

Does Enronitis Threaten the Dollar and the Economy? American and French Views

IS THE GLASS HALF-EMPTY OR HALF FULL?

By Paul Horne and Albert Merlin



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An American and a French economist debate whether the dollar is vulnerable because "Enronitis," the bear equity market, and the weak economy may make foreign financing of the U.S. external deficit problematic. The dollar appears vulnerable because foreign financing of the U.S. external deficit is being slowed by corporate mal-governance nicknamed "Enronitis," the bear equity market, and economic weakness. Foreign investors may fear that once-respected U.S. corporate management, accountancy, legal counsel, profit quality, and regulatory institutions may be less trustworthy and that U.S. economic growth and fiscal policies are relatively less attractive. If the level of foreign investment slows below that of the current account deficit for a significant time, not only would the

dollar weaken but U.S. consumption, investment, and savings patterns might have to change. Paul Horne (the American economist) argues these negative factors make the dollar more vulnerable than at any time since 1985. Albert Merlin (the French economist) responds that despite the bear market, Enronitis, and the weak economy, the U.S. lead over Europe and Japan remains so great that the dollar is not fundamentally at risk.

Paul Horne: A Pessimistic American View

Foreign investor confidence in U.S. assets has been sharply diminished by the equity bear market, economic weakness, and—above all—the contagion of corporate mal-governance that I nickname “Enronitis.” If this confidence crisis causes a prolonged slowing of the rate of voluntary foreign capital inflows, financing our unprecedented current account deficit will become problematical and the dollar could weaken enough to lead to changes in U.S. consumption, investment, and savings patterns. Available data suggest that foreign financing began to slow in 2000 with the start of the equity market correction and has decelerated sharply as corporate governance scandals and doubts about economic growth and corporate earnings exacerbated the correction into a bear market. I conclude that the dollar is potentially more vulnerable than any time since its previous peak in the mid-1980s.

The potential for dollar (USD) depreciation to overshoot is substantial if Enronitis proves to be wider spread than expected, if policy response to Enronitis and other problems appears inadequate, and if economic growth remains sub-par. Under these circumstances, international investors might further reduce acquisition of dollar assets until they are persuaded that the U.S. situation is correcting satisfactorily. Until that time, a diminished capital inflow that fails to fully finance the external deficit will exacerbate dollar weakness and increase pressure for U.S. economic adjustment.

On the other side of the Atlantic, appreciation of European currencies could increase pressure for much-needed structural and economic adjustments that might make investing in Europe more attractive relative to the U.S. Exporting companies, as well as domestic producers competing with American imports, would be forced to improve their productivity and competitiveness. A strong euro (EUR) would initially weaken European economic and employment growth, pressuring governments to implement much needed reforms of labor and product markets. Non-European investors would also benefit from increased investment in the euro area, particularly at today’s sharply discounted asset prices. Ironically, USD weakness might prod Europe into action to attempt to

reduce the undeniably large gap in today’s relative attractiveness of U.S. and European investments that my French colleague, Albert Merlin, discusses below.

The Capital Inflow

The dollar’s decline from its cyclical peak in February appears to be related to foreign investors’ growing concerns about the equity market correction, weaker-than-expected economic growth, and especially—I maintain—the *tsunami* of corporate scandals. By September 2002, the USD was down thirteen percent against the euro since the cyclical high in February; thirteen percent versus the yen, and eight percent in trade-weighted (TW) terms against major currencies.¹ Is this depreciation short-term? Or could it be the start of a more fundamental downturn for the currency whose forty percent rise against major currencies from its April 1995 cyclical low made it a symbol of the “New Economy?”

The answer depends on the investment preferences of foreigners whose voluntary acquisition of dollar assets has financed the U.S. current account (C/A) deficit. Since 1982, our borrowing requirement increased steadily to an average annual 4.2 percent of GDP in 1999-2001 and a forecast \$450 billion, or 4.3 percent of GDP this year.² Up to early this year, the remarkable growth of capital inflows was motivated by foreign confidence in the competitive and low-risk rate of return (ROR) on dollar assets relative to Europe, Japan, and elsewhere.

Capital inflows accelerated after 1995 when U.S. economic, capital spending, and productivity growth soared during the “new economic paradigm.” Confidence was such that the capital inflow regularly over-financed the C/A deficit, causing significant USD appreciation. Net foreign direct investment (FDI) surged from a \$57.8 billion in 1995 to a \$307.7 billion peak in 2000. Economic slowdown, the equity bear market, Enronitis, and terrorism contributed to slow net FDI to a \$130 billion annual rate in 2001 and 1Q2002. An even larger foreign flow went into “securities other than U.S. Treasury debt,” a shorter-term and riskier asset class that soared from a net \$156 billion in 1995 to \$455 billion in 2001.³

¹U.S. Federal Reserve’s monthly average trade-weighted index for major currencies was used for the smoothed high in February 2002; spot daily rates were used for euro and yen highs in 2002. Percentage changes as of 4 September 2002 for EUR and yen spot rates, 30 August for the Fed’s major currency indexes.

²The C/A deficit has risen regularly since 3Q1982 except for Q1 and Q2 of 1991 when Saudi Arabia, Kuwait, Japan, and Germany contributed to the cost of the Gulf War, generating a \$16.4 billion C/A surplus in the first half of 1991. The C/A returned to deficit in 3Q1991. Source: Bureau of Economic Analysis quarterly data.

³FDI trend data from Bureau of Economic Analysis’ *U.S. International Transactions*.

The capital inflow, financed by foreign savings, was an important offset to diminishing U.S. net national saving, which dropped from an average annual 9.1 percent of GDP in the 1970s to 5.0 percent in the 1990s. Foreign savings thus contributed to the 4.5 percent average annual growth of U.S. real private consumption in 1996-2000. Similarly, FDI added to the 11.7 percent average annual growth of real gross private non-residential investment (GFCF) in late 1990s. Some FDI went into information technology and communications (IT), the keys to sharply improved U.S. trend productivity that attracted still more capital inflows.

The U.S. has long profited from capital inflows resulting from excess savings in Europe and Japan. The euro area's net national saving averaged 8.2 percent of GDP a year in 1990-2000, but private consumption rose only 1.7 percent a year and real investment (GFCF) growth averaged only 2.4 percent a year in this period.⁴ These factors, plus strong export growth, meant the euro area C/A was in surplus, averaging 1.6 percent of GDP a year.⁵ High taxes and social costs, inadequate labor and product market deregulation, a non-competitive ROR on European assets, and concerns over the new euro currency and the European Union's (E.U.) institutional shortcomings were additional compelling reasons for the capital outflow to the U.S. In short, the European investor voted in favor of U.S. assets. Japanese investors were an even larger source of capital inflows for broadly similar reasons.

Tenets of Foreign Faith

Foreign confidence in the American risk-reward relationship was based on faith in our political democracy, the economy's dynamic productivity, and corporate integrity—all relative to the situation in Europe and Japan. Despite Europeans' initial doubts about their qualifications, U.S. Presidents usually won a degree of foreign confidence. Economic, monetary, and fiscal policy in the 1990s received good marks abroad as productivity and GDP growth accelerated and asset prices soared. The Federal Reserve appeared to manage monetary policy well, dealing effectively with crises, and prolonging the robust business

⁴Comparative national savings, consumption and investment data from *OECD Historical Statistics, 1970-2000*. The euro area's net national savings rate dropped from an average annual 13.5 percent in the 1970s to 8.2 percent in the 1990s. Japanese national savings are even higher, averaging a net annual 13.2 percent of GDP in the 1990s. Real investment growth has dwindled to 0.9 percent per year in 1990-2000 from 4.4 percent in 1979-89. Japanese consumption averaged 54.8 percent of GDP per year in 1990-2000, versus 58.1 percent in the European Union and 67.4 percent in the U.S. Japan exports most of its surplus savings to the U.S.

⁵Balance of payments data from *OECD Historical Statistics, 1970-2000*.

cycle and equity market boom. The fiscal balance's turnaround from a deficit equal to 5.9 percent of GDP in 1992 to a surplus of 1.7 percent in 2000, and lower long-term interest rates also impressed foreign investors.⁶

Harvard Business School-trained corporate management and strong profits growth became the international model. U.S. corporate accounting was seen abroad to be rigorously responsive to the world's largest and most demanding institutional investors, a paradigm of transparency compared with murky European and Japanese bookkeeping. U.S. generally accepted accounting principles were pushed by the Big Five accounting firms as the benchmark for foreign companies aiming for a U.S. stock exchange listing or wanting to do business here.

Until 2002, international investors believed U.S. public and private sector regulatory institutions to be unrelentingly rigorous, unlike those in Europe and Japan.

International investors believed public and private sector regulatory institutions to be unrelentingly rigorous, unlike those in Europe and Japan. The Security and Exchange Commission (SEC) and the Internal Revenue Service (IRS) were respected for what was thought to be their aggressive pursuit of market and tax transgressors. The New York Stock Exchange's software programs for tracking illegal equity trading were marketed to foreign exchanges. The National Association of Security Dealers' and the chartered financial analysts' organizations were perceived as guarantors of the qualifications and integrity of securities dealers and analysts. The Federal Reserve was the model for central bank independence and its chairman revered for his knowledge of the business sector and persuasive rationalization of the Fed's monetary policies.

Completing this virtuous circle, the U.S. dollar's sharp appreciation after 1995 enhanced the return on U.S. assets, yet another reason to buy yet more dollars. Everything encouraged the growing inflow of foreign savings that allowed the U.S. to invest and consume more than it could afford while saving less and less. More insidiously, foreign capital lulled a generation of U.S. politi-

⁶Fiscal data and projections from the U.S. Congressional Budget Office.

cians, policy makers, and investors into thinking they no longer had to balance the books.

The Fed's Punch Bowl

The intoxication of the New Paradigm and the bull market may have encouraged investor amnesia about business and market cycles. The 1991 recession occurred before many of Wall Street's young traders and salespeople had started work. Even fewer remembered the 1981-82 recession, the worst since World War II. If they did worry, they knew the Fed would intervene rapidly to correct recessions and market crises, as it had in 1987, 1991, 1994-95, and 1998.

But the Fed finally took away the punch bowl, beginning in July 1999, to cool the over-heated New Economy. Although the resulting three-quarters of negative growth are considered a shallow three-quarter recession, real GDP growth plunged from a peak 7.1 percent, seasonally adjusted at an annual rate () in 4Q1999, to a negative 1.6 percent in 2Q2001 (data updated with BEA's latest revised data); and business investment in equipment and software declined in 2001 after years of double-digit growth.⁷ Clearly worried, the Fed implemented unprecedented monetary easing in a short time to prevent an even greater economic slowdown. Although a major recession has been avoided, for the time being, the New Economic Paradigm is history. Early hopes of a "V"-shaped recovery back to rapid growth have faded, especially after the September 11, 2001 terrorist attacks on the United States and with the burgeoning implications of Enronitis for corporate profits and capital spending.

Revised GDP showed the recession in 2001 to be deeper than initially estimated. In the first half of 2002, recovery was weaker than expected by the consensus. Although 1Q2002 GDP expanded 5.0 percent, the inventory correction accounted for 2.6 percent of GDP; and capital spending on equipment and software declined 2.7 percent. Second quarter GDP growth slowed to only 1.1 percent, with inventory change accounting for 1.4 percent of GDP and capital spending rising 3.1 percent. With "acquired growth" (assuming zero growth in the second half) now about 1.5 percent in 2002, consensus forecasts now expect average GDP growth in 2002 to be in a 2.0 percent-to-3.0 percent range, compared with the 3.9 per-

⁷All quarterly data cited in this paper are seasonally adjusted at annual rates.

TABLE 1

LABOR PRODUCTIVITY AND TOTAL HOURS WORKED (AVERAGE ANNUAL PERCENTAGE GROWTH): UNITED STATES , EUROPEAN UNION AND JAPAN			
	United States	European Union	Japan
Labor Productivity			
1990-1995	1.1	2.5	1.8
1995-2000	2.0	1.4	2.2
2000-2001	1.8	0.6	-0.3
Total Hours Worked			
1990-1995	1.2	-1.0	-0.4
1995-2000	2.0	1.2	-0.7
2000-2001	-0.7	1.1	-0.4

cent average in 1995-2000. I consider the balance of risks to be on the downside.

Relative Productivity

Worse yet, revisionism is in the air about U.S. potential GDP growth and, more fundamentally, about trend productivity growth prospects. At the New Paradigm peak, estimates of potential GDP growth jumped from a 2.2 percent consensus in the early 1990s to 4.0 percent, premised on trend productivity growth rising from an annual average of 1.5 percent between the early 1970s and mid-1990s to around 3 percent by the end of the cycle.⁸

Today's consensus hopes trend productivity growth remains over 2.5 percent, although the Federal Reserve reiterates that this will require continued strong capital spending. But reduced economic growth expectations, Enronitis' impact on corporate profits, and a higher effective cost of capital in the high growth sectors of the economy may mean business investment recovers slowly, limiting future improvement of productivity.

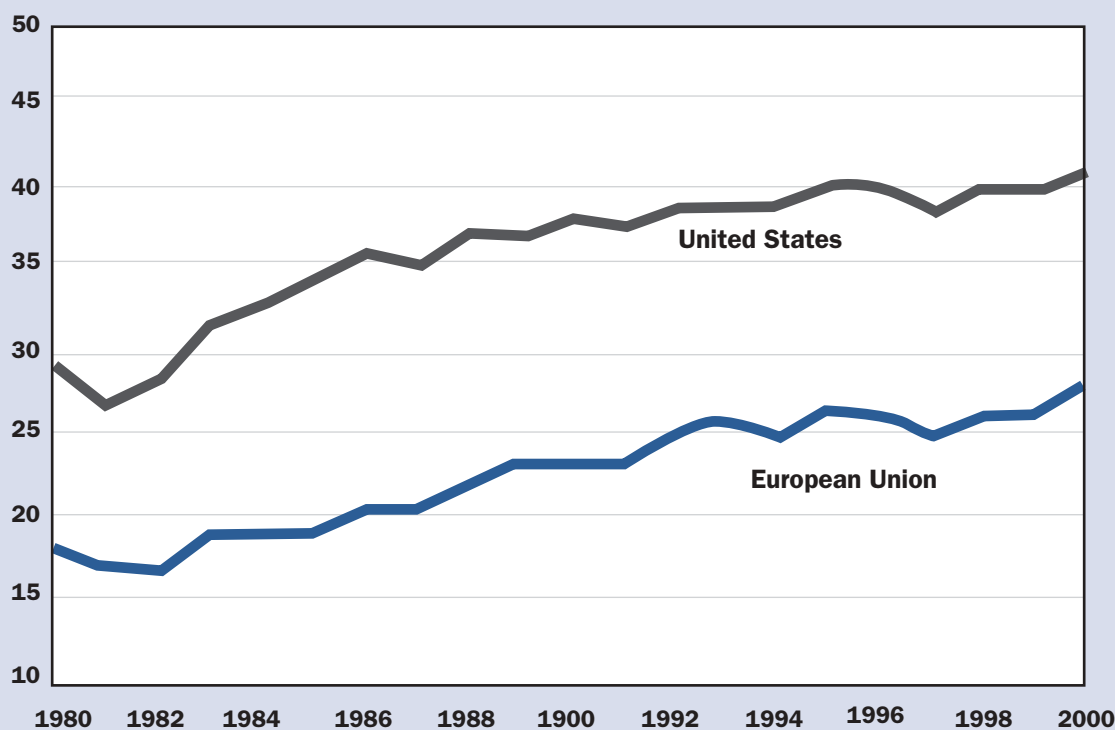
Table 1, from McGuckin and Van Ark (2002), shows how sharply U.S. labor productivity rose in 1995-2000, even though hours worked also increased. The reasons: double-digit growth of investment in productivity-enhancing information and communications technology (IT) in the 1990s and assiduous application of IT by corporate management to business practices.

On the other side of the Atlantic, labor productivity growth in the E.U. declined significantly in the latter half of the 1990s, hours worked were stagnant, and IT investment was languid.

⁸Prior to 1972, U.S. labor productivity averaged around three percent a year. Source: Bureau of Labor Statistics.

FIGURE 1

IT SHARE IN TOTAL EQUIPMENT CAPITAL FLOWS (IN %), EU AND USA, 1980-2000



It is worth noting that between the early 1970s and the mid-1990s, European productivity growth typically exceeded that of the U.S., as business sought to offset high labor costs. Today's big gap in trans-Atlantic productivity growth could mean, however, that the biggest opportunity for significant future improvement of productivity growth is in Europe, not the U.S. Moreover, if it turns out that U.S. business over-invested in IT in the 1990s, leaving a difficult-to-adjust capital stock overhang or if future economic and corporate profits growth are stunted by Enronitis, capital spending may weaken enough to cause productivity growth to stagnate. If there were to be signs that Europe might narrow the productivity gap over the medium-term, investors would undoubtedly invest more in Europe—reducing the capital flow to the U.S.

Other Issues

Productivity will be the key to the *relative* economic growth outlook for the U.S. and the euro area over the next economic cycle. Euro area GDP growth averaged 2.5 percent in 1995-2000, nearly two percentage points less than the U.S. But the long-term (1970-to-2000) differential averaged only 0.7 percent. Today, I see the European

Union in a position similar to that of the U.S. in the early 1990s, with powerful incentives to invest more in IT-driven productivity: an inadequate capital stock, high social and labor costs, a declining workweek, and ageing population. For the venturesome investor, Europe may be, eventually, a better growth opportunity than the U.S.

A new consideration facing would-be investors in the U.S. is the sharp deterioration in the U.S. net international investment position, a counterpart of the C/A deficit and capital inflow. Total foreign-owned assets in the U.S. (with direct investment positions calculated at current cost) soared from \$569 billion (eleven percent of nominal GDP) in 1980 to \$8.14 trillion, or eighty percent of GDP, in 2001. The net investment position, U.S. assets abroad minus foreign investment here, deteriorated from a peak surplus of \$360.8 billion in 1980, to a \$1.94 trillion deficit in 2001. Net investment income thus deteriorated from a long-time surplus to a \$19 billion deficit in 2001, and will worsen.⁹

Current U.S. policies may worry foreign investors. Once-virtuous fiscal policy and the federal surplus have

⁹Source: U.S. International Transactions Data, Bureau of Economic Analysis.

disappeared with slower economic growth and the tax cuts enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001. Together with the sharp rise in post-9/11 spending, these fiscal factors point to a FY2002 deficit that is now forecast at \$165 billion by the administration, with deficits in the out years. This new situation will make additional fiscal stimulus problematical if economic growth proves to be weaker than expected over the next few quarters.

There is concern that the Fed's ability to stimulate the economy may be limited, like that of the Bank of Japan, since the fed funds rate is only 1.75 percent, the lowest since 1961. Foreign policy is also problematical with the administration reneging on its free trade stance to impose protectionist measures for electoral reasons. Unilateralism in foreign, defense, tax, and trade policy could inhibit foreign investors from expanding their U.S. asset base.

Enronitis, the Market and the Economy

Associated as it is with the equity bear market, "Enronitis" threatens to stunt foreign investment if enough international investors conclude that U.S. corporate management and accounting cannot be trusted. Given the magnitude of our borrowing requirement, a relatively small reduction of voluntary capital inflows suffices, at the margin, to depress the dollar. Its decline since February is evidence that foreign investors are already reacting to dramatic losses in their U.S. equity holdings.¹⁰

The bear market's potential impact on the economic outlook, hence future corporate earnings and the ROR on their U.S. assets, is a serious concern to investors. One measure of the equity market's economic significance is the ratio of total stock market capitalization to nominal GDP. From a ratio of 46 percent of GDP in 1990, total market cap soared to 175 percent at the market peak in March 2000.¹¹ Never before was the equity market so disproportionately large relative to the economy, nor in policymakers' thinking.

Fed Chairman Alan Greenspan famously warned about "irrational exuberance" on December 5, 1996 when the ratio stood at a relatively high ninety-five percent.¹²

¹⁰I recognize that international investors have experienced losses in European equity markets similar to those in the U.S. since March 2000, meaning that their trans-Atlantic diversification has not protected them very much.

¹¹Source: Salomon Smith Barney's Broad Market Index, which measures daily the value of all listed U.S. equities of over \$100 million in market capitalization. On March 24, 2000, the BMI index measured a total of \$17.29 trillion which compared with the 2000 nominal GDP of \$9.87 trillion.

¹²Chairman Greenspan made the speech on December 5, 1996 to the American Enterprise Institute in Washington, D.C.

Because of the Asian, Russian and Long Term Capital Management crises, the Fed lowered the fed funds rate by seventy-five basis points in the ensuing two-and-a-half years, extending the economic boom and bull market that caused the ratio to nearly double from the "irrational" level in 1996. U.S. equity market capitalization hit its all-time high on March 24, 2000 of \$17.2 trillion (using the broadest measure). When the fed funds rate reached six percent in April 2000, the Internet bubble began to implode, followed by the telecoms and technology sectors. Since then, the broad indices of the U.S. equity market have plunged over forty percent, eliminating some \$7 trillion of paper wealth—equivalent to about seventy percent of U.S. nominal GDP.¹³ The market cap-to-GDP ratio has more than halved, a huge potential negative wealth effect.

Largely overlooked in Greenspan's "irrational exuberance" speech was another warning applicable to today. "But what about future prices or more importantly prices of claims on future goods and services, like equities, real estate, or other earning assets?" he asked. "Are stability of these prices essential to the stability of the economy? Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

"We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance sheets generally, and in asset prices particularly, must be an integral part of the development of monetary policy," he warned.

Can It Get Worse?

The equity market, although dramatically down from its March 2000 peak, still faces some daunting problems. Continuing revelations about corporate accounting and management ethics, the laxity of public regulators, and doubt about the adequacy of the public policy response, all suggest that Greenspan's diagnosis of "infectious greed" in the go-go years, and its current consequences,

¹³Current dollar U.S. GDP based on the average of the four quarters 2Q2001-1Q2002.

FIGURE 2

S&P STOCK PRICE INDEX 1883-2002, 2002 DOLLARS (1)—MONTHLY



may take a while to be corrected. If so, disillusioned investors could continue shifting from equities to safer asset classes.

Although as of September 2002, the S&P 500 index was down about forty percent from its 2000 peak, the index's price-to-earnings ratio was still around eighteen (based on reported earnings), well down from an average of twenty-five in the 1990s but still above its historical (1950-1999) average of fourteen. To return to that long-term P/E, the S&P 500 would have to drop another twenty to twenty-five percent.¹⁴

History suggests this is possible. William W. Helman, the retired chief economist of Smith Barney Inc., created Figure 2, which shows the S&P 500, adjusted for inflation since 1885. It shows a 1.7 percent average annual ("real") rise through the 117-year period. But the first three of the four major bull markets, all led by technological breakthroughs, were followed by collapses to well below the 1885-2002 trend line. If the S&P 500 were to repeat this pattern, the index could drop from today's 800 level to around 500, another thirty to forty percent decline—and down two-thirds from the 2000 peak.

Such potential further damage means Greenspan's

1996 warning is apt today because of the possible impact of the equity market's collapse on consumer and business confidence, hence the economy and possibly other asset classes such as real estate—bearing in mind the example of Japan's continuing deflation. As Greenspan reiterated in mid-July Congressional testimony, it is difficult to estimate the effect and consequences of such a negative equity wealth effect on consumer confidence and consumption, residential real estate, and business investment. This is a daunting possibility for investors, as well as consumers and businessmen.

Foreign Trust Fades

From the overseas viewpoint, Enronitis has serious implications for investors' basic faith in U.S. investments. The list of infected companies or under suspicion includes new paradigm symbols of the New Economy such as: Enron, WorldCom, Xerox, Qwest Communications, Adelphia Communications and Tyco International; as well as the likes of Merck, Bristol Meyers Squibb, and Halliburton. The accounting practices of even venerable blue chips such as IBM, GE and money center banks are in question.

U.S. auditing, once synonymous with reliability and the guardian of corporate integrity, is now suspect following Arthur Andersen's downfall, and with it the credibili-

¹⁴The price-to-earnings ratio of the S&P 500 would average around twenty in 2002 if options were fully expensed and second half earnings were unchanged from early September consensus expectations.

ty of audited profits numbers. Financial services and investment firms that engineered and marketed many of the bubble companies and investment products are now being shown to have participated in selling the new paradigm “business models.” These firms may now face a major credibility, if not legal, test. Leading law firms which drew up the legal documents governing most of the dubious transactions involved in Enronitis have yet to be seriously implicated but may be future targets.

Even institutional and individual shareholders, while the principal victims of Enronitis so far, may bear some blame. Their laissez-faire attitude toward corporate accounting during the go-go years may have contributed to the fudge turning to fraud.

Perhaps most serious, investor trust in public regulators such as the SEC, the IRS, the Fed, and others, as well as private regulatory institutions such as the New York Stock Exchange and NASD, has been shaken by their failure to prevent, uncover, and halt Enronitis years ago. The federal government, starting with the permissiveness of the Clinton administration and Congress during the 1990s and continuing with many senior figures of the current administration, clearly lacked the will to prevent the corruption. The current head of the SEC was for years the accounting industry’s lobbyist who fended off increased regulation. The head of President George W. Bush’s multi-agency “financial SWAT team”—created in July to combat corporate corruption—is the Justice Department’s Deputy Attorney General Larry Thompson. Prior to his confirmation in March 2001, he had been a director and head of the audit and compliance committee of Provident Financial Corp., which was obliged to make a \$400 million settlement with the SEC in mid-2001 after allegations of consumer and securities fraud.

Last year, 270 listed companies restated earnings, up from 233 in 2000 and 116 in 1997 (*The New York Times*, 2002). This year’s number will be far higher. Federal securities fraud class-action lawsuits more than doubled last year to 485, two-and-a-half times the average rate since the Private Securities Litigation Reform Act was approved in 1995.¹⁵ More can be expected.

The Bottom Line

Traditional foreign trust in the U.S. investment envi-

¹⁵Source: The Securities Class Action Clearinghouse provides detailed information relating to the prosecution, defense, and settlement of federal class action securities fraud litigation. The Clearinghouse maintains an Index of Filings of 1,538 issuers that have been named in federal class action securities fraud lawsuits since passage of the Private Securities Litigation Reform Act of 1995. The Clearinghouse also contains copies of more than 2000 complaints, briefs, filings, and other litigation-related materials filed in these cases.

ronment is frayed today, just when the U.S. deficit requires more foreign financing than ever before. The foundations of investment confidence—corporate governance, accountancy, the legal profession, financial-investment services, banking, public-private regulators, and policy-makers—no longer have the credibility they once had.

Such a fundamental loss of investor confidence is rare. One must look back to the early 1930s to find such a dramatic reversal. There is, however, a crucial difference. Today the United States requires more foreign savings to finance the C/A deficit than ever before. Foreigner investors have already slowed their lending. Net FDI decelerated from a peak \$384 billion annual rate inflow in 2Q2000 to \$102 billion by 1Q2002 and net foreign purchases of non-Treasury securities are off from a \$455 billion rate to \$281 billion in 1Q2002. If Enronitis and its consequences continue to slow the foreign capital inflow, the dollar will decline further.

The principal risks seem to me two-fold: 1) that public policymakers and corporate management fail to restore investor confidence soon enough; and/or 2) economic, profit, and asset price growth fail to restore a competitive rate of return on U.S. assets over the next year. Alternatively, if (admittedly a big IF) Europe and Japan were to improve their trend productivity growth and make other structural reforms during this period of U.S. troubles, euro- and yen-dominated assets would become relatively more attractive, further reducing foreign financing of the U.S. external deficit and adding to pressure on the dollar. The odds are against this happening soon.¹⁶

In conclusion, I think current U.S. problems make the dollar more vulnerable than at any time since its long-term peak in 1985. Dollar weakness could last until foreign investors perceive Enronitis is being adequately treated, and that growth of the U.S. economy and financial asset prices will again outperform those of Europe and Japan. Or until the U.S. payments deficit is reduced by less consumption, increased savings, and more investment in productivity.

Albert Merlin: American Capitalism Will Survive—A French Point of View

Why Panic?

At the beginning of the 1960s, Jacques Rueff, then General de Gaulle’s much respected advisor, never stopped

¹⁶I recognize that foreign central banks will always need additional dollars in foreign exchange reserves to enable their citizens and businesses to acquire products, services and assets from the U.S. or the dollar zone. The U.S. C/A is thus unlikely to ever be in equilibrium. But foreign central bank demand for dollars is several magnitudes less than the U.S. foreign borrowing requirement today.

criticizing the inter-war Gold Exchange Standard (under which the United States promised to exchange a fixed amount of gold for dollars). This system allowed the United States, he said, to accumulate deficits irresponsibly.

He attributed this advantage to two factors. First, the U.S. was the country issuing the world's principal international currency. Second, there was strong demand for dollars because of other countries' need to buy American capital equipment and technology.

The system was abnormal, Rueff complained. At some point, the United States must, like any other country, correct its balance of payments. To do that, he thought, would require ending the Gold Exchange Standard and a return to the old gold standard.

Since then, many things have changed in the world. However, the paradox denounced by Rueff remains, and in some ways, has even been accentuated. The balance of payments deficit now includes a trade deficit, which was not the case forty years ago. Moreover, U.S. external indebtedness continued to increase, and yet that did not prevent the dollar from remaining ensconced on its pedestal up to the beginning of this year. Has anything changed?

Of course, the American balance of payments deficit is today criticized not only by economists. It is also judged by the foreign exchange market's fluctuations, which have far more impact than economists' chatter. Thus, the dollar is depreciating today, a decline being aggravated by the new factor roiling the body politic, which Paul Horne calls "Enronitis." Its disastrously negative effects on investors' morale cannot be denied. Does it mean, however, that the party is over; that we are at the beginning of a long period of dollar weakness or even, as some suggest, at the start of an inescapable decline of the American economy?

Probably not. To start with the short-term, we must not neglect purely mechanical aspects, notably the role of short-term interest rates. No one can deny the correlation between the massive decline of interest rates in the United States since last year and the dollar's subsequent depreciation. With the Fed reluctant to raise its 1.75 percent fed funds rate and the European Central Bank maintaining its 3.25 percent refinancing rate, it is easy to see why short-term investors prefer the Old Continent. At least for the moment!

Next, we must not forget that the U.S. C/A deficit is not like that of other countries, since a growing share of international trade between companies occurs on an intra-corporate basis in the large multinational industrial groups. When an American group imports raw materials or semi-finished products from this or that Asian country, the transaction occurs *en famille*, in the same monetary

zone: the dollar zone. This means that there is no increase in the U.S. external indebtedness in the usual sense.

Last and most important, one should not extrapolate too much from the market's latest moods. The stability of a currency must be judged on a long-term basis, considering the strengths and weaknesses of the underlying economy and those of competing economies and currencies.

Who are the possible challengers to the dollar in the medium term? Japan? Possibly, but only when that country has recovered a semblance of economic health. And that will not happen any time soon. Europe? No doubt a major rival, but only when it overcomes its two major weaknesses: its technological backwardness and its inability to date to create workable E.U. political institutions. Single currency or not, Europe remains politically weak.

Enronitis or not, my conclusion is that America is bound to keep its lead for the next few years. Below, I present why I believe this.

The American Advantage in Technology

Just what is the technological advantage of the United States? The most evident is the accumulated capital stock, notably in IT. No one seriously denies this structural lead, even if it is difficult to measure precisely. In a detailed study published in February 2000, Morgan Stanley estimated that Europe's IT capital stock was equal to that of the United States in 1992 (Morgan Stanley, 2000). It noted that the European gap was somewhat smaller in telecommunications but a bit larger in information technology.

Who are the possible challengers to the dollar in the medium term?

Europe will catch up, its partisans claim. Maybe. But how long will it take? Between 1992 and 1999, IT's weight, (as a percent of GDP), moved from 4.6 percent to 4.9 percent in Germany and from 4.9 percent to 4.8 percent in France. In the United States, it rose from 5.9 percent to 7.2 percent of GDP ("Revue de l'Institut Rexecode," 2002). Net private investment in IT between 1992 and 1999 rose from 2.6 percent to 4.6 percent of GDP in the United States and from 1.8 percent to 2.4 percent in the European Union. Given the stark contrast between the dynamism of investment in America and Europe's pathetic flabbiness in recent years, all evidence leads us to believe that the trans-Atlantic IT gap probably widened further after 1999, at least until 2001.

To complete the picture, compare productivity in the

two regions. The Conference Board compared the two in the 1990s, based on OECD data (The Conference Board, 2002). Using output per hour worked, the E.U.'s performance was not too scandalously bad. It was only thirteen percent less than that of the U.S. over the decade. But the output per inhabitant was an entirely different story. Table 2 shows that the European Union produced only sixty-seven percent of the American rate. This was because working hours per employee were 12.1 percent lower in the European Union and the number of employed persons per capita was 8.2 percent smaller. It is clear that Europeans work less than Americans. Taking into account differences in the legal framework and social behavior, this fundamental difference between European and the U.S. work habits is not about to change.

So much for the quantitative aspects. But the superiority of American companies is tied to yet another factor: the way in which they utilize their high tech capital stock. In a recent presentation to the Conference Board Europe, Professor Bart van Ark of the universities of Groningen (The Netherlands) and Yale, showed several studies that demonstrated the crucial role of “intangible” investments

will take time for Europe to catch up. As we say in France: “No photo-finish in this race.” But is the U.S. lead in IT enough to assure dollar strength in the medium term? Perhaps not. But several other factors strengthen the case for the U.S. currency.

Demographic Dynamism

The American demographic advantage is not often mentioned in this debate, but it is crucial and not purely quantitative. Comparative data show trans-Atlantic population trends to be unambiguously divergent. In the European Union over the next decade, the World Bank predicts the working age population will stagnate, if not decline by 0.1 percent to 0.2 percent a year. In the United States, the Department of Labor's Bureau of Labor Statistics expects the working age population to expand by one percent a year. Everything else being equal, this means the demographic trend guarantees the Americans will enjoy annual economic growth one percent or more faster than that of Europe.

In fact, this demographic arithmetic is misleading, because what really counts is a young population as in the

United States with a high proportion of youth (a result of the baby boom and immigration), which provides a greater degree of flexibility in national manpower resources. To switch one's line of work, to change domicile, to adapt to new technologies, there is nothing

better than a young population eager to learn and go to work.

The situation is completely different in Europe where every country has an ageing population. This demographic reality has serious financial consequences, notably how to pay future retirement benefits with the current public, pay-as-you-go social security systems. Europe is not sufficiently conscious of the consequences of its demographic situation on economic growth and productivity. Europe's labor force is a major source of rigidity, as is Europeans' attachment to their social safety net.

Comparing maps of the two areas, one is struck by what is clearly a new country to the west, and an old continent to the east where the percentage of “rentiers” is

TABLE 2

Country	GDP per hour worked:		Effect of:		GDP per capita:	
	in USD (1996 prices)	As a % of U.S.	working hours	employment/ population	in USD	As % of U.S.
United States	36.97	100.00	0.00	0.00	\$33,538	100.00
OECD ex-U.S.	24.87	67.30	-2.80	-8.40	\$18,818	56.10
Japan	26.64	72.10	-2.70	+3.00	\$24,267	72.40
European Union (15)	32.30	87.40	-12.10	-8.20	\$22,511	67.10

Source: The Conference Board, based on OECD data

in which organizational qualities played a leading part (Conference Board, 2002).

Even assuming Americans and Europeans had the same capital stock, Van Ark maintains that the Americans would produce better results. This is because they profit from technological advances in a methodical and organized fashion. The improved performance of one division in a company, for instance, is systematically passed on to the firm's other divisions. This “spillover” approach to disseminating IT-based productivity gains is much more intensively applied in the United States than in Europe.

At the technological level, American supremacy is incontestable and has been re-enforced in recent years. It

growing every year. It is obvious that the United States is a consumer of capital and that Europe is a supplier of it. European savers, it is true, made a major contribution to financing American innovation and investment. The demographic outlook suggests that this trend will continue, although perhaps not indefinitely.

America's Institutions Trump Divided Europe's

The technologically powerful United States, propelled by a dynamic demographic wave, has yet another advantage relative to Europe. Its development is based on an institutional system and economic policies that are generally efficient despite the many faults attributed to them. In particular, the duo represented by the Executive Branch and the Federal Reserve is an example of a "good division of labor" that is unmatched over the long term, albeit with ups and downs.

The European Union, on the other hand, is having great difficulty creating its own institutions to define European economic policy on which policymakers could base their strategy. The European Central Bank in Frankfurt is mandated only to maintain price stability by acting on interest rates. The European Union Commission and European Parliament have only limited influence on budgetary policy. Commission efforts to use the E.U.'s "Fiscal Stability Pact" to limit country deficits have been controversial with member governments.

the influence of European scientists remains abnormally low. The situation is summarized in Table 3.

There are other, even more worrying factors. Not only does Europe fail to exploit fully potential economies of scale, but bickering over pan-European scientific, defense and industrial projects is frequent. For example, in the aviation and aerospace industries, the relatively pain-free creation of the EADS holding company for production and marketing of the Airbus and military aircraft did not halt quarreling between France and Germany, EAD's principal partners.

There is also the curious position of European Union Competition Commissioner Mario Monti, whose totally rigorous views on competition block company mergers that would allow European industry to respond to the American challenge. The E.U.'s first major step forward was the single currency, but it succeeded only by dint of the sheer political stubbornness of a few European leaders, none of whom are in office today. Now Europe dithers on how to move ahead on enlargement and institutional reform.

Confidence Will Return

Then there is, of course, the troubled climate of today's markets, the panicky gloom on Wall Street and the profound disillusionment of international investors following Enron, Arthur Andersen, WorldCom, and many other scandals. The shock is such that it is logical to wonder just how profound the psychological trauma is. The markets, as we know, function with that impalpable factor called confidence. Since the initial shock, however, practical decisions were taken. The Sarbanes-Oxley Act looks as if it is a significant reform, requiring personal certification by chief executive officers of their corporate accounts, an audit committee made up of independent auditors, the legal obligation to publish information on all off-balance sheet operations, the creation of a Public Company Accounting Oversight Board to supervise accounting firms, and other stringent requirements. All this will take time to be translated into corporate reality, but these reforms go in the right direction. In Europe there has been no such effort, not to mention approval of any reform legislation.

TABLE 3

RESEARCH AND DEVELOPMENT TRENDS

	Fundamental Research (% of GDP)	Public Sector (% of GDP)	No. of Researchers Per 10,000 Employed	Scientists and Engineers As % of Total Employment
United States	2.7	4.2	80	7.5
Japan	3.1	3.9	97	—
Germany	2.1	1.9	58	4.8
France	2.2	—	60	4.0
United Kingdom	—	1.9	55	7.3
Italy	1.1	1.4	32	2.3
Spain	0.8	1.8	35	3.5

Source: OECD data published in *La Recherche*, April 2002.

At the structural level, efforts to coordinate member countries' research and development (R&D), the key to the trans-Atlantic technology "battle," remain very modest. This area, above all others, is where the European Union should develop a policy based on R&D synergies. European R&D policy efforts to date have been, with the exception of several small countries such as Finland, far less effective than those of the United States. As a result,

In the light of these scandals and the responses to them, must we conclude that American capitalism, which only yesterday was idolized for its creativity, is at risk and that King Dollar will be dethroned? As egregious as Enronitis has been, I think the confidence crisis would have to be far more profound and lasting to wipe out all the objective advantages of the American economy.

Let's look at Enronitis. First, I would emphasize that it has at least one positive aspect: it produced an immediate reaction. In totalitarian regimes, fraud and corruption of all sorts usually remain buried for a long time. Not in the U.S. As Michel David-Weill, French head of the Lazard international investment bank, noted, the execution of Arthur Andersen took only a few weeks. It is clear that justice will not stop there and that the cleaning up operation will continue. That is healthy. France's high profile prosecuting judge, Eva Joly, was known for her courageous attacks on French corruption in high places. She said, "A good financial market is one under surveillance. The sentencing of major figures in the financial world is a sign of vitality. Generally speaking, justice is a valuable ally of capitalism."

Not Condemned To Fail

That said, it will not suffice simply to punish past faults. Ways must be found to avoid the same behavior in the future. This will take some time but it is clear that the corrective mechanism is launched and cannot be stopped, because public opinion demands action. No one contests the need for tightening the regulatory system, as President George W. Bush promised on July 9, 2002, although his pledge was greeted with skepticism for various reasons.

Serious reform may involve delay, but all is relative. As egregious as Enronitis has been, the culprits' behavior has caused little damage to the fundamental strengths of the American real economy. An economic-political system that corrects its excesses is not a system condemned to fail. Quite the contrary. The system just needs a bit of time to correct itself.

The return to ethical behavior in the United States will, in any case, take less time than the closing of the technological and institutional gaps between Europe and the United States. When investors wake up to that reality (and the price-to-earnings ratio in the U.S. market has declined somewhat more), they will regain confidence.

As for the dollar, it will reflect, with some delay, a gradual return to calm normality, although it is always vulnerable to surprise events. On a technical level, I note that the decline of the U.S. currency to parity with the euro as of July 15, 2002, is not abnormal if one uses the concept of purchasing power parity. Virtually all price compar-

isons in recent years show an important gap between the USD:EUR market exchange rate and the rate implied by PPPs. Although the gap has narrowed with dollar depreciation so far this year, the OECD's August 2002 estimate of PPP parities suggested the EUR was worth \$1.13.¹⁷ That does not mean the "correct" exchange rate should be \$1.13 but rather that the current market rate around parity is not extravagantly out of line.

All that, one may object, does not resolve the problem of the disequilibrium between saving and investment in the United States. Granted, it will take time to resolve; but a weaker dollar will obviously help improve the balance of payments. It will be more difficult, however, to formulate and implement policies to boost the savings rate. Washington has all the policy tools one could hope for, but such a fundamental change will depend a great deal on public opinion. After the "Wild Years" of the 1990s, Americans must eventually understand the need to return to reason.

The Current Crisis is Serious but not Desperate

In view of the current bear market environment, my view may seem extremely optimistic about American prospects. As we say in France: the current crisis is serious but not desperate. Nor will it end tomorrow. Nor will we see, any time soon, the rate of return on invested capital recover to fifteen percent-to-twenty percent, a chimera that belongs to the past. In fact, Wall Street's current capitalization suggests that the market decline is not yet over.

That market participants are very sensitive to today's bad climate, and too focused on short-term signals, is entirely understandable. But economists should not act the same way. In fact, we should expect a bit of sang-froid from business economists . . . even if that is a Sisyphian task.

I object most of all to the idea (not yet consensus but spreading rapidly) that the current problems foreshadow a decline of the American economy relative to Europe. This seems totally improbable, given the gap separating the two continents that I have discussed. ■

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¹⁷The OECD estimates and publishes purchasing power parities each year by comparing baskets of the same goods and services in major currency countries.

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