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# **Not Business as Usual:** The Transatlantic Economy in an Age of Uncertainty

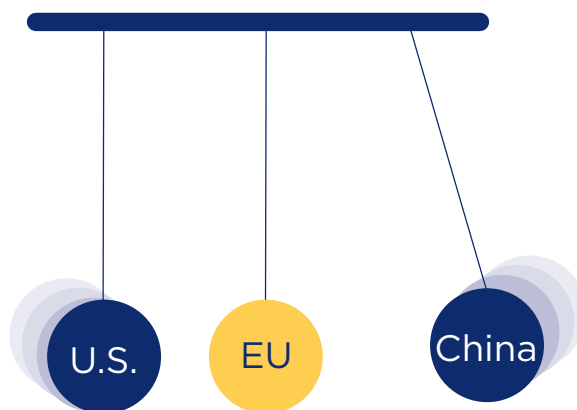






## U.S.-China trade war or trade truce?

Significant collateral effects on Europe over 2020 and beyond



“May you live in interesting times” is purported to be a Chinese curse. It aptly describes the transatlantic partnership in 2020. These are interesting times for the United States and Europe. The world’s largest and most important bilateral commercial relationship remains under considerable strain due to escalating trade disputes and threatened tariff increases, differences over data issues, sanctions on Iran, Russia and European energy security, NATO defense spending, climate change objectives, the crisis at the WTO Appellate Body, and the uncertain conditions likely to govern the United Kingdom’s post-Brexit commercial relationships, in particular with the European Union (EU) and the United States. Overshadowing all of these issues are the cascading shocks imposed on the transatlantic and global economy by the novel coronavirus COVID-19.

As stock markets have plunged, oil prices have tumbled, and central banks have slashed interest rates, some have likened the COVID-19 shock to the 2007-2009 financial crisis. This time, however, the banking system is not in crisis, and toxic debt is limited. The nature of the challenge is also different; whereas the 2007-2009 crisis emanated from the financial industry, the COVID-19 crisis is a health emergency. Then, the challenge was to get cash to banks to guarantee their liabilities and rouse the bond markets. Now, the challenge is to cushion the impact on individuals and to help companies survive a cash crunch as health concerns ripple through offices, schools, factories, transportation, hospitality and other “human contact industries.”<sup>1</sup> The COVID-19 hurricane is wreaking havoc on people’s lives across many sectors of the economy, but this time the underlying strengths of the transatlantic economy are sturdy enough to weather the storm, and the storm will pass.

Whether the transatlantic partners can navigate these headwinds effectively together, however,

depends also on their ability to address other issues that bedevil their relationship. Europe has stiffened its resolve over the past year to stand up to the United States and to chart a more independent course from its long-time ally. As German Chancellor Angela Merkel put it, “Europe, as a general rule, needs to be able to do everything itself.”<sup>2</sup> Whether this bold talk turns into action remains to be seen, but European leaders have become more assertive in defending and advancing their economic interests in a world of more diffuse power. The new European Commission led by Ursula von der Leyen supports a larger role for the euro as a global reserve currency and is increasingly assertive on the regulatory front when it comes to data and data privacy. Europe’s Green Deal, meanwhile, is among the most ambitious plans in the world to decarbonize the economy and society; the Commission aims to turn Europe into “the first climate-neutral continent by 2050.” This will require new regulations, directives, member state buy-in and copious amounts of capital, so whether the Green Deal gains traction remains to be seen. Moreover, Europe is haunted by FOMO – the fear of missing out – as the continent begins the new decade lagging behind the United States or China in such critical technologies as 5G, artificial intelligence, the internet of things, computer software, quantum computing and related activities. It is against this backdrop that some European leaders have openly embraced a more interventionist industrial policy. The likely downside to these grand plans is more transatlantic discord and divergence.

Last year we wrote that when it came to trade, “the Trump team’s primary target is China, not Europe.” One year later, the tables have turned. It is Europe that is now in the crosshairs of U.S. trade negotiators. Since securing Congressional ratification of the United States-Mexico-Canada Agreement (USMCA) – successor to the 1994 North American Free Trade Agreement (NAFTA) – and following the Phase



One trade deal signed with China in January 2020, the Trump administration has pivoted to Europe, threatening tariffs on autos, in addition to the WTO-authorized tariffs already levied on finished aircraft, French wine, Italian cheese, and other goods stemming from the Airbus subsidy trade dispute. Proposals by several European countries for digital services taxes have exacerbated transatlantic frictions, risking further escalation of trade tensions between the world's largest economies. Complicating the picture: the UK's post-Brexit attempts to broker new commercial arrangements with both the EU and the United States. How each agreement is crafted and implemented will ultimately affect trade and investment flows between the UK and the EU, the United States and the UK, and the United States and the EU.

In addition to the above, it is important to note that just as Europe suffered some collateral effects of the U.S.-China trade war, Europe could also be penalized by the Sino-American trade truce. One consequence of U.S. imposition of global steel tariffs in 2018, for instance, was to divert steel from China and other countries to Europe, forcing Europe to impose its own set of restrictions. Fast forward to today, and under the Phase One deal, China has committed to buying \$200 billion more of American-made goods and services over the next two years. That portends a surge in new export orders for U.S. firms, as well as a significant shift and redirection in Chinese

purchases towards the United States and away from other regions of the world, including Europe. To make the agreement work, Beijing may feel compelled to require Chinese state-owned firms to give preference to U.S. goods and services (agriculture, aircraft, energy products, etc.) at the expense of comparable European products. In addition, the agreement leaves in place 25% tariffs on a host of Chinese goods, which could divert more Chinese exports to larger, alternative markets like Europe, undercutting the sales and profits of many European firms. Either way – U.S.-China trade war or trade truce – the collateral effects on Europe have been significant and will continue to mount over 2020 and beyond. All told, the Phase One agreement is estimated to cut demand for nearly \$11 billion in European goods, with the German and French manufacturing sectors particularly affected. Moreover, the deal potentially heralds an age of managed trade that could upend how trade disputes have been managed traditionally, challenge the most-favored-nation principle, and further weaken the World Trade Organization.<sup>3</sup>

Similarly, when it comes to the U.S.-China Cold War over technology – or the race to create the technological standards of the future – Europe again finds itself between a rock (U.S. demands that Europe adopt U.S. tech standards) and a hard place (the attractiveness of China's growing tech capabilities, notably 5G networks). If an “economic iron curtain” descends upon the global economy, as former



U.S. Treasury Secretary Hank Paulson has warned, then Europeans will be pressed to choose between Western-style capitalism versus authoritarian state capitalism. A potential “third way,” where Europe tries to promote an alternate approach to both the U.S. and China, could also prove disruptive to transatlantic economic cooperation. At the heart of the debate are U.S. national security concerns regarding the Chinese telecommunications giant Huawei, a leader in 5G technology ready to sell in Europe but also, according to the United States, a potential conduit for Chinese espionage given the close linkages of the firm to the Chinese state and its heavy dependence on state subsidies. Huawei leads the world in 5G infrastructure with 30% of global market share in Q3 2019, followed by Samsung (23%) and European leaders Ericsson (20%) and Nokia (14%).<sup>4</sup> Many EU member states have already adopted Huawei’s technology, further complicating matters in terms of technological dependence on China.

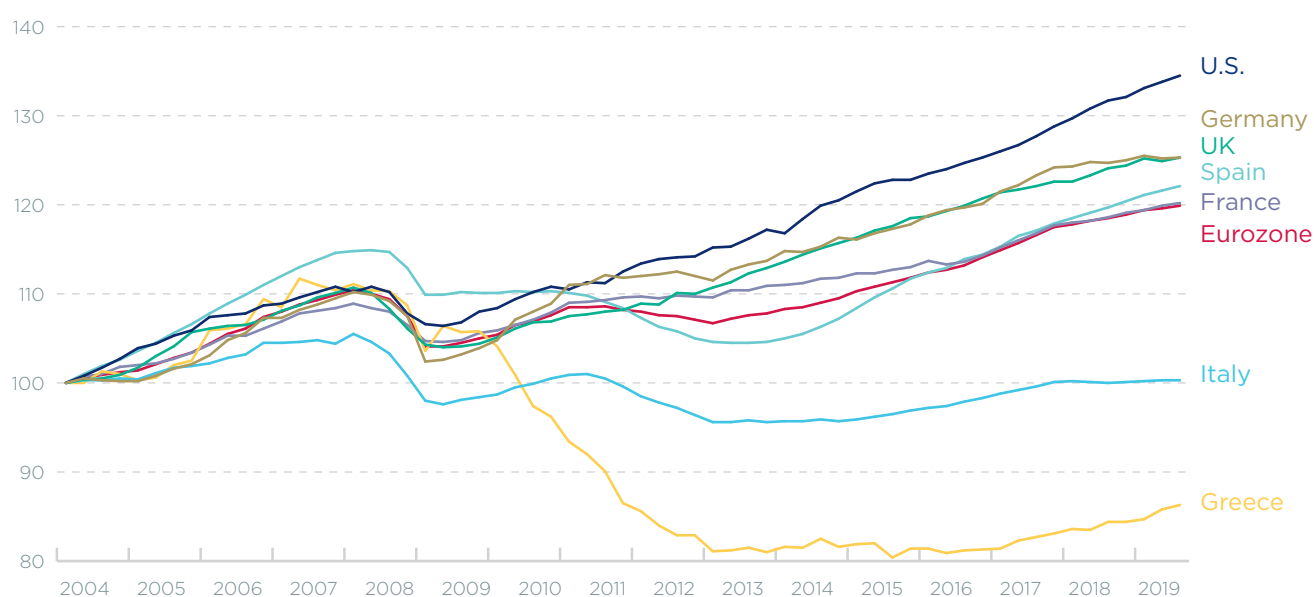
## Transatlantic Economic Outlook

The transatlantic economy entered 2020 on firmer ground, but the planks under the largest bilateral relationship in the world have since been subjected to some extraordinary stress tests as COVID-19 throttles supply chains and economic growth. As the year began, the United States was expected to expand

yet again at a faster pace than the European Union, with consensus estimates of U.S. real GDP growth of around 2% versus just 1.4% estimated growth in the EU. Those growth estimates were based on a number of key assumptions, including diminished U.S.-China trade tensions in 2020 (boosting global trade); strongly accommodative monetary policies on both sides of the pond (bolstering consumption and investment levels); and less austerity in favor of fiscal spending across Europe, particularly in Germany (helping to end Europe’s manufacturing recession). By March 2020 COVID-19 had dampened such estimates, with the OECD projecting the U.S. economy to grow 1.9% in 2020 before rebounding to 2.1% in 2021, and for the eurozone to grow 0.8% in 2020 before rebounding to 1.2% in 2021. A host of economic analysts, including the European Commission, are far more dour, projecting that COVID-19 is very likely to push the U.S. and European economies into recession in 2020, and that a rebound later in the year, stretching into 2021, would depend on a bold responses from governments.

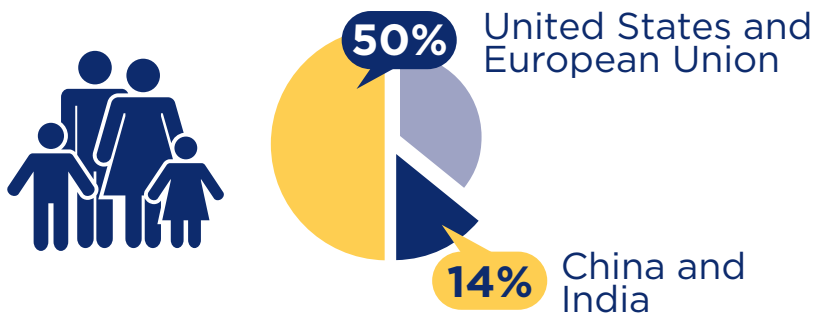
In part because of this uncertainty, fiscal policies across Europe have become more growth-oriented. The European Commission is taking a more accommodating and flexible stance towards member states running budget deficits and attendant rising debt levels. Brussels has come to realize that easier monetary policies – in isolation – cannot generate

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



Source: Haver Analytics.  
Data through Q3 2019.

## Global personal consumption (2018)



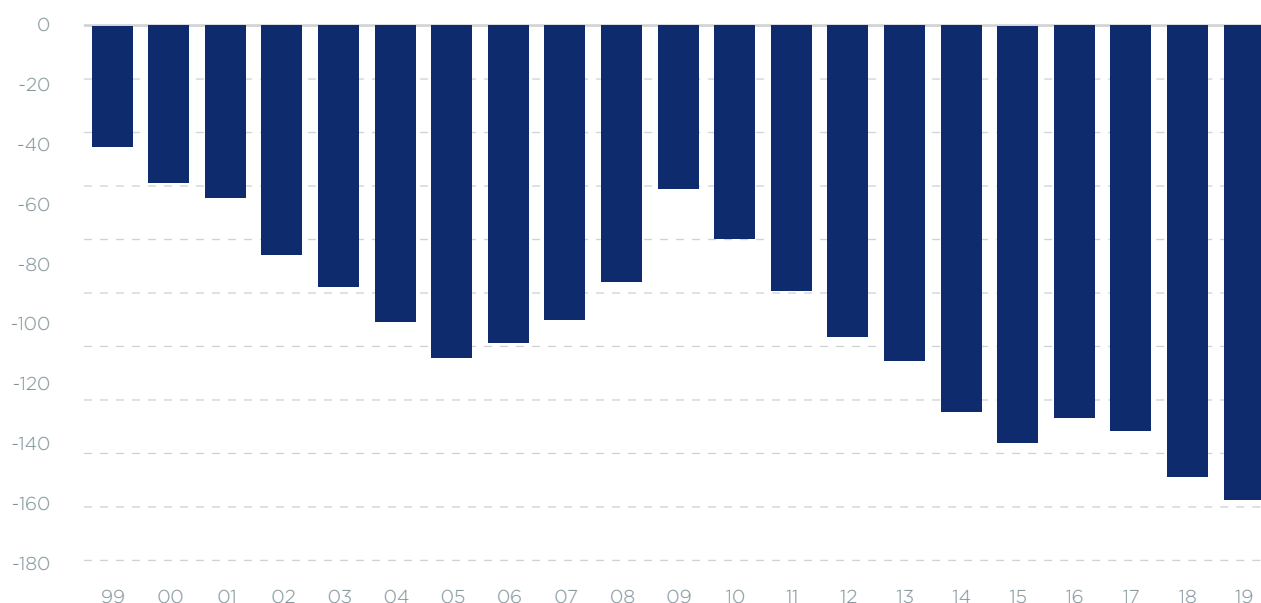
sustained growth, and has become more fiscally lenient towards nations with weak finances (Spain, France, and Italy, for instance). Germany experienced a severe manufacturing slump over the second half of 2019, led by a downturn in automobile production. The latter not only crimped German industrial production but also boosted the number of unemployed automobile workers in Germany as various German car companies announced sizable layoffs in the fourth quarter of 2019. The additional uncertainty generated by COVID-19 finally led German financial and economic leaders to declare that they were prepared to move away from their fixation on balanced budgets and toward more fiscal stimulus/spending to mitigate the coronavirus effect and to revive growth in Europe. The European Commission and EU member states are all deploying significant sums to support industries and workers hit hard by the pandemic.

Against this backdrop, while Europe will certainly take a hit, the economic outlook for the continent is expected to gradually improve over the balance of this year as it emerges from the COVID-19 storm, although an escalation in U.S.-EU trade tensions, such as the implementation of U.S. tariffs on EU autos, poses a significant risk. Prospects are not necessarily brighter in the United States. Market jitters over COVID-19 ended the longest economic expansion in U.S. history. U.S. growth was bifurcated last year, with solid consumer spending offsetting the weakness in U.S. manufacturing and agriculture, stemming from the U.S.-China trade war and other U.S. tariff measures. The rebound in U.S. manufacturing, anticipated in 2020 with the signing of the Phase One trade deal along with the increased certainty of having USMCA finalized, is now expected to be delayed until later in the year or sometime in 2021.

The extent and nature of a COVID-19 induced transatlantic recession will depend on how quickly the virus can be brought under control, and the extent to which governments are prepared to help economies weather the storm. Economists expect a U-shaped economic cycle in which growth first plunges, then remains stagnant for some time before sharply recovering as consumers emerge from isolation with money to spend and jobs to go to.<sup>5</sup>

COVID-19 concerns will temper consumer spending in many sectors of the U.S. economy at least into the second half of the year. Nonetheless, at \$14 trillion, U.S. personal consumption remains one of the most potent economic forces in the world, accounting for nearly 30% of global personal consumption in 2018 – greater than that of the next five largest consuming markets in the world combined: China, Japan, Germany, the UK, and India. U.S. consumption accounts for almost 70% of U.S. GDP. As goes the U.S. consumer, so goes the U.S. economy. 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.

Combined, U.S. and European consumers accounted for half of world consumption in 2018, a fact that underscores the attractiveness of the transatlantic economy and reinforces a point we have made many times in the past: despite the rise of many emerging market economies such as China and India, the United States and European Union still command the largest share of global consumption, 50% together in 2018 versus only 14% from China and India combined. China and India have gained significant share over

**Table 2 U.S. Merchandise Trade Balance with the EU** (Billions of \$)

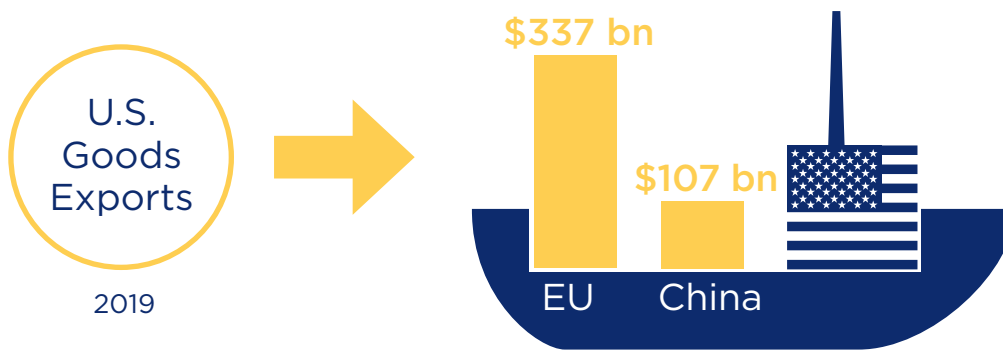
Source: United States Census Bureau.

the past few decades, but the gap remains wide and has actually been very steady over the past few years. At the end of the day, consumers in the United States and Europe are far wealthier (on a per-capita income basis) than their counterparts in India or China. Consumer spending will continue to be a main catalyst for transatlantic economic growth this year.

This deferred consumer growth will influence bilateral trade. Transatlantic trade continued to expand in 2019 but remained largely unbalanced. Transatlantic trade flows are among the largest in the world, even eclipsing trade with China. For instance, U.S. exports of goods to the EU totaled \$337 billion in 2019, up 6% from the prior year. That figure was more than three times larger than U.S. goods exports to China (\$107 billion in 2019). That said, U.S. goods imports from

the EU (\$515 billion in 2019) were significantly larger than U.S. exports last year, leaving a sizable U.S. merchandise trade deficit with the European Union. Overall U.S.-European commercial interactions are far more balanced if one includes services, as we explain in Chapter 2. Nonetheless, the Trump administration focuses inordinately on goods trade imbalances, which remain a constant source of tension that could trigger more protectionist measures from the United States in 2020.

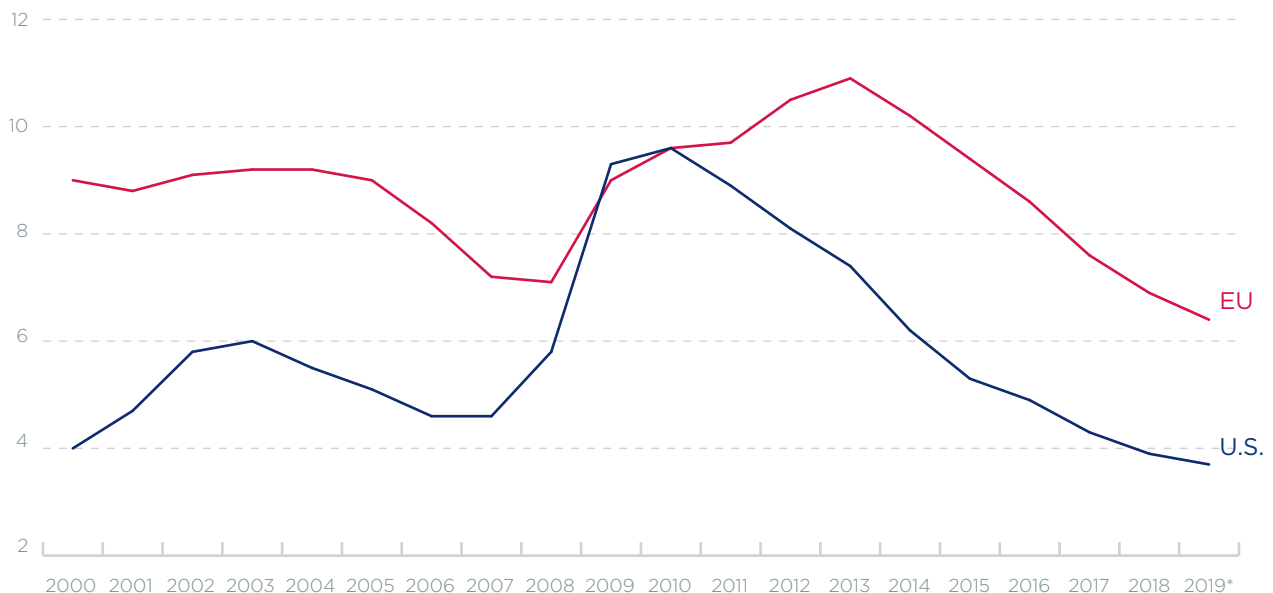
On the employment front, into 2020 the job markets in both the United States and the EU continued to improve, and remained supportive of consumption-led transatlantic economic growth. The U.S. job market is the strongest in decades. The U.S. unemployment rate ended 2019 at 3.5%, a multi-decade low.



The EU jobless rate, while above U.S. levels, is now at its lowest point since before the financial crisis of 2008-2009. In December 2019, the EU unemployment rate stood at 6.2%. What's more, unemployment rates across the continent are diverse, with Germany's jobless rate of 3.2% in December standing in sharp contrast to a jobless rate of 16.6% in Greece and 13.7% in Spain. Even those countries, however, have made significant positive strides over the past year. Meanwhile,

the EU's youth unemployment rate remains problematic, with the rate standing at 14.1% in December 2019. This is down considerably, however, from a peak of 24% in 2013. In sum, the transatlantic economy is on the cusp of a cyclical upswing led by consumption, and supported by easy monetary and fiscal policies. However, politics, protectionism and uncertainty over the coronavirus could undermine the stimulatory effects in place and ultimately derail the budding recovery.

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



\*2019 EU data is average through November 2019.  
Source: OECD.



## Box 1. Post-Brexit Europe and the Transatlantic Economy

The United Kingdom formally left the European Union on January 31, 2020, in the process losing its EU voting rights. At the same time, EU law is still applicable on UK territory, at least through the end of 2020. During this year, the UK retains access to the EU Single Market and remains a party to existing EU trade deals with other countries, even as it negotiates the nature of future UK-EU commercial, political and security relations. UK Prime Minister Boris Johnson is adamant that he will not prolong the Brexit process, which leaves just 10 months to conclude trade talks. Negotiations are already proving to be difficult.

Brexit is a defining moment for Britain's relations with the rest of Europe, even perhaps for its future as a united kingdom of England, Wales, Scotland, and Northern Ireland. It will also impact the strategic partnership with the United States that has been a fundamental pillar of the liberal international order over the past several decades.

Northern Ireland remains the most complex and politically fraught element surrounding the UK-EU divorce agreement. The prospective deal creates a customs border in the middle of the Irish Sea. This means that Northern Ireland remains officially part of the UK's customs territory, but without checks on goods crossing Northern Ireland's 310-mile land border with EU member Ireland. Northern Ireland companies and farmers continue to follow EU customs and regulatory rules, and in practice, Northern Ireland remains part of the EU's Single Market. The United States has a particular interest in ensuring that the ultimate outcome preserves the political and economic progress achieved through the 1998 Good Friday peace agreement between the British and Irish governments, and most of the political parties in Northern Ireland, which was facilitated by the United States.

The best-case trade scenario by the end of 2020 is a bare-bones placeholder agreement that ensures duty-free and quota-free access for goods, at best providing market access for services at least similar to that granted in the EU's recent trade deals with Canada and Japan. The two sides should also work to ensure the future free flow of data and recognition of equivalence for financial services regulations, among other important considerations. Besides Northern Ireland, a key issue in the negotiations is regulatory divergence. London wants greater freedom from EU rules and standards. The EU wants to keep the two economies more aligned, and has linked the issue to UK access to the EU Single Market.

As the UK negotiates terms with the EU it is busy trying to arrange new trade arrangements with scores of other countries, including the United States. Washington and London are finalizing various arrangements governing customs, mutual recognition of standards, trade continuity and privacy issues so that commercial flows are not disrupted during the transition. They are also intent on concluding a bilateral trade agreement, which has already revealed tough issues regarding market access, particularly for agricultural products and financial services.

By some measures, the UK economy is in a relatively strong position to weather the Brexit storm. The UK employment rate was at a record high at the end of 2019 and total pay grew at its fastest rate in over a decade last summer, with growth moderating slightly since then. Real estate price growth has started to pick back up as the clarity of the Conservatives' convincing December election and avoidance of a no-deal Brexit reduced some of the uncertainty that had stifled growth.

Nonetheless, potentially gale-force winds can be felt. The UK economy slowed markedly 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. In 2019, real GDP growth was unchanged at just 1.3%, as the economy continued to be dragged down by business uncertainty, reduced investment and weakness in the manufacturing sector.

In terms of FDI trends, UK-based EU institutions are decamping for other parts of Europe. According to Reuters, financial firms in the UK have opened over 300 subsidiaries in the EU with an estimated 7,000 workers to staff these operations, in order to avoid any disruptions to financial market access after the transition period.<sup>6</sup> According to preliminary data from the UN, total world FDI flows to the UK declined 6% in 2019 due to a lack of large M&A deals targeting the country. However, U.S. foreign direct investment flows to the UK rebounded in 2019 after 2018 flows were the weakest in thirteen years.

All totaled, Bloomberg economics estimates that Brexit has cost the UK economy about \$170 billion since the referendum and expects the costs to keep increasing amid a new trade arrangement with the EU and reduced productivity growth.<sup>7</sup> According to UK government estimates, an exit from the EU with a free-trade agreement and stricter migration arrangements would cause GDP to be lower by about 6.7% after 15 years, compared with baseline forecasts.<sup>8</sup> 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 years.

This could portend slower U.S. FDI flows to the one-time prime location for U.S. companies doing business in the EU. After the Netherlands, America's corporate stakes in the UK are the deepest in the world. Totalling \$758 billion in 2018, the latest year of available data, America's capital stock in the UK is almost triple the combined investment in South America, the Middle East and Africa (\$260 billion). Total U.S. investment stock in China was just \$117 billion in 2018. Even when the U.S. investment presence in China and India are combined – totalling \$163 billion in 2018 – the figure is just 21% 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 UK has been a longtime 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 8% of the cumulative global income of U.S. affiliates, a proxy for global earnings. In the first nine months of 2019, U.S. affiliate income earned in the UK was a robust \$36.1 billion, a 5% increase from the same period a year ago. For all of Europe, U.S. income in the first nine months was basically flat.

In the end, Brexit is likely to prove costly for the UK and dampen the business climate in the EU. Many indicators suggest that the 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. companies remains unclear, as the UK and U.S. and the UK and the EU negotiate future trade relationships. Firms are hedging their positions in the UK by exploring alternative locations in the EU, with Germany, France, the Netherlands, and Ireland among the favored locations for ex-UK investment.

#### Endnotes

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