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Europe: Seven Years with the Euro And Still Trailing America*

Europe has become increasingly integrated economically and politically in recent decades. In the 1990s 15 countries ratified the Maastricht Treaty and created the European Union (EU), which now has 25 members. Seven years ago a subset of the EU countries created a new central bank and adopted a single currency, the euro. All countries in the EU are supposed to maintain disciplined fiscal policies, and countries within the euro area share a common monetary policy. The economic goals of this integration are to achieve growth and low price inflation, but results have been mixed. With the major exception of Ireland, the EU and the euro area still trail the United States in terms of growth.

Europe has been slowly but steadily unifying politically and economically since the end of World War II. The European Coal and Steel Treaty of 1951, created by France, Germany, and four other nations, was the first step to tie former enemies together in a mutually beneficial trade agreement. As more markets were added and more countries joined, economic and political ties between the member states grew stronger. The first plans for a European monetary union were drafted in the early 1970s, but were shelved during the turbulent economic times of the mid-to-late 1970s.

A comprehensive plan for an economic union was drafted during the late 1980s, and in 1992-93, 12 nations ratified the Maastricht Treaty, which effectively became the first constitution of the European Union (EU). Three other countries, Austria, Finland and Sweden, joined the EU in 1995, and another 10 countries joined in 2004.

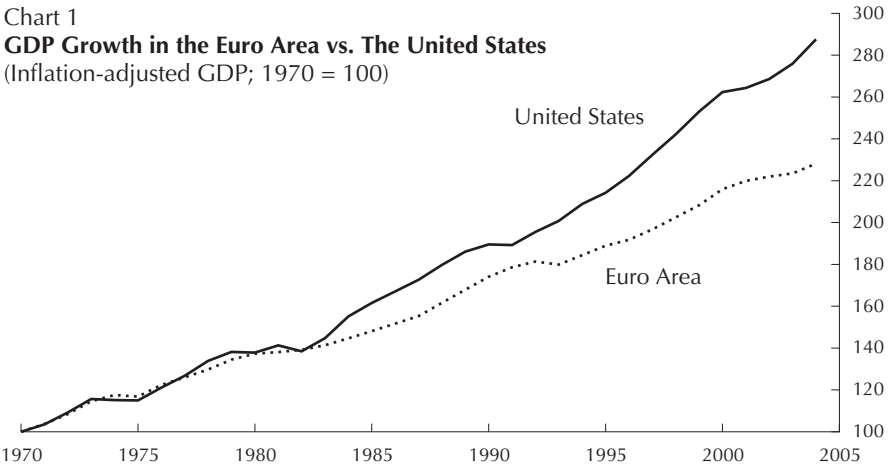
The Maastricht Treaty not only brought about a stronger economic union but also provided a framework for a monetary union. Broadly speaking, the monetary union developed in two major steps: the adoption of the Stability and Growth Pact (SGP) in 1993 and the introduction of a common currency in 1999. The SGP requires all countries in the EU to meet specific fiscal criteria. If a country violates the Pact—i.e., if its annual budget deficit is more than three percent of Gross Domestic Product (GDP) or its public debt exceeds 60 percent of GDP—it faces sanctions from the European Commission, which is in charge of overseeing the Maastricht Treaty. In practice, enforcement has been weak, and major countries such as France and Germany have violated the Pact with little consequence. But on paper, all EU countries are still technically bound by it.

In 1999 the EU launched the second step of the monetary union. The European Central Bank (ECB) began operating in January 1999 and the euro became the common currency in all respects except cash. Coins and bills came a year later. Twelve of the EU countries joined this euro area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

These changes might reasonably have been expected to have a major impact on Europe's economy. However, the evidence is mixed, at best.

Since the adoption of a common monetary policy seven years ago, price inflation has averaged 2.0 percent in the euro area. By contrast, U.S. inflation averaged 2.5 percent per year. During this period at least, the ECB has been more successful than the Federal Reserve in pursuing low inflation. The two central banks have pursued very different policies. The Fed slashed interest rates in an effort to keep the U.S. economy on track, while the ECB refused to lower rates in response to weak

Chart 1
GDP Growth in the Euro Area vs. The United States
(Inflation-adjusted GDP; 1970 = 100)



Source: OECD.

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growth in France, Germany, and other euro countries. These different policies reflect the banks' different mandates. The ECB is responsible solely for maintaining price stability, while the Fed's objectives include stable prices and economic growth.

If Europe has recently outperformed the U.S. economy in terms of price inflation, its economic growth has not been as impressive. Chart 1 shows how the euro area has lagged behind the U.S. in terms of growth. The growth gap emerged during the 1980s and since the adoption of the Maastricht Treaty and the creation of the currency union it has only widened. To some extent this gap reflects slower population growth in Europe relative to the United States, but even on a per capita basis, GDP growth has lagged the United States.

Lack of growth in Europe is also evident in the labor market. Since 1993, when the Maastricht Treaty was ratified, the overall unemployment rate in the European Union has consistently been higher than in the United States. The German and French unemployment rate was 9.5 percent last year, compared with 4.3 percent in the U.S. (see Chart 2).

Europe also has a more serious problem with long-term unemployment, defined as a person being involuntarily out of work for 12 consecutive months or more. Compared to unemployed Americans, the unemployed in Europe were four times as likely to be long term unemployed in 1994, and 3.5 times in 2004.

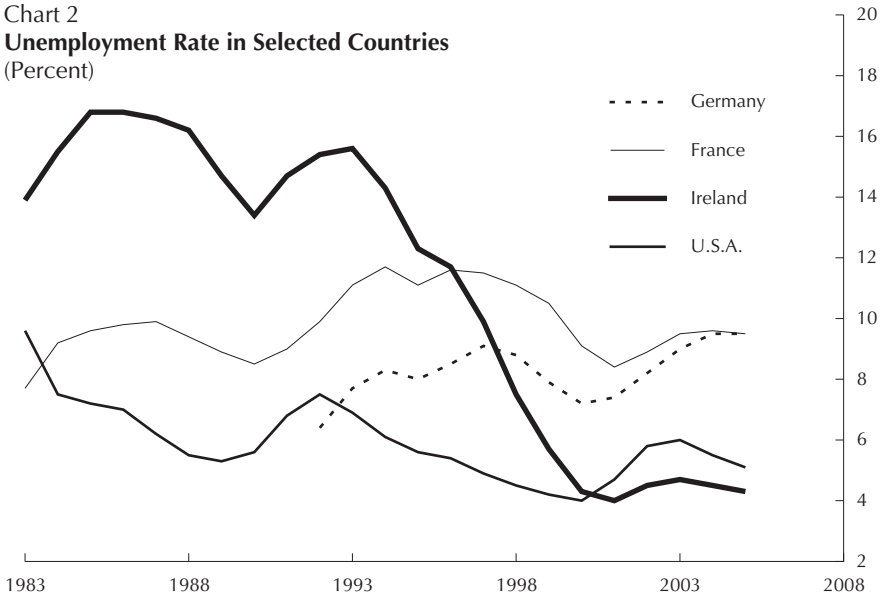
In short, the dismal data for GDP growth and unemployment indicate that Europe's success in achieving low inflation has not spilled over into the rest of the economy.

The Irish Success Story

The major exception to the soft European economy of the past 15 years is Ireland. Beginning in the early 1990s, Ireland's rate of economic growth soared, its rate of job growth outpaced all other EU countries, and its unemployment rate plummeted from over 15 percent to less than 5 percent today (see Chart 2). Its per capita income, once among the lowest in Western Europe, is now among the highest.

A variety of factors contributed to the success of the "Celtic Tiger," but one of the most important was the Irish government's decision to cut taxes in order to stimulate the economy. The corporate tax was reduced from 50 percent to 24 percent, with a special rate of 10 percent on internationally traded goods and services. (When other EU countries complained that this discriminated against goods made for domestic consumption, Ireland responded by cutting its standard corporate tax to 12.5 percent in 2003. It now has one of the lowest corporate tax rates in the world.) Personal income tax rates were also cut, as was government spending, which decreased from 55 percent of GDP in 1985 to 40 percent in 1995. The resulting restructuring of the Irish economy led to a broad-based boom in manufacturing, construction, and exports.

Chart 2
Unemployment Rate in Selected Countries
(Percent)



Source: Eurostat.

Ireland's economic boom is unique among the EU countries not only because of what Irish policymakers have done, but because of what the rest of Europe has *not* done. Germany, France, Italy, *et al*. have focused on "harmonizing" their economic, fiscal, and monetary policies. But it is not enough to adopt common policies—you also have to have good policies.

Instead of liberating their countries from high taxes and excessive regulations, the EU countries have focused on "economic integration," an approach driven by the desire to create a common market where national differences would not matter to businesses. Unfortunately, they have integrated a tax system and a regulatory framework that stifle economic growth.

The Stability and Growth Pact, an effort to harmonize fiscal policy, contributes to the problem. Forcing governments to limit their deficits and their borrowing does not force them to limit government. Rather, lawmakers may focus on keeping revenues high to match high levels of spending. Indeed, the SGP discourages supply-side tax reform, because "static" economic models invariably predict that any tax cut will reduce revenue, increase deficits, and thereby violate the Pact. It may also encourage governments to use accounting tricks to keep reported deficits low rather than focus on fixing genuine fiscal problems.

Similarly, "harmonizing" Europe's rigid labor market policies will do little to reduce its persistently high unemployment rates. Businesses need more flexibility to hire and fire. European countries also need to rethink their generous system of unemployment benefits. Benefits are higher in Europe than in the United States, and last a year or more, compared to six months in the U.S. But this generosity comes at a cost. Taxes are higher, and the unemployed have less incentive to return to work.

Ironically, higher economic growth often has been touted as the very goal of European economic integration. But adopting a common set of policies centered on high taxes, high spending, and rigid regulations will not spur growth. These policies do serve another goal—preserving Europe's generous system of social welfare benefits. But Europeans will find it increasingly unaffordable to maintain that system in the face of slow growth and lack of job creation. ❑

CONSUMER PRICE CHANGES IN 2005

The Consumer Price Index for all urban consumers increased by 3.4 percent last year, roughly the same as the 3.3 percent increase in 2004.

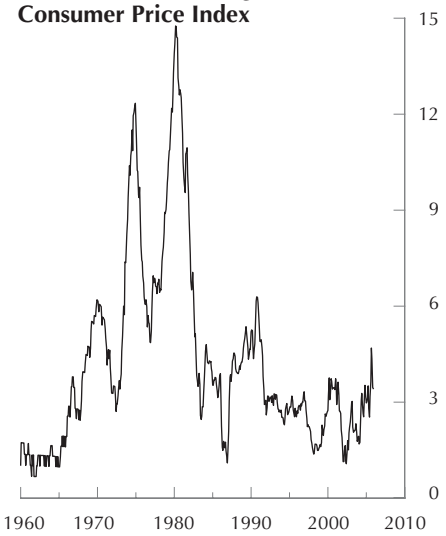
Last year the rate of price inflation peaked in September at 4.7 percent, largely due to the spike in energy prices following Hurricane Katrina. Although energy prices receded somewhat in the fourth quarter, they remain far higher than a year ago. The table below shows prices changes in 2005 for a range of consumer goods and services, and among all the items shown, the prices of energy products increased the most: utility natural gas service (up 30.2 percent), fuel oil (up 27.2 percent) and gasoline (up 16.1 percent). This is the second straight year that energy prices have led the list.

Other items with larger-than-average price increases include coffee (up 11.5 percent), electricity (10.7 percent), college tuition and fees (6.6 percent), and airline fares (6.4 percent).

The prices of some goods and services fell last year, led by tomatoes (down 19.5 percent) and hi-tech goods such as personal computers and related equipment (down 15.8 percent), televisions (down 14.4), and audio equipment (down 8.8 percent).

The overall rate of consumer price inflation has been accelerating since 2002 (see chart). So far, however, the spillover effect from the rapid rise in energy prices has been limited. Excluding energy, the CPI increased 2.2 percent last year, the same as the year before.

Annual Percent Change in the Consumer Price Index



Percent Change in Selected Consumer Price Indexes
December 2004 – December 2005

Expenditure Category	*Percent Change*
All Items	3.4
Food and Beverages (15% of expenditures)	3.9
Food	2.3
Food at Home	1.7
Breakfast Cereal	-2.1
Bread	2.9
Cookies	2.1
Meats	1.2
Beef and Veal	2.2
Pork	-0.1
Bacon, breakfast sausage, and related products	-3.6
Pork Chops	-0.1
Poultry	0.3
Fish and Seafood	3.8
Eggs	1.4
Milk	3.5
Cheese and related products	0.5
Ice cream and related products	0.4
Fresh fruits and vegetables	-0.5
Apples	4.2
Bananas	7.4
Citrus fruits	7.5
Potatoes	9.2
Lettuce	-6.1
Tomatoes	-19.5
Canned fruits and vegetables	2.2
Frozen vegetables	3.6
Candy and chewing gum	3.6
Butter	-6.2
Salad dressing	-4.3
Peanut butter	1.3
Nonalcoholic beverages	3.5
Juices and carbonated drinks	3.0
Coffee	11.5
Soup	1.9
Food away from home	3.2
Full service meals and snacks	2.8
Limited service meals and snacks	3.3
Alcoholic beverages at home	0.4
Beer and ale	-0.5
Wine	1.6
Distilled spirits	1.1
Housing (42% of expenditures)	4.0
Shelter	2.6
Rent of primary residence	3.1
Owners' equivalent rent of primary residence	2.5
Hotels and motels	3.3
Fuels and utilities	15.6
Fuel oil	27.2
Electricity	10.7
Utility natural gas service	30.2
Water and sewerage maintenance	5.5
Garbage and trash collection	4.3
Household furnishings and operations	0.7
Floor coverings	6.2
Window coverings	0.1
Bedroom furniture	4.7
Living room, kitchen, and dining room furniture	-1.5
Major appliances	5.8
Clocks, lamps, and decor items	-7.7
Dishes and flatware	-6.8
Tools, hardware and supplies	2.6
Outdoor equipment and supplies	-1.1
Housekeeping supplies	2.3
Household operations	5.0
Gardening and lawncare services	3.8
Repair of household items	6.8
Apparel (4% of expenditures)	-1.1
Men's apparel	-1.3
Suits, coats, and jackets	-0.6
Shirts and sweaters	-0.7
Pants and shorts	-3.5
Boys' apparel	-3.8
Women's apparel	0.1
Outerwear	-4.1
Dresses	7.6
Suits and separates	-0.5
Girls' apparel	-6.9
Infants' and toddlers' apparel	-3.0
Watches	0.8
Jewelry	-2.6
Footwear	0.9
Transportation (17% of expenditures)	4.8
New cars	0.8
New trucks	-1.9
Used cars and trucks	1.4
Car and truck rental	8.6
Gasoline	16.1
Motor vehicle maintenance and repair	3.6
Tires	2.9
Motor vehicle insurance	1.0
Motor vehicle fees	2.9
Public transportation	5.9
Airline fare	6.4
Ship fare	-0.3
Public transportation within city	5.4
Medical care (6% of expenditures)	4.3
Medical care commodities	3.7
Prescription drugs and medical supplies	4.4
Over-the-counter drugs	2.1
Medical care services	4.5
Physicians' services	3.1
Dental services	5.7
Eye glasses and eye care	3.1
Inpatient hospital services	5.3
Outpatient hospital services	5.0
Nursing homes and adult daycare	3.5
Recreation (6% of expenditures)	1.1
Video and audio	0.0
Televisions	-14.4
Cable and satellite tv/radio service	3.3
Video cassettes and discs	-0.8
Rental of video tapes and discs	4.2
Audio equipment	-8.8
Pet food	1.2
Veterinarian services	5.2
Sporting goods	1.8
Photographic equipment & supplies	-4.9
Toys	-4.5
Sewing machines, fabric and supplies	-3.4
Music instruments and accessories	-1.8
Recreation services	3.0
Club membership dues and fees	2.6
Admissions	3.5
Fees for lessons or instructions	2.6
Newpapers and magazines	1.7
Recreational books	-1.2
Education and communication (6% of expenditures)	2.4
Education	6.1
Educational books and supplies	5.2
College tuition and fees	6.6
Elementary and high school tuition and fees	5.6
Child care and nursery school	5.5
Communication	-1.3
Postage and delivery services	0.4
Telephone services (landline, local)	3.3
Telephone services (landline, long distance)	-1.7
Wireless telephone services	-1.5
Personal computers and peripheral equipment	-15.8
Computer software and accessories	-4.3
Other goods and services (4% of expenditures)	3.1
Tobacco and smoking products	5.8
Personal care	2.3
Cosmetics and related products	2.3
Haircuts and other personal care services	2.6
Legal services	3.4
Financial services, incl. tax returns	1.6
Funeral expenses	4.6

THE MEDIA AND THE NUMBERS

Many news stories are based on quantitative information that is neither compiled by media personnel nor well understood by them. The treatment typically given to reports on employment and unemployment provides a good example of this lack of understanding.

Weather reports typically compare current conditions to "normal." Here in New England anyway, it might be said that "normal" weather is some unexpected combination of heat, cold, flood, or drought. At any given time our weather is *normally* very different from the *averages* of temperature and precipitation for that date. In other words, because weather conditions seldom equal their averages, what is normal is not what is average.

This confusion between average and normal is relatively harmless—most people understand what is meant. However, reports of economic statistics often are given with little understanding of their significance or how they relate to the economy as a whole. Perhaps the clearest example of this is the reporting of monthly data on employment and unemployment.

Who is "Unemployed"?

In the minds of many people, an unemployed person is someone who has been fired, laid off, or completed a temporary job and who needs to find another one soon. This description fits less than 50 percent of the persons currently counted as unemployed (and about one-fifth of the rest are on temporary layoff, *i.e.,* are likely to be recalled to their jobs). Around 30 percent of persons counted as unemployed have reentered the labor force after a period of schooling, care-giving, or other unremunerated activities. The remainder is about equally divided between persons who voluntarily quit their jobs for one reason or another, and persons who have never worked before and are seeking their first job.

The reason these categories do not fit the common image of unemployment is that *the data were never designed as a measure of hardship*. The monthly survey of the employment status of the members of households began during World War II. It was designed to enable the government to award defense contracts where labor was available to do the work. This is the reason an unemployed person is defined as someone who is *looking for work,* as opposed to someone who simply lost a job or those who say they want a job but are not currently looking for one (so-called discouraged workers).

Nevertheless, when the media, especially the broadcast media, report on the monthly level of unemployment, the presentation of the number of unemployed persons and of the unemployment rate (unemployed persons as a percent of the labor force) are usually followed by scenes of people standing on unemployment lines and/or the heart-wrenching story of an out-of work person.

This was how the media usually presented the unemployment numbers during the 18 years ended in April 2000. During that period, the number of persons counted as unemployed decreased from more than 12 million to less than 5.5 million and the media generally ignored the important story, which was the rapid growth of employment in the United States (as measured by the household survey), from 99 million at the end of 1982 to 138 million in early 2000. In 2001, the economy slid into recession, the unemployment rate increased from less than 4 percent to a high of more than 6 percent, and (needless to say) reports on the employment situation became increasingly dire. They remained gloomy long after employment began an increasing trend.

Through all this, the employment situation in the United States compared very favorably to previous conditions and to the rest of the world. During the last 4 decades of the 20th century, the U.S. unemployment rate *averaged* 6.0 percent and it exceeded 10 percent at times. An unemployment rate of 6 percent means, after all, that 94 percent of those who want jobs have them. In many parts of the world, less than half the working age population enjoys gainful employment.

The apparent media bias may simply reflect the response of editors and reporters to the monthly release of the employment data, which might be something like "Hey! There are people who are unemployed out there, let's get their story. It will appeal to the *schadenfreude* of our viewers and readers."

However, these media reports on the monthly establishment survey of employment conditions often reflect and foster a profound misunderstanding of our economy and the economic process in general. For example the *New York Times* reported the latest results as follows: "U.S. employers added 193,000 jobs to payrolls in January." Most other reports similarly implied that the economy "created" 193,000 new jobs last month, even though a thoughtful observer should realize that the 193,000 number was *net* of jobs that ended for one reason or another. But few observers realize the minuteness of the net change in relations to its components.

Since February 2004, the Department of Labor has published the results of another survey of employers providing estimates of "Job Openings and Labor Turnover." The timing and methodology of this survey are not strictly comparable to the much larger establishment survey. Nevertheless, since December 2000 (the earliest datum published) the Department of Labor's estimate of the number of new hires has averaged about 4.3 *million* each *month*. That's a lot of job creation!

Of course, the monthly number of job separations (quitting, being fired, retiring, severe illness, or death) has fluctuated above and below the number of new hires, with the difference being approximately the monthly change in employment that is the usual focus of the media. The point is that describing a monthly increase in the number of employed persons as "job creation" (as in "the economy created 193,000 jobs last month") completely misses the extraordinary flexibility and mobility of the U.S. labor force (especially in comparison to Europe—see the preceding article) which has been a major factor in the growth of our economy. ❑

PRICE OF GOLD

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