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Europeans might consider it unfair if America escapes the consequences of its past profligacy at their expense



HOPES that the euro-area's economies might be perking up have been dashed by the latest GDP figures. The area grew at an annual rate of only 1.2% in the third quarter, half as fast as in the first half of 2004. The two biggest economies, France and Germany, grew at annual rates of only 0.4%, compared with 3.7% in America. Not only is domestic spending still weak; exports, hitherto the main driver of growth, have slowed. Fears are mounting that another rise in the euro could tip Europe's economies back into recession.

Since the end of 2000, America's output has grown more than twice as fast as the euro

area's (see chart). Euro-pessimists see this as further evidence that arthritic economies are being held back by lazy workers and by governments unwilling or unable to carry out reforms. In contrast, America's more robust recovery, it is often said, reflects its amazing flexibility.

America's productivity growth has indeed been faster than the euro area's. Yet most of its GDP growth since 2000 is down to big tax cuts and lower interest rates, which fuelled a consumer-spending binge. Such policies are not sustainable. America's structural budget deficit (after adjusting for the economic cycle) stands at 4.5% of GDP, almost three times as big as the average in the euro area; its household saving rate has fallen to 0.5%, compared with 12% in the euro area; and its current-account deficit is almost 6% of GDP, while the euro area runs a modest surplus. Such imbalances suggest that America's future may be a lot less rosy.

This is not to deny that the euro area's economic performance has been dismal. Germany's Council of Economic Advisers forecast this week that the economy would grow by only 1.4% in 2005, no better than in 2004. Some of the weakness in both Germany and its neighbours may reflect the short-term impact of government and corporate reforms, which may be boosting long-term competitiveness, but are also dampening wages and thus consumer spending. Worries about job and social-welfare cuts have also taken their toll on consumer confidence. Retail sales in the euro area have remained flat over the past year.

On the other hand, thanks to low wage increases and a pick-up in productivity growth this year, profits in the euro area are now rising at their fastest pace for a decade. It is striking that, despite relatively slower GDP growth, share prices in the euro area have outperformed Wall Street in the past two years.

Awkwardly, the faster that governments and companies push ahead with reforms to make labour markets more flexible and so boost long-term growth, the weaker consumer spending is likely to be in the short run. But other reforms could boost demand. One possible reason why inflation has remained above the European Central Bank's ceiling of 2%, despite low growth, is a lack of price competition. Not only does this force the ECB to run a tighter policy than it otherwise would; high prices are also directly curbing consumer spending.

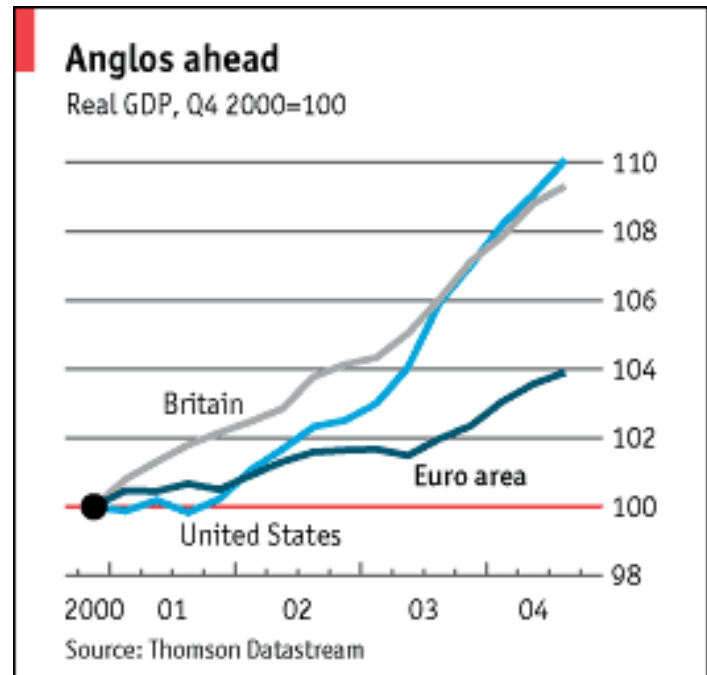
A study by Ben Broadbent, an economist at Goldman Sachs, finds that, although consumers in America and Britain have enjoyed a sharp fall in the prices of clothes in recent years, thanks to imports from low-cost countries, clothes prices have not fallen in the euro area. One explanation may be that retailers, insulated from fierce competition, have not passed on cost savings. Measures to boost retail competition could thus increase demand.

Over the past couple of years, Europe's economies have been supported by strong export growth. But that is now being threatened by the rise of the euro, which has already appreciated by more than 50% against the dollar in the past three years. The euro's trade-

weighted value, however, has risen by much less, taking it back to its value at launch in January 1999. This is because only 16% of the area's exports go to America, compared with almost 50% to the rest of Europe.

In any case, a strong currency can have advantages. It helps to reduce inflation and hence interest rates, and by intensifying competition it should speed up structural reforms in Europe. Even so, if the euro rises towards \$1.50, as some predict, many European businesses will be hard pressed.

So far the ECB has tried to talk down the euro, but it has not intervened in the currency markets. Such intervention is unlikely to succeed without the help of America. John Snow, America's treasury secretary, claimed during a visit to Europe this week that America still supported a "strong dollar". But the markets now suspect that America is happy to let the dollar slide, as an easy way to reduce its vast current-account deficit without suffering a slump in demand and jobs. If that is right, America's gain may be Europe's loss.



Mr Snow also argued that the euro area's slow growth was partly to blame for America's growing current-account deficit; he urged Europe to boost demand. But this is easier said than done. With real interest rates in the euro area already negative, and average budget deficits around 3% of GDP, there is little room for stimulus. Structural reforms may boost growth in the long term, but not immediately.

If the dollar keeps falling, Europeans may feel that it is unfair that Europe should now suffer after years of profligacy by America's consumers and government. America is seen as a prodigal son who has squandered his wealth through wild living. His European brother, who has lived prudently, has no desire to bail him out now that his luck is running low.

Policymakers in Europe insist that, rather than rely on a fall in the dollar to correct its trade deficit, America should save more by cutting its budget deficit. Yet if that reduced American demand, European exporters would still suffer. Anyway, America is unlikely to heed Europe's advice. As Jean-Claude Juncker, Luxembourg's prime minister, put it this week, "I think there is an underdeveloped sense of hearing in the United States".