

Will the U.S. Go the Way of Europe?

A lack of political and fiscal integration makes Europe's problems harder to solve than those of the U.S. Larger entitlements on the continent further complicate the recovery.

by **Dominick Salvatore, PhD**

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A video of the presentation is available at www.aier.org.

There are two immediate problems and one fundamental problem with the euro.

The first immediate problem is that the countries of southern Europe—Greece, Ireland, Portugal, Spain, and Italy—have over-borrowed, and now they cannot service their debt.

Before the euro was created, these five countries paid much higher interest rates on their debts than Germany or Northern Europe. After the euro, the interest rates on government debt for those countries became much lower—the same as the rates for Northern Europe and Germany. That encouraged those countries to borrow a great deal.

Then Lehman Brothers failed in 2008, causing a ripple effect as companies that did business with Lehman Brothers were hit with major losses. This damaged trust in the financial market. Investors realized that debt from

these weak southern European countries was much riskier than debt from Germany. The interest rates once again shot up, becoming much higher than in Germany or another northern country. That made the southern countries' debt unsustainable.

An unsustainable debt, according to the markets, is when the interest rate of a 10-year bond goes above 7 percent. This is what happened to Greece and Ireland in 2010 and to Portugal in 2011. Now it's very likely that Spain will have to default or be rescued. After Spain, it will be Italy and then France. Financial markets always attack the weakest link. When the weakest link falls, they go to the next and then the next.

The only way for these countries to address their debt is to restructure their economies. For Greece, that means lowering wages by 30 or 40 percent. But they have been living beyond their means, and they don't want to restructure. For example, if you are a train conductor in Greece, you earn, net of taxes, 7,000 euros per month. You may also receive a bonus of 350 euros a month just for going to work on time. And people in Greece want to retire at 57 and still have the same pension as Germans, who retire at 67.

Some economists, such as Paul Krugman, argue that past experiences with Estonia, Latvia, and Lithuania show that when countries in crisis attempt austerity, they end up with high unemployment. But that's not the case. In Estonia, for example, austerity didn't create the unemployment problem. Estonia got into a recession in 2008 because the rest of Europe was in trouble financially, and Estonia could not receive any more bank loans or capital. As a result, real GDP fell, government revenues declined, and unemployment peaked at 19.8 percent. That's when they had to reduce expenditures. Austerity was the result of the crisis, not the cause.

Estonia, Latvia, and Lithuania put their houses in order under great sacrifice. Today, they are growing

more rapidly than any other country in Europe. But the Southern European countries that are now in trouble only want to collect more debt.

Even if that debt disappeared, however, the euro's second problem would remain: The southern countries are not competitive. The facts are clear. From 2000 to 2010, the unit cost of labor in those five countries—Greece, Ireland, Portugal, Spain, and Italy—increased vis-a-vis the German unit labor cost by 30 or 40 percent.

A big part of the problem is that these countries have increased wages without increasing productivity. This comes at an obvious cost to competitiveness. If you increase productivity by 5 percent, you can increase your wages by 5 percent without increasing unit labor costs. But if you increase wages 10 percent and productivity increases by only 5 percent, or if, as in England, productivity increases by 0 percent and wages increase by 3 percent, this increases unit labor cost. You lose international competitiveness.

Political Integration is Critical

Even if those two problems were somehow resolved, the fundamental problem of the euro would still remain: Europe is only unified monetarily. The euro cannot succeed without political and fiscal integration.

To understand the problem, compare recessions in the U.S. to recessions in Europe. Suppose that the Northeast of the United States is in a recession, while the rest of the country is not. The northeastern states cannot do expansionary fiscal policy, since most states—except Vermont—are constitutionally required to balance the budget each year. They cannot do exchange-rate policy because the dollar is the currency for the entire country.

But there is an escape hatch for people in the Northeast: labor mobility. If only the Northeast is in a recession, people can move somewhere else to find work. The degree of mobility in the U.S. labor market is three or four times higher than that of Europe. The Northeast also benefits from unemployment insurance, which is paid for by the federal government. So although the Northeast cannot do monetary, fiscal, or exchange rate policy, labor mobility and financial redistribution helps it overcome the crisis.

In Europe, this does not exist. Today, Greece is in a recession. It can't do monetary policy or exchange rate policy because the European Central Bank makes those decisions for all of the countries in the eurozone.

It also can't use fiscal policy to fix the problem because it already has huge debt that it accumulated by lying at the government level about the extent of the deficit. The government said that the extent of the deficit in relation to GDP was 5 percent. In fact, it was above 15 percent.

But unlike people who live in the U.S., Greeks cannot move easily in order to find work. A labor economist said to me, "What do you mean there's no labor mobility in Europe? Look at the hundreds of thousands of people who moved from Portugal or Turkey to the European Union." But this is not mobility. Mobility means that people on every professional level are able to relocate, including doctors and lawyers. In Europe, skilled workers have a hard time moving between countries because they must deal with different certification requirements and languages. The people who are able to move are the unskilled workers, whose jobs are often less dependent on accreditation and language.

Greece also lacks the opportunity for fiscal redistribution. In the Northeast, the federal government pays for unemployment insurance. In the eurozone, on the other hand, individual countries administer unemployment insurance. So in Greece, where the unemployment rate was 23.1 percent as of May, unemployment benefits are fairly small—currently 360 euros a month—and include many restrictions. Only 16 percent of the 800,000 Greeks who are registered as unemployed qualify for benefits.

Unless Europe moves toward complete fiscal and political unification, the euro will forever have problems. Unfortunately, many countries are not prepared to move toward full integration. They want to retain their independence and their individual cultures. So instead, they take steps that pacify the market temporarily. This merely postpones a continued series of crises.

A Non-Virtuous Path

There are two major differences between the U.S. and Europe. One is that the U.S. has a true economic union of monetary, fiscal, and political policy. That is still what saves us.

Secondly, we do not live on entitlements as Europe does. In Europe, there is more social cohesion. Everyone expects the government to take care of them from birth to death. In Europe, you have guaranteed vacations. Even if you retire, the government pays you two weeks' guaranteed vacation. Health care and education are free; everything is free.

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But America is in trouble. When I came to America, I was 16. My father said that we came here because this was the country for young people, the country of optimism, the country of the future. The U.S. was dynamic, and it was different from every other country.

That was more true then than it is today. We have become a non-virtuous country. If someone had told me four or five years ago about a country with a budget deficit that is 7 or 10 percent of GDP and a national debt that exceeds the GDP, I would have thought of Greece. But this is the United States today.

The national debt has ballooned in recent years. In 2006, it was 64 percent of GDP. In 2011, it was 98.7 percent. This year, it will be 104.8 percent. The annual deficit in relation to GDP has swelled from 1.9 percent in 2006 to a projected 7.3 percent in 2012. The ceiling for a healthy deficit is 3 percent to GDP. We are spending at a non-sustainable level.

Four years after the peak level of employment in 2007, we still have nearly 4 percentage points of unemployment that is unresolved. In other words, our level of unemployment now could be something like 4.5 percent. Instead, as of mid-2012, it is 8.3 percent. That's not including discouraged workers and part-time workers who would like to work full-time. If we included those groups, the level of unemployment would be about 14.9 percent.

Previous recessions were either smaller or more easily corrected. In 2001, we had a shallow recession and lost 2 percentage points worth of jobs. It still took four years to go back to the peak level of employment. The deepest recession prior to this one was in 1981. That year, the U.S. lost between 3 and 4 percentage points of employment. But after 24 months, we were back at the peak level of employment. It was a deep recession, but it was a recession of the real sector as opposed to the financial sector. Those recessions are easier in a sense: They can be very deep, but can be more easily corrected.

Three years after the recession ended, the U.S. unemployment rate still hovers around 8 percent. And we are facing the fiscal cliff. If we do nothing—and with today's political paralysis, it is very likely that we will do nothing until after the election in November—the Bush tax cuts will expire and the scheduled government expenditure cuts will take effect. If that happens, the Congressional Budget Office predicts that we will be in a recession for the first half of 2013, with a loss of about 0.5 percent of G.D.P. Then in late 2013, growth will resume, with the expansion averaging a projected 4.3 percent from 2014 through 2017.

If we instead allow those Bush tax cuts to continue, and we do not reduce expenditures, the CBO predicts that real GDP would grow 1.7 percent between the fourth quarter of 2012 and the fourth quarter of 2013. But the national debt would increase by \$1 trillion, whereas it would increase by \$641 billion if the tax cuts are allowed to expire.

Spending and Unemployment

The question now is what to do. Some economists would say that we have to solve immediate problem of unemployment and so we shouldn't reduce expenditures or let the tax cuts expire—at least for some people. Then you have people like Kenneth Rogoff of Harvard who says, "We have an immediate problem of unsustainable debt. Not in the future, we have it now." If not for the fact that we are a political and fiscal union in addition to a monetary union, we'd be in exactly the trouble that Europe is in. We cannot kick the can down the road. We have a budget deficit that's over 8 percent, and we must cut expenditures now.

A paper by the European Central Bank, "Debt and Growth: New Evidence for the Euro Area," can help shed light on the quandary. The study says that stimulus packages can have a positive impact on the economy up till debt in relation to GDP reaches about 67 percent. When debt in relation to GDP is between 67 and 95 percent, fiscal stimulus is effectively a wash. After debt-to-GDP ratios are over 95 percent, a fiscal stimulus package is actually harmful. Both the United States and Europe are in the latter situation.

That's not to say that we should necessarily discount a stimulus. Our previous stimulus package of \$831 billion may not have lived up to expectations, but at the time of the crisis it was perfectly legitimate to think that the country could enter a depression. But if we are going to have a new stimulus package, we must agree to do so now. The future trend of expenditure is not sustainable. Yet no one wants to reduce spending on the military, or on education, or on health care. So offsetting a new stimulus seems difficult to say the least.

We are not going to resolve this problem in a year, or two, or three.

The biggest damage that this recession is doing is that it is changing the very nature of this country. Young, educated people have been unemployed or underemployed for three or four years, whereas under normal conditions they could expect to have a job commensurate to their training. It's true that there are not many unemployed PhDs, for example. But an English PhD who is driving a taxi is structurally unemployed. He or she doesn't need a PhD in English to drive the taxi. It's not the job for which that person trained.

For the first time, the U.S. has produced multiple graduation years' worth of people who expected to find jobs that were appropriate for their level of education, and they cannot. We are not even creating enough jobs to employ the new entrants into the labor force. In the first quarter of 2012, we averaged 226,000 new jobs per month. But we need to add 125,000 jobs per month just to absorb new entrants into the labor force. That leaves 101,000 new jobs per month for the more than 4 million workers who lost their jobs during the recession but have not yet found

employment. Imagine how many years it will take to do that. And now our economy is slowing down again.

Barriers to Growth

There are three big reasons why the U.S. is not growing rapidly. First, firms are not investing because of economic uncertainty. Companies do not know what tax rate they will pay this year. They do not know what the cost of health expenditure will be this year. Firms do not operate well under that kind of uncertainty, and that's one reason we don't grow.

The second reason the U.S. isn't growing is that our tax rate on the profits corporations make abroad is the highest in the world at 39.5 percent. This means that a U.S. multi-national corporation has a choice. Either bring back profits and pay almost 40 percent tax, or reinvest elsewhere—say, in Ireland, where they pay 15 percent. So they invest abroad.

The third reason the U.S. isn't growing is that we have too large an import deficit. The problem is not that we aren't innovating. Who created the iPad? We did. How many iPads have been produced? Sixty million. How many iPads have been produced in the U.S.? Zero. The problem is that the U.S. doesn't benefit from American innovation. We've outsourced manufacturing to China, even though only 10 or 20 percent of the materials used to make iPads are actually made in China.

U.S. exports to China total \$100 billion per year. Our imports from China total \$400 billion per year. There

is no theory that says countries must balance their trade bilaterally. But when a single country is responsible for more than 40 percent of our trade deficit, which is the case with China, something is amiss.

Mapping the Future

We need good economic analysis to form the policies that will drive the U.S. recovery. To have correct economic analysis you need three things. First, you need to have profound knowledge of theory, which is like the GPS. Without theory, you are floating in the dark.

You also need to know the real world. Often, the real world does not work as theory postulates. There are many economists who know all of the equations, and they are proud not to know anything about the real world. They don't need to dirty their hands with the real world. Then you have the business economists who cannot look any further than their noses. They look at the charts, and that's all they see. But there is a social side to this science: Economics is not pure physics.

The third thing economists need to have is a little common sense. Many people in our profession lack common sense, which makes them overly pessimistic. The real pessimists are those who are not happy to be wrong when the crisis they always predict does not come. Instead, they are unhappy, because they thrive on crises. My definition of a pessimist is someone who would rather be right about doom than wrong about progress.

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