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The Transatlantic Economy in 2018: Cyclically Strong, but Structurally and Politically Challenged

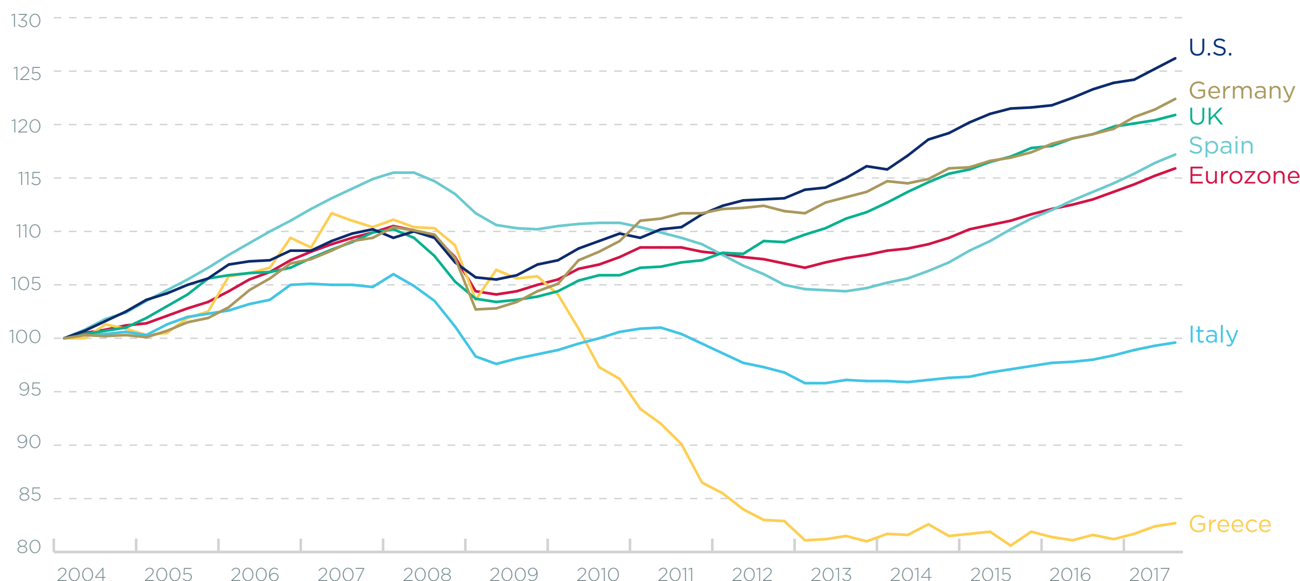
The transatlantic economy is powering ahead

Economics trumped politics in 2017. Transatlantic trade and investment ties thickened over the past year, despite a whirlwind of political uncertainty, ranging from unsettling presidential tweets and frosty "Brexit" negotiations to protracted coalition negotiations in Germany and the growing divide between the European Union and its eastern member states Poland and Hungary. Political drama and charges of "fake news" have stolen the headlines. But the real news is that the transatlantic economy is powering ahead.

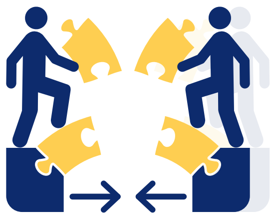
The transatlantic economy enters 2018 amidst a synchronized global economic expansion. For the first time in roughly a decade, since the 2008 financial crisis, all major economic regions of the world are expanding – including the perennial global laggard, the European Union (EU). According to figures from Eurostat, economic growth in the euro area accelerated to 2.5% in 2017 from 1.8% in 2016, with most nations across Europe experiencing an uptick in activity over the past twelve months. Even Greece emerged from recession, posting year-over-year growth of 1.3% in Q3 2017. Both Germany and the Netherlands posted healthy growth figures, while the United Kingdom, in the shadows of "Brexit," lagged behind. The UK was the outlier to Europe's improving economic backdrop last year, while, in contrast, the bulk of nations in the EU benefited from easy monetary policies, a rebound in consumption, accelerating capital expenditures, and solid export growth. This forward momentum has carried over to 2018, with the IMF projecting +2% or higher growth in the eurozone again this year.

In the United States, one of the longest economic expansions in modern history continues, with the economy expanding by 2.3% in 2017. This figure, however, masks the fact that in Q2 and Q3 of 2017, the economy expanded at annualized growth rates in excess of 3%. The notion of "secular stagnation," or the United States remaining stuck in a subpar 2% slow growth mode, is being rethought. As 2018 began, the U.S. economy was firing on all cylinders, with growth underpinned by solid consumer spending, a revival in capital spending, rising exports due to stronger global demand and a weaker U.S. dollar, and reflationary policies (i.e., tax reform) coming out of Washington.

Table 1 Most Developed Economies Back Above Pre-Recession Output Levels (Real GDP level, Q1 2004 = 100)



Source: Haver Analytics.
Data through Q3 2017.



Transatlantic gaps in growth, employment and trade have narrowed

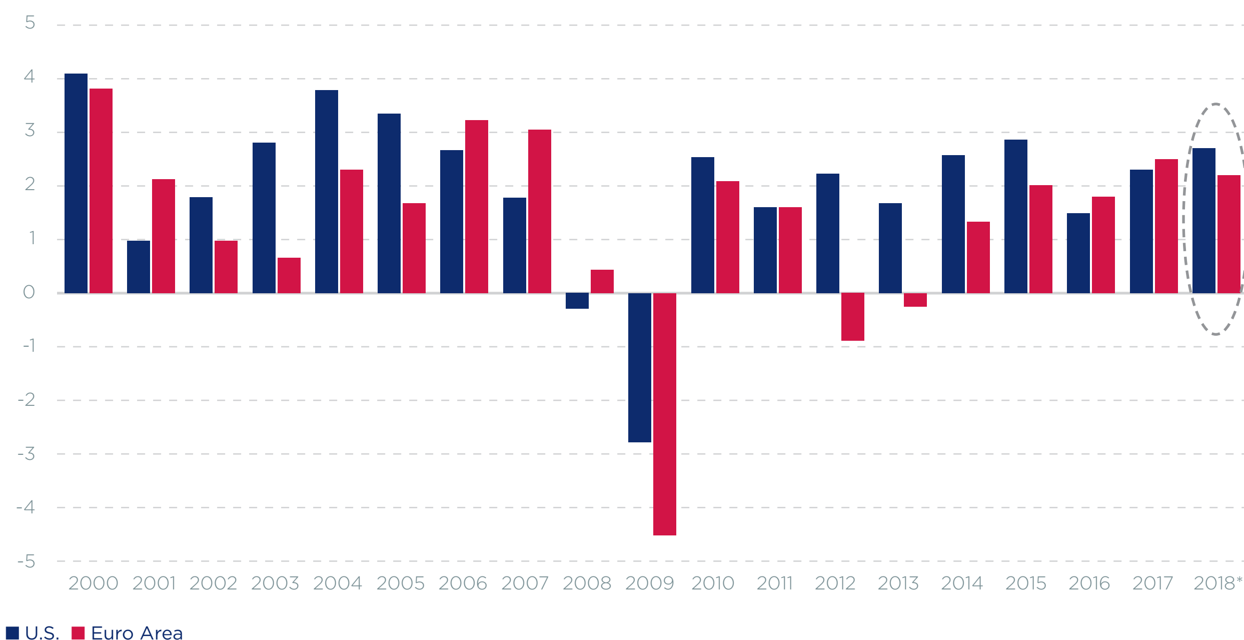
Given all of the above, the U.S. economy has broken free from secular stagnation and is expected to expand by 2.5-3% this year, one of the strongest levels of growth in years. Against this backdrop, the U.S. unemployment rate is expected to drop below 4% this year, with rising wages against a tight labor market a key challenge for U.S. firms. Labor shortages have also emerged in parts of Europe (most notably Germany), with the eurozone unemployment rate dropping to 8.7% in November 2017, one of the lowest levels in years. In Germany, the level of unemployment stands at a multiple year low (3.6%). Across the EU last year, there was a discernible decline in national unemployment rates, with further improvements expected in 2018.

Thanks to accelerating economic growth on both sides of the pond, the transatlantic gaps in growth and employment we highlighted in last year's survey have narrowed. So too, to a degree, has the U.S.-EU trade gap. After widening significantly over most of the post-crisis era, the U.S. merchandise trade gap with the European Union in 2017 narrowed slightly from the prior year. U.S. merchandise exports to the European Union—after declining in 2015 and 2016—rose by an estimated 5% for the year, to a record $284 billion. Notably strong export markets for U.S. goods in 2017 included Germany, with U.S. exports up 8% in the first eleven months of the year, France (+10%), and Ireland (+9%). U.S. imports from the EU rose by less than exports, or by 3.3% for the year, helping to narrow (albeit slightly) the U.S. annual merchandise trade deficit with the EU. Last year's gap, estimated at $146 billion for all of 2017, was down 6% from the peak deficit of 2015.

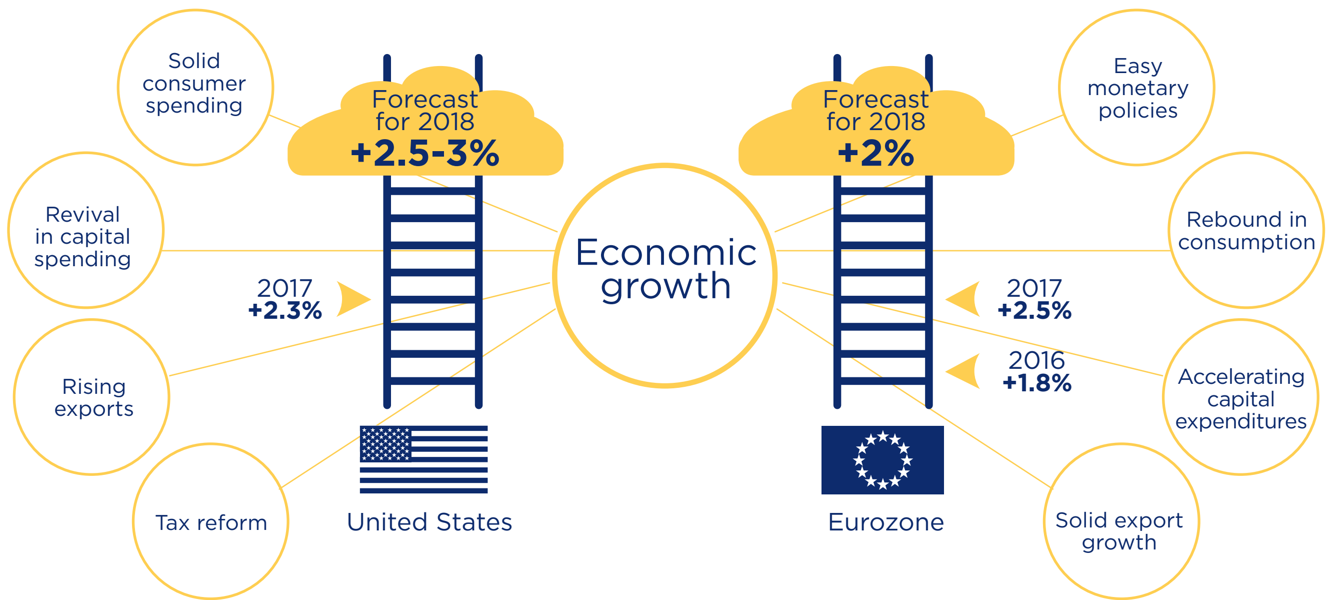
Here's the key point: while far from being anywhere near equilibrium, transatlantic trade is in the process of being rebalanced, thanks in large part to a weaker U.S. dollar and the cyclical rebound in EU economic growth.

Meanwhile, transatlantic trade still stands as one of the largest such relationships in the world, even when compared to America's trade ties with China. In the first eleven months of 2017, U.S. goods exports to the EU ($259 billion) were more than double U.S. goods exports to China ($117 billion). Only Canada, due to NAFTA, consumed slightly more U.S. exports than the EU (also about $259 billion in the first eleven months of 2017). Moreover, it is important to keep in mind that U.S.-China trade relations are heavily skewed, favoring a Chinese merchandise trade surplus that hit a record $371 billion in 2017,

Table 2 U.S. vs. Euro Area Real GDP, Real GDP, Annual Percent Change



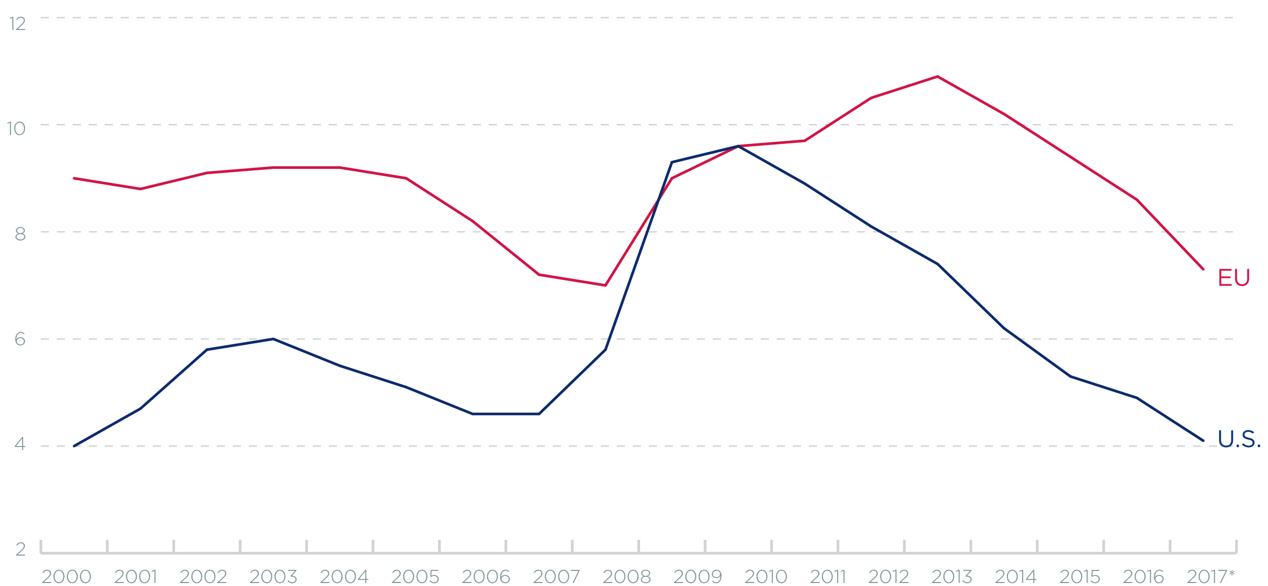
** 2018 forecast.*
Data as of January 2018.
Sources: International Monetary Fund; Eurostat; Bureau of Economic Analysis.



according to estimates, more than double America's merchandise trade deficit with the European Union.

In sum, nearly a decade after the global economic meltdown of 2008/09, the transatlantic economy is not only on the mend, it is gathering strength and momentum. Nonetheless, not only is there still a great deal of work to be done to strengthen bilateral ties, there is considerable uncertainty as to where the partnership is headed. Globalization—or the unfettered cross-border flows of goods, services, people, and data—is no longer a given. Each side of the Atlantic is facing strong currents of populist nationalism that could undermine support for open borders and trade, as well as for the primary institutions of the post-war era, including the WTO, the IMF and other multilateral institutions. The challenge for policy makers is to make the most of today's economic good times to create a more supportive and sustainable transatlantic economic partnership for the future.

Table 3 U.S. vs. EU Unemployment Rate Harmonized Unemployment Rate (%)



**2017 EU data is for November 2017, U.S. data is for December 2017.*
Source: OECD.

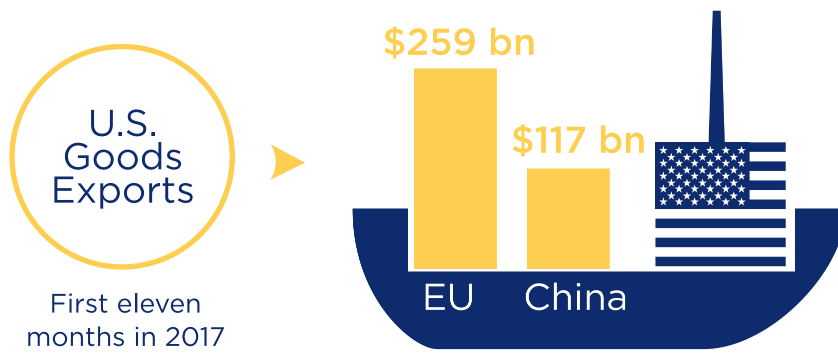
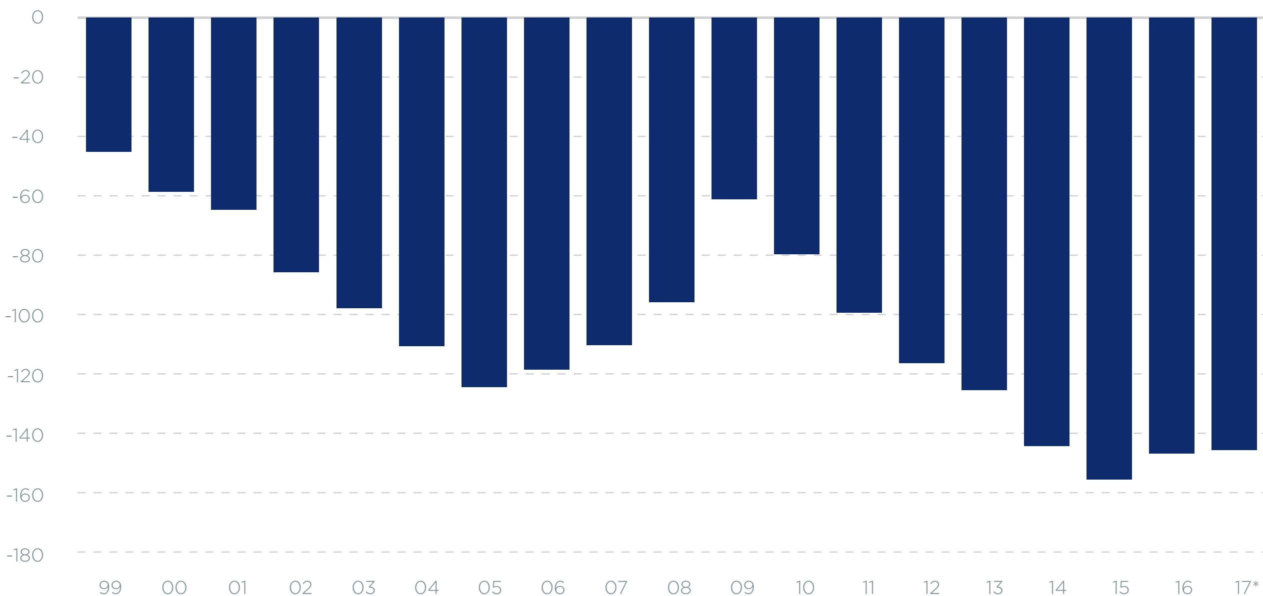


Table 4 U.S. Merchandise Trade Balance with the EU (Billions of $)



**2017 Estimate.*
Source: United States Census Bureau.

Brexit: Crunch Time

The transatlantic economy remains strong but has fault lines, with the decision by the United Kingdom to quit the European Union ("Brexit") among the largest and most dangerous. It is unclear whether or not the two parties will settle for a "hard" or "soft" Brexit, but some knock-on effects of the impending divorce are already apparent. For instance, in contrast to much of Europe, the British economy slowed markedly in 2017, weighed down by weaker private consumption owing in part to the pound's depreciation and the attendant rise in inflation and loss of real disposable income. Meanwhile, EU institutions based in the UK have announced plans to decamp for other parts of Europe. Real estate prices have weakened, while U.S. foreign direct investment flows to the UK plunged by over 50% in the first three quarters of 2017 versus the same period a year earlier.

The cloud of uncertainty that hangs over the United Kingdom is depressing business and consumer confidence. 2018 is the Brexit crunch year when it comes to UK-EU negotiations, and there is little to expect in the way of upside surprises. Brexit is due to happen on March 30, 2019, which means an agreement on the separation must be in place by late 2018, if not sooner. Negotiations on many key parts of the divorce have yet to start, which implies a great deal of headline risk between the UK and EU this year.

The UK must not only negotiate its exit from the EU, it will also have to do three things that will affect U.S. and wider European economic interests. First, it will have to replace the EU's common external tariff with its own customs tariff, and will also need to submit new tariff commitments for goods and services at the World Trade Organization. Second, it will negotiate new trade arrangements between

the UK and the EU27. Third, it will want to negotiate new trade arrangements with the United States and Canada, as well as many other non-EU states.

As we have noted in the past, a future UK-EU trade framework is unlikely to simply replicate UK access to the Single Market. The terms are likely to be less advantageous and more burdensome. While tariff-free access for goods is a possibility, firms based in the UK are likely to face some local content requirements within the EU. Tariff-free access to services is unlikely as well, which represents a blow to the UK's service-based economy. All of this poses considerable risk for UK financial, transportation, logistics and insurance companies.

Meanwhile, EU rules mean that London cannot legally begin negotiating a trade deal with Washington before the UK leaves the EU, which at the earliest is March 2019. In addition, with U.S.-UK relations notably strained under the Trump administration, no deal is likely anytime soon, which portends more U.S. disinvestment from the one-time prime location for U.S. multinationals doing business in the EU.

After the Netherlands, America's corporate stakes in the United Kingdom are among the deepest in the world. Totaling $682 billion in 2016, the last year of available data, America's capital stock in the UK is more than double the combined U.S. investment in South America, the Middle East and Africa ($235 billion). Total U.S. investment stock in China was just $92 billion in 2016, only about 14% of U.S. investment stock in the United Kingdom. Even when the U.S. investment presence in China and India are combined—totaling $125 billion in 2016—the figure is just 18% of total U.S. investment in the UK.

Wealthy consumers, respect for the rule of law, the ease of doing business, credible institutions, membership in the European Union—all of these factors, and more, have long made the UK a more attractive place to do business for American firms. Whatever the metric—total assets, R&D expenditures, foreign affiliate sales, employment, trade, etc.—the United Kingdom has been a long-time pillar of America's global economic infrastructure and a key hub for the global competitiveness of U.S. companies. Since 2000, the UK has accounted for nearly 10% of the cumulative global income of U.S. affiliates, a proxy for global earnings. In the first nine months of 2017, however, U.S. affiliate income earned in the UK was flat from the same period a year earlier, whereas for the EU as a whole it was up 6%.

In the end, Brexit is likely to prove costly to the United Kingdom. Very early signs suggest that the impending separation will weigh on real economic growth, diminish consumer and business confidence, spur disinvestment from foreign investors, and trigger bouts of political instability as the May government navigates this tumultuous backdrop. That said, the cost to U.S. multinationals remains unclear. Firms are hedging their positions in the UK by exploring alternative locations in the European Union, with Germany, France and Ireland among the favored locations for post-UK investment.

A deeper issue for U.S. and European firms alike, however, is the future nature of the transatlantic economy and the future path of the transatlantic partnership. Political bonds are fraying on both sides of the North Atlantic, portending tougher times when it comes to promoting deeper transatlantic investment and trade ties. "We used to operate under the idea that Western markets are politically stable, while we accepted that frontier markets were risky," notes Martin Scheepbouwer, chief executive officer of the OLX Group. "Nowadays, with Brexit in Europe and the presidency of the United States, there's a new level of instability looming over the economy. That's something that concerns us."[1]

In Box 1 we chart potential ways to navigate the turbulence.

Box 1. Navigating Transatlantic Turbulence

For decades the partnership between North America and Europe has been a steady anchor in a world of rapid change. Today, however, even as the transatlantic economy revives, the transatlantic political partnership has become unsettled and uncertain.

Moreover, despite some economic bright spots, voters across the United States and many parts of Europe have grown skeptical of open markets. Concerns about stagnant wages, widening income inequality, and pockets of stubbornly high unemployment have combined with fears of automation, digitization and immigration to swell economic insecurities on each side of the Atlantic.

This state of division and mutual inwardness threatens the prosperity and ultimately the position of North America and Europe in the global economy and the broader global security system.

Opportunities may still be within reach. U.S. President Donald Trump has campaigned hard against what he calls “disastrous trade deals” in Asia and North America. When it comes to economic negotiations with Europe, however, the Trump Administration has been cautiously positive. European officials have been equally tentative, yet open, to resuming negotiations with the United States on an ambitious transatlantic economic compact, “when the time is right.”

Different options could be considered.[2] Each of them offers both gains and pains. The time to choose may not yet be at hand, but, most importantly, they provide opportunities to think through some of the ways forward for the United States and Europe.

Deep Freeze: The Road to Nowhere

One option is to keep transatlantic negotiations where they are now: in the deep freeze. This approach would simply recognize that for the foreseeable future the obstacles are too high, and the incentives too low, for either side of the Atlantic to invest much political capital in any major transatlantic economic initiative. Small single-issue deals might emerge, but nothing substantial. Given current inertia and mutual distractions on each side of the Atlantic, this is likely to be the default scenario for the relationship going forward.

Cherry-Picking

The United States and the EU could choose a middle path between the Deep Freeze and ambitious negotiations. Under this path, the two parties would abandon efforts to strike a comprehensive TTIP deal in favor of “cherry-picking” wins on issues where both sides were already close to agreement within the TTIP framework, or on other issues where agreement seems high and opposition seems low.

Three possible examples of such areas are:
- The United States and the EU could commit to work jointly towards a tariff-only free trade agreement, eliminating all duties on traded industrial and agricultural products.
- Both sides have already identified steps to reduce unnecessarily burdensome requirements and delays at each other's borders, which could support small companies on both sides.
- In the area of regulatory cooperation, U.S. and EU officials have already found common ground on a number of important good regulatory practices and could be further explored.

TTIP 2.0

A possible third option would be to resume TTIP negotiations, albeit with some modifications and improvements. The economic and strategic rationale for an agreement between the world's two largest advanced industrial economies has only grown stronger since TTIP negotiations began in 2013. TTIP has the potential to increase the trade and investment flows that fuel economies and support high-quality jobs on both sides of the Atlantic. It would be the largest mega-regional agreement in history. It would not be just another free trade agreement, it would pioneer new ways the two major democratic actors in the global economy could address costly frictions generated via their deep commercial integration by aligning regulations, opening services, and setting benchmarks for high-quality global norms and rules.

An Alternative Path: The North Atlantic Marketplace

Under this path, leaders would set forth a more compelling narrative about the need to create a North Atlantic Marketplace that boosts jobs and growth in ways that can ensure that the North Atlantic remains a rule-maker, rather than a rule-taker, for the global economy. The North Atlantic Marketplace would advance an activist agenda instead of falling prey to "deep freeze" inertia. It would be high-profile politics, not low-profile "cherry picking."

The goal of a North Atlantic Marketplace by 2025 would not be to negotiate yet another preferential "free trade agreement;" it would be framed by a more politically relevant series of bilateral Jobs And Growth Agreements (JAGA), a discrete set of principles and tailored contractual undertakings, agreed by sovereign signatory parties, to advance strategies, together or in parallel, to promote jobs and growth. Instead of focusing primarily on complicated and drawn-out processes of regulatory convergence, JAGA signatories would seek out practical areas where progress could be made in relatively short time. JAGAs could include, but go beyond, U.S.-EU arrangements to also encompass non-EU countries such as (soon) the UK, as well as Norway, Switzerland, and Turkey.

Endnotes

1 Cited in Peter S. Goodman, "Every One of the World's Big Economies is Now Growing," *New York Times*, January 27, 2018.
2 For greater detail, see Daniel S. Hamilton, *Creating a North Atlantic Marketplace for Jobs and Growth: Three Paths, One Detour, A U-Turn, and the Road to Nowhere* (Washington, DC: Center for Transatlantic Relations, 2018).