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The Transatlantic Economy: Fraught Politics, Fragile Economics

Economic uncertainty
Slowdown in global growth

Politics trumped economics in 2018 and threatens to do so again in 2019. Transatlantic trade and investment flows have been buffeted and unsettled by the Trump Administration's "America First" mantle and its attendant assertive trade and investment policies. Uncertainties over the United Kingdom's decision to leave the European Union (EU), known as Brexit, loom large in 2019. Political fissures have wrought economic damage across a number of continental European countries. All of these issues, in the context of a cyclical slowdown in global growth, are testing the resilience and strength of the transatlantic economy – still the most significant commercial artery for both sides of the North Atlantic.

The Trump team's primary target is China, not Europe. Yet Europe has not been able to escape the negative shocks from simmering U.S.-China trade disputes. One consequence of U.S. imposition of steel tariffs, for instance, was to divert steel from China and other countries to Europe, forcing the EU to impose its own set of restrictions.

The EU shares many of the Trump team's frustrations with Chinese cybertheft, its assaults on intellectual property, forced technology transfers, poor implementation of its World Trade Organization (WTO) obligations, and its state-subsidized overcapacity in steel and potentially autos, robotics and other sectors of the economy. Severe Chinese restrictions on investment by U.S., European and other non-Chinese companies in modern services, energy, agriculture and high-tech sectors are a further shared concern. Both are wary of growing investments by state-owned Chinese firms in Europe and the United States. Brussels has joined Washington and Tokyo in trilateral talks focused on the commercial challenges posed by China.

The International Monetary Fund (IMF) estimates that a full-blown trade war could shave 1.6% off of Chinese gross domestic product (GDP) and 1% off U.S. GDP. And while the United Nations Conference on Trade and Development (UNCTAD) estimates that in such a situation the EU theoretically stands to capture about $70 billion of the U.S.-China bilateral trade that would be diverted elsewhere, the shock waves generated by a U.S.-China trade war on other trade flows, investment decisions and currencies would likely also overwhelm European economies. Even absent a full-scale trade war, tit-for-tat protectionist measures between the U.S. and China, the world's two largest economies, have rattled global business confidence, raised uncertainty about the effectiveness of global supply chains, and contributed to slower growth in global trade. It has also undercut real growth and momentum in China and the United States and dampened economic activity around the world, including in trade-dependent Europe.

A second area of friction, less significant economically but equally fraught politically, is related to Iran. Furious after President Trump pulled out of the Iran nuclear deal and reimposed punitive banking sanctions last year, European leaders first set up a "blocking statute" to forbid European companies from complying with sanctions and then introduced a special purpose vehicle called Instex to prop up European business with Iran as one means to keep Iran in the deal. The move has heightened transatlantic tensions even though it is unlikely that any European companies would risk their substantial commercial engagement with the United States for far smaller opportunities with Iran.

Additional transatlantic economic challenges have been generated by political frictions over climate change, European levels of defense spending, and European energy dependencies on Russia.

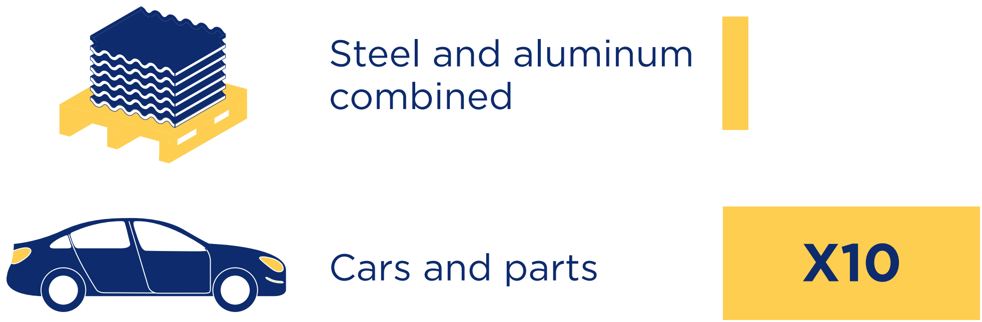
These issues offer a negative political backdrop for efforts by Washington and Brussels to kickstart U.S.-EU trade talks. Trade tensions between the United States and the EU were coming to a boil until President Trump and European Commission President Jean-Claude Junker declared a "truce" in July 2018. The two sides are now re-launching bilateral trade negotiations, but with very different goals in mind.

The Trump Administration is adamant about including agriculture in the negotiations, which the EU resists. It still holds open the possibility of invoking section 232 of the Trade Expansion Act of 1962 to move ahead with tariffs on EU cars and auto parts – the same national-security grounds the White House used to impose levies on foreign steel and aluminum, which prompted the EU to retaliate with duties on U.S. goods. U.S. auto-related tariffs would further inflame tensions, given that EU automotive exports to the United States are about 10 times greater in value than EU steel and aluminum exports combined. German producers would be the biggest losers: Germany alone accounts for 60% of Europe's €40 billion in annual exports of cars and parts to the United States.

The EU, in turn, is keen to eliminate transatlantic tariffs on industrial goods and automobiles that Trump is

Why auto-related tariffs would further inflame EU-U.S. trade tensions

1. EU exports to the U.S.: a comparison



2. Annual EU exports of cars and parts to the U.S.

fighting to protect. Trump has pledged not to impose auto duties as long as talks continue in good faith. But prospects of a quick agreement are slim. If the U.S. administration imposes Section 232 tariffs on European cars, the EU will end the negotiations and impose tariffs in response, as it did with steel and aluminum, by identifying products that are politically sensitive in the United States, but which are readily substituted in the EU, in order to minimize any negative effects for European firms and consumers. Not only would the economic scale of such a dispute be significantly greater than the irritation caused by the tariffs currently in place, a transatlantic trade dispute could easily spill over into national security issues, possibly damaging NATO and the broader transatlantic relationship.

These tensions are unfolding in the context of a slowdown in global growth. Prospects of a global recession remain minimal: the Big Three – the United States, China and the European Union – are all expected to post positive real GDP growth this year, although growth rates will be down from the prior year. The key worry, then, is not the economics associated with what could be a modest cyclical slowdown, but political instabilities that could confound efforts to manage a downturn.

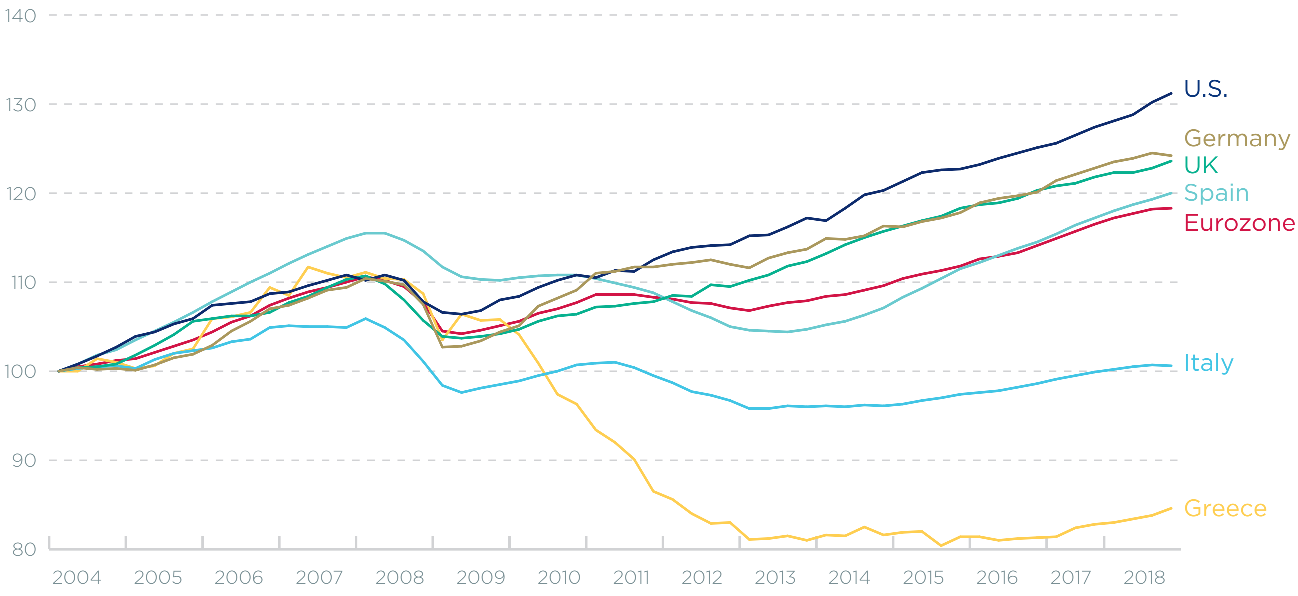
Transatlantic Economic Outlook

In short, the transatlantic economy enters 2019 on unsettled ground, beset by political volatility and economic uncertainty. Transatlantic economic growth is set to slow. The United States is expected to outperform relative to the European Union and most countries in Europe.

A year ago, the situation was different; the transatlantic economy was in sync – the United States and Europe were expanding in tandem owing to a number of variables, including rising consumption levels, investment outlays and trade volumes. By mid-year, however, the paths of the two economies had diverged; growth noticeably slowed across Europe in the second half of 2018, while the U.S. economy powered ahead.

Growth slowed in Europe in the second half of 2018, while the **U.S. economy is powering ahead**

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

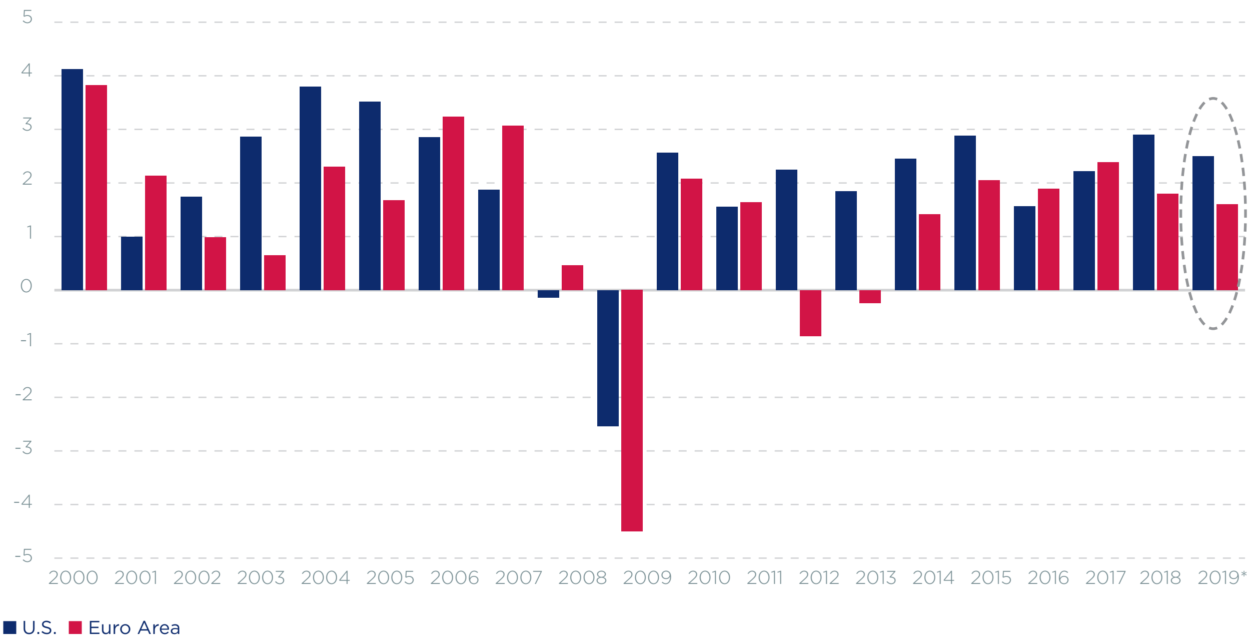


Source: Haver Analytics.
Data through Q3 2018.

According to the latest figures from the IMF, the eurozone is expected to expand by just 1.6% this year, down from 1.8% in 2018. Growth momentum has been sapped by a number of political variables, ranging from street protests in France, political uncertainty over Brexit, and financial stress in heavily-indebted Italy. Overlaid with U.S.-China trade tensions, consumer and business confidence has declined across Europe, and is not likely to rebound anytime soon, as Brexit drags on and Europe braces for May elections to the European Parliament, which could usher in more Euroskeptic, anti-immigration policies, triggering additional economic and market volatility.

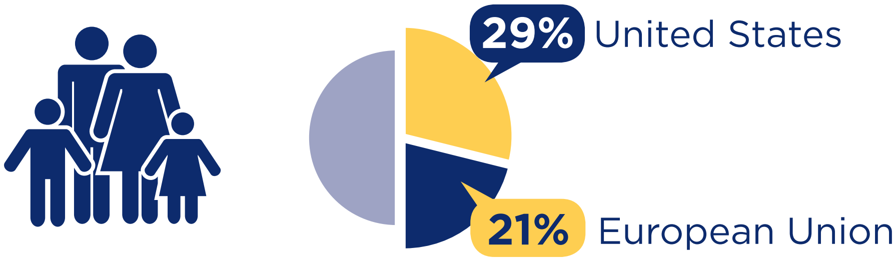
In the United States, meanwhile, one of the longest economic expansions in modern history continues. In 2018, the U.S. economy grew by 2.9%. Economic momentum will downshift in 2019, with growth

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



**2019 forecast.*
Data as of January 2019.
Source : International Monetary Fund; Bureau of Economic Analysis; Eurostat.

Global personal consumption (2017)

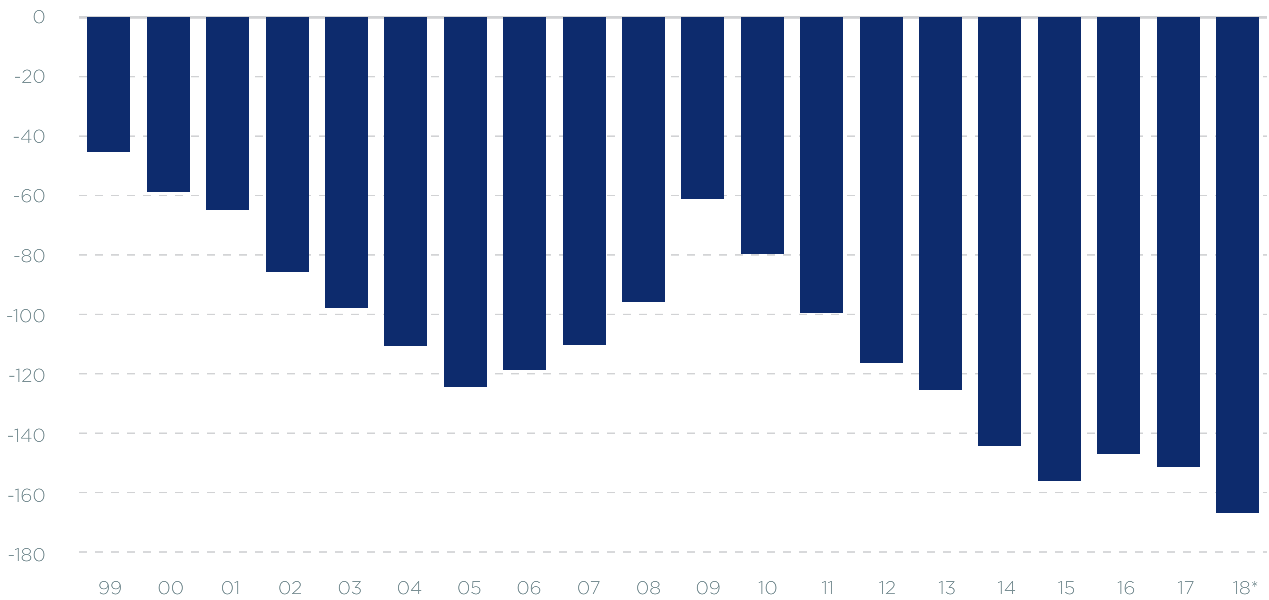


slowing on the account of the lagged effects of monetary tightening, the waning fiscal stimulus (including tax reform) and downdraft in capital investment. However, prospects of a recession in the United States are slim thanks to healthy levels of personal consumption.

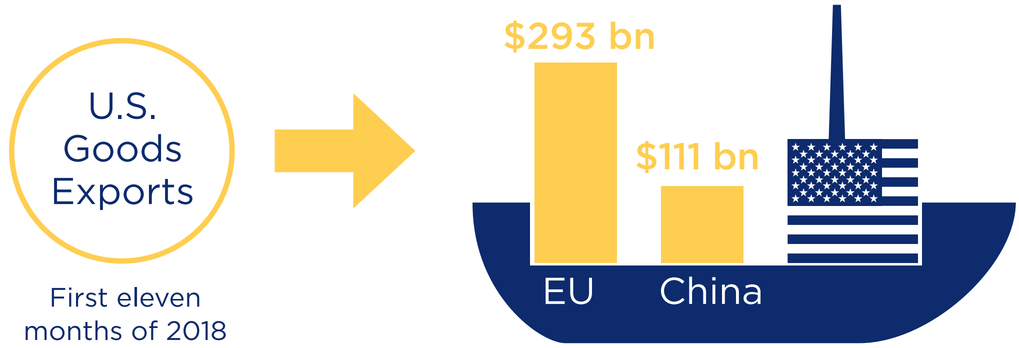
A key bright spot for both U.S. and European firms is the U.S. consumer, who remains one of the most potent economic forces in the world, accounting for roughly 29% of global personal consumption in 2017, the last year of available data. Totaling over $13 trillion, U.S. consumer spending is greater than the combined spending of the next five largest consuming markets in the world: China, Japan, Germany, the United Kingdom, and India.

The one-two combination of solid employment gains and higher wages has underpinned consumer confidence and spending, with U.S. consumer spending accounting for nearly 70% of U.S. gross domestic product. And since many European firms sell more goods and services in the United States than in their home markets, buoyant U.S. consumer spending positively spills over to Europe via enhanced sales of European affiliates in the United States and higher European exports. Fully half of the world's personal consumption in 2017 was accounted for by the United States (29%) and the European Union (21%) – a reflection of the overarching attractiveness of the transatlantic market.

Table 3 U.S. Merchandise Trade Balance with the EU (Billions of $)



**2018 estimate.*
Source: United States Census Bureau.

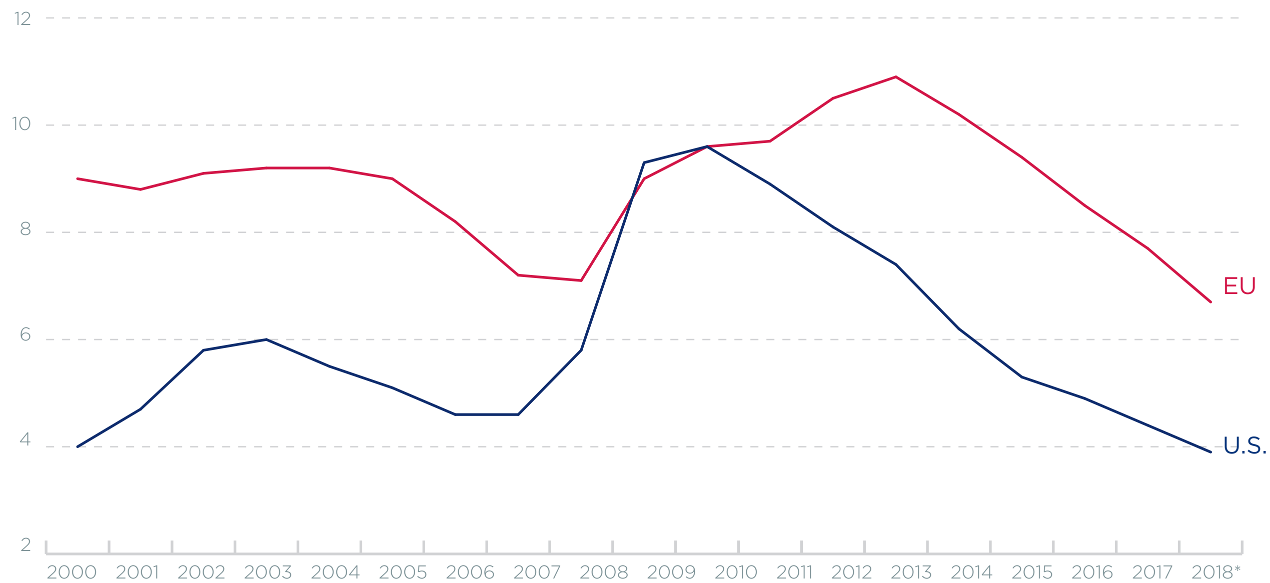


This wealth underpins bilateral trade. Indeed, transatlantic trade still stands as the largest such relationship in the world, even when compared to America's trade ties with China. In the first eleven months of 2018, for instance, U.S. goods exports to the European Union totaled $293 billion, up 13.2% from the same period earlier and over 2.5 more than U.S. exports to China ($111 billion). U.S. goods imports from the EU totaled $447 billion, leaving a sizable trade gap of $154 billion, up 14% from the prior year. America's merchandise trade deficit with the EU reached an estimated $168 billion in 2018, a record high and a thorn in the side of a Trump Administration fixated on bilateral trade deficits. America's deficit with China was larger (estimated at $417 billion), although that will provide little ballast to U.S.-Europe trade negotiations. America's expanding trade deficit with Europe will remain a constant source of tension between the two parties again this year.

Meanwhile, unemployment levels on both sides of the Atlantic have improved over the past year, notably in the United States. Heading into 2019, the job market in America is one the tightest in decades. The national unemployment rate for December 2018 clocked in at 3.9%; among workers with a four-year degree or more, the unemployment rate was 2.1% in December, which is basically full employment. Job openings were a staggering 7.3 million in December 2018. Moreover, roughly 428,000 manufacturing jobs remained unfilled, a fact largely overlooked by pundits and politicians tuned into the false narrative that America is not in the business of "making stuff", or manufacturing. Nothing could be further from the truth.

Among the skilled labor pool in the United States, the unemployment rate hovered around 2% for the balance of 2018. Most new jobs, however, have not tended to be in high-paying services jobs, where the

Table 4 U.S. vs. EU Unemployment Rate Harmonized Unemployment Rate (%)



**2018 EU data is for November 2018, U.S. data is for December 2018.*
Source: OECD.

U.S. traditionally has excelled, but in workaday services positions, where pay is mediocre. Automation is changing the very nature of work in many areas, less in terms of replacing workers than displacing them from higher-wage, higher-productivity sectors to lower-wage, lower-productivity sectors of the economy.[1] The U.S. economy continues to evolve, unevenly, but still on a positive trajectory for jobs and growth.

The eurozone unemployment rate fell to a decade-record low of 7.9% in December 2018 – a positive sign, although that figure was nearly double the same rate in the United States. Regional divergences persist: Germany's unemployment rate (3.3% in December 2018) was well below comparable rates in France (9.1%), Italy (10.3%), Spain (14.3%), and Greece (18.6%).

In sum, fraught transatlantic politics threaten to exacerbate an economic situation that, while still positive overall, is more fragile than a year ago.

Box 1. Brexit Update: As Clear as Mud

The decision by the United Kingdom in 2016 to quit the European Union ("Brexit") and the subsequent negotiations to settle terms of divorce have generated deep fissures through British society and rattled markets throughout Europe. The negotiations have become sloppy, torturous and fraught with downside risks for the United Kingdom, the European Union and the United States.

By some measures, the UK economy is in a relatively strong position to weather the Brexit storm. UK employment reached its highest level on record at the end of 2018 and total pay grew at its fastest in over a decade. Nonetheless, potentially gale-force winds can be felt. The UK economy slowed markedly in 2017 and again in 2018, weighed down by flagging private consumption owing in part to the pound's depreciation and the attendant rise in inflation and loss of real disposable income. Real estate prices have weakened. Ernst and Young expects a trillion euros in bank assets to flee the UK. More than one in seven European companies with UK suppliers have moved part or all of their business out of Britain. UK-based EU institutions are decamping for other parts of Europe. U.S. foreign direct investment flows to the UK plunged by 31% in 2017 and by another 9.8% in the first nine months of 2018. The UK government itself estimated that under the terms of the 2018 UK-EU draft agreement – rejected by the British Parliament yet deemed the best deal the UK could expect by the EU – the British economy would shrink by 3.9% (a loss of £100 billion) by 2030. And without a deal, the Confederation of British Industry concluded that every part of the United Kingdom would pay an "unacceptable economic price."[2] No matter what the Brexit terms may be, the process is likely to unsettle markets and cast a cloud over the UK's relations with key partners for many years.

2019 is crunch time. The UK must not only define the nature of its exit from the EU, it will also have to do three other 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 submit new tariff commitments for goods and services at the World Trade Organization. Second, it must negotiate new trade arrangements between the UK and the EU27. Third, it will want to negotiate new trade arrangements with the United States and many other non-EU states. Yet Britain has failed to finalize most trade deals needed to replace the EU's 40 existing agreements with leading global economies and will not be close to doing so when Brexit occurs on March 29. Without a formal Brussels divorce agreement, most of the deals would lapse, putting more than £150 billion of UK trade at risk.[3] And even with an agreement in hand, the UK is likely to remain under the EU umbrella for at least two additional years, pending a UK-EU trade agreement – but as a rule taker, not a rule maker.

Moreover, 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 services-based economy. At risk: UK financial, transportation, logistics and insurance companies as well as UK-based U.S. and EU affiliates in those sectors.

Meanwhile, EU rules mean that London cannot legally begin negotiating a trade deal with Washington before the UK leaves the EU. 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 $748 billion in 2017, the last year of available data, America's capital stock in the UK is more than double the combined investment in South America, the Middle East and Africa ($253 billion). Total U.S. investment stock in China was just $108 billion in 2017. Even when the U.S. investment presence in China and India are combined – totaling $152 billion in 2017 – the figure is just 20% 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. firms. Since 2000, the UK has accounted for nearly 9% of the cumulative global income of U.S. affiliates, a proxy for global earnings. In the first nine months of 2018, U.S. affiliate income earned in the UK was a robust $34.2 billion, a 21% increase from the same period a year ago. For all of Europe, it was up 10%.

In the end, Brexit is likely to prove costly for the United Kingdom and dampen the business climate in the EU. Many indicators suggest that the impending separation will weigh on real economic growth, subdue consumer and business confidence, spur disinvestment from foreign investors, and trigger bouts of political instability. 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, the Netherlands, and Ireland among the favored locations for ex-UK investment. A deeper issue for Corporate America is the future contours of the transatlantic economy and the future path of the transatlantic partnership. On both sides of the ocean, the political bonds are fraying, portending tougher times in terms of promoting deeper transatlantic investment and trade ties.

Endnotes

1 C. Daron Acamoglu and Pascual Restrepo, "Automation and New Tasks: The Implications of the Task Content of Production for Labor Demand," working paper for *Journal of Economic Perspectives*, November 6, 2018, https://economics.mit.edu/files/16338.
2 Seema Malhotra, "Brexit trade uncertainty threatens to set UK back by 46 years," *Financial Times*, December 9, 2018.
3 James Blitz, Jim Pickard and George Parker, "UK fails to close global trade deals ahead of Brexit deadline," *Financial Times*, January 17, 2019.