 percent, a level that had been reached only once (in 1996) since Germany's reunification.

However, nobody can say for sure that this recovery will be long lasting. In the first quarter of 2007, quarter over quarter labor productivity declined by 0.8 percent. Furthermore, the numbers for 2006 are not that impressive. After all, as much as it is a normal pattern that productivity growth rates get depressed in the late stage of a business cycle, it is common that productivity growth rises above its longer-term average in the early stages of an economic recovery. Early on during a recovery, companies' order books fill up. However, executives tend to doubt whether the recovery will last and are therefore reluctant to hire new people, causing the output per hour worked to rise.

Furthermore, the economic expansion in Germany seems to be very labor-intensive. In May 2007, the number of unemployed persons was 22 percent lower than a year before. Groups usually considered at a disadvantage benefited in particular from the expansion. The number of unemployed people under the age of twenty-five declined by 37 percent within two years. Long-term unemployment, which for decades grew more or less steadily and deepened Germany's labor market problems, has come down impressively: between May 2006 and May 2007, the re-integration of long-term unemployed into the labor market accounted for two thirds of the decline in the number of officially registered unemployed people in Germany.

By itself, this certainly is good news, as the integration of disadvantaged groups eases social problems and the potential for social tensions. More generally, it is also good news when overall unemployment comes down after years in which the exclusion of millions of people from the labor market had become a stigma for the former "Wirtschaftswunderland."

Another sign of the labor-intensity of the current expansion is the rise in multiple job-holding in Germany. After the removal of tax disincentives, and helped by the economic recovery, the number of people holding more than one job in Germany jumped from 0.9 to 1.5 million between 2002 and 2004. Nearly 4.7 percent of the labor force engaged in multiple job-holding. The ratio in America is only slightly higher: according to the U.S. Bureau of Labor Statistics it stood at 5.2 percent. Thus, multiple holding is not—or at least is no longer—considerably more common in the U.S. than in Germany.

This is somewhat ironic, since multiple job-holding has long been a major stereotype about America's cowboy capitalism. Former chancellor Gerhard Schröder once said: "Social democrats are convinced that it has to be possible for people to live in decency and dignity without having to do three jobs a day." Michael Sommer, Germany's top labor union leader, believes to know that in the United States, "Employees need three or four jobs to feed themselves." Even Kajo Neukirchen, a German executive famous in the media for his ruthlessness does "not want American conditions (...) Three jobs at the same time just to make a living," he said in a newspaper interview, "you don't want that and neither do I."

In Germany, however, increasing multiple job-holding as well as other forms of surging labor participation is celebrated by the media. The so-called employment threshold has been lowered: instead of 1.5 to 2 percent, Germany's economy, it is said, now needs to grow by 1 to 1.5 percent for employment to increase. As a journalist at Financial Times Deutschland put it, "First estimates show that the German economy creates more jobs for any given level of economic growth than in the past."

However, you can also view it the other way around: any given increase in employment yields less economic growth than in the past. In other words, Germans increase output by adding more labor
input—not by using labor more efficiently.

While the attempts to reform the German economic system might contribute to the higher productivity growth the country has been enjoying recently, it is at least highly doubtful at this point that they play a major role in the expansion. If, on the other hand, the expansion is mainly driven by cyclical factors, the serious mismatching problems on the German labor market will cause the expansion not to be the “long-lasting” phenomenon that the German finance minister dreams about.

However, for a longer-term perspective, it seems important to look beyond current business cycles—and try to find out how the United States and Europe are positioned in terms of longer-term growth.
EUROPE AND THE UNITED STATES IN 2015:
A NEW BALANCE OF ECONOMIC PROWESS?

Long-term economic prospects crucially depend on how much money and effort a society invests rather than consumes. In recent years, the claim has often been made that the United States invests too little; that rising productivity in the last couple of years were benefits reaped from investments made much earlier; and that recent investment activity is allegedly rather weak.

At the same time, investment in Europe is said to be rebounding. “The Investment boom in full swing,” read the headline of a report by Allianz economists on the expansion in Germany in June 2007. The experts pointed out that strong investment growth helped to keep the overall economic growth stronger than initially expected.

However, a closer look reveals that America’s position relative to Europe is stronger than is often believed.

First, official statistics only display tangible investments. What is not shown are intangible investments such as the accumulation of knowledge or spending to reorganize production. In the U.S. these intangible investments, according to recent estimates, might be larger by now than traditional tangible investments; a correct classification of intangible investment might increase the level of GDP in the U.S. by as much as 10 percent. In Europe, economists Alberto Alesina and Guido Tabellini point out, the corresponding number is likely to be much smaller. This is because, among other factors, Europe’s service sector (where much hard to measure investment takes place) is smaller. Furthermore, in Europe almost all productivity growth can be accounted for by tangible investment. By contrast, in the U.S. a large part of productivity growth consists of increases in the so-called total factor productivity (TFP). TFP growth is the residual in labor productivity growth that cannot be explained by a sheer accumulation of physical capital—and is thus an indication that intangible investments have taken place.

Secondly, even tangible investment in Europe is not as strong as is often claimed these days. True, the ratio of overall net investment of private households, corporations, and the government rose from 2.7 percent of disposable income in 2005 to 3.9 percent in 2006. However, this number is still well below the level reached in the 1990s, when the annual average was close to 10 percent.

Moreover, while corporate net investment is now far higher than it was in the recession earlier in the decade, it is still far below the level it reached during the economic boom that ended in early 2001 (see Table 4).

Investment remains at a level that is low by historical standards, even though interest rates are still low—and even though strong profits in recent years have filled many company’s coffers. Net saving in Germany has doubled between 2003 and 2006; a large part of that increase—about 40 percent of it—consisted of corporate savings.

Obviously, German companies found too few ways to
spend their money for potentially high-yielding investment. Thus, less than one fourth of total savings in 2006 went into net investment. Around 60 percent of savings was instead being sent abroad. The result was a current account surplus of around 5 percent of GDP. While economists consider a small surplus—say, 1 or 2 percent—to be the norm for highly developed countries, a substantial surplus of 5 percent must be considered a massive vote of no confidence in Germany and its economy.

Thirdly, Germany and other European countries are still doing particularly poorly with respect to the kind of investment that could potentially have a large impact on future productivity growth and competitiveness: investments in research and development (R&D). As the European Commission lamented in June 2007, "R&D intensity in Europe has stagnated since the mid-nineties, while major competitors such as Japan, China, or South Korea have been able to increase substantially their R&D effort (...) Moreover, the R&D investment deficit against the U.S. has remained constant over recent years."

Especially “worrying” is, according to the EU Commission, “the low level of business R&D in Europe.” After all, you might expect executives in private companies to be better able than government bureaucrats to determine what kind of R&D activity is likely to yield productivity gains in the future. However, privately financed gross domestic expenditure stands at only 1.0 percent of GDP in the EU. By contrast, the shares in the U.S., South Korea, and Japan, are 1.7 percent, 2.1 percent, and 2.4 percent, respectively.

In Germany, the picture looks worse than elsewhere in Europe. In recent years, the country “significantly lost ground,” says a report published by the German government in June 2007. R&D expenditure grew only half as fast as in the rest of the industrialized world on average. The consequences are already being felt. Since 1998, Germany’s share of new international patents has declined in every single year.

Compared to many other countries, R&D intensity in Germany remains high. But this, according to the German government report, is “almost entirely owed to the automobile industry.”

Moreover,

- Less than 1 percent of start-ups in Germany conduct business in a high-tech industry.
- Less than 30 percent of R&D intensive goods that Germany exports are high tech goods. By contrast, the shares in the U.S., Great Britain, and smaller European countries such as Finland, the Netherlands,
and Switzerland are between 45 and 50 percent.

Of all of Germany's manufactured exports, less than one seventh are high-tech goods.

All of this casts doubt on whether Germany will be able to retain its status as the world’s leading exporter for much longer. In other parts of Europe, the situation looks better. However, the situation in Europe as a whole is sobering, too.

The low level of business R&D, the experts from Brussels believe, reflects “differences in the industrial structure of the EU compared to countries such as the U.S.” Those differences include “a smaller high-tech industrial sector.” Indeed, EU statistics show that R&D activities in the U.S. are much more concentrated in ICT than in Europe (see Table 5).

In other words, a small high-tech sector leads to smaller R&D investment in ICT—which in turn is likely to perpetuate Europe’s weak position in producing ICT. That means that weak contribution to productivity growth in Europe that comes from ICT producers is likely to remain.

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*Table 5: Sectarian composition of R&D investment by EU and U.S. companies, percent*

Source: European Commission
CONCLUSION

The picture of Europe—both in absolute terms and in comparison to the U.S.—is far more sobering than recent news stories about a re-emerging Europe might lead one to believe. Continental Europe (and its biggest economy, Germany) still do not look poised for an impressive economic performance in the longer-term. If Europe looks better now and if it continues to look better in the future when compared to the United States, this is likely a reflection of American weakness rather than European strength.

Therefore, complacency in Europe now will likely backfire. More to the point, it would be dangerous for Europe’s opinion leaders to take the current period of relative economic strength as proof that, after a quarter century of dismal performance, the Rhineland model of capitalism will somehow manage to outperform America’s cowboy capitalism over any extended period of time.
REFERENCES