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Southwest Economy

The New Paradigm in Europe: Is Goldilocks Going Global?

Since the mid-1990s, the U.S. economy has experienced a combination of high growth and low inflation that has made it the envy of the world. Some argue we have entered a new era, one in which the old rules no longer apply. Others argue the country has benefited from a series of favorable supply shocks that have simultaneously lowered inflation and unemployment. While commentators may disagree over what is and isn't new about the New Paradigm, the fact remains that the U.S. economy is experiencing a combination of output growth, inflation and unemployment not seen since the onset of the productivity slowdown in 1973.

What *is* new about the New Paradigm is the proximate cause of the high growth and low inflation experienced over the past five years—rapid technological innovation. But given the ease with which technology can be transferred between nations, the question arises of why only the United States seems to have benefited from the computer revolution. Despite its large domestic market and highly educated workforce, Europe hasn't exhibited the same performance. There's

(continued on page 2)

A Common Currency for the Americas?

As part of the Federal Reserve Bank of Dallas' ongoing efforts to support effective economic policies, the bank hosted a conference in March 2000 entitled *Dollarization: A Common Currency for the Americas?* The question mark in the conference title signaled attendees that both sides of the dollarization debate would be represented.

Dollarization

When a nation officially dollarizes, it abolishes its own currency and formally adopts the U.S. dollar as legal tender. Advocates argue that dollarization helps establish fiscal and monetary credibility because inflating the currency to cover fiscal deficits is no longer an option. For the same reason, dollarization helps maintain price stability. Accordingly, dollarization can lower transaction costs for trade and investments. It also eliminates the devaluation

(continued on page 7)

Special Issue Focusing on International Economics and Monetary Policy

reason to believe, however, that the process of European integration—as manifested most recently in the European Union's (EU) single-market initiative and the launch of economic and monetary union (EMU)—is setting the stage for the emergence of the New Paradigm in Europe.

U.S. Economic Strength

The United States is enjoying its longest economic expansion ever. Over the past five years, GDP growth has averaged 4 percent a year, while inflation has averaged less than 3 percent. But robust growth and low inflation don't tell the whole story. Unemployment rates are at a 40-year low, and, unlike the pattern of previous expansions, productivity growth has increased over the course of this one. Stock market gains have boosted the wealth of millions of households, and burgeoning surpluses have allowed the federal government to start paying down the national debt.

So far, only the United States has simultaneously experienced the combination of rapid GDP growth, low inflation, low unemployment and high productivity growth.

So far, only the United States has simultaneously experienced the combination of rapid GDP growth, low inflation, low unemployment and high productivity growth. While some European countries may exhibit one or more of these features, none has them in the same combination. For example, while inflation in the EU is lower than in the United States, unemployment is higher and GDP growth is lower. The UK is experiencing low inflation and low unemployment but has not grown at the same rate as the United States. And Ireland, dubbed the Celtic Tiger, has grown at rates far in excess of the United States' but is experiencing its highest inflation in 15 years.

Table 1 compares key economic indicators for the United States and Europe.[1] Average annual GDP growth over the past five years was 1.6 percentage points faster in the United States than in Europe. In fact, Europe experienced a mild growth recession in recent years, due in part to fallout from the Asian crisis. Inflation was low and falling in both the United States and Europe from 1995 until last year. Indeed, for most of that period, Europe posted the better inflation performance, as candidates for EMU strove to bring inflation rates down to German levels. Inflation rose in both the United States and Europe over the past year and a half, primarily as a result of higher oil prices. Inflation in Europe has also been adversely affected by the euro's decline against the dollar.

Table 1

U.S. and European Economic Performance, 1995–2000

	United States (percent)	Europe (percent)
GDP growth	4.0	2.4
Unemployment	4.8	10.0
Inflation	2.6	1.9
Productivity growth	1.9	1.5

NOTES: All numbers are annual averages. European productivity growth is for the 11-nation euro area only. GDP is through first quarter 2000. Inflation is through July 2000. Unemployment is through June 2000. Productivity is through first quarter 2000.

SOURCES: Eurostat; Bureau of Economic Analysis; Bureau of Labor Statistics; European Central Bank.

Some have argued that the struggle to meet the stringent Maastricht criteria for EMU participation was a key contributor to Europe's sluggish output growth and high unemployment in the latter half of the 1990s. However, it seems more likely that labor market rigidities were the main factor keeping unemployment high. European unemployment has been declining since 1997, but the jobless rate is still more than twice that of the United States.

Europe has done well in terms of productivity, at least in the industrial sector, where productivity growth has been consistently positive and solid since 1994. While cross-country comparisons of productivity are difficult, some past measures have shown manufacturing productivity in France and Germany exceeding that of the United States.

But even with strong productivity performance in the industrial sector, Europe has been outperformed by the tech-fueled American economy through much of the 1990s and into the new millennium. Chart 1 shows the trends in overall labor productivity growth for the United States and Europe.[2] During the first half of the decade, these trends were not all that different. But since 1995, there has been a persistent and growing gap between U.S. and European productivity growth. The acceleration in U.S. productivity lies

at the heart of the New Economy, making it possible for rapid growth, low unemployment and low inflation to coexist.

Many factors have contributed to America's robust economic performance. Adoption of new technology—particularly information technology—has allowed many businesses to become more efficient. Deregulation and crumbling trade barriers have exposed U.S. firms to intense competition, spurring innovation and leaner production systems. The U.S. labor market remains one of the most flexible in the world, making it easier for businesses to respond to rapidly changing conditions. Mature financial markets have provided the capital needed to develop new ideas and move discoveries from the laboratory (or garage) to the marketplace. Finally, relatively low capital gains taxes and use of stock-option-based compensation have encouraged entrepreneurship and risk taking, which in turn have sustained growing business activity.

Until very recently, the prospects for Europe participating in the New Paradigm looked decidedly weak. A long history of government intervention reinforced market rigidity, propping up Industrial Age corporations with subsidies and delaying much-needed restructuring. Heavy reliance on bank lending as the primary source of business capital worked against new business development. Laws intended to promote job security discouraged hiring and promoted a rigid labor market. Conflicting and confusing regulatory regimes across European borders increased uncertainty and inhibited interstate commerce. "Eurosclerosis" was the diagnosis, and the condition seemed terminal. But things may be changing.

Europe

With America experiencing its longest expansion ever, many European leaders are looking across the Atlantic in search of the recipe for the "just right," Goldilocks economy. While it is unlikely Europe will be able, or even want, to replicate every aspect of the U.S. experience any time soon, the prospect of the New Economy emerging there is no longer just wishful thinking. A variety of market and political trends are creating the institutional infrastructure that may transform Europe from its current torpor to a more dynamic environment.

Competition. One of the key factors that contributed to the New Economy's emergence in the United States is the intense competitive environment American firms face, both from within and from overseas. For example, the overall level of tariff protection is lower in the United States than in Europe. In 1996, the average tariff on all products in the United States was 5.2 percent, while the

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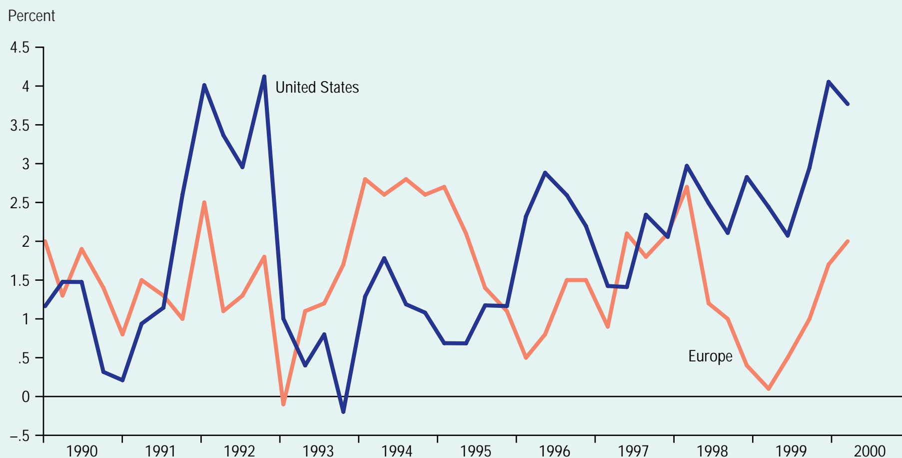
Chart 1

U.S. and European Productivity Growth, 1990–2000



NOTE: Data for 2000 are through the first quarter.

SOURCES: Bureau of Labor Statistics; European Central Bank.

average in the EU was 7.7 percent. Government bailouts of ailing firms are rare in the United States, and the federal government has never been deeply involved in the day-to-day activities of business, as has often been the case in Europe. Fierce competition in the U.S. marketplace has forced American firms to raise performance levels. To stay viable, they have had to boost productivity, become more efficient and pursue myriad business innovations.

European integration, which began with the Common Market's creation more than 40 years ago, has gradually intensified the competitive pressures firms in Europe face. The first step was the elimination of formal tariff barriers to trade, which was rapidly accomplished. A more radical step was taken in 1986 with the passage of the Single Market Act, which required the elimination of nontariff barriers to trade by 1992. These moves toward greater openness (at least vis-à-vis other EU members) have been accompanied by privatization of nationalized industries and deregulation. Combined, these measures have enhanced the competitive environment in Europe, although as Chart 2 shows, firms there are still less exposed to global competition than their U.S. counterparts.

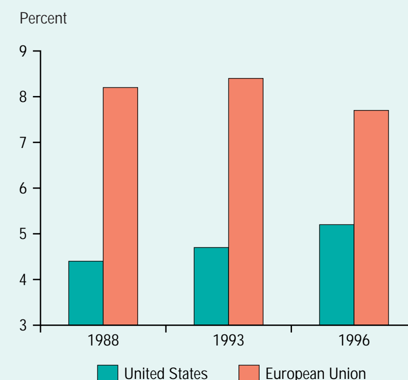
Many consider Europe's financial system another obstacle to realizing New Economy growth in the Old World.

Entrepreneurship. It seems obvious that entrepreneurship is central to economic growth. Yet surprisingly little effort has been devoted to studying entrepreneurship or understanding what policies best promote it. One recent study found that variations in rates of entrepreneurship may account for as much as one-third of the variation in economic growth across countries. The same study found that at any given time, 8.5 percent of the U.S. population is involved in starting new businesses, the highest percentage of any country.[3]

Historically, Europe has been a less friendly environment for entrepreneurship. High taxes on profits, dividends and other types of capital gains have discouraged risk taking and constrained business initiative. In France, two-thirds of profits from stock options are taken in taxes. Excessive bankruptcy penalties have long stymied entrepreneurial initiative, with legislation erring on the side of protecting creditors. Failed entrepreneurs rarely get a second chance.

Chart 2

Production-Weighted Average Tariff Rates



SOURCE: *OECD Economic Outlook*, June 1999, Organization for Economic Cooperation and Development, Paris.

Cultural norms have generally been incongruent with those that allow entrepreneurial spirit to thrive. The high value European countries traditionally place on social cohesion has as a corollary an unwillingness to accept high levels of income disparity. Many Europeans would be glad to see a homegrown equivalent of Microsoft but unwilling to accept the concentration of wealth that would accompany it.

However, there are signs the entrepreneurial environment in Europe is changing. Most important, many countries have cut taxes to encourage capital formation and new business initiatives. Germany recently announced one of the most dramatic tax reforms, which will see the top income tax rate fall from 53 percent in 1999 to 47 percent in 2003. France is following suit, with proposals to cut the corporate income tax rate for small and medium-sized enterprises from 36.6 percent to 33.3 percent. In 1998 the European Commission proposed a variety of measures to foster entrepreneurship, including simplifying the process for starting a company, improving access to seed capital and fostering "the spirit of enterprise." Different attitudes about risk taking, new technology and new products are taking hold. Entrepreneurs are viewed more favorably, and outdated regulations restricting competition are slowly being dismantled. Venture capital alternatives and equity markets, both essential to facilitating entre-

preneurial activity, are increasingly gaining ground.

Financial Markets. Many consider Europe's financial system another obstacle to realizing New Economy growth in the Old World. Traditionally, debt financing has been the primary vehicle for funding European business ventures, putting powerful European banks in total control of financing. As a result, start-up firms with little in the way of tangible assets to offer as collateral often had difficulty raising capital. Additionally, a variety of regulatory barriers have impeded institutional investing in venture capital and private equity markets.

In contrast, the American financial system has been well equipped to handle the technology-driven demand for seed funding. Regulatory and structural changes in the late 1970s cleared the way for pension funds, insurance companies and mutual funds to invest in venture capital and private equity funds. This deregulation made it much easier for entrepreneurs to take their ideas from the drawing board to the marketplace. The difference in financial systems is underscored by the fact that real business investment in America increased almost twofold between 1990 and 1999 but rose only 16 percent in Europe.

Despite these past difficulties, the outlook for Europe's financial markets now appears much brighter. The euro's much-anticipated unveiling in 1999 began the development of a single European capital market. The unifying force of the new currency will make capital markets more efficient in the long term.

Another sign of strengthening European financial markets is the growing popularity of venture capital funding. European venture capital funding increased significantly in 1999 and is expected to double or triple over the next few years.[4] To complement the maturing venture capital market, Internet and other technology incubators are springing up throughout Europe. In some cases, new businesses have rushed to go public, bypassing venture fund opportunities altogether. The creation of Le Nouveau Marché in France and the Neuer Markt in Germany has further broadened the funding opportunities for start-ups.

Yet another encouraging trend can be seen in European equity markets. Share ownership is becoming more common, and a shareholder culture is emerging. The seeds of this culture were planted by the privatization of nationalized industries, such as airlines, telecommunications firms and utilities. Much of the deregulation and privatization is being driven by directives from the European Commission.

The development of a shareholder culture is likely to lead to a shakeout in many industries. Management will increasingly have to answer to shareholders and not to broader state interests or stakeholders. The understanding that firms belong to shareholders and not bosses or society will replace the existing paradigm, and European managers will begin feeling the kinds of pressures their American counterparts have long endured. Return on equity and earnings growth targets will force firms to become more efficient and productive.

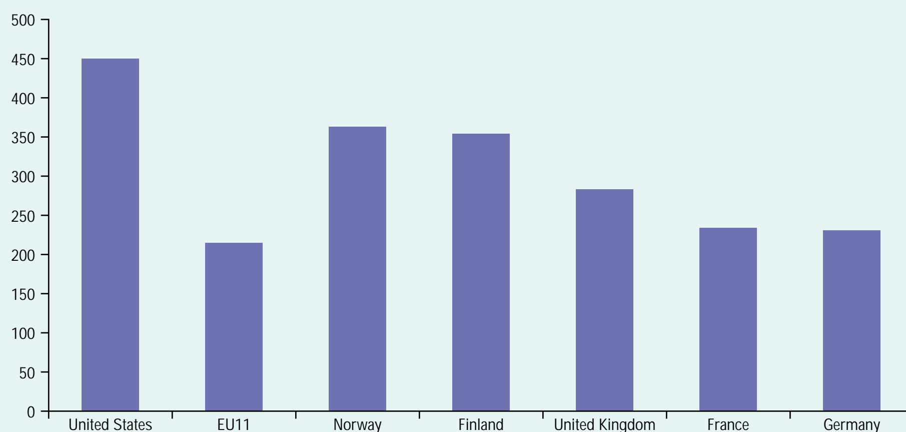
Technology. New information technologies have been key to the recent rise in U.S. productivity. Large investments in information technology in the early '90s paved the way for higher output growth in the latter half of the decade. In general, the use of computers, the Internet and mobile telephones is lower in Europe than in the United States. More than 90 percent of U.S. white-collar workers use a PC, compared with only 55 percent of Europeans. The United States has one PC for every two people, while the ratio is one for every four in Europe's big industrial economies (*Chart 3*). However, some individual European countries exceed the United States in Internet and mobile telephone use, in particular, the Scandinavian countries. Finland and Sweden are home to leaders in mobile telephony (Nokia and Ericsson), and by most accounts Europe is leading the mobile Internet revolution.

About one-third of Europeans own a cell phone for personal use; in Finland and Sweden, the figure is closer to two-thirds. The number of people connected to the Internet via a wireless device is expected to grow dramatically in coming years. Furthermore, Europe has already adopted a single digital cellular telephone standard, while the United States continues to rely on multiple, incompatible standards.

Labor Markets. Even with large productivity gains from business innovation, it's unlikely technology alone can lead to sustained rapid output growth across Europe. Low labor force growth means that it would take productivity growth rates well in excess of those in the United States to propel comparable output growth in the euro area. As Chart 4 shows, since the early 1990s labor force growth in Europe has been running at about half the U.S. pace. To realize New Economy levels of output growth,

Chart 3

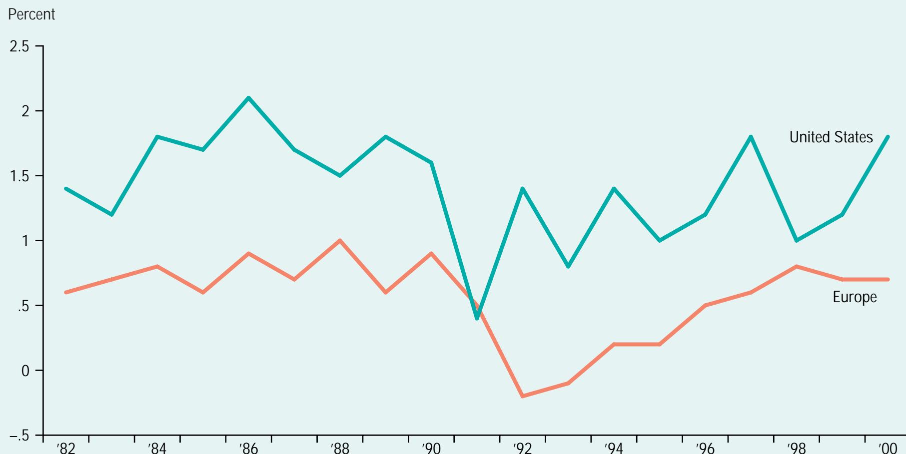
Use of Computers, 1997



SOURCES: *Fostering Entrepreneurship in Europe: The UNICE Benchmarking Report*, 1999, Union of Industrial and Employers' Confederations of Europe, Brussels.

Chart 4

U.S. and European Labor Force Growth, 1982–2000



NOTE: Data for 2000 are OECD projections.

SOURCE: *OECD Economic Outlook*, June 2000, Organization for Economic Cooperation and Development, Paris.

Europe would have to draw deeply on its pool of unemployed workers and attract more workers into the labor force.

In Germany the labor force has shrunk in five of the past eight years. Ireland has been one of the few European countries posting rapid labor force growth, but it is too small to have much effect on areawide aggregates. Labor force participation rates remain much lower in Europe than in the United States. According to recent estimates, slightly more than two-thirds of Europe's working-age population participates in the labor force, compared with nearly four-fifths of America's.

Cultural and language differences across borders have been a deterrent to European labor mobility. It's the Continent's rigid labor markets, however, that have long drawn reformers' ire. In the past, powerful labor unions systematically averted efforts to increase businesses' flexibility to hire and fire workers. The absence of this flexibility has undermined global competitiveness by hampering firms' ability to respond to changing market conditions. The downsizing of U.S. firms a decade ago created room for companies to exploit new market niches. The use of flexible work contracts and other forms of temporary employment—more common than in Europe—have also enhanced the efficiency of America's labor market, freeing workers to move from industries in decline to those growing rapidly.

Current trends, however, suggest that Europe's labor markets are becoming less rigid. As rules become less strict, more workers have been hired on fixed-term contracts or as part-timers, reducing labor costs. Policy changes in Italy, Spain, Germany and France have further mobilized labor markets. These "friction-free" policies have reduced the social cost of dismissing workers and made it more attractive to hire younger and lower paid workers.

Some European countries have also adopted "making work pay" policies, such as tax incentives for entering employment. These policies have stimulated employment in France and the Netherlands. While the dynamic effects are still uncertain, it is commonly agreed that the efficacy of such policies depends on flexible labor markets and the easing of hiring constraints.

The Future

Europe is increasingly trusting market solutions and resisting the temptation to legislate commerce. UK-based Vodafone AirTouch's hostile takeover of Germany's Mannesmann is a good example. Hostile takeovers were once taboo in Germany, and when the bid started to materialize, many expected the German government to kill the deal. In the end, though, the state backed down and allowed the massive transaction.

There is still room for improvement. It is far more expensive to start a business in Europe than in America, and some regulations continue to stifle firms and discourage job creation. Gaps in the law result in insufficient protection of intellectual property. Prohibition of stock options in France continues to impair entrepreneurship and new company growth.

However, as the countries of Europe become more integrated, sharing a common currency and a market bigger than the United States by about 100 million people, the competitive pressures firms and governments will face cannot but lead to greater efficiency and higher growth.

— Mark A.Wynne
John B. Thompson

Wynne is senior economist and research officer in the Research Department of the Federal Reserve Bank of Dallas. Thompson is an assistant economist in the department.

Notes

1. The data are for the European Union (EU), which consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. The euro area (EU11) consists of all these countries except Denmark, Greece, Sweden and the United Kingdom. However, starting January 1, 2001, Greece will also adopt the euro.
2. The data for Europe refer to the 11-nation euro area only.
3. Paul D. Reynolds, Michael Hay and S. Michael Camp (1999), "Global Entrepreneurship Monitor," 1999 Executive Report, Babson College, Kauffman Center and London Business School, p. 3.
4. Reynolds, Hay and Camp (1999).

A Common Currency for the Americas?

(Continued from front page)

premium built into many countries' interest rates since the domestic currency cannot be depreciated. Advocates also argue that an increase in credit to small and medium-sized companies and a narrowing of income distribution are likely.

Dollarization opponents point out that the dollarized country loses control of its monetary policy and say that this loss is too costly. Dollarization limits the central bank's ability to serve as lender of last resort to troubled commercial banks during a banking crisis. Critics contend it is often the countries with very weak banking systems that consider dollarization. One of the most common arguments is that it is simply the wrong policy: it delays a country from establishing sound macroeconomic and fiscal policies.

Sen. Connie Mack, chairman of the Joint Economic Committee of the U.S. Congress, opened the conference with a strong affirmation of dollarization. The Florida senator said that dollarization would do more to ensure the long-term economic health of the nations in this hemisphere, more to expand trade, more to enhance economic stability and more to increase standards of living and create jobs than any other single policy shift he is aware of. Mack introduced a related bill taken up by the U.S. Senate Banking Committee: the International Monetary Stability Act (S.1879, Nov. 8, 1999). This bill creates a framework for the United States to compensate dollarizing countries for the seigniorage they lose by abandoning their domestic currencies. Seigniorage is the revenue countries earn from the difference between the cost of printing money and the money's official worth. Responding to criticism that dollarization would undermine a nation's sovereignty, Mack said dollarization would not interfere with a nation's ability to create its own fiscal, regulatory or most other public policies.

Despite Mack's comments, much of the conference focused on debates over what dollarization prevents nations from doing. One of the big questions raised by dollarization opponents was whether the benefits warranted the surrender of monetary sovereignty—especially to a country whose monetary policy would not necessarily be consistent with the interests of the dollarizing country. A Federal Reserve decision to hike interest rates to cool inflationary pressures in the United States might have a deleterious impact on a dollarized country with low inflation, no growth and excess capacity. These issues led some speakers to wonder whether any exchange-rate regime but a flexible one could succeed. Later discussions revealed that dollarization's limit on the central bank's ability to serve as a lender of last resort could be a blessing or a curse.

Hyperactive Central Banks

In responding to concerns about the restrictions that dollarization imposes on the lender of last resort function, Guillermo Calvo, director of the Center for International Economics at the University of Maryland, addressed the issue by characterizing Latin American central banks as hyperactive. Calvo said it is not unusual during financial crises for central banks to print money to create the liquidity required for bailing out commercial banks. Surrendering the freedom to inflate, he argued, is not really surrendering the ability to stabilize, since inflating is not stabilizing. "Power comes from credit and not from printing money," he said. In other words, national creditworthiness is more important than a good printing press.

Continuing on this theme, Inter-American Development Bank chief economist Ricardo Hausmann added that the term *lender of last resort* is a misnomer; the correct phrase would be *borrower of last resort*. According to Hausmann, a serious problem for emerging market countries is "original sin," which he calls the unstable currency history of most emerging-market countries. That history and lenders' fears of it being repeated severely limit borrowing options in emerging-market countries. For example, if a firm in an emerging market needs money, it can only borrow in its local currency for the very short term; for the long term, it can only borrow in dol-

Dollarization's limit on the central bank's ability to serve as a lender of last resort could be a blessing or a curse.

lars. However, if a company borrows in dollars, it will have a currency mismatch, and if it borrows short-term, it will typically have a maturity mismatch.

When exchange rate pressures materialize under these financial market circumstances, central banks have difficulty adjusting. If the central bank lets the exchange rate go, the consequences for the companies that have currency mismatches are not good. Andrew Powell, chief economist at the Central Bank of Argentina, emphasized that because of the currency mismatches, currency devaluation can dramatically increase the likelihood of defaults. And, if the central bank defends the currency by tightening monetary policy, companies that have maturity mismatches will have trouble rolling over their debts. Any way the central bank moves can trigger a financial crisis. Both Hausmann and Calvo called for dollarization as solutions to these problems.

Pegged or Floating Exchange-Rate Regime?

In the past decade, the six main currency-crisis countries—Brazil, Indonesia, Mexico, Russia, South Korea and Thailand—suffered in varying degrees the short-term borrowing dilemma Hausmann described. Hausmann indicated that this maturity mismatch is aggravated by a pegged exchange-rate regime. Under a pegged regime, a developing country typically fixes its exchange rate by unilaterally pegging its currency to that of an industrialized country. The developing country then buys or sells the foreign money in return for domestic money to maintain the selected exchange rate. The volatile circumstances surrounding small open economies—including terms-of-trade shocks and sudden changes in capital inflows—sometimes push exchange rates toward overvaluation. Then, balance-of-payment pressures materialize. Investors become nervous that when a devaluation occurs, it will be much more severe than if the currency had been allowed to float. The financial crises of the 1990s witnessed such megadevaluations, and as a result, the pegged exchange-rate regime has virtually disappeared as an option.

According to Sebastian Edwards, professor at the University of California at Los Angeles, countries in the region now have two choices: dollarize or freely float. A floating exchange-rate regime is one in which the central bank has no commitment to support a given exchange rate. It sets the money supply and then allows the exchange rate to fluctuate in response to economic conditions that affect supply of and demand for the currencies.

Table 1

Nominal Interest Rate Volatility in Floating Exchange-Rate Regimes

Country	Period	±25 basis points	±50 basis points
United States	2/73–4/99	59.7	80.7
Japan	2/73–4/99	67.9	86.4
Bolivia	9/85–12/97	16.3	25.9
Peru	8/90–4/99	24.8	32.3
Uganda	1/92–4/99	11.6	32.6

SOURCE: Guillermo Calvo and Carmen Reinhart, "Fear of Floating," forthcoming.

Fear of Floating

Edwards pointed out that we lack substantive historical experiences in either floating or dollarization. Panama had been the only dollarized country in Latin America until Ecuador's recent decision to dollarize. Mexico, Brazil, Chile and Colombia have abandoned their pegged regimes in favor of floating. However, Calvo and Edwards questioned whether these countries really float. Calvo explained that emerging-market countries have a "fear of floating." Edwards maintained that instead of floating, developing countries often have pegged regimes in disguise. If these countries float at all, they, in Calvo's words, "float with a life jacket." This means that even though they are operating under flexible rates, or a floating regime, they will from time to time intervene to stabilize the exchange rate. They intervene by buying or selling foreign currency on the foreign exchange market or by manipulating interest rates through open market operations.

The reason for this fear of floating reinforces Hausmann's observation of original sin. These currencies don't have the recognition or the credibility of developed countries' currencies. A developing country fears what might happen if its currency is allowed to float. The resulting volatility of its exchange rate may scare investors into pulling out their capital. Consequently, these countries float with a life jacket.

According to Calvo, while the exchange rate does not move in these so-called floating-rate countries, what does move is the interest rate because interest rate intervention is used to shore up exchange rates. The resulting volatility is especially striking when compared with the low interest rate variances of industrialized countries that actually do have floating exchange rates. Table 1 shows an 81 percent probability that U.S. nominal interest rate changes fall within a plus or minus 50-basis-point band and an 86 percent probability for Japan. In contrast, Bolivia has extremely volatile interest rates and thus only a 26 percent probability that they will stay within the plus or minus 50-basis-point band.

Edwards explained that dollarization makes eminent sense for some countries but perhaps not for all. He expressed concern over the difficulty of relative price adjustments in a dollarized economy. He warned that the dollarized country may be buying higher unemployment and pointed out that the countries with the highest unemployment rates in the 1990s were the superfixers, Argentina and Panama. With dollarization, shocks or sudden unexpected disturbances in the economy are more costly. If you get a real shock, you need a movement in relative prices. Edwards maintained that exchange-rate fluctuations facilitate that movement. Hausmann agreed: "It is easier to change one price, the exchange rate, than it is to change a multitude of labor contracts."

However, Hausmann offered a compelling argument for dollarization by questioning the benefits of floating in economies that are susceptible to shocks.

He used the oil-based Venezuelan economy as an example. If the price of oil goes up, the exchange rate will appreciate and vice versa. Using the connection between exchange rate and oil price movements, Hausmann questioned whether a country's residents would willingly save in their domestic currency if they were allowed to save in another. According to Hausmann, sound risk management requires savings in a currency that has a negative correlation to income. People need to have savings with a maximum buying power when their incomes are low. When their incomes are high, having a maximum buying power is less important. He maintained that if the currency moves up and down with income, it has the wrong correlation. People will want to diversify away from that currency. Floating in an economy suffering real shocks will do away with savings in the national currency. Assuming that the exchange rate can help during the adjustment period is assuming that the financial system and everything else will stay the same, and according to Hausmann, "They simply don't."

Other conference speakers who supported dollarization also saw it as a policy that might bring economic stability. They questioned—along with Hausmann and Calvo—the existence of independent monetary policies in the region. Calvo perhaps expressed this notion most succinctly when he compared an emerging market economy conducting its own monetary policy to a small boat in the middle of the ocean. He said, "One can say to the boat, 'You are free to row.' Yes, the boat is free to row, but it probably is not a good idea."

A Wall Street Perspective

Walter Molano, head of economic and financial research at BCP Securities Inc., disagreed. He said the small boat needs to row in the ocean. The downside of dollarization is that it keeps the boat from rowing, he said, and thereby limits the development process. According to Molano, dollarized governments fail to develop the skills and experience needed to establish macroeconomic policies to deal with various phases of business cycles. Molano maintained that most of Latin America's fiscal problems are the result of institutional flaws, and dollarization does nothing to solve these.

Molano shared a session entitled *A Wall Street Perspective* with two other economists: Michael Gavin, head of economic research for Latin America at the firm Warburg Dillon Read, and John H. Welch, chief economist, Latin America, Barclays Capital. According to Molano and Welch, no country talks about dollarization when things are going well, and they gave Ecuador as an example. In 1999 Ecuador's inflation topped 60 percent, the economy shrank 7 percent, unemployment reached 17 percent, the currency plunged 67 percent against the dollar and the banking system collapsed. Ecuador responded by dollarizing. Molano argued that fiscal reform and privatization were needed—not dollarization.

Gavin countered by emphasizing that the most appropriate question for countries with weak fundamentals is which exchange-rate regime best limits the damage that can be done. Gavin said, "When the fundamentals are weak enough, simply avoiding a hyperinflation is the first imperative of macroeconomic policy. Nothing good has ever happened in an economy that is having a hyperinflation. Monetary integration—dollarization—clearly makes sense for the basket cases." Welch extolled a sound fiscal policy: "Fiscal policies are by far and away the most important. Once you get a reasonable fiscal policy, then you can go about dealing with these other issues."

The Wall Street session built upon a presentation by University of California at Berkeley professor Barry Eichengreen, who introduced the concept of timing. He explained that implicit in the dollarization debate are two very different views of when to dollarize: the dollarize-

The volatile circumstances surrounding small open economies… sometimes push exchange rates toward overvaluation.

Dollarization: A Limerick

There once was a
hyperactive central banker
Whose boat needed
a stronger anchor.
The ocean was big,
The boat was small,
So he tied his anchor
to a tanker.

—*Bob McTeer*

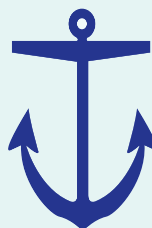
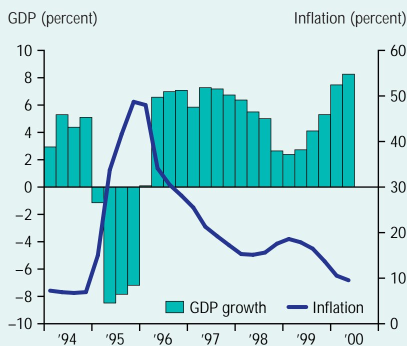


Chart 1

Mexico's GDP and Inflation
(Annual growth rates)



SOURCE: Instituto Nacional de Estadística, Geografía e Informática.

last school and the dollarize-first school. The common view is that to work smoothly, dollarization must occur after major economic reforms are in place. This way, dollarization locks in reform. The dollarize-first school takes the opposite position. Since major reforms take time, dollarization should be instituted first, thus initiating reforms. This is Ecuador's approach. Some of Molano's concerns were substantiated by Eichengreen's models and data-based conclusion that reform should precede dollarization—or at least that dollarizing in advance of other fundamental reforms is risky business.

Though dollarizing before reforms might be risky, research by Andrew Rose, professor at the University of California at Berkeley, implies that it is a chance worth taking. In his presentation, Rose concluded, "The best estimate is that countries with the same currency trade over three times as much with each other as countries with different currencies."[1] Rose expounded on this increased trade's impact on growth by referring to the work of Frankel and Romer (1999).[2] They found that when the ratio of trade to GDP increases one percentage point, income per capita increases between 0.5 percent and 2 percent. Rose made a powerful argument for the possible welfare gains through growth via dollarization.

The Importance of Politics

University of California at Santa Barbara professor Benjamin Cohen added another dimension to Rose's argument. Cohen asked, "Why would any rational person oppose anything that might lead to lower interest rates, greater price stability, deeper financial markets, more trade?" His answer was no surprise: "Well, it is politics....Politics does matter."

Cohen discussed sovereignty concerns, including the loss of seigniorage, which can often be a source of emergency income when other sources are harder to secure. Robert Stein, staff director, U.S. Senate Subcommittee on Economic Policy, and Kurt Schuler, senior economist, Joint Economic Committee, had addressed this issue earlier in the conference while explaining Mack's dollarization bill. The bill would allow the U.S. Treasury secretary to rebate quarterly 85 percent of lost seigniorage, the revenue the dollarized country would have earned by printing its own money. Although governments regain a percentage of their lost seigniorage, they are still limited by the bill's provision of quarterly rebates. Cohen is concerned that the inability to raise money quickly could add to a country's vulnerability, especially in times of national security threats.

Cohen also emphasized the vital role money plays as a national symbol. He said that most nation-states are not natural entities but are created and require nurture. Loyalty is fostered through a variety of national symbols: the flag, the anthem, sports teams, national language and money. Cohen warned that the psychological effects of adopting a foreign currency could include loss of a strong national identity. He cautioned that governments should take this seriously.

As the debate wound down, it became more evident that the obstacles to dollarization are at least as much political as they are economic. Carlos Menem, former president of Argentina, gave a compelling argument for dollarization in his keynote address. But Martín Lagos, vice governor of the Central Bank of Argentina, opened his presentation by saying that "the current Argentine authorities are not seeking any change in the currency arrangements or regime prevailing in Argentina since 1991." Regardless of how much Menem advocates dollarization, he is no longer president, and the current administration is not actively pursuing dollarization. This does not mean the issue is dead in Argentina. Menem quipped that he would be back in 2003 as president.[3]

Guillermo Ortiz, governor of the Bank of Mexico, likewise gave no indication that Mexico would give serious consideration to dollarization any time soon. Mexico began floating at the end of 1994 because it had no more reserves. Ortiz said he is now "convinced that the floating exchange-rate regime has been extremely good for Mexico." He pointed out that floating has not been an impediment to economic recovery or to reduction in inflation (*Chart 1*).

In closing, Dallas Fed President Bob McTeer told the audience dollarization was "about as close to a free lunch as you can get." Emphasizing that he was speaking for himself and not for the Federal Reserve, McTeer said, "Governments could get the benefits of greater price stability cold turkey without having to suffer decades of austerity to reach that point on their own."

—Sherry Kiser

Kiser is an associate economist in the Research Department and coordinator of the Center for Latin American Economics at the Federal Reserve Bank of Dallas.

Copies of the dollarization conference speeches and papers can be found on the Dallas Fed web site at http://www.dallasfed.org/htm/dallas/events/dollarspeech.html

Notes

1. Andrew K. Rose (Nov. 23, 1999), "Does a Currency Union Boost International Trade?" This paper is a nontechnical version of Rose's working paper, "One Money, One Market: Estimating the Effect of Common Currencies on Trade," which is forthcoming in *Economic Policy*. Rose's model is estimated using a data set with 33,903 bilateral trade observations spanning five different years. His sample contains 320 observations in which two countries trade and use the same currency.
2. Jeffrey A. Frankel and David Romer (1999), "Does Trade Cause Growth?" *American Economic Review* 89 (June), pp. 379–99.
3. When Menem was elected president in 1989, Argentina's economy was experiencing hyperinflation. In 1991, the Argentine Congress passed the Convertibility Law, which established a currency board-like system that forbids monetizing government deficits. Under a currency board, the monetary authority issues money against a foreign currency only at a fixed exchange rate. Since Argentina instituted the Convertibility Law, the exchange rate of the U.S. dollar and Argentine peso has remained pegged 1:1, and Argentina's average annual rate of inflation fell from 600 percent (1983–91) to 4.6 percent (1992–98). Menem left office in December 1999.

The Eleventh District experienced a broad-based slowing in employment growth in the second quarter and into July. Texas employment growth slowed to 1.8 percent (July over May). The August Beige Book also reported signs of cooling. However, after bottoming out in April, private month-over-month employment growth picked up again and was a healthy 4.4 percent in July. At the same time, the Texas unemployment rate fell to 4.1 percent—the lowest rate in 26 years. These developments suggest that tight labor markets are playing a role in slowing the District economy.

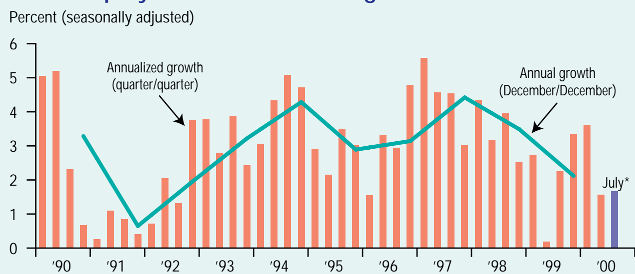
Part of the moderation in growth, however, is simply a return to "average" growth rates following the breakneck pace of late 1999 and early 2000. Texas exports, for example, grew at an annualized rate of 9.5 percent in the first half of 2000—down from 29 percent in 1999. Slower growth in interest-rate-sensitive sectors such as construction are also a factor. Employment grew only 0.7 percent (annualized rate, July over May) in this sector, down from yearly averages around 6 percent.

Any softening of the Texas economy, however, is moderated by continued growth in the high-tech sector and the recovery of the oil and gas industry, a recovery that is still in its early stages. Oil and natural gas prices remain at very high levels. Employment growth in this sector—1.5 percent for July 2000 over July 1999—should pick up speed in the second half of 2000. Overall, despite the second-quarter slowing, the Texas economy is growing faster in 2000 than in 1999—a trend we expect to continue.

—Pia M. Orrenius

Texas Employment Growth Slowing

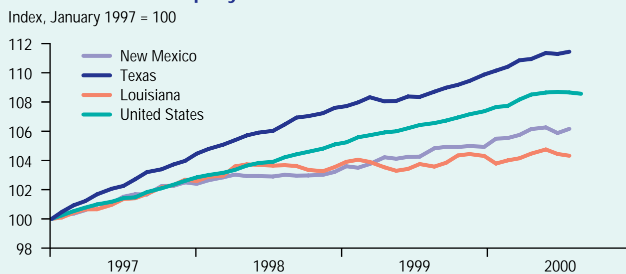
Percent (seasonally adjusted)



* July 2000 data are annualized.

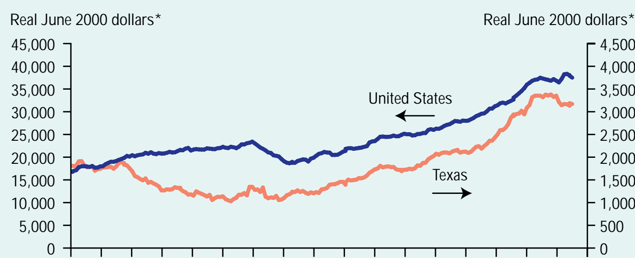
Total Nonfarm Employment

Index, January 1997 = 100



Value of Construction on Downward Trend

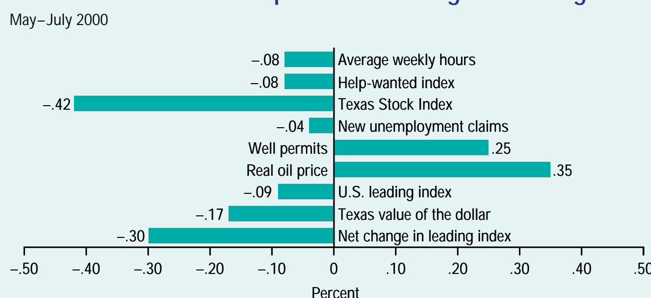
Real June 2000 dollars* Real June 2000 dollars*



* Six-month moving average, seasonally adjusted.

Net Contributions of Components to Change in Leading Index

May–July 2000



Regional Economic Indicators

	Texas Leading Index	TIPI† total	Mining (Texas employment*)	Construction (Texas employment*)	Manufacturing (Texas employment*)	Government (Texas employment*)	Private service-producing (Texas employment*)	Texas (Total nonfarm employment*)	Louisiana (Total nonfarm employment*)	New Mexico (Total nonfarm employment*)
7/00	126.6	130.7	145.5	559.4	1,082.2	1,554.7	6,048.0	9,389.8	1,903.9	742.7
6/00	126.1	129.6	146.7	557.5	1,079.7	1,569.8	6,023.2	9,376.9	1,906.1	740.7
5/00	125.8	129.0	146.3	555.7	1,078.1	1,589.9	6,012.6	9,382.6	1,911.7	743.4
4/00	126.9	128.4	146.2	558.4	1,075.5	1,562.7	6,004.9	9,347.7	1,906.5	742.6
3/00	127.9	128.4	146.5	553.4	1,081.0	1,559.4	6,000.2	9,340.5	1,900.7	739.8
2/00	126.7	128.0	145.9	550.7	1,080.7	1,552.4	5,973.3	9,303.0	1,898.1	738.3
1/00	125.8	128.2	146.0	547.1	1,080.5	1,550.7	5,956.3	9,280.6	1,894.1	738.0
12/99	126.4	128.2	145.7	541.2	1,078.2	1,543.3	5,949.7	9,258.1	1,903.6	734.1
11/99	124.6	128.2	145.4	537.4	1,077.1	1,535.2	5,926.3	9,221.4	1,906.0	734.5
10/99	124.3	127.5	145.2	533.4	1,077.8	1,534.3	5,908.0	9,198.7	1,904.2	734.0
9/99	123.4	126.7	144.1	531.9	1,079.2	1,535.8	5,891.3	9,182.3	1,895.1	734.1
8/99	123.9	126.7	143.8	527.2	1,080.1	1,531.5	5,876.6	9,159.2	1,890.3	733.4

* In thousands. † Texas Industrial Production Index.

For more information on employment data, see "Reassessing Texas Employment Growth" (*Southwest Economy*, July/August 1993). For TIPI, see "The Texas Industrial Production Index" (Dallas Fed *Economic Review*, November 1989). For the Texas Leading Index and its components, see "The Texas Index of Leading Indicators: A Revision and Further Evaluation" (Dallas Fed *Economic Review*, July 1990). Online economic data and articles are available on the Dallas Fed's Internet web site, www.dallasfed.org.

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