Europe's Quiet Leap Forward

The United States and China should watch their backs -- a new economic juggernaut may dominate the 21st century.

BY KENNETH ROGOFF | JULY 1, 2004

Is the European economy sinking or swimming? The discouraging headlines are by now monotonously familiar. "Europe is lagging in global recovery," declared the *New York Times* recently. "U.S. Outshines Expanding EU in Economic Competitiveness Study," reported Bloomberg in April. "Most Europeans who want to watch an economic recovery," one U.S. economist quipped in September 2003, "will have to watch it on TV." (Okay, that was me during my farewell remarks as chief economist of the International Monetary Fund.) But it's not just economists and journalists who are discouraged; Europeans are as well. Beneath the veneer of exuberance surrounding the European Union's (EU) recent eastern enlargement lies deep concern over the region's economic future.

Yet, recall how just 15 years ago everyone was heralding the slowdown and ultimate collapse of the U.S. economic juggernaut. At the time, economist Paul Krugman wrote the popular *Age of Diminished Expectations*, which envisioned a U.S. economy in perpetually low gear. Business guru Michael Porter wrote about how U.S. companies needed to learn from the Japanese economic model. Indeed, during the 1980s, other economic models, particularly Japan's, looked pretty good. When it came to manufacturing a superior automobile, Japanese firms and workers had much to teach the rest of the world. But then the 1990s arrived with waves of technological innovation, and suddenly the free-spirited and relentlessly entrepreneurial U.S. approach proved more adept at embracing new opportunities. So Japan dropped the baton and the United States reclaimed it. Times do change, and an economic system well suited to one set of historical circumstances often proves less appropriate for another.

Fast forward to 2004. Today, if you really want to get a rise out of top European policymakers and business leaders, don't berate them about Europe's well-known economic ills. Don't mention the rigid labor markets, the aging population, or the weak state-run university systems. Instead, tell them that there is a one in three chance that the world's leading economic superpower in 2050 will not be the United States or China, but Europe. They'll stand and stare at you, waiting for the punch line.

The truth is that Europe's economy is far from hopeless. First, the notion that European firms and workers are much less productive than those in the United States is simply uninformed. The main reason why Europe's output per capita stands at only 70 percent of U.S. levels is that Europeans work less than Americans -- a lot less. Europeans work fewer hours per week, take longer vacations, and retire earlier. When it comes to leisure, it is the Americans, Japanese, and even the Chinese who have plenty of catching up to do. And as they and others start "consuming" more leisure over the next 50 years, Europe's relative economic size will expand. Second, Europe still has a spectacularly well-educated and versatile work force, even if dubious labor legislation holds it back, particularly in Germany. Third, recent empirical studies have convincingly shown that strong political and legal institutions drive economic growth. Say what you want about Italian politicians and the EU's new draft constitution, but European institutions remain models of honesty and transparency compared to those in Asia, Latin America, and the Middle East.

Finally, geography is another important driver of economic destiny and, last I checked, Europe was still situated in a relatively disease-free and temperate locale that offers far better working conditions than large parts of Africa, India, or Latin America. (Even compared to the United States, Europeans save at least a couple percent of annual income on heating and cooling costs.)

What would it take to catalyze Europe's economic advantages over the next 10 to 15 years? Actually, not that much. Catching up and leapfrogging are common throughout the history of international economics, at least for those regions that display strong institutions and remain open to international trade. As the United States develops new technologies, Europe can copy them. Where the United States has to make commitments to certain technologies -- such as cellular-phone technology -- Europe can leapfrog to the next, more efficient, technology. And though experience has left me too jaded to wax poetic over European economic policymaking, I believe that Europe just might succeed in addressing some of its structural economic challenges. Through German Chancellor Gerhard Schröder's "Agenda 2010" economic reform program, for example, Germany has at least begun to admit that its archaic labor laws might pose a problem.

Someday, too, Europe might realize that trade with more than 3 billion people in Asia is as important as internal trade within Europe. And finally, the Europeans might get lucky in a completely unexpected way that boosts their economic prospects. For example, one of Europe's biggest obstacles to deeper integration and economic growth is language. What if all Europeans are one day able to carry around small pocket computers that instantly and flawlessly translate languages? With the language barrier gone, competition and true regional integration would flourish in Europe. Stranger things have happened.

Yes, there is a fair chance that Europe's economy will fall farther and farther behind the United States and Asia. But there is also a significant chance -- about one in three -- that Europe is playing leapfrog and getting ready for a big jump. So don't write off the EU just yet. When all the experts agree that Europe is hopeless, you know it is time to take a second look. Maybe it will not happen this year or next, but there is every reason to believe that someday, Europe's economy just might be on top. No joke.

Kenneth Rogoff, **FOREIGN POLICY***'s economics columnist, is professor of economics and Thomas D. Cabot professor of public policy at Harvard University.*

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11 DUPONT CIRCLE NW, SUITE 600 | WASHINGTON, DC 20036 | PHONE: 202-728-7300 | FAX: 202-728-7342
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