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IS EUROPE REALLY FALLING BEHIND?

(a disagreement among statisticians)

by Francisco Vergara*

It is widely believed that Europe is falling behind the United States in *per capita* GDP and in its standard of living. The opinion is often expressed by economist as well as by politicians. In October 2006, for example, in a paper published by BRUEGEL (the fashionable new European think tank directed by Mario Monti and Jean Pisani-Ferry), Harvard professor Philippe Aghion writes :

> "Over the last ten years, the average annual growth of GDP per capita in the European Union (EU15) has been 0.4 percentage points below that of the US … income per head in the EU has begun to decline in comparison to that of the US"[1].

In April 2006, in a talk before the Council on Foreign Relations in New York, the European Central Bank president – Jean-Claude Trichet – said something even more alarming:

> "Since the beginning of the 1990s, the gap in per capita income growth between the US and the euro area has continuously widened – by 0.8% on average per year during the 1990s, increasing to 1.3% per year from 2002 onward"[2].

Not everyone agrees

In spite of the apparent consensus on the subject, several experts (even among European Commission statisticians) disagree with this conclusion. Thus, in a small "technical box" in one of the European Commission's yearly Economic Reports, one reads :

> "There is a widespread perception that the US economic performance is much stronger than that of the euro area … This picture needs to be qualified … the differential in GDP growth since 1990 disappears when viewed in per capita terms. The growth performance and the rise in living standards in both economic areas were broadly comparable."[3]

How can such divergent perceptions, concerning an issue so charged with political implications, be explained?

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[1] Philippe Aghion , " A Primer on Innovation and Growth ", *Bruegel Policy Brief*, October 2006.

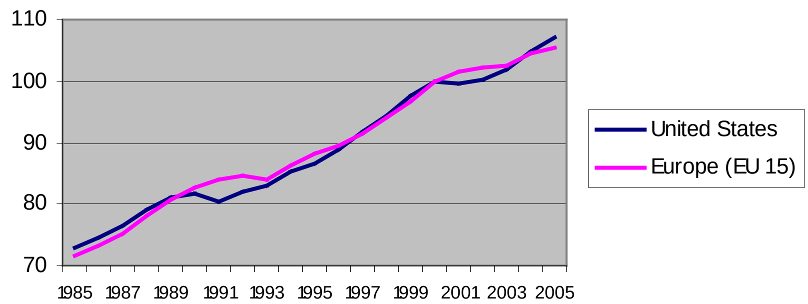
[2] Jean-Claude Trichet, " Why Europe needs structural reforms ", New York, April 24, 2006.

[3] *European Economy 2003*, " Box 1: Economic performance and policies in the euro area and the USA ", Directorate-General for Economic and Financial Affairs, 2004, page 45.

Differences in method

Several methodological difficulties can contribute to giving a false picture. The most common mistake is to compare growth rates starting from a year which is a round number ("from 1990", for example, or "from 1995"). If one starts from these round (and apparently natural) years, the comparison is distorted because of the important differences that exist between the American and the European trade cycle. As Graph 1 shows, the fluctuations of the U.S. cycle are *more pronounced* than those in Europe (periods of expansion are faster, but slow-downs are more abrupt), and the cycles in the two zones are *not synchronized*. In the United States, for example, the trough of the last cycle was in 2001, but only came two years later in Europe. During the previous cycle the low point was reached in 1991 in the U.S. but only in 1993 in the 'Old Continent'[4].

Graph 1 : per capita GDP
(constant prices, year 2000 = 100)



Source : OECD, *National Accounts of OECD Countries* , volume 1, 2007, pg. 332 et 333.

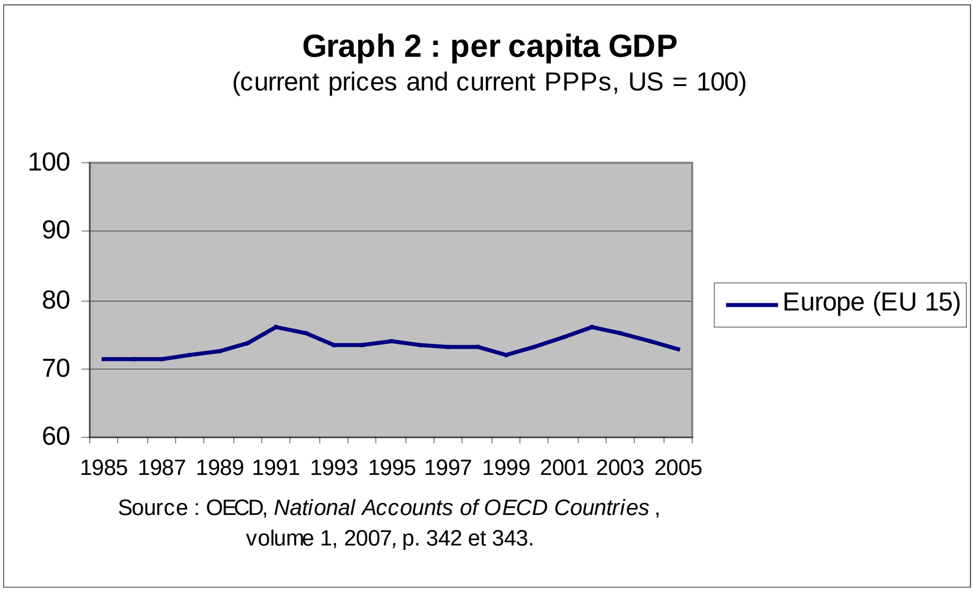
If one takes 1990 as the starting year in one's comparisons (as Jean-Claude Trichet does), performance per year seems higher the United States (0.2% faster according to the latest figures published by the OECD). But, in so doing, you have chosen a period that contains two complete slow-downs in Europe but only one in the United States (one and a half to be precise). If you want to choose a period containing comparable phases of both business cycles (a period during which both regions experienced the same number of slowdowns), you have to take 1988 as a starting date (instead of 1990). If this is done, the difference in growth rates disappears.

Something similar happens if you use 1995 as the starting year (as does Philippe Aghion). In this case, you are comparing performances during a period comprising two complete upswings in the United States, but only one in Europe (since the acceleration which started in 2002 in the U.S. has barely begun in Europe).

[4] To get OECD data www.fvergara.com/donnees.pdf

As for the growth-differential that seems to have increased in favor of the US after 2002 (about which Trichet is so exited), it is just the manifestation of the fact that American accelerations are stronger (the fluctuations of their trade cycle being more pronounced). The same thing occurs during each American growth phase, once every ten years (which is the average length of these cycles). It occurred in the years after 1982 under Ronald Reagan, after 1991 under Bill Clinton, and just recently after 2002. But these bursts of speed only last a few years, and then the European per capita starts growing faster, as has happened, once again, during the second half of 2006.

Per capita GDP growth rates in Europe and the U.S. during the past 20 years have been like the alternating speeds of two racing cyclists competing in the Tour de France. One of them accelerates for a few kilometers only to slow down a bit later, while the other does the same thing, but not at the same time. If we choose a period containing an equal number of accelerations and slowdowns on each side, when comparing performances, it turns out that GDP per head grows at a similar rate in both regions. As Graph 2 shows, the fact is corroborated by the latest



per capita GDPs expressed in purchasing power parities (PPAs) published by OECD. These statistics clearly show that GDP per head in Europe fluctuates at around 73% of the American level (reflecting the different phases at which their trade cycles are). But the gap is not widening, Europe is not being left behind.