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Is Europe Sick?

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Robert C. Shelburne*

*United Nations Economic Commission for Europe, robert.shelburne@unece.org

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Is Europe Sick?*

Robert C. Shelburne

Abstract

Europe's economic performance has deteriorated continuously over the last two decades both in terms of its unemployment and its labor force participation rate; more recently its productivity has declined relative to the United States. This is due to a complex interaction between the how these welfare states are designed, the institutions created by the European Union, idiosyncratic factors resulting from linguistic differences, population dynamics and other cultural factors, and an increasing emphasis on non-economic objectives. Although structural reforms can provide a solution, it will be a long, difficult and costly process. A more successful approach involves a redesign of the macroeconomic framework in Europe. Aggregate demand stimulation should be given priority since it will not only increase employment directly, but, by slightly raising inflation, will allow negative real interest rates and separate real wages movements from nominal wages. More generally, EU institutions appear to have been designed assuming a perfect world; instead these need to be designed around existing national institutions and cultural practices.

KEYWORDS: Europe, Economic Growth, Economic Policy

*The views are those of the author and do not necessarily represent the official positions of the United Nations ECE or its member countries. This paper was first presented at the International Trade and Finance Association conference in Istanbul, Turkey in May 2005; the author wishes to thank seminar participants for their helpful comments.

INTRODUCTION

The economic performance of Western Europe has deteriorated over the last two decades. The fundamental question is whether this is due to an incompatibility of a modern welfare state with globalization, systemic problems in the design of the European Union, idiosyncratic factors affecting Europe, or a policy choice that has been freely made by Europeans to sacrifice economic performance in order to pursue non-economic objectives. The answer to this question will significantly shape the future not only of European society but may alter the design and evolution of capitalist societies throughout the world and the process of globalization.

The relative poor performance of the Western European economies has sparked a number of papers that attempt to document this development and explain it. As with any major development of this type, it takes time for a consensus view to develop; although a consensus may be developing on certain aspects of the issue there remain different interpretations about the agreed upon aspects and unresolved questions. The poor performance of the European states has also become fodder for the U.S. right-wing conservative movement which always attempts to connect the poor performance of any economy to the failure to implement free market mechanisms. Thus they view the poor performance of Western Europe as a pre-mortem for the welfare state. Left-wing economists have taken the defense of Europe as a necessity and have attempted to minimize its problems since Europe represents the only hope for a modern welfare state. As is typical, once an economic controversy gets drawn into a larger ideological debate, the analysis becomes more one-sided as many of the contributors fail to provide an objective weighing of the evidence and instead present only selective information which supports their ideological position.

In this paper the recent economic performance of Europe is examined; the fundamental changes that have occurred are highlighted. Next the basic hypotheses that have been advanced to explain the poor performance are described and their strengths and weaknesses are examined. Finally some new hypotheses are presented and their empirical support and connection to other hypotheses are explained.

THE EMPIRICAL EVIDENCE

In the first decades after WWII there was fairly rapid economic growth in Europe and a persistent convergence towards U.S. income levels. In 1950, the ex-Axis states of Germany and Italy had a GDP per man-hour of about one third of the U.S. level, while France was at 40 percent and some of the other smaller European countries which suffered less damage were close to almost 50 percent

(the current eurozone had a per capita income of about 38 percent of the U.S.). In the early 1950s, the rapid growth could be explained as a recovery to pre-war levels, but by 1960 their productivity compared to the U.S. was back to their relative levels in 1938. Yet this convergence continued, and by 1970 the current eurozone countries had per capita incomes (PPP basis), which were 69 percent of the U.S. level while France's¹ income was 76 percent of the United States. These relative income levels further increased in the 1970s, and by 1982 the respective ratios were .75 and .84. However, over the next two decades the economic performance of Europe declined both absolutely and relatively. By 2003, the relative per capita income ratios were back to their approximate levels in 1970 (.71 and .74). Europe's poor performance most recently is highlighted by the fact that economic growth in Western Europe was the lowest of any area in the world in both 2003 and 2004, lower than even Africa which has been characterized recently by a dismal performance. Within Europe, members of the eurozone have performed more poorly than those outside the euro, and the three largest countries – Germany, France, and Italy – which make up 70 percent of the GDP of the eurozone, have performed the worst.

Europe's relatively poor performance has two basic dimensions, employment and productivity. Where the U.S. has really excelled versus the European economies has been in terms of total employment growth. Between 1988 and 2000 the United States created more new jobs than the total employment of either France (24.9 million) or Italy (24.5 million) in 2004; during 1983-2000 the U.S. produced more jobs than the total of German employment (38.4 million) in 2004. The relative difference in employment growth has three basic dimensions – population growth, unemployment, and labor force participation rates. The higher employment growth is the result partially of higher population growth. The U.S. population has grown about .75 of a percentage point per year faster than that of the EU-15 over the last decade. Since a large portion of the differential in employment growth is due to differences in population growth, employment growth itself is not of any particular interest, but it may nevertheless be an underlying contributing factor for some other explanations which will be discussed later. The under performance in terms of unemployment and labor force participation, however, does represent areas for legitimate concern.

The superior unemployment performance of the United States can be dated to 1984, although the relative deterioration in Europe's performance goes back to the years following the first oil crisis in 1973. The general pattern seems to be that with each recession, unemployment rose in both Europe and the United States; during the recovery however, unemployment in the U.S. tended to fall back to the level in the previous recovery while it fell only slightly in Europe. Thus for the

¹ The analysis will at times concentrate on France as it typifies the problem under consideration but is free from many of the data or conceptual problems present for Germany.

U.S., unemployment has followed a basically cyclical pattern while in Europe it has been increasingly ratcheted up with each business cycle going back to 1973. Through the early post-war decades, Europe had unemployment rates significantly below U.S. levels. At the time of the 1973 oil crisis, Europe had significantly lower unemployment rates than the U.S.; for example the U.S. unemployment rate in 1974 was 5.5 percent while it was 2.8 percent in France and 2.1 percent in Germany (OECD, 1998 table 5.1). During the 1970s the U.S. and Europe experienced increases in unemployment from the first oil shock and the breakdown of the Bretton Woods system. However by 1979 the U.S. rate was back to 5.8 percent while it was 5.9 in France and 3.2 in Germany. Thus during the 1970s, although the absolute European performance was better than that of the U.S., the seeds of its ultimate problem had already sprouted. The European poor performance in absolute terms, however, did not begin at the same time for each country. France and Italy began to have unemployment rates above the U.S. in 1984.

German unemployment was reasonably low, and compared favourably with that of the United States until 1993. Clearly unification, and the inclusion of East German workers in the German statistics is a significant factor in explaining unemployment in Germany. The setting of the one-to-one exchange rate of the German currencies has to be considered one of the greatest economic blunders in post war German economic policy. East German enterprises were simply not competitive at that exchange rate, and nominal wage rigidity produced high unemployment in East Germany; unemployment in the east is still around 25 percent and would be even higher if so many young people had not emigrated to the west or to other neighboring countries. Quite simply, even after 15 years, Germany has not gotten over that mistake.

Sweden was able to keep its unemployment rate below the 4 percent level until 1992, Austria till 1993, and Norway until 1989. Luxembourg has yet to have an annual unemployment rate above 4 percent. Although the patterns of the others vary, the experiences of France and Italy seem to typify what is the more general European unemployment pattern since 1980. Both had increasing employment in the early 1980s, which never receded significantly through the rest of the decade and began to increase again in the early 1990s; unemployment in France was above 10 percent from 1993 through 1999, and in Italy from 1993 through 2000. The employment situation improved slightly beginning in 2000, as employment in the EU increased by 4.1 million between 2000 and the end of 2003, compared to an increase of only 1.5 million in the United States (between January 2001 and January 2004, the U.S. economy created only 119,000 jobs). Overall, the eurozone unemployment rate (OECD comparable), which was close to 9 percent at the beginning of 2000, dropped to 8 percent in 2001 before increasing back to an 8.9 percent level in 2003 and 2004. Unemployment in Germany and France is

currently (2005), back above 10 percent, as is unemployment in Spain. (German unemployment is partially high due to East Germany; in the old western section unemployment is around 8 percent.) By comparison, the U.S. unemployment rate was 4 percent in 2000 and drifted up to 6 percent in 2003 before falling back to 5.5 percent in 2004 (OECD, 2005). The accession of the 10 new Central and Eastern European countries (and Malta and Cyprus) does little to help the situation, since they generally have even higher levels of unemployment, and any migration, where allowed, is likely to only further increase unemployment in the eurozone. European unemployment is also characterized by its length; over one-half of the unemployed in Germany and Italy have been that way for over a year.

Although Europe has had higher unemployment since 1984, it must be recognized that the growth of real labor compensation has been higher in most of Europe relative to the U.S. during the 1980-2000 period. All of the major European countries had higher growth in real labor compensation than the U.S. during each decade (except for Italy and the Netherlands during the 1990s). It would appear that there has clearly been a wage and unemployment trade-off during this period.

Although unemployment is widely accepted as an undesirable economic outcome, there is another aspect of European employment that is subject to various interpretations: that is, the low level of labor force participation and the low number of hours worked each year due to a shorter work week, more vacations, and long maternity leaves. For example in 1999, the average U.S. worker worked an average of 1,877 hours, while the average German worker worked 1,399 hours – 25 percent less (Navarro, Schmitt, and Astudillo, 2004). At the end of 2003, in the U.S. 71.2 percent of the working age population were employed while in the EU only 64.8 were employed (As recently as 1995 the EU rate was below 60 percent.). However according to the OECD, four EU countries had a higher employment rate than the U.S.; these were Denmark (75.1 percent), Sweden (74.3 percent), the Netherlands (73.6 percent), and Britain (72.9 percent). To the degree that these differences are the result of an exogenous European preference for leisure, they cannot be considered as an undesirable performance indicator; Europeans have simply chosen to trade off additional consumption of goods for increased leisure. However, if this low level of work is the result of endogenous factors such as high tax rates or the lack of employment opportunities, then the low employment participation rate, the shorter workweek, and increased vacations need to be added to the higher unemployment rates as additional performance weaknesses of the European model. One factor which is not generally appreciated is that Europeans worked more than Americans in the early post war period, so if there is a European preference for leisure it is a relatively new development.

Prescott (2004) argues that marginal tax rate differences (for 1993-96) can explain the different labor force participation rates of the G-7. His calculations find that the marginal tax rate on labor income is .59 in Germany and France and .64 in Italy. In the U.S. the marginal tax rate is .40 and the U.K.'s is .44. He also argues that changes in tax rates can explain the changes in participation rates since the 1970s; for example, in 1970-74 the U.S. and Italy had essentially the same marginal tax rate of .40. These results undoubtedly require careful consideration but are limited by the small sample size, which does not include any of the high tax and high participation rates of the Scandinavian countries. Blanchard (2004) has criticized the assumptions underlying the Prescott results and cited Ireland as a counter example. Average hours worked in Ireland have decreased at the European average of 25 percent between 1970 and 2000, yet unemployment is low, and average tax rates have increased by less than half of their increase in the United States. Nickell (2003) also concludes that higher taxes can explain only about one-third of the decrease in hours worked in Europe. The European Commission, however, appears to have concluded that the low participation rate is a problem in need of a solution and has set a goal, as part of the Lisbon agenda, to increase the labor force participation rate to 70 percent by 2010.

One aspect of this employment participation rate difference that particularly stands out is the large difference in participation of experienced older workers. In 2003, 60 percent of the U.S. population aged 55-64 was employed while only 41 percent in this age group were employed in the EU-15. In the better performing Nordic countries, the employment participation rate for those over 55 is significantly higher than the European average. The employment rate in continental Europe for those under 25 is also below U.S. levels; in France the unemployment rate for those under 25 has been over 20 percent since the mid-1990s. The unemployment and the participation rates are not generally believed to be independent; cross-sectional analysis reveals a strong negative relationship between the two, there would therefore appear to be reasonable empirical evidence that part of Europe's low participation rate is due to its high unemployment rate (IMF, 2003).

As with the more general participation rate there are questions as to whether this lower participation for older workers is due to a European preference for leisure or the result of the lack of employment opportunities. It has been argued that this is due to the nature of the pension systems in Europe that do not fully compensate workers with deferred pensions when they postpone retirement. In the OECD analysis of this they leave the impression that since U.S. workers are not penalized for deferring retirement, each worker is allowed to set his own retirement age and that this is superior to "forcing" workers to retire at a given time as in Europe. However, this analysis is misleading in that it concentrates solely on working past the "institutionalized" working age and fails to consider

the very steep penalty in the U.S. for retiring before its older “institutionalized” working age. In essence, U.S. workers have to work until they are 62 or 65, although those that can or must work past this age are not particularly penalized. Thus in both cases, the retirement age is institutionally set, and this age determines to large degree when people in the respective economies retire. The age is set young for Europeans and they are penalized for working past it, while the age is set much older for U.S. workers and they are penalized for retiring before it. The basic question remains whether this lower institutionalized retirement age is the result of a European cultural preference or an outcome that has been shaped by the poor labor market.

Although the employment rate differential goes back decades, the relative productivity differential between the U.S. and Europe is a fairly recent phenomenon and can be dated to about 1995, the year in which U.S. productivity began to really increase. In the seventy years prior to World War II there was little convergence in productivity between the large continental countries and the U.S.; the relative difference in GDP per hour stayed at approximately one-half of the U.S. level. In 1870, French productivity was 54 percent of the U.S. level, German productivity was 48 percent and the Italian level was 39 percent. Just before the Second World War, these percentages were remarkably similar (France 54 percent, Germany 46 percent, Italy 40 percent; Maddison, 1991). However, there was a general convergence in productivity towards U.S. levels throughout most of the post-World War II period. Both Europe and the U.S. had rapid productivity growth during the so-called Golden Age from 1950-73, but Europe’s was faster and reached two-thirds of the U.S. productivity level by 1973 (France 70 percent, Germany 64, Italy 64 percent). Productivity growth in both Europe and the U.S. fell significantly after 1973, but convergence continued. There are numerous measures of productivity, and the degree of convergence towards U.S. levels has varied; this has been especially the case over the last two decades as European workers began to work fewer hours than U.S. workers. Since European workers generally work fewer hours per week than U.S. workers, and the difference has been increasing through time, the convergence in GDP per hour worked was much faster than the GDP per worker. By 1995, European GDP per hour was about 95 percent of U.S. levels, while GDP per employee was only about 85 percent. Since 1995, there has been a slow relative divergence in GDP per hour at about the same rate as the earlier convergence, so that by 2002, the relative performance by hour worked was back to the level in 1989.² However in 2002, GDP per hour was actually higher in France, Belgium, and Italy (among others) than in the United States. However incorporating the lower hours worked per

² Deutsche Bank analysis argues that the productivity differential is due to a statistical artifact caused by different classifications and measurement methods and that U.S. and German productivity grew at the same rate over the last decade (Financial Times, 2005).

worker, relative GDP per worker began a steep decline after 1995 and by 2002 was back to the relative level in the early 1980s (Aiginger, 2005). Since 1995, the increase in the U.S. lead in productivity per hour is due not so much to a productivity slowdown in Europe but to its failure to take part in the latest productivity boom in the United States.

Generally it has been concluded that this is due to the failure of the EU economies to benefit from information and communication technologies (European Commission, 2003). Because of the relatively short period involved in this productivity turnaround, one could argue that it was due to more cyclical considerations than long-run structural changes. Since this latest productivity boom in the U.S. is generally thought to be due to finding Solow's "long missing" productivity gain from incorporating computer technology into the production process,³ it may be that Europe is only slowly lagging behind and that they will get this boost in the immediate future. However, as the length of this differential productivity performance has increased now to almost nine years, it is becoming apparent that there may indeed be some structural problem. Baumol has suggested that it is the lack of competition in the product and service sectors that has made it unnecessary for European firms to make these IT investments. The lack of competition may also limit the amount of business turnover (new firms replacing old firms). Sieling, Friedman, and Dumas, (2001) and Foster, Haltiwanger and Krizan (2002) conclude that almost all of the productivity growth in the retail sector resulted from highly productive new firms replacing low productive old firms; productivity in existing firms did not increase regardless of their investment in IT equipment. Krueger and Kumar (2004) have proposed that the root of Europe's productivity problem lies with its education system. The focus on vocational education instead of general education as in the U.S. has produced a workforce that is unable to adapt to rapidly changing conditions stemming from globalization and technological change.

It is somewhat surprising that this productivity differential should have occurred when it did. The justification for the EU-1992 Single Market initiative and the creation of the euro was that they would lead to further integration by eliminating all kinds of transaction costs and regulatory inefficiencies and this would create a boom in productivity (Baldwin, 1989); needless to say this never materialized.

The level of productivity and employment may be connected. It has been suggested (for example, see Boeri, 2002; Artus and Cette, 2004) that since the unemployed are likely to be less productive than average workers, if Europe increased its employment rate it would likely lead to a reduction in average productivity by possibly up to 15 percent. Thus the relatively similar productivity

³ In 1987 Solow observed that "computers are found everywhere but in the productivity data."

levels between the major continental economies and the United States may not be quite as similar as believed. Those that would need to be drawn into the labor market are those with a weak attachment to the labor force, informal sector workers, and possibly some that are already retired. These workers are likely to have low productivity and it may not be possible to employ them without lowering minimum or existing industry standard wages. This would raise a number of equity efficiency trade-off issues.

Historical and cross-sectional analyses of economic growth reveal a very strong correlation between investment, savings and growth. However, growth is not low in Europe due to low savings and investment rates. Over the 1989-96 period in the U.S. national savings averaged 16.7 percent of GDP and investment 18.3 percent; corresponding figures for the euro area were 21.9 and 20.3 percent. More recently between 1997 and 2003, U.S. savings and investment were 17.2 and 19.9 percent while in the eurozone they were 21.7 and 20.8 percent (IMF, 2003). Given the slower population growth in Europe, less investment is needed to maintain the capital-labor ratio. The growth differential is not due to low profit rates either, as Germany and France recently announced record profits; profits as a percentage of national income have increased considerably over the last decades in Europe.

Although the labor markets have performed poorly, the performance of the European and U.S. stock markets were almost identical between 1994 and 2002II, although the U.S. market did not decline as significantly during the 2002II-2003II pull back; the performances have been similar since then (2003II-2004).⁴ If the economic prospects of the euro area are so bad, then why is there so much inward FDI? During 2003, FDI inflows into the eurozone totalled \$118 billion (outflows were \$138 billion), while inflows into the U.S. were \$40 billion (outflows were \$174 billion). In terms of equity, the flows displayed a similar trend, with foreigners buying \$120 of eurozone equities (while eurozone residents purchased \$79 billion of foreign equities) but only \$37 billion of U.S. equities (U.S. residents purchased \$100 billion of foreign equities). For debt securities the story is different but that is dominated by central bank purchases of official reserve assets (IMF, 2004).

There is also a question as to whether it is valid in long-term analysis to compare the U.S. to Germany and France. In the U.S., the overall growth rate has been kept high due to the rapid growth of the southern states. At the turn of the century, the per capita income of the South was only one-half that of the North. Perhaps since Germany and France were the richer core area of Europe, the appropriate comparison would be to the Northern states of the U.S. and not the overall United States.

⁴ Comparison of Standard & Poor's 500 verses the Dow Jones Euro Stoxx Broad. Table 4.8 and graph C.26, *ECB Monthly Bulletin*, November 2004, page S 42.

The differences in income per capita (or per worker or per hour) between the U.S and Europe basically break down into the employment and productivity differences outlined above. There remain, however, important questions as to why these differences in employment and productivity exist; there is much disagreement about the fundamental causes of these differences.

THE PARIS CONSENSUS

A number of researchers as well as international organizations such as the OECD have argued that the lack of employment growth in Europe is due to inflexible labor markets; Aiginger (2005) has cleverly referred to this as the “Paris consensus.” Nominal or even real wage rigidity is argued to keep labor markets from adjusting to changing circumstances. Wages, especially for unskilled labor, are now believed to be above the equilibrium level. Thus while the real wages of the unskilled, relative and in some cases absolute wages, have been on a downward trend in the U.S. and other English speaking countries which generally have more flexible labor markets, they have been maintained through various institutional mechanisms in most continental European countries. In addition, the difficulty in firing workers makes firms reluctant to hire workers in the first place. The problem is not just on the demand side of the labor market. Generous welfare and unemployment benefits have kept the unemployed out of the labor market for too long. Thus the “problem” with the European institutions is that they are maintaining wage rates above their equilibrium level and making adjustments in employment levels, within firms and sectors, extremely costly. Politicians and market oriented economists use the neutral term “labor market flexibility” to describe this problem, but it should be clear that what they really mean is that there should be lower wages and fewer job protections.

Not everyone agrees that there is a strong case that labor market protections are related to unemployment. On a cross-sectional basis, it would be expected that those nations with the highest protections should have the highest unemployment rates. The OECD and the IMF (2003, Chapter 4) have published a number of studies alleging such a relationship. However, a careful review of these studies by Baker, Glyn, Howell, and Schmitt (2004) finds that these empirical findings are quite sensitive to the specification of the estimated equations and reasonable alternatives fail to find any significant relationship.

There is no doubt that labor market inflexibility has played a role, perhaps a significant role, in producing these high levels of unemployment. Excess supply or demand for anything is unlikely to exist for long if the price is perfectly flexible. Undoubtedly, more flexible labor markets are desirable, if that can be achieved without harmful consequences for other aspects of social welfare. However, there is an aspect to the labor market flexibility diagnosis that is trivial,

much like a diagnosis of inflation as being due to rapid monetary growth. Although true, it misses the more fundamental question as to why the flexibility is needed in the first place (or similarly for inflation, why monetary growth was so high). European policy makers by exposing their admittedly inflexible labor markets to overly abundant shocks are a fundamental source of the employment problem. The almost continual expansion of the EU, the single market liberalization, multilateral trade liberalization, liberal immigration policies, euro creation, and a host of domestic market liberalizations have subjected the labor markets to more adjustment than they are designed to take. It's like a racecar driver pushing his car until it cracks, who is responsible the maker of the car or the driver? European policy makers, the drivers, should have taken the labor markets as given and structured a set of policies within that framework rather than implementing a host of policies (which may be beneficial in a perfect world of perfect markets) which could not be assimilated by the existing labor market structure. The cost of this policy failure has been enormous. At easily one percent of eurozone GDP it amounts to \$86 billion a year, or over the last 10 years to almost one trillion euros.

Regardless of how one assigns responsibility, more flexible labor markets are better, *ceteris paribus*, in that they allow a more aggressive policy agenda. Most would agree that even during the Great Depression more flexible wages would have significantly reduced unemployment, yet many if not most would agree that policies promoting wage flexibility were not the optimal response during the depression. To the degree that flexibility can be achieved without negative consequences for the social welfare state, they would appear sensible; however, generally flexibility results in some loss of equity or security for workers. For example, during 2004 Germany cut back unemployment benefits and cut health and pension benefits, and France has reduced pensions for public sector workers to keep them working and simplified lay-off requirements; these policies reduce worker incomes and rights. The French 35 hour week put in place by the French Socialists has now been swept aside. Given that wages were not reduced proportionally when first implemented, this policy was unlikely to increase employment and it did not although it undoubtedly increased the life satisfaction of many people. Although some would argue that allowing workers to work longer hours is simply increasing the freedom of workers to pursue their own objectives, such an assessment fails to consider the economic context in which they work. Italy, due to strong union pressure, has had a more difficult time in cutting worker benefits. Nevertheless, in the majority of cases, the actual outcome of policies creating more flexible labor markets has been a reduced welfare state; creating flexible labor markets without destroying the social welfare state requires surgically precise policy action which the European governments implementing flexible labor markets have been unable or unwilling to implement.

Although Europe has less labor market flexibility than the U.S., it actually needs more labor market flexibility. In the U.S. when a region is hit by a negative shock, there is both a fall in wages and an out migration of workers to other regions experiencing employment growth. In Europe, with differences in languages and customs,⁵ this type of labor migration is unlikely to happen; in addition the housing markets are such that even within a country people are less likely to move. As a result, since the supply of workers is not going to adjust as in the U.S., there is all the more need for wage flexibility. In summary, the situation is that Europe needs labor markets where wages are more flexible than in the U.S. but actually has wages that are far less flexible.

The fundamental political problem is that the leaders of the western European countries have not been honest with their populations. The social welfare state as it exists in the large continental countries is not consistent with 1) EU enlargement to include poorer countries as with the southern and eastern enlargements, 2) the creation of the euro, and 3) allowing individual countries to set their own social dimensions covering labor, tax, and fiscal policies. Instead of explaining to their population that the above initiatives would require a complete reform of their economic model, they instead pretended that these policies could be implemented without altering their basic economic model.

Although the economic model of the continental economies may not be suitable for a globalized world, the question remains whether any social welfare state is compatible with globalization. Several analyses of the comparative performances of the European economies have concluded that the source of the problem is not the social welfare state at its most general level (Baker et al, 2003; and Navarro, Schmitt, and Astudillo, 2004). This is because the states with the greatest social welfare aspects (i.e., the Nordic states of Denmark, Finland, and Sweden) have been the best performing of the European states over the last 15 years (Aiginger, 2005). The experience of these smaller social welfare states would suggest that labor market reform if properly undertaken is possible without destroying the modern social welfare state. In addition it should be noted that a fairly well-developed social welfare state existed in Europe during its period of rapid growth in the 1960s.

The foundation of a social welfare state is an egalitarian distribution of income. Yet with a globalized economy, wages within a country will ultimately have to mirror the global distribution of income due to factor price equalization. Because of limits on the size of trade flows and migration, factor price equalization is far from a reality; nevertheless the forces of globalization are pushing things in that direction. If the advanced economies desire to have or maintain an egalitarian distribution of income, there are fundamentally four ways

⁵ Simple things like procedures for setting up a bank account, finding an apartment, figuring out the medical or pension system differ from country to country but are similar throughout the U.S.

to achieve higher incomes for the lower-paid low-skilled workers. The demand for the unskilled workers can be increased, the supply can be decreased, the wage paid to the unskilled can be increased regardless of supply and demand, or a progressive income tax can redistribute market determined income to the low-income workers.

The high unemployment in the continental economies would suggest that they have been relying on the third option; high minimum wages and/or union wage bargaining has kept the wage of the low skilled above the free market equilibrium. Thus a recent OECD report urges the French to lower their minimum wage for youth and unskilled workers. The institutional structure of unions in a country is another factor that can contribute to wages significantly above the equilibrium level. Where there is centralized collective bargaining that covers a large percentage of the workforce, as in Scandinavia, there is established an overall average wage increase that is likely to be moderated by unemployment concerns. This is unlikely to be the case where unions are fragmented, as in France, as each union is only concerned about its own members. Although setting wages higher than equilibrium wage can reduce employment in that sector, in a growing economy with some natural turnover higher than equilibrium wages are unlikely to produce actual layoffs for existing members but just less employment growth than would have occurred otherwise. Thus in fragmented union structures, unions can push for wages significantly above equilibrium wages but they need not worry about layoffs for their existing members. Wages for workers in the private sector may be moderated by the need to keep their firm viable due to foreign competition but unionized public sector workers have few constraints. Thus the institutional structure of labor unions can be a significant factor in creating a situation where the economy's wage rate is too high to produce full employment.

An alternative to keeping wages for the unskilled above the equilibrium level is to allow equilibrium wages but redistribute income through tax/benefit systems. Although this approach avoids high levels of unemployment for the unskilled it creates incentive problems for the skilled workers and lowers the returns to the owners of capital. As long as the factors are not particularly mobile, this strategy may work; with the increasing mobility of capital, inevitably taxes will be shifted from capital on to skilled labor, as has already been documented by Rodrik (1997). The Nordic approach emphasizes redistribution relative to the continental approach. Thus the Nordic model has turned the low mobility of labor from being a problem to an asset.

In figure 1 the basic predicament of the European countries is summarized. In quadrant four, increased openness increases market-generated inequality through Stolper-Samuelson effects. In order for societies to reach a certain level of equality represented by a given Gini level in quadrant one, either wages have to

be set above equilibrium levels creating unemployment or taxes have to be increased reducing incentives. These policies lower growth along the frontier in quadrant two, thus the relationship between openness and growth as shown in the third quadrant.

Demand for the unskilled can be increased through public works projects or wage subsidies and trade protectionism also operates through this channel. To some degree this was the mechanism that operated in Europe during the first decades after WWII. Trade liberalization with the creation of the EEC did not lower wages of the unskilled as the generated trade was largely intra-industry trade with minimal Stolper-Samuelson effects, but the globalization policies undertaken over the last two decades have. The policy favourite, for many, is a reduction in the supply of the unskilled which can be achieved with enhanced education and training programs; however, any benefit achieved by these policies in making the unskilled relatively scarce (and thus increasing their wages) is easily undone with a liberal immigration policy. Increased immigration from the new member states into the old member states as well as the future accession to the EU of even poorer countries is likely to keep the equilibrium wage for the unskilled in the current eurozone low for the next decade.

Thus it would appear that a number of welfare state policies when combined with globalization have probably had a negative impact on European unemployment. The continental approach will need to be modified. The recent generally good economic performance of the Scandinavian economies⁶ suggests that perhaps if carefully implemented, it may nevertheless be possible to have a prosperous welfare state. A less sanguine interpretation would be that the Nordic countries' business cycles simply differ from the EU core and their success is likely to be temporary. The 34 percent devaluation of the Swedish Krona in 1993 perhaps did as much as anything to restore competitiveness to Sweden and put growth on an upward path. Perhaps a little more time will be required before it can be concluded that the Scandinavian model is able to provide long-term equitable growth.

IS THE EU THE PROBLEM?

An alternative explanation to the welfare state is the explanation that the heart of the problem lies in the design of the European Union and its institutions. There are numerous channels that could connect Brussels to the poor performance of the EU but the most obvious would have to be its role in constraining aggregate demand. Thus the problem is not so much labor markets but the lack of aggregate demand; but why has aggregate demand been deficient? Clearly any of the

⁶ The performance of Norway is ignored; their great oil and gas windfall makes any comparison to other industrialized economies meaningless.

components of aggregate demand could be deficient; savings may be too high due to uncertain job or pension prospects, investment may be too low due high interest rates or to competitiveness problems from any number of causes including high labor costs, or exports too low due to an overvalued exchange rate or high labor costs. The fact that the most successful of the advanced economies over the last decade have had very low national savings is circumstantial evidence for the importance of aggregate demand. If the problem is one of insufficient aggregate demand, then policies to stimulate consumption or investment could be useful but the most obvious solution is a more expansionary monetary or fiscal policy. Why have European governments not brought monetary and fiscal policy to the rescue?

The short answer is, of course, that European governments do not have control over these policies; that control has been transferred to Brussels and Frankfurt and both appear to have a complete aversion to expansionary macroeconomic policy. More specifically the Stability and Growth Pact (SGP) limits fiscal government deficits to 3 percent of GDP (even when unemployment is 10 percent!), and the eurozone's monetary policy is being conducted by a central bank that has a single-minded focus on keeping inflation to "below but close to two percent." What underlies this almost classical pre-Keynesian view of macroeconomic policy?

Although there is some logic behind each of these policy designs, neither can survive a rigorous evaluation. The SGP is based upon a belief that the relative size of each country's deficits needs to be kept relatively close and the absolute long-run fiscal stance needs to be balanced or slightly in surplus. The relative requirement is based upon the fact that when fiscal policy is set at one level (national) and monetary policy at another level (eurozone) that there exists a negative externality from fiscal deficits. More specifically, a deficit by one state raises the interest rates that all the states must pay; the deficit state does not bear the full costs of its indulgence but is able to pass it on to its neighbors. In addition, the deficit allows additional spending in the deficit country and if the central bank is going to regulate aggregate demand over the whole monetary region, the deficit country is therefore able to export unemployment to the other states. Thus, there needs to be some requirement to keep deficits in line with one another.⁷ However, the problem with the 3 percent rule is that it keeps deficits too low during high unemployment periods. Why then not a moving (cyclically adjusted) fiscal deficit limit that increases with the overall monetary zone's unemployment rate? Thus large deficits would be allowed during recessionary periods and much smaller ones during recovery phases. The externality problem would be addressed without hampering the use of fiscal policy during recessions. The European objection to

⁷ This problem would appear to be more serious if the excessive deficit was incurred by a large country; it is ironic then that the large countries appear to be more able to get away with excessive deficits.

this seems to be the long-run demographic concern about the need to save today to support retirees in the future; thus the need to balance the budget over the business cycle. In theory this may be desirable, but if in practice this means that unemployment needs to be kept at double-digit levels for a decade or more, the economy is really not building up resources to finance future retirees. Another objection to government deficits is that they might crowd-out investment and lower growth, but under current conditions increased deficits by stimulating income are more likely to promote investment than reduce it. In the final analysis the belief in the need for a cyclically balanced fiscal policy is based more on conservative ideological dogma than practical economic analysis.

The inadequacy of the European fiscal response to the latest downturn is most obvious if compared to the highly stimulative U.S. response. The U.S. budget deficit went from a surplus of 2.4 percent of GDP in 2000 (fiscal year) to minus 3.6 percent in 2004; this amounts to an additional stimulus of 6.0 percent of GDP. Conservatively ignoring any multiplier effects, this stimulus increased GDP by at least 6 percent. The fiscal balance for the eurozone went from being roughly in balance at the beginning of 2000 to minus 2.75 percent by 2004; this is less than half the U.S. fiscal response. In March 2005, some changes in the SGP were agreed upon to relax this constraint. Germany's unification costs are to be excluded from the deficit calculation, as is some French military spending. The new members' pension benefits are to be interpreted liberally as well. This relaxation in the fiscal limit is likely to be helpful in increasing aggregate demand. However, if and when prosperity returns fiscal consolidation will be necessary since the demographic problems are real.

Although there is a role for more expansionary fiscal policy in Europe, it has been the failure of monetary policy that has been most glaring. Over the decade prior to mid-year 2003, real long-term interest rates were higher in the eurozone than the United States despite Europe's much higher unemployment. It is noteworthy that as the U.S. unemployment rate began to fall below its supposed natural rate of 6 percent at the beginning of 1996 (where it would stay for over 7 years), real long-term interest rates were 2.75 percent; in the eurozone where unemployment was 10.75 percent and rising, real interest rates were almost 5 percent and rising. During the more recent downturn, the U.S. Federal Reserve lowered U.S. short-term interests to negative one percent by 2003 (based upon quarterly data). Japan also had negative real interest rates in the mid-1990s before deflation made that impossible. The ECB, however has never lowered eurozone short-run interest rates below zero. The ECB seems to believe that since rates were low by historical standards that that should be sufficient. Other arguments are that the ECB needed to establish its credibility, and/or it needed to keep some backup capability in case some other major disturbance occurs.

More fundamentally, however, the ECB does not seem to have much confidence in its ability to use monetary expansion to increase economic activity. It is not clear if its reluctance is due to a belief that the aggregate supply curve is basically vertical even though unemployment is high so that any additional stimulus would simply create inflation, or if they believe that there may actually be an unemployment-inflation trade-off but do not have the flexibility of allowing inflation to go above 2 percent even if unemployment could be brought down significantly because of their mandate. The fundamental question is whether significant employment growth could have been achieved in the euro area if the ECB had been willing to tolerate a higher inflation rate of one to two percent more. Similarly, it is doubtful if the U.S. could have achieved its employment growth if the U.S. Federal Reserve had tightened monetary policy at the first sign that inflation might go above two percent.

The other possibility is that there really is no inflation-unemployment trade-off, i.e., that there is a vertical Phillips curve and additional monetary stimulus would have only increased inflation.⁸ Although there is fairly good evidence that in an inflationary environment, the Phillips curve might be vertical, there is no strong evidence that in a Europe characterized by low inflation and high unemployment that the Phillips curve is vertical. However, the EU Commission has stated that although demand management policies can iron out the business cycle they would not be useful now since they cannot alter the medium run level of unemployment.⁹ However, this view seems to be confused about what the medium term is, and essentially collapses into an extreme version of the long-run Phillips curve. It is also important to keep in mind the ratchet pattern discussed previously; the higher long-run unemployment trend is due to the fact that in each recession monetary policy was not used to get the economy back to a desired level of employment. Thus unresolved cyclical unemployment was allowed to turn into structural unemployment. The presence of long-term wage contracts, long-term home mortgages in nominal terms, the possibility that the equilibrium real interest rates might be negative and an especially strong resistance to negative nominal wage changes all imply that in a low inflation environment additional stimulus can be employment creating. In this situation small rises in prices need not set off an inflationary spiral.

Those believing in a vertical Phillips curve rest their case on simplistic theoretical models supposedly backed by sophisticated econometrics. However, the econometrics suggests economic relationships far more specific; the leap from these empirical findings to the vertical Phillips curve is a leap of faith. Blanchard

⁸ Note that the vertical Phillips curve concept as being used here is not inconsistent with a NAIRU that adjusts through time.

⁹ Comments made by the European Commission at the UNECE Annual Session to policy recommendations provided in the *Economic Survey of Europe*, 2005, No.1.

(2003b) finds the evidence unconvincing, as have prominent economists Robert Eisner, Ray Fair, James Medoff, Peter Gray, William Dickens, and James Galbraith (1999). European opposition comes from Peter Bofinger and Michael Hüther. In case one is inclined to argue that these economists really don't understand things, there is also a nice bunch of Nobel laureates in the same camp including the late James Tobin and William Vickrey, and the quite living Joe Stiglitz (2005) and the MIT brain trust of Paul Samuelson and Robert Solow.

Solow's (2002) assesses the situation, "What replaced the initial Phillips curve idea was the Friedman-Phelps natural rate of unemployment long-run vertical Phillips curve. And I have never, from the very first day, thought that that was other than a flimsy theory supported by flimsy empirical analysis. The theory that leads to the expectations-augmented Phillips curve is very weak. It's full of ad hoc assumptions that turn out just right, and it depends crucially on the natural rate of unemployment—the unemployment rate at which the long-run Phillips curve is vertical—being a number with some structural stability. And I have never been able to convince myself that there was a number with that kind of structural stability."

Solow (2002) summarizes European monetary policy: "To say that there's only one policy problem—to control inflation—is to say that if only you control inflation, the rest of the system would work itself out very well. The Bundesbank people used to say this almost with dead seriousness, but it strikes me as the most utter foolishness."

The position here is in agreement with the critique of Blanchard (2003b) regarding the interpretation of the empirical evidence regarding the medium term impact of monetary policy on real interest rates and employment. Monetary policy can affect the real interest rate and employment for over a decade before becoming neutral. And within that decade, the higher employment growth obtained will significantly change the existing structure of production, human capital acquisition and wage structure so that by the time the long run arrives, it is significantly different than what it would have been. In this way current monetary policy has a permanent effect on the long-term course an economy will follow.

Even if there is a natural rate of unemployment, policy makers do not know with any certainty what it is. In the U.S. those supporters of a natural rate clearly believed it to be at least 6 percent. However, unemployment stayed below 6 percent from 1995 until a recession pushed it back to 6 percent in 2003 and during this time it was able to fall as low as 4 percent in 2000; yet during this period there was hardly a hint of inflation. Clearly if there is a natural rate in Europe, the ECB does not know what it is; and it is not 9 percent.

The eurozone inflation target of two percent is too low. It should be recognized that the eurozone does not have one inflation rate; the rate of inflation varies considerably across countries and empirical analysis has failed to find a

tendency towards convergence even after the introduction of the euro. For example, during the first three quarters of 2004, the inflation rate was almost zero in Finland but over three percent in Luxembourg. Thus if the eurozone has a two percent rate, some of the countries especially the slower growing ones are likely to have inflation rates at least a point or so lower. Thus when the ECB sets the inflation target at two percent, the inflation rate in some countries is likely to be below one percent. Two percent inflation (which means less than one percent in some countries) is too low a target for three basic reasons. Not only does it limit the ability to take inflation a little higher to lower unemployment along a Phillips curve, it places an unacceptable limit on how low the real interest rate can go and eliminates the very important distinction between nominal and real wages.

With two percent inflation, and a nominal minimum limit on interest rates of perhaps one or one-half percent, the real interest rate can never go below minus one or one and a half percent. Given Europe's high savings rate (which is much higher than in the U.S.) this is not low enough to always ensure a savings investment balance when fiscal policy is so limited. Also note that if inflation is lower in the slower growing regions, their real interest rates will be that much higher. This not only makes obtaining the needed negative rate harder to achieve, but also results in a situation where those slow growing regions have higher real rates than the rest of the eurozone; hardly a recipe for stimulating investment where unemployment is high. Note that during the latest downturn in 2003, that the U.S. had inflation at 2 percent and short-term interest rates at one percent, thus the real rate averaged minus one percent; in the second quarter of 2004, inflation was 4.4 percent while nominal interest rates were 1.1 percent giving the U.S. a real rate of minus 3.3 percent. Thus the U.S. which has notoriously low savings nevertheless needed negative real interest rates of these magnitudes (on top of a huge fiscal stimulus) to equilibrate savings and investment at close to full employment.

In addition, the two percent target is too low to provide the proper range of different industry wage dispersions necessary to absorb different industry shocks without some industries having to have negative nominal wage declines. The overall inflation target should be set at a rate that would allow real wages in the declining industries to fall without the nominal wage having to fall. As discussed, due to the immobility of labor within Europe, structural changes will have to rely much more than in the U.S. on changing real wages. Yet the ECB has made this mechanism much more difficult by requiring all real adjustments to be nominal adjustments. This distinction between the ease of cutting nominal and real wages, whether it is due to pure money illusion, minimum wages, long-term union contracts, or workers' mortgage debt obligations being set in nominal terms, is central to modern macroeconomics but plays no role in ECB economics. With the two percent inflation target, the eurozone has simply boxed itself out of the full

employment equilibrium zone. Blanchard (2003b) summarizes the situation well when he writes, "Economies which try to aim for very low inflation (0 to 2%), and put sharp constraints on fiscal policy, are playing with fire." Europe has already been burned. Also it should be remembered that during Europe's golden age of growth with low unemployment during the 1950s and 1960s the average rate of inflation was about four percent, i.e., twice the current ECB target.

Fundamentally the operational mandate of the ECB needs to be changed from a sole emphasis on inflation to a more general responsibility for the overall performance of the economy similar to the mandate of the U.S. Federal Reserve.¹⁰ Because of this failure, the ECB is currently failing to properly account for two recent economic developments – the oil price increase and the appreciation of the euro. With its single-minded focus on the two percent inflation rate and another oil price shock underway, Europe is likely to recreate the mistakes of the first oil crisis in 1973. As has been proposed by Peter Gray, the goal of monetary policy should be to base the inflation target on the domestic value added component of inflation instead of the overall price level. Higher oil prices, which may or may not be a temporary blip, will create a cost-push type of inflation which should be passed on to consumers. To attempt to reduce aggregate demand with tight monetary policy in order to counteract this price pressure will only create a recession; nevertheless this is what the ECB must do in order to meet the two percent target.

Yet another problem with the narrow inflation focus of the ECB is that it does not give the proper weight to the exchange rate that is necessary. The euro is already overvalued but is likely to go much higher; the large and extended overvaluation of the euro is likely to do permanent damage (even after the euro declines) to Europe's export sectors. This will further reduce investment, which will not only lower aggregate demand, creating more unemployment, but will reduce Europe's ability to remain technologically competitive. Yet the exchange rate remains outside of the ECB's vision, except to the degree that it might impact inflation.

The problem is not only that monetary policy has been too tight; it is that the ECB has not been an activist in fine-tuning it to the needed level of monetary stimulus. As the U.S. Fed (and U.K. Bank of England) has loosened and tightened to adopt monetary policy to changing conditions, the ECB has kept interest rates essentially fixed. For example over the last 23 months (to May 2005) and all of the 18 months of the presidency of Jean-Claude Trichet, the ECB has not changed rates once while in the last 18 months the Fed has adjusted rates 7 times and the Bank of England 4 times.

¹⁰ Incidentally, the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978 did suggest a price stability goal of three percent, but that has never been interpreted as a formal mandate.

Although European monetary policy has been too tight, the actual monetary growth numbers would not give that impression. During both 2003 and 2004, M1 growth was above 10 percent while M2 and M3 varied between 6 and 8 percent. The underlying factor has been a preference for liquidity instead of for securities due to financial uncertainty instead of a desire for transaction balances. This monetary growth has not given rise to inflationary expectations as a recent survey of professional forecasters conducted by the ECB shows expected inflation in the eurozone to be below 2 percent in 2005 and 2006 (ECB, 2005). More generally, nominal interest rates on 10-year euro bonds have tracked U.S. levels quite closely since 1997; but given lower inflation in the eurozone the real rate has been higher. Recent monetary policy could also be viewed as having been expansionary as short-term interest rates have been below the estimated Taylor rate since the beginning of 2001 (Gerdesmeier and Roffia, 2003); however, this approach is based largely on circular reasoning.

The similarity of the European situation with that of Japan over the last decade should not be overlooked. In both cases there has been a fundamental macroeconomic problem that governments (and their central banks) have argued are outside the realm of conventional macroeconomic therapy. Although the respective policy makers have emphasized different structural features as being the source of the problem (the banks in Japan and labor institutions in Europe), in both cases their description of the problem and their solution was unconventional and a bit nebulous. The reality, however, is that the problem is largely the same, inadequate macroeconomic stimulation due to demographic concerns about using fiscal policy and an inflation rate too low to allow the real interest rate to go as low as is needed. In each case, with economic stagnation, consumer confidence also declined and this further reduced aggregate demand.

If the euro and its complementary institutional structure are a fundamental source of the problem should not the experiences of those outside the eurozone have been relatively better? In fact, those outside the eurozone including the U.K., Denmark and Sweden have been performing significantly better.¹¹ This is especially apparent from looking at the employment data of the three EU countries outside of the euro area. During the 2001-2004III period, the annual average unemployment rate in the euro area was 8.0, 8.4, 8.9, and 8.9 percent. The large economies of France, Germany, Italy, and Spain generally had even higher rates. The unemployment rate in the UK was 5.0, 5.1, 4.9, 4.7; for Denmark 4.3, 4.6, 5.6, and 5.4; and Sweden 4.9, 4.9, 5.6, and 6.4. Given the weaknesses inherent in the SGP and ECB operations regarding fiscal and monetary policy there is obviously a clear potential theoretical reason as to a possible reason for this superior economic performance in terms of employment. An examination of

¹¹ And those outside the EU altogether, such as Norway and Switzerland, have been doing even better in terms of unemployment.

the actual monetary and fiscal policies implemented in these three successful economies provides limited support for this thesis. All three countries had general government surpluses during 1998-2001 (Sweden had a surplus of 5.2 percent of GDP in 2000) and although they deteriorated in the following years, only the U.K. in 2003 exceeded the 3 percent deficit limit of the SGP. These countries therefore did implement significant counter cyclical fiscal stimulation (both through automatic stabilizers and discretionary actions such as Sweden's income tax cut) but it did not take them significantly past the 3 percent limit. Thus it can not be argued, that since these three were not covered by the Stability Pact, that they were able to maintain aggregate demand with a fiscal expansion that would not have been allowed if they had been in the eurozone. However, the conclusion cannot be extended to mean that the countries in the eurozone have not had their performances damped by the 3 percent deficit limit since many of them did not have the leeway provided by surpluses prior to the downturn and bumped up against that limit quite early in the latest downturn. France, Germany and Italy actually went over the limit, but by not as much as they probably would have, had the requirement not been present. These countries generally had sizable deficits during the 1998-2001 period so that when there was a need for fiscal expansion they ran up against the 3 percent limit without being able to inject that much additional stimulus. Thus the relative performance difference between the eurozone and those outside the zone is due to some degree to the SGP; but the important point is that it's not that the outsiders were outside but that the insiders were inside.

There is only limited evidence to suggest that the non-euro countries have benefited from having an independent monetary policy. Over the long-run, none of these three countries had a monetary policy significantly more expansionary than the euro zone; this holds whether one considers the growth of monetary aggregates or interest rates. In fact, the U.K. and Sweden have also largely adopted the ECB mandate of giving almost sole priority to inflation, and Denmark's focus has been on maintaining the euro-krone exchange rate. Since they are supposed to act like the ECB one would really not expect there to be a significant difference in their monetary policy. In 2004, Sweden and Denmark had the lowest inflation rates (along with Finland) in the EU; thus they did not move along a Phillips curve and obtain their lower unemployment by allowing higher inflation. Neither did they take advantage of their separate currencies and depreciate as a way to gain export competitiveness and thereby export their unemployment. Denmark joined the ERM-2 and since 1999 has kept its exchange rate within a 2.25 band; Sweden has also kept its krona relatively close to the euro although not as tightly fixed. However, the U.K. has been able to use its monetary policy to keep its nominal effective exchange rate stable since 2001 while the euro has appreciated 30 percent during that time. Thus the U.K., by being out of the

eurozone, has been able to avoid the damage to its export sectors and this has helped maintain employment. (Also, Sweden and the U.K did depreciate in the early 1990s; this might be a factor towards explaining their current success but there is no reason to believe that these changes could not have occurred even if they were planning on euro entry.) Thus a careful examination of these nations' policy actions finds only a limited explanation as to why being outside the eurozone might be an explanation for their superior performance.¹² One additional possibility is the idea of a confidence effect and self-fulfilling expectations; markets can count on the non-euro countries to conduct the needed macro policies if really needed so agents have invested and consumed anticipating prosperity while in the eurozone agents are coming to expect slow growth and their behaviour actually creates it.

The case that their superior performance is the result of their being outside the eurozone is further muddled by the fact that the non-euro states generally had lower unemployment than the euro states even before the introduction of the euro. The non-euro three averaged lower unemployment than the average of the countries that would eventually adopt the euro every year between 1984 and 1999. However, this should not be taken as strong evidence against the role of the ECB in creating the eurozone's problems. As has been stressed, with perfectly flexible labor markets, any monetary policy will do. Thus the fact that these countries have done relatively well with essentially the same monetary policy simply means labor market flexibility is an option, it does not imply that it is the only option.

If the institutional structure supporting the euro is a major source of Europe's growth problem, why was this problem evident even before the creation of the euro? The euro is only the latest manifestation of a longer running institutional bias in Europe against using macroeconomic tools. The current ECB assessment of the proper role of monetary policy is quite similar to that of the Bundesbank; it's only appropriate that they were established in the same town. Prior to the creation of the euro, the Bundesbank basically set monetary policy throughout Europe as countries attempted to maintain their exchange rates with the German mark; this was formalized with the creation of the European Monetary System in 1979. With fixed exchange rates and capital mobility, due to the impossibility trilemma or the irreconcilable trinity of international finance, the rest of Europe did not have an effective and independent monetary policy (especially after full capital account liberalization in the 1980s). Throughout this period, as Germany implemented its classically tight monetary policy, the rest of Europe was "forced" to adopt a tighter monetary policy than would have been optimal. The situation was particularly dysfunctional since Germany largely ignored the economic conditions in the rest of Europe in making its monetary

¹² A more nuanced discussion of this can be found in Moser, Pointner, and Reitschuler (2004).

policy. Throughout this period the rest of Europe had a tighter monetary policy than would have been optimal. It would be like having monetary policy set in the U.S. by the N.Y. Fed based solely upon the economic conditions in the second district which includes only New York and New Jersey. Thus monetary policy in Europe, then as now, had only a limited connection with the prevailing economic conditions. In addition, IMF analysis has found that counter cyclical fiscal policy was not typical in many of the EU countries even in the 1980s and 1990s. In Germany and Italy in particular, even considering the counter cyclical contribution of automatic stabilizers, these countries had net procyclical fiscal policies (Annett and Jaeger, 2004; German Council, 2004/05). Thus the loss of fiscal policy under the SGP was not a real loss if compared to the two earlier decades since they never really used fiscal policy as a stabilization tool. Thus the lack of an effective fiscal and monetary policy is a partial explanation of Europe's poor employment performance going back to the beginning of the unemployment differential in the early 1980s; the creation of the euro has only altered the nature of the constraints on using these policy tools and not the constraints themselves.

The view that policies to increase aggregate demand are central to the solution to Europe's problem can appropriately be termed the Geneva consensus. This has been the view expressed in the United Nations Economic Commission for Europe's *Economic Survey of Europe* (2005) for some time. The emphasis on a "Keynesian" solution instead of the classical emphasis on labor markets is only appropriate since several of the most important Cambridge economists developing Keynesian economics spent part of their careers at the ECE; this includes Nicholas Kaldor and Richard F. Kahn. This historical note also brings to mind the similarity of the policy debate that existed in Europe and the United States during the inter-war period. European economists had been at the forefront then, as now, with their advocacy of wage cuts as the solution to unemployment, with the continental economists being the strongest advocates. It was in the United States that Keynesian economics was most quickly and readily received, as wage cutting had never been viewed, as the solution to unemployment even before Keynes' theoretical contribution (Blaug, 1978). Today, as then, macroeconomic policy is viewed much more favorably in the U.S. than continental Europe.

How is that that a collection of largely welfare states, often under the political control of socialist governments implemented a Maastricht framework to govern them that was essentially based upon classical macroeconomic reasoning? In addition to the fact discussed above that the discretionary use of monetary and fiscal policy was never used extensively in Europe from the 1980s onward, this outcome was primarily the result of the fact that European integration was foremost a political undertaking which co-opted the proposed economic benefits whenever possible, but whose momentum derived primarily from political and not economic objectives. The second major contributing factor was the requirement

for a consensus among members in designing EU policy. As a result, EU economic policy was always determined by the lowest common denominator. A highly integrated EU with strong governance and activist economic policy was not politically possible with a widened membership that included most notably Britain. Although often denied, there was a significant trade-off between deepening and widening. Thus the role of pan-European institutions was limited to the role favored by the most conservative members. Those states desiring a more activist role for Brussels were unwilling to opt-out since political considerations were simply more important. The basic problem was quite fundamental, the rationale for widening the EU was primarily political and for deepening the EU was primarily economic; this was one of the few cases where politics triumphed over economics due to the fact that most of the early policy makers had experienced World War II or its aftermath directly. This is not to say that in the very long run, the expansion of the EU will not prove to be a beneficial exercise. However, those pushing for expansion clearly have underestimated the degree to which it would limit deepening and failed to appreciate the significant adjustment costs involved. Given that the European Commission seems intent on destroying the continental style social welfare state, there should be no surprise of increasing opposition to a EU constitution that will give Brussels even more power. A recent survey of French voters showed that 58 percent of left-leaning voters opposed the new EU constitution while only 33 percent of right-leaning voters opposed it (CNN, 2005). For the left, the constitution is viewed as primarily a commercial treaty without a social dimension.

DOES SIZE MATTER?

Since not all of the European economies have experienced high unemployment, what is different about those that have? What then is unique about Germany, France and Italy? The answer is that they are large countries. The significance of this is that prior to the extensive integration efforts beginning in the 1980s, they were countries used to having some policy autonomy not only for monetary and fiscal policy, but for trade policy and a whole range of labour and product market regulations. The smaller countries had faced the reality decades before that they had quite limited autonomy and demand management policies largely leaked out through trade and financial flows; thus their institutions and policy mindset had evolved to ensure that their economies were not dependent on aggregate demand policies and their economies could adapt to whatever conditions prevailed. This was not the case for large countries; thus when the pan-European institutions took away their policy autonomy, they were ill adapted in dealing with its implications. This explanation therefore incorporates some of the other factors already discussed but provides a reason as to why these other factors

were more significant in some countries than others. Although Spain has not been analyzed as thoroughly as the other large continental economies it has had an especially large long-run unemployment problem, and would also be covered by this explanation. However, this explanation fails to explain the causes of Belgium's relatively poor performance.

IS GOD THE ANSWER?

A comparison of those countries doing relatively well with those doing poorly reveals yet another pattern. Those doing poorly are basically Catholic while those doing well are largely Protestant. Thus it has been suggested (Ferguson, 2003) that this religious difference can explain the difference in income growth not only between Europe and the United States but also within the European countries. The percentage of the population that is Catholic in Spain is 99 percent, Italy 98 percent, France 81 percent, Belgium 75 percent, and Germany 34 percent. In the more successful economies, the percentage is 1.5 in Sweden, 2 percent in Denmark, less than 3 percent in Norway, but is 34 percent in the Netherlands. One does not need to look far to find a theory as to why this might be a factor. Max Weber's *The Protestant Ethic and the Spirit of Capitalism* published exactly a century ago postulated such a connection and although it has never been fully accepted by the profession, it has remained an intriguing theory continuously cited. More recent research by Barro and McCleary (2003) finds, using country cross-sectional growth analysis, that certain religious beliefs are associated with higher growth. Needless to say, the U.S. is much more religious than Europe, and the slowdown in Europe has coincided with the decline in religion in Europe.

The precise mechanism that might be at work is harder to pin down. Academic economists tend to avoid this topic in their writings, perhaps anticipating a possible "Larry Summers" effect. However, over coffee, in an informal setting this explanation is inevitably raised. One possibility is that Protestants appear to have a greater inclination towards debt, and since one of the fundamental causes of Europe's poor performance is the lack of aggregate demand, Protestant shoppers have kept their economies humming. Thus the notoriously low savings rates in the U.S. (and to some degree in the U.K., Denmark and Sweden) have not been a problem but instead have acted to keep demand up and growth going. In a way this explanation turns Weber's on its head, since he believed growth benefited from thrift and now it seems to benefit from wantonness. Another view is that bankruptcy procedures are more lenient in Protestant economies and this leads to more dynamic economies as unprofitable ventures are more quickly abandoned and resources reallocated.

IS IT A RACE TO THE PERIPHERY?

Another possible explanation for the poor performance of Europe's core might be the southern expansion of the EU in the 1980s with the accessions of Greece in 1981, and Spain and Portugal in 1985, and the eastern expansion in 2004 to include the eight East European countries and Malta and Cyprus. The periphery countries have wages much lower than the core countries and tax rates, especially taxes on corporations that are much lower. For both reasons businesses and investment are leaving the core countries. To try to stay competitive the core areas will have to lower taxes; a beggar-thy-neighbor round of tax cuts is likely over the coming decade. German chancellor, Gerhard Schröder has recently (March 2005) proposed lowering the corporate tax rate from 25 to 19 percent. Although Schröder has proposed to offset the revenue losses by closing tax loopholes, the more realistic outcome will be a reduction in social expenditures. The policy of widening the European Union (first the UK, then southern expansion and now the eastern expansion) is a fundamental cause for the scaling back of the European welfare model.

The current structure of the fiscal transfers within the EU has also placed an undue burden on Germany. Not only has Germany contributed about 4 percent of its GDP each year for rebuilding East Germany, but Germany is a major contributor to the EU while many of the faster growing countries are beneficiaries; even Ireland which is richer than Germany is a beneficiary. These funds could have been used in Germany to build physical infrastructure or enhance education but have instead been sacrificed to promote growth in the EU periphery. Although the largess of Germany may pay off in the future with a more equitable and stable Europe, it has, nevertheless, come at a significant economic cost for Germany.

SLOW POPULATION AND LABOR FORCE GROWTH

Another significant factor in the poor employment performance of the European core areas is their low level of population and labor force growth. When there is population and labor force growth, sectoral shocks that would cause an absolute decline in the employment in a sector if the overall size of the economy remained constant can be absorbed as simple reductions in the growth rate of a sector as opposed to absolute declines. Between 1978 and 1995, total U.S. employment increased by 24.7 million or 25.2 percent; similar size increases were observed in Australia where employment increased by 25.3 percent (1978-1992) and in Canada where it increased by 23.8 percent (1978-1995). However in the European core, the labor force hardly increased, with employment growth of 1.5

percent in France (1978-1995), 4.7 percent in Germany (1978-1990), 0.3 percent in Italy (1978-1994), and 1.8 percent in the U.K. (1978-94)¹³. As discussed labor force participation has been a factor but it is primarily the population growth differential that is the key factor. Between 1980 and 2000, the population of France increased by 9.3 percent, Italy 2.3 percent, Germany 3.4 percent (1990-2000), and the United States 23.9 percent. Most recently, during 2003 the population of the EU increased by 216,000 which includes a French increase of 211,000. Thus holding everything else equal, a shock that might have required an employment decline of 20 percent in a sector over two decades, would have resulted in an industry still able to increase by 5 percent in the U.S. while in the European core employment would have had to decline absolutely by 15-20 percent. Thus the U.S. is able to absorb a shock of this magnitude with little or no displacement while Europe would have experienced the wrenching effects of employment dislocations, lost human capital, and downward industry wage pressure. Thus once again, in order to maintain full employment, Europe needs (relative to the U.S.) much more downward wage flexibility. Population projections for the future suggest that this problem will only worsen, as the slow population growth in Europe is likely to turn into a significant decline. For example, between now and 2050, the population of Germany is projected by the UN to fall by 14 percent, and Italy by 25 percent.

THE NEED FOR INCREASED COMPETITION

The recent controversy about the EU's service sector directive illustrates quite well the basic predicament facing the European economies. Competition and efficiency in the service sectors in most of Europe are quite low. Markets in the continental economies are highly regulated in terms of a number of parameters such as store hours and prices and the even the ability of having a sale is regulated. Cross border competition in many sectors such as banking is extremely low. As such, liberalization is needed to increase competition and bring prices down; with services accounting for more than half of GDP, the economic gains could be considerable. However, liberalization won't simply eliminate monopoly-pricing power and leave the structure of production unchanged. Instead the structure of production, including the geographical location of jobs is likely to be significantly affected. As previously discussed, productivity growth comes primarily from efficient firms eliminating inefficient firms, not from inefficient firms becoming efficient. Thus productivity growth in services is not going to be painless and will result in significant layoffs and restructuring. Yet with unemployment near double digits, Europeans are increasingly waking up to the

¹³ OECD (1998) and OECD (1999).

fact that these EU initiatives have real costs and increasingly are deciding that these liberalization experiments need to be put on hold until the employment issue is properly resolved. Both Chirac of France and Schröder of Germany have concluded that the services directive is unacceptable in its present form at the current time.

The services directive brings to the forefront a critical issue in regard to openness and the welfare state. The directive would establish the country of origin principle for services similar to that which applies for goods. If a good meets the standards of the place where it is produced, it can be freely traded throughout the EU; this same standard would apply to cross-border traded services as well. Can a country maintain a social welfare state in an economic union consisting of many “free market” economies; the ability to do so is being strained on two broad fronts. First is the accession of the new member states which in addition to having much lower wages appear to have more of a policy focus on growth instead of distribution. And second is the expanding size of the tradeable sector which by including services increases the likelihood of factor price equalization or at least moves wages more in that direction (Shelburne, 2004).

FUTURE PROSPECTS

Is the relatively poor performance of Europe likely to turn around, and are the current problems likely to be viewed in hindsight as simply a difference in cyclical patterns. Unfortunately, for the Europeans, their future prospects are not encouraging. Unemployment in Germany reached a post-war high of 12.6 percent¹⁴ (9.7 by comparable OECD international standards and seasonally adjusted) in February 2005, with 5.22 million unemployed (4.88 million seasonally adjusted) – the most since the great depression. Inflation remains below 2 percent and its international competitiveness continues to decline as the euro continues to appreciate with a further appreciation still likely, yet the ECB is more likely to raise interest rates than lower them. Since Germany, France and Italy are already over the three percent fiscal deficit limit, a further expansion in fiscal policy in these countries is also unlikely even with the minor reform of the SGP. In Germany, the money saved from the 2004 cut in unemployment benefits which will force people to take low wage jobs is being targeted to pay for a corporate tax cut, not fiscal consolidation; it is unlikely that a corporate tax cut will provide any more stimulus than unemployment benefits but these policies will slightly further erode the welfare state (Bloomberg, 2005). In France unemployment is at a five year high of 10 percent and growth is expected to be under 2 percent in 2005. Italy is in no better shape, with GDP shrinking during

¹⁴ Those working part-time under 15 hours a week are considered unemployed using the German definition.

the last of 2004 and a recession underway with a government growth forecast of less than one percent for 2005; the employment rate is one of the lowest in Europe, and unemployment is approaching double digits. In Italy the emphasis has been on productivity enhancing changes such as encouraging small firms to merge so as to benefit from scale economies and be in a better position to conduct R&D.

In the short-run, the SGP, the ECB and labour market inflexibility are unlikely to change. The rising euro is likely to choke off the remaining component of aggregate demand that has been keeping Europe afloat. In the medium term, competition from the new EU-10, a lack of entrepreneurship, and continued labor market inflexibility will continue to suppress growth. The European Commission in its Lisbon Agenda of 2000 proposed a series of measures to boost EU real economic growth from 2 to 3 percent per year and make the EU the “most competitive and dynamic knowledge –based economy in the world” by 2010. Since 2000 growth has remained slightly below the 2 percent level. Most of the 28 main objectives and 120 sub-objectives are unlikely to be met by 2010. For instance, the Lisbon agenda aims to increase the employment rate to 70 percent from its current level of 64.4 percent (in 2000 it was 61 percent), and to increase R&D from 2 percent (also the level in 2000) to 3 percent. Economic dynamism in EU innovation remains quite low with only one-fourth of the number of patents per capita as in the United States. Europe has also chosen not to be a viable participant in several of the most important scientific revolutions taking place, especially in the biological area of genetic engineering and stem cell research.

If the short and medium run outlooks are not too promising the longer-term outlook is even less so. The problem here is demographics – a problem far worse than what is in store for the U.S. or even Japan. For example in Germany, government spending for pensions will increase from the already high level of 10.3 percent of GDP to 15.4 percent in 2040. One component of this is the falling number of workers per dependent persons (children, students, and the retired.) A small proportion of the labor force working reduces GDP per capita directly, but it also reduces it indirectly since higher taxes must be levied on those working, which further lowers their interests in working. Wim Kok, former Dutch prime minister, has suggested that the aging of Europe will lower the annual EU growth rate by a full percentage point by 2040 (Brooks, 2005). Another component is somewhat of a wildcard, that being the likely absolute decline in population. No advanced society since the industrial revolution has experienced a persistent fall in population. Although it is possible to theorize how this might affect things for good and bad, the lack of any previous case to study will mean that any forecast is likely to estimate effects poorly and totally miss other important implications. A possible partial solution to this problem would be increased levels of immigration which is an important component of the U.S. solution to its weaker demographic

problem; however it makes little sense today to be encouraging immigration with double-digit unemployment rates. The demographic problem is exacerbated by the already high public debt to GDP ratios in a number of countries. Thus the option of borrowing one's way through the demographic transition is not a viable option. An additional factor making the longer-term outlook gloomy is the likely competition from China into Europe's product niche.

There is little correlation between a country's overall economic performance and the returns of its basic stock indexes. Thus the likely disappointing overall economic performance of Europe should not be assumed to suggest that Europe is a bad place to invest. In the short to medium run the appreciation of the euro is likely to further increase the returns on unhedged investments. Likewise the analysis here has focused strictly on the economic performance of Europe; in many ways Europe is and will remain one of the most desirable places on earth in which to live.

SUMMARY

We began by asking what is the fundamental problem in Europe, the welfare state, the EU, or some idiosyncratic factor. The answer would appear to be all three; there is no single problem. The interrelationships between these three factors make a diagnosis difficult and the solution therefore becomes imprecise and complex. The slow population growth, limited labor mobility due to linguistic and cultural factors, traditional institutions, hysteresis from the accumulated policy failures, and a liberal external trade regime in a globalizing world result in a situation where required structural adjustments are large but very difficult to achieve. On top of this the European welfare state, which is more extensive than elsewhere, has resulted in further rigidities to changing market outcomes. Technological and preference changes which are being intensified by globalization are producing trends and effects (i.e., factor price equalization) which must be countered or resisted in order to pursue the security and egalitarianism inherent in a welfare state. Some welfare designs appear to be working better than others; more specifically those that allow greater flexibility of wages and prices and instead rely on tax and transfers appear to be working better. However these have their own Achilles heel, negative incentive effects, out migration, and capital outflows that can result from high taxes. Whether increased labor and capital mobility will one day also doom them remains to be seen. Despite all these problems, however, what has really provided the deathblow has been the creation of the EU and its numerous institutions. These institutions appear to have been designed in a vacuum. They are all just fine for a perfect world, but they were not the set of institutions needed to complement what already existed. Europe basically has no macroeconomic policy to maintain

employment since the ability to conduct countercyclical monetary and fiscal policy is currently emasculated by the SGP and ECB. The question of why the EU has been so poorly designed can perhaps be left to political scientists but one obvious problem has been its democratic deficit. It has evolved not as a supranational democratic institution but a cooperative agreement between sovereign nations with the lowest common denominator determining the outcome. That denominator has proven to be classical free market fundamentalism. More recently there have been attempts to alter this, but it has been too little too late.

The approach to deal with the accompanying economic stagnation has been to attempt to change everything else to accommodate the directives from Brussels. This has proven to be a long and costly process that has gone on for two decades with no end in sight. How to escape this malaise? Although in theory the current approach might eventually work, once the perfect markets that exist in economic theory can be established in reality, it will be a long and costly journey. Exactly what reforms will be needed are uncertain, the way to get there nebulous, and given that policy changes of this sort inevitability involve significant redistributions of a slowly growing pie, they will be resisted all the way. There is a better way to move forward; monetary and fiscal policy must be used aggressively to get the European economies moving, only then can structural reforms be efficiently implemented. Although there are limitations to what macroeconomic policy can accomplish, opposition to their current full use is based more upon ideology and simplistic econometrics than a careful analysis of what is possible and sensible by weighing the true economic and social costs and benefits. Inflation needs to be increased in order to provide the manoeuvrability in nominal space required so that real interests rates and real wages and prices can adjust to their equilibrium levels. The delay has already cost Europe over a trillion euros; with further delay Europe might one day end up in a liquidity trap where even this option may no longer exist. Although more basic structural reforms including increased labor market flexibility will ultimately be needed, as with trade liberalization, these are best undertaken during periods of prosperity and low unemployment; now is not the time. In contemplating these reforms, however, it must be appreciated that although the U.S. has done relatively well on overall growth and unemployment, its model has nevertheless failed to provide any significant increase in the real living standards for a majority of its population for over two decades. Thus duplication of the U.S. model will simply replace one inadequate model with another.

POSTSCRIPT

As this article goes to print, the Netherlands and France have just voted down the proposed new constitution. This result is consistent with a basic theme

of this paper: that being that the EU has not been building a supranational institutional structure that will allow the current modern European welfare state to flourish. Instead the EU has been attempting to dismantle the welfare state and turn old Europe into the “Anglo-Saxon” model where countries compete with each other for jobs, high-skilled immigrants, and investment. Although some of these reforms will be required given the realities of global capitalism, they have been implemented in a costly and clumsy manner made all the worse by very poor macroeconomic policy. Any fall in the euro resulting from these referendums that occurs due to investor concern about the future of the euro or Europe will benefit the eurozone by stimulating exports; this might marginally help the employment situation. Also as this goes to print, the OECD has belatedly acknowledged the need for monetary easing in the eurozone and the U.K. and Sweden have exercised their monetary independence by lowering their interest rates.

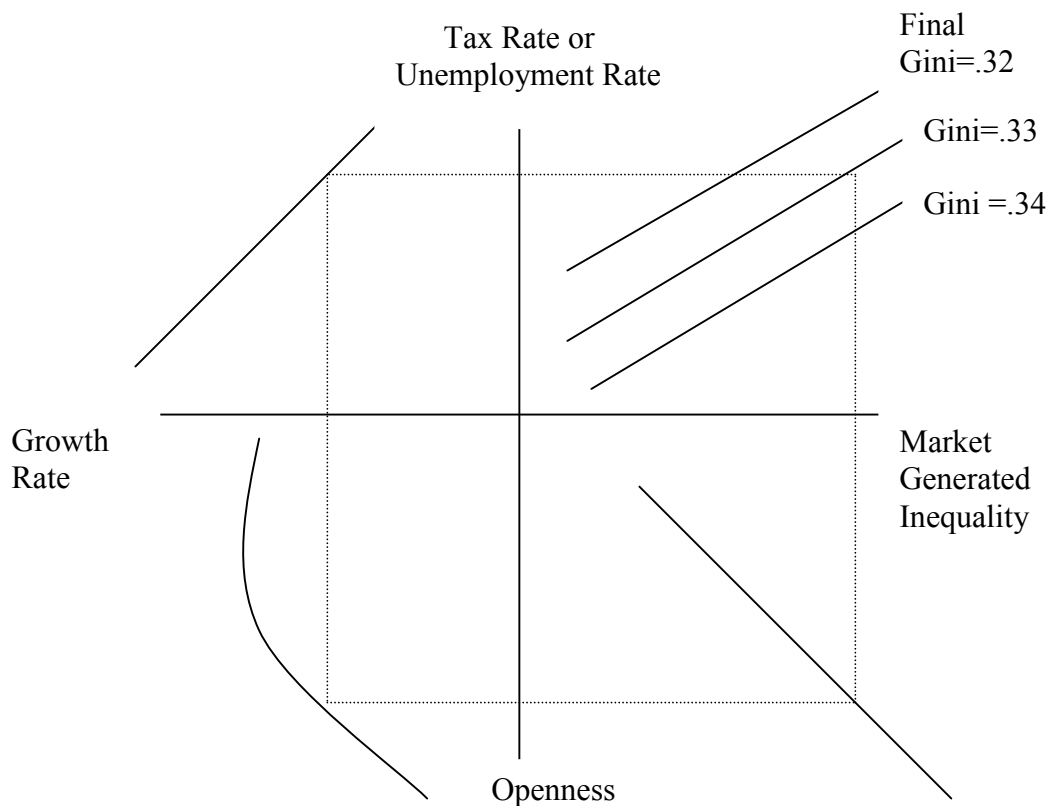


Figure 1
The Relationship between Openness and
Growth in a European Welfare State

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