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for Transatlantic Ties?*

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Global Euro. Testing Times for Transatlantic Ties?

Miriam Campanella ♦

Abstract

Theories of international cooperation (TIC) predict that deeper economic integration raises the costs of policy conflicts and promotes coordination. As the US-EU economy makes up 60 per cent of the world GDP, policymakers on the two sides of the Atlantic are expected to assign highest priority to joint policy action.

Angela Merkel's resumption of TAFTA with the objective of fixing some regulatory issues, offers comfort to TIC's tenets. Though, the correction of the global imbalances and especially the huge US external deficit does not add as much of comfort to TIC's tenets. A likely overshooting of dollar's exchange rate vis-à-vis the euro will bring huge consequences on euro zone economies. While TIC's supporters would call for transatlantic mechanism to arbitrate and coordinate monetary policy to offset potentially huge spillover effects, this paper would suggest EMU institutions to prepare for exchange rate shock adopting a policy of risk management, rather than banking on implausible transatlantic coordination.

Key-words:

Transatlantic economy, global imbalances, competitive dollar, impact on euro economies, EMU institutions.

Transatlantic Economy and Global Imbalances.

The transatlantic relationship is often overshadowed by press reports about political bickering and commercial frictions. Figures published by Daniel Hamilton and Joseph Quinlan from the Center for Transatlantic Relations (CFTR) put the transatlantic economy on a different picture. Two-way trade and capital flows are currently worth \$3 trillion – or around 60% of the world's GDP – and employs 14 million workers both in the EU and the US. Trade and investment flows between the world's two largest economies are thriving. In fact, despite all the clamors about the new Asian Giants, in 2005, the US invested in China only 23% of what it invested in Belgium. Even in slow-growth Germany, investment from the US was four times higher than in China. As Daniel Hamilton, director of the Center for Transatlantic Relations of the Johns Hopkins University "Everyone talks about China but the action is actually somewhere else". During the first half of this year, U.S. companies invested \$51 billion in Europe, up 53% for the same period in 2005.

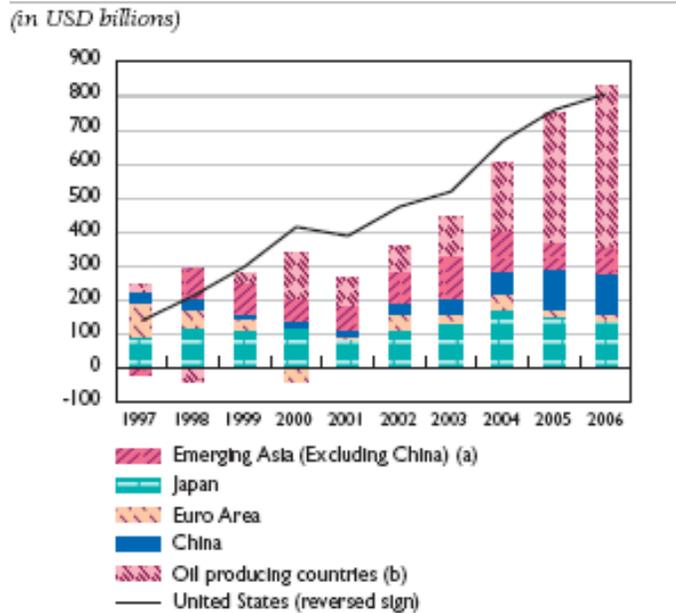
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Although the jump was in part due to a one-off U.S. tax change allowing companies to repatriate foreign earnings, the U.S. continues to invest more in Europe than in China. Total U.S. investment in China last year was \$1.6 billion, just about a quarter of U.S. investment in Belgium. U.S. investment in Germany was about four-and-a-half times larger than U.S. investment in China last year, the report adds. U.S. companies earned \$106 billion in Europe last year, the report says. That compares to only \$50.4 billion in Asia. Europe also is a key investor in the U.S. European investment in the U.S. totaled \$108 billion in 2005, a 76% jump from the previous year. European subsidiaries in the U.S. earned \$77 billion in 2005, up from \$14 billion in 2001. To an important degree, corporate Europe's earning boom has been 'Made in America'.

Though, a major risk to transatlantic economy is to take this relationship for granted. As promising as sounds the Angela Merkel's initiative at relaunching the transatlantic free-trade area, global imbalances and the correction of the US external deficit as could put to severe testing economic and political relations between the two sides of the Atlantic.

The working of globalization has indeed increased international trade and capital mobility, though it has accrued to the potential to provide both the benefits of more efficient international allocation of production and capital, and greater cross-border risks. In the last ten years, global financial integration has set in motion larger and persistent global current account imbalances, as it shows in the build-up of the huge trade and current account deficits, especially in the US, and significant surpluses in Asia and oil countries (Chart 1).

Chart 1. Current account balances in US dollars.



(a) Defined as Hong Kong, India, Indonesia, Korea, Malaisi, Philippines, Singapore, Taiwan, Thailand

Source: IMF WEO

(b) Ten top oil producers (Algeria, Kuwait, Mexico, Nigeria, Norway, Russia, Saudi Arabia, United Arab Emirates, Venezuela)

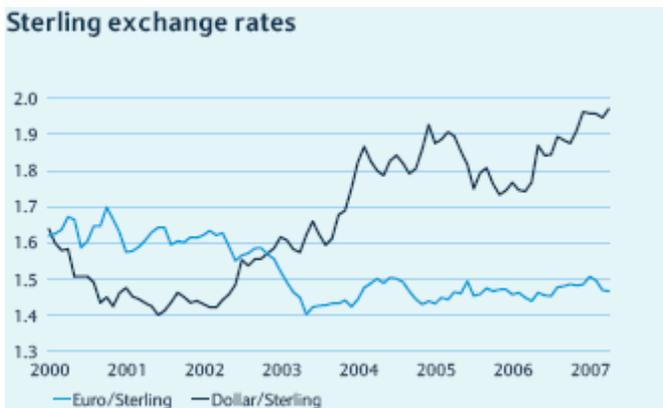
Source: IMF WEO

Correction of such imbalances are set to have consequences beyond those countries that must reduce external gaps, and will extend to those countries that are linked through trade and finance to the adjusting economies. Europe, which in the aggregate is not a major contributor to global current account imbalances, and maintain trade and financial linkages with both groups, might result especially vulnerable to changes in the current configuration of external deficits and surpluses (Ahearne and von Hagen, 2005; Lane and Milesi-Ferretti, 2006). As the way to the correction has taken the dollar's steady depreciation, and euro and sterling appreciate more than other currencies, European economies, and especially euro zone, are above all exposed to face consequences (Figure 1, Figure 2).

Figure 1. Euro-dollar exchange rate (ECB 2007 b).



Figure 2. sterling/dollar, sterling/euro exchange rates



In addition to trade linkages and net capital flows, a weak dollar could impact on the balance sheets of European firms, governments, and households as highly vulnerable to the changes in exchange rates and asset prices, as the dollar's slide will reflect mainly on those European economies mostly exposed to the US dollar with implications for the value of their external holdings (Lane and Milesi-Ferretti 2006:4)¹. Though, the United States, in terms of the overall international investment position, accounted for only 17 percent of the aggregate cross-border holdings of Europe in 2004, reflecting the predominance of intra-European cross-holdings in the total, "the United States is easily the most important extra-European destination for European investors: for instance, according to ECB data, it accounted in 2004 for 39 percent of the foreign equity holdings of euro area investors and 34 percent of the foreign bond holdings (the shares for FDI and other investment are lower at 22 percent and 14 percent respectively)" (Lane and Milesi-Ferretti, 2006:8). The United States is the major extra-European destination for outward investment from Europe, with the scale of the engagement growing rapidly over the last two decades. These financial linkages provide a potentially important transmission mechanism by which fluctuations in financial returns in the United States affect the wealth of European investors.

Is a Weak dollar the Best One Way out?

A competitive dollar, weak on foreign exchange markets and strong at home, is for Martin Feldstein of Harvard the most effective way to reduce the US current account deficit. For a competitive dollar to succeed the US Administration insistence on changes in the dollar-yuan bilateral exchange rate is inadequate, as China's exports to US are responsible for only a fraction of US trade deficit. Feldstein points straight to a drop of the "overall international value of the dollar", which implies that in an environment of few free-floating currencies major exchange rate shock will hit the European currency. To the dollar to work as an effective channel of correction, the Fed's monetary policy should play a crucial role in the game. Fed's policy should tackle closely domestic inflation, dumping unmistakably its second growth-employment mandate. Feldstein is adamant about rising interest rates, this should not harm U.S. exports, as even with a strong dollar, US has ranked high in export performance, exporting in 2005, \$892 billion worth of goods, including \$450 billion of capital goods, \$116 billion of consumer goods and \$230 billion of industrial supplies and materials. "A lower dollar would raise sales volume in all of these categories" (Feldstein 2006:7). Though, U.S. manufacturers would still generally be unable to compete with producers in low-wage countries, "nearly half of US imports come from high-wage Europe, Canada and Japan. So that a dollar that is more competitive will favor American consumers to buy U.S.-made products instead of imports from those countries" (ibid.). The Feldstein's exit strategy is built strongly in domestic framework rather than in multilateral joint policy action of the kind experienced at the Plaza and Louvre accords of the 80s. Though, Feldstein warns that is not a guarantee that a dollar decline now would not raise inflation. For a sharp dollar decline with no adverse effect on inflation (2006:7), the Federal Reserve should tackle closely inflationary pressures. As business investment is unlikely to rise faster when sales to consumers are declining and housing construction is already in decline, the key to maintaining aggregate demand, i.e., the key to expansion if consumer spending slows, "must be a shift in the trade balance - increased exports, lower imports and more spending on goods and services produced in the U.S. For this, the dollar must decline to make U.S. goods and services more attractive" (Feldstein, 2006:7). The Feldstein's strategy seems perfectly in tune with the US Federal Reserve policymakers more concerned about inflation than tepid economic growth (Washington Post, May 10, 2007).

How Resilient are Euro Area Economies to a Weak Dollar?

In a speech to the Washington European Institute, IMF President Rodrigo de Rato warned European policymakers to avoid too much complacency about global imbalances, and the evolution of US adjustment. "While Europe so far has not been at the center of the problem of widening external imbalances, it should be part of the solution". The fact that the euro area's current account balance has been small and stable while imbalances have grown elsewhere is no assurance that it can escape the fallout from a disorderly adjustment - especially given the growing international role of the euro. The question how much resilient are euro zone economies to a weaker dollar and reduced U.S. imports brings to the fore the degree of convergence, and the sources of persisting divergences within euro area economies.

In a recent conference before the European Parliament (February 2007), the ECB President Jean-Claude Trichet insisted on three factors of convergence in the euro zone as a success-story of the euro (Box 1).

Box 1. Factors of convergence in the euro zone economy (J-C Trichet 2007)

1. Inflation. In 2006, inflation dispersion reached a level of 0.7 percentage points from 1 percentage point in 1999. An inflation dispersion practically the same as that in the US (14 US Metropolitan Statistical Areas).

2. Output. The degree of dispersion on annual average terms has declined from a 2 percentage points to slightly below 1.5 percentage points, which does not appear to be significantly different than that observed across regions or states within the United States.

3. Synchronization of business cycles. Across the euro area business cycle has increased since the beginning of the 1990s. In 2006, the economic rebound in the euro area's real GDP growth was widely shared across the various countries within the euro area.

Though, divergences are as much important. For Daniel Gros, divergences in the euro zone could indeed intensify in a phase of upward cycle:

If during 1999 and now, the weighted standard deviation of the growth rates of the euro area members has barely moved as the large three euro area members tended to move broadly together, in the second half of the decade growth differentials will show off. Despite some superficial developments between Germany and Italy, it is now becoming clear that a chasm has opened up between them under the surface (Gros 2006:1-2).

Gros points out that the way Germany has regained competitiveness through a 'competitive deflation', i.e. extracting continuous concessions from trade unions on labor costs, is impossible to other member countries, such as Italy, which, instead, has continuously lost competitiveness with labor costs increase by about 20% relative to those of Germany since the introduction of the euro.

Not surprisingly, Gros predicts that idiosyncratic features and weak resiliency to global competition will surface strongly in the next half of this decade because, which will show in the North and the South of euro area diverging rather than converging.

Early evidence of deterioration in price competitiveness of several euro economies are weighed up in the ECB February Bulletin 2007. It shows that the evolution of the Harmonized

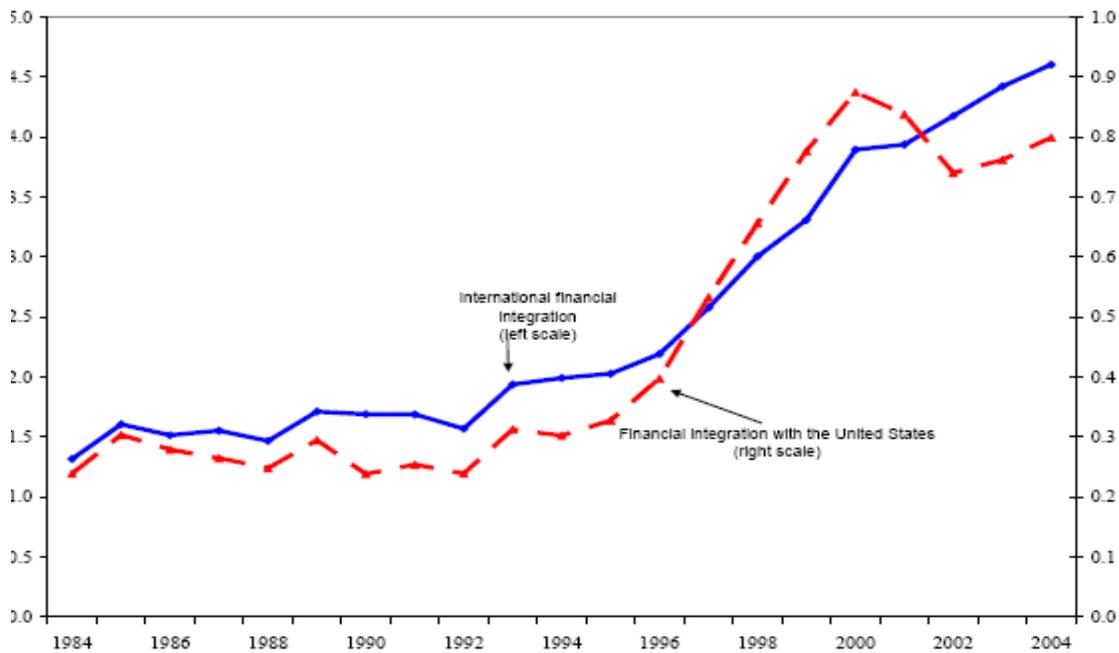
Competitiveness Indicators (HCI)² across euro area countries between the first quarter of 1999 and the fourth quarter of 2006 have recorded an increase in their HCIs, which points to deterioration in the price competitiveness of these countries. This is not surprising given that the corresponding measure of the euro Real Exchange Rate (REER) appreciated by 4.3% over this period. However, HCI changes differed substantially across countries. At one end of the spectrum, Germany, Austria and Finland experienced a moderate decline in their HCIs, indicating an improvement in their price competitiveness, whereas, at the other end, rises in the HCIs were particularly strong in Ireland and Spain. The countries that appeared to have improved their price competitiveness since 1999 are those that also recorded the lowest rates of inflation (Harmonized Index of Consumer Price) during this period, while inflation in Ireland, Greece, Spain and Portugal has been well above the euro area average. The country-specific pattern of foreign trade flows determines the relevance of both changes in foreign consumer prices and exchange rate developments. Concerning exchange rate developments, the extent to which a change in the euro exchange rate affects the HCI of a particular euro area country is closely related to the exposure of that country to extra-euro area trade.

The share of extra-euro area trade in total cross-border trade is the lowest for Portugal (31%) and the highest for Ireland (almost 68%). In addition, the geographical allocation of extra-euro area trade of each euro area country also affects HCI developments. For example, the appreciation of the euro vis-à-vis the US dollar over the past two years has had a rather strong impact on the HCI of Ireland, because a relatively large share of the foreign trade of that country is with the United States. On balance, the impact of euro exchange rate fluctuations affects variously member economies and works at revealing the different rates of vulnerability to exchange rates dynamic.

Transatlantic Financial Integration and Valuation Effects.

Financial integration is a further channel through which negative spillovers could affect directly European investors. Financial integration represents after trade, a second key factor of transatlantic economy. The U.S. and EU together account for about 70 percent of global equity capitalization - about \$16 trillion in the U.S. and \$10 trillion in the EU. The two-way flow of trade, portfolio, and direct investment between our two regions exceeds \$1 trillion annually. Of the top 500 companies in the world, 358 are based in the transatlantic market, including 19 of the top 20. The recent historic enlargement of the EU by 10 new Member States has only magnified the region's importance to the United States - the EU now has 450 million potential investors and a GDP exceeding \$12 trillion. In comparison, the U.S. population totals 280 million, with a GDP almost reaching \$12.2 trillion. Financial globalization has grown rapidly – the ratio of foreign assets and liabilities to GDP has grown by a factor of 3.5 over 1984-2004 (from 130 percent to over 450 percent). Financial globalization in recent years, with the increase in holdings of foreign assets and liabilities across the Atlantic means that “the transmission mechanism by which external adjustment in the U.S. affects Europe has become more far-reaching” (Lane and Milesi-Ferretti 2006:4-5). Changes in exchange rates and asset prices will clearly impact on the balance sheets of European firms, governments, and households.

Figure 2: Financial Integration of Europe (from Lane and Milesi-Ferretti, 2006)



The figure above also shows that the bilateral financial position vis-à-vis the United States has grown at only a marginally slower pace. This suggests that the importance for the wealth of European investors of movements in the value of U.S. assets and the dollar against European currencies has grown sharply over this period. “In terms of the overall international investment position, the United States accounted for only 17 percent of the aggregate cross-border holdings of Europe in 2004, reflecting the predominance of intra-European cross-holdings in the total. However, the United States is easily the most important extra-European destination for European investors: for instance, according to ECB data, it accounted in 2004 for 39 percent of the foreign equity holdings of euro area investors and 34 percent of the foreign bond holdings (the shares for FDI and other investment are lower at 22 percent and 14 percent respectively).”(Lane and Milesi-Ferretti 2006: 8-9).

Euro-Dollar Cooperation: Fallacies and Downside.

Consistently with the Bernanke’s explanation that global imbalances originate from a global saving glut, the US correction is going on through a steady fall of the dollar. An abrupt fall of the dollar, though, would have consequences especially on the euro, causing an exchange rate shock on those economies mostly exposed to the dollar. Intra-euro conflicts are likely to stir protectionist demands, eventually putting to the test transatlantic ties. This train of consequences would push, - as popular wisdom and TIC sustainers alike advocate-, for more euro-dollar cooperation and coordination, eventually setting up some transatlantic mechanisms. Is this the only way left? Rogoff’s heretical answer is no. He remarks that:

monetary policy coordination, no matter how well they are designed and no matter how seamlessly they are implemented, brings to small advantage compared with the overall potential benefits that would flow from having (..) central banks simply follow good domestic monetary policies (Rogoff 2003:1-2).

A first question relates the likelihood of a dollar-euro exchange rate shock. How far the dollar's depreciation should go to bring the US current account deficit at 3 per cent of GDP? For the dollar's depreciation to reduce the trade deficit at 3 percent of GDP, estimates range between a 20 percent depreciation of the dollar from where it was in January 2007 to 15%. Baily (2007) empirical analysis based on historical experience of US trade and the dollar over the past 25 years reaches the conclusion that a further depreciation of between 15 and 20 percent on the Fed's real broad dollar index would be needed to reach a trade deficit roughly consistent with a three percent current account deficit (Baily 2007:3-6). On the euro's side, with a nominal exchange rate appreciation by 10 per cent against the dollar, though inflation and increase in unit labor costs have been lower than in other industrialized countries (with the exception of Japan), and much lower than in Asian economies, euro zone economies have indeed lost competitiveness since 2002 (Dullien 2007). So, even if the current level 1.36 (or even a level of \$1.40) of the euro exchange rate might not pose excessive problems, there is not much room for complacency, as foreign exchange markets could overshoot with the euro hiking at \$1.50 or \$1.60. At this point, euro overvaluation might hit companies and might slow growth and employment dynamics. On a similar tune, Bergsten (2005) warns that:

three or four events—generalized further dollar depreciation, disproportionate euro appreciation due to continued Asian resistance to participation in the adjustment process, subsequent acceleration of the inevitable portfolio diversification from dollars to euros and perhaps a positive shift in the relative economic appeal of Euroland vis-à-vis the United States—could produce a very large further rise in the euro (2005:14).

Such a scenario would indeed be extremely uncomfortable for euro zone and extremely destabilizing for the world economy, perhaps even triggering a global recession.

The second question relates to EMU institutions. Are ECB and European Commission ready to deliver in face of an exchange rate shock? The ECB monetary policy equipped to counter negative consequences?

Relative to the ECB, Svensson (2004) considers that “[U]nder the present monetary policy paradigm, the euro appreciation is “a challenge for the monetary policy of the ECB and the Eurosystem”(2004: 4-5). Ahearne and von Hagen (2005) warn that failure of the ECB to act promptly vis-à-vis an exchange rate shock could origin erratic responses in the euro area “with an increased risk of a more protectionist response” (Ahearne and von Hagen 2006:1). Assessment of EMU policies is somewhat mixed. Some analysts (Posen2005, Ahearne and von Hagen 2005) argue that EMU policymakers have acted rather pro-cyclically in the last five years. In 2001, the ECB showed an unresponsive attitude to the risk of deflation, at least compared with the Federal Reserve. For example, by the time of the first ECB interest rate cut in mid-2001, at which time the policy rate was trimmed 25 basis points to 4½ percent, the Federal Reserve had already carried out 250 basis points of easing. As a result, in mid-2001 real interest rates in the euro area, at about 2 per cent, were almost double the level in the US” (Ahearne and von Hagen, 2006:18). In 2003, the European Commission played wrongly the fines policy (Stability and Growth Pact) in a phase of serious slowdown and recession in the euro zone (Posen 2005). So, concerns that it might hinder a sufficiently strong fiscal reaction to exchange rate shock, especially one that would be forward-looking in the sense of acting quickly when the dollar declines fast (Ahearne and von Hagen 2006: 18). Furthermore, how will the European

Commission act if the ensuing recession is asymmetric across euro countries, there may be more tension in the European Council between the countries strongly affected that desire a large fiscal response and those less affected that will insist on staying within the SGB limits? Aherane and von Hagen argue that the European Commission “might reveal slow to provide the leadership necessary in such situations” (2006:9-10).

As a result, inconsistent responses, slow delivery, and lack of leadership might open to erratic responses and individual/collective protectionist measures, which can disrupt transatlantic relations. What should be done to prevent this worst case scenario to materialize? Conventional responses would endorse the precepts of the theory of international cooperation. The Bergsten’s 4 steps strategy (Box 2) depicts perfectly the TIC sophisticated paradigm. The aim is, of course, to manage an orderly correction of the global payments imbalances and an orderly further depreciation of the dollar, rather than a hard-landing, and hence an exchange rate shock (Box 2).

Box 2. Bergsten 4 steps-strategy in pills.

- The United States must launch a serious program to cut its budget deficit to increase national saving, and thus reduce its dependence on foreign capital.
- The G-7 (especially Euroland) must insist that the International Monetary Fund implement its rules against currency manipulation and require China, in particular, to cease the competitive undervaluation of its currency.
- Japan and (especially) Europe must stimulate domestic demand to affect the decline in their external surpluses, but also through a lowering of interest rates by the European Central Bank (which the euro appreciation will help to permit).
- Euroland and the United States, as the issuers of the world’s two key currencies, must create a new “finance G-2” to manage exchange rate volatility.

The first step is done: the Bush Administration has planned balancing the Federal budget within 2012. The second step would require enforcement policy lacking to the IMF, and outright repelled by China’s authorities. Third step looks tricky. By limiting to Europe: How would the ECB justify reduction of interest rate, at a time of overshooting M3, positive growth cycle, and after a long pause of accommodative interest rates? Step four falls into the Rogoff’s analysis of the fallacies of coordination. As he remarks grandiose schemes have been designed since the shift to floating exchange rates in the early 1970s. Leading economists have suggested “grandiose mechanism and institutions for guiding global monetary policy” (2003:1). At their roots, however, are at least two major fallacies:

- “International monetary policy coordination always leads to less exchange rate volatility. Not necessarily. (...) The Plaza and Louvre accords of the 1980s, announced with great fanfare by the top industrial powers, were aimed at achieving sustainable parities, thereby avoiding disorderly adjustments and excessive volatility. The results were mixed. But even if significant exchange rate stabilization were achievable—and given today’s large and moody foreign exchange markets, it may not be—it is far from obvious that such a policy is always desirable” (Rogoff, 2003:2).
- “The stronger the international financial links, the stronger the need for institutionalized coordination. In other words, the argument goes, as Europeans boost their holdings of U.S. assets through direct foreign investment and equities and vice versa, Europe and the United States will have a greater direct interest in each other’s growth. With greater potential international spillover effects, there needs to be greater coordination of monetary policy. But

this isn't necessarily the case. International investment and equity linkages already enhance authorities' incentives to look at the global effects of their national monetary policies, with or without centralized cooperation” (Rogoff, 2003:2-3).

Fallacies are not all the story. Cooperation could reserve downside, too. In opposition to those who want to institutionalize joint monetary policy decision making, Rogoff warns that “a push to create a new cooperative international monetary policy institution might provoke a political debate that could cause to give up some of the big gains of recent years: reducing central bank independence”(Rogoff, 2003:2). Is it this an outcome to welcome? Or, could it work as an expedient to attack central bank independence, and with it monetary stability enjoyed in last decades?

Eurogroup Chairman Jean-Claude Juncker has just blown up on ECB exchange policy, and the French new president Nicolas Sarkozy in a television interview attacked ECB President Jean-Claude Trichet's policy of allowing the euro to appreciate against other currencies. Sarkozy called Europe's exchange policy "incomprehensible." "The Germans don't agree and the Prime Minister of Luxembourg who presides over the Eurogroup, Mr. Juncker (...) threatened to resign if Mr. Trichet continued," with the bank's monetary policy, he said. "The Americans push the dollar down to favor growth.(..)The Japanese and Chinese do the same." Sarkozy then went on ask, "Why create the world's second currency if it's not to use it?"

In conclusion.

At odds with TIC' tenets that cooperation is the best one way to fix negative spillovers, this paper sustains that is up to domestic monetary institutions on two sides of the Atlantic to cope with negative spillovers, gearing up to risk management approach rather than taking refuge in complacency, or, after Rogoff, in “grandiose schemes”, as they are more likely to backfire putting to the test transatlantic ties.

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¹ Lane and Milesi-Ferretti (2006: 20) find that “level of dollar exposure is relatively small for most European countries. Among the members of the euro area, three groups can be distinguished, with the group of Austria, Finland, Greece, Italy, and Portugal having a low level of dollar exposure, a second group comprising Belgium, France, and Germany having an intermediate level of exposure, while the financial centers of Ireland, Luxembourg and the Netherlands have a much higher level of exposure”.

² HCI is “a means of providing a comparable measure of individual euro area countries’ price

competitiveness that is also consistent with the real effective exchange rates (REER) of the euro". For more ECB 2007: 54-56.