Europe's productivity growth has been almost as rapid as America's

IMMEDIATELY after September 11th the dollar weakened against the euro, and economists predicted that this would mark the end of investors' love affair with the greenback. Yet, despite a small drop this week after the Federal Reserve cut interest rates by half a point on November 6th (a move followed by the ECB's own half-point cut on November 8th), the dollar has returned close to its level before the attacks—so the euro is still 25% below its value at birth in January 1999. Why is the dollar so strong against the euro, despite the evidence that America is in recession?

A popular argument is that productivity growth is faster in America than in the euro area. America's productivity growth has dipped in the downturn, but it is argued that it will bounce back and even outpace growth in Europe for years to come. Figures this week showed that America's productivity growth has held up surprisingly well, rising by 1.8% in the year to the third quarter. America, so it is said, will remain the best place in which to invest—so the dollar will stay strong.

Yet in recent years productivity growth in America, if measured correctly, has not been much faster than in Europe. International comparisons are tricky because there are so many ways to measure productivity (see chart). The simplest is GDP per worker. In the five years to 2000, this rose by an annual average of 2.5% in America, and by just 1.2% in the euro area. But this is misleading, because a big increase in part-time working in Europe has depressed productivity growth. Better is GDP per hour worked: over the past five years this rose by 2.1% in America and by 1.6% in the euro area—a narrower gap.

To confuse matters more, the most popular productivity measure in America is output per hour in the non-farm business sector, which grew by an annual average of 2.5% over the past five years. Lazy economists compare this number with the 1.6% growth in total GDP per man-hour in Europe, exaggerating the productivity gap.

Another problem is that American statisticians count firms' spending on software as investment; in Europe it is treated as intermediate consumption. The surge in spending on software in recent years inflates American growth, but not Europe's.

One solution that partially gets around this problem is to use net domestic product (NDP) rather than the more common gross domestic product (GDP). NDP subtracts capital depreciation, and is
considered a superior measure of economic progress. Normally, the two measures grow at the same pace, but in recent years a gap has opened up. That is because the average rate of depreciation of the capital stock has risen as investment has shifted from traditional machinery to shorter-lived assets such as computers and software.

Julian Callow, at CSFB, has calculated NDP per hour worked in America and the euro area. He finds that, over the past five years, America's productivity growth has only slightly outpaced that in the euro zone, at 1.8% and 1.5% respectively. However, over any period longer than the five years of America's boom, the euro area's productivity growth pulls well ahead. In the seven years to 2000, NDP per hour rose by an average of 1.8% in the euro area, but by only 1.4% in America.

These calculations also ignore the fact that American number-crunchers have done more than their European counterparts to take into account improvements in the quality of goods and services. Europe's productivity growth is therefore probably understated relative to America's.

None of this is to deny that America's productivity growth has accelerated from its dismal rate in the two decades before 1995. But compared with Europe's productivity growth, it no longer looks so miraculous. Once investors wake up to this, their fondness for the dollar and disdain for the euro could quickly change.