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US pressure should encourage the two countries to reform the euro area

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While the US and China trade rift is settling down, President Trump is setting his sights on Europe and, surprisingly, Italy is at the center of US concerns. The US Treasury macroeconomic and foreign exchange report to Congress for 2019 (published in mid-January 2020) clearly indicates that the US Administration is ready to pile pressure on Germany, Italy and Ireland. Those are the only euro-area countries mentioned in the report's Monitoring List of major trading partners whose currency practices and macroeconomic policies merit close attention. In addition to China, the Monitoring List comprises Japan, South Korea, Germany, Italy, Ireland, Singapore, Malaysia, Vietnam, and Switzerland.

Highlighting the German and Italian external positions vis-à-vis the United States, the US Administration directly implicates the way European economic governance is conducted. Fiscal restraint in Germany and lack of dynamism – that is, structural reforms - in Italy depress the external demand from those countries and reduce their import from the US Calling to task the two tenets of the Stability and Growth Pact – fiscal discipline and growth-inducing reforms – represents a direct accusation for the euro area's economic management. In this context, Ireland is a different case. Ireland's current account balance has been significantly impacted by the growing presence of foreign multinational enterprises, which contribute both to an extremely large goods trade surplus and a substantial income deficit. The Irish problem, however, is being addressed also through changes in the US fiscal regime. Normally, the Report sheds light on currency manipulation practices, but in the case of the euro-area countries this is not possible because monetary policy is not conducted at the national level. The European Central Bank (ECB) has not intervened unilaterally in foreign currency markets since 2001. Italy and Germany do not exercise their own monetary policy. The problem lies with the economic policies that are enacted in the context of euro-area governance.

Given the impact of Trump's direct economic pressure on China and indirect economic pressure on Germany during the last two years, the possibility that Washington will induce a game-changing reflection on the way the euro area is governed should not be overlooked. The implications are potentially wide-ranging.

Although US-China relations are most relevant for the future of the global economy, the EU and the US economies together account for about half of the entire world GDP and for nearly a third of world trade flows. Moreover, economic links across the Atlantic go beyond trade. The European Union and the United States still have the largest bilateral trade and investment relationship and enjoy the most integrated economic relationship in the world. In fact, total US investment in the EU is three times higher than in all of Asia and EU investment in the US is around eight times the amount of EU investment in India and

China together. A third of transatlantic trade consists of intra-company transfers, demonstrating the close relations between the economic actors of the two regions.

Given the low average tariffs (under 3%), the key to unlocking the potential in trade relations lies in the tackling of non-tariff barriers. These consist mainly of customs procedures and behind the border regulatory restrictions. The non-tariff barriers come from diverging regulatory systems (standard definitions notably), but also other non-tariff measures, such as those related to certain aspects of security or consumer protection. The implications go beyond trade and affect the common strategic interests of the transatlantic community. In recent weeks, rumors have spread about tariffs on European cars being levied by the US Administration in retaliation for Europe's refusal to comply with the American strategy on Iran and specifically with the Iran nuclear deal.

According to the US Treasury Report, Germany's current account surplus remained the largest in the world in nominal dollar terms ($283 billion) over the four quarters through June 2019. Meanwhile, Germany's bilateral goods trade surplus with the United States has been broadly stable and sits at $67 billion over the same period. The persistence of the massive current account surplus and the large bilateral trade imbalance with the United States has resulted from lackluster demand growth in Germany and a real effective exchange rate that the report calculates as 18% undervalued in respect of a neutral level. The considerable moderation in Germany's growth in 2018 and the contraction in Germany's GDP in the second quarter of 2019 underscores the urgent need for Germany to cut its elevated labor and value-added taxes, restore stronger purchasing power to German households, and undertake reforms to unleash robust domestic investment and consumption. This would help underpin domestically driven growth and reduce large external imbalances. Germany's growth is now the lowest since 2013 but the government in Berlin is planning a non-expansive fiscal policy aiming at further reducing its public debt. According to Washington, as the fourth-largest economy globally, Germany has a responsibility to contribute to more balanced demand growth and to more balanced trade flows.

Italy recorded a current account surplus of 2.8 percent of GDP over the four quarters through June 2019, while its goods trade surplus with the United States rose to $33 billion. According to the US Treasury, Italy suffers from stagnant productivity and rising labor costs and the country needs to undertake fundamental structural reforms to raise long-term growth – consistent with reducing high unemployment and public debt – and safeguard fiscal and external sustainability.

Italy's external position is in line with fundamentals, so the US Treasury's critical assessment goes beyond Italy's policies and impinges on the structural weaknesses of the country. "Credible, growth-friendly, and inclusive fiscal consolidation is necessary to reduce external vulnerabilities and maintain investor confidence. Structural reforms, including to improve the wage bargaining mechanisms to better align wages with productivity at the firm level, as well as efforts to strengthen bank balance sheets, are also critical to improving competitiveness, boosting potential growth, and reducing vulnerabilities". Structural reforms could have offsetting effects on the current account while being supportive of overall growth. While European economic governance is mainly focused on the compliance with fiscal criteria, the US Administration suggests that the real issue is the implementation of a structural package of reforms.

The US's approach should not be considered an objective assessment for the sake of single countries or for the reduction of global imbalances. In fact, current account deficits and surpluses can be desirable from an individual country and global perspective. A country's ability to run current account deficits and surpluses at different times is key for absorbing country-specific shocks and facilitating a globally efficient allocation of capital. Germany maintains that it needs to save through current account surpluses because of its aging population. Italy knows too well that the fragility of its fiscal position requires a cautionary approach that may also affect the implementation of structural reforms. Obtaining an external surplus is consistent with Italy's necessary fiscal restraint.

The German fiscal policy is stubbornly aimed at reducing the stock of public debt without much concern for the level of growth. In 2019, the German economy slowed down to its lowest level since 2013 but the fiscal balance recorded its sixth straight surplus.

Current account balances are deemed excessive if they depart from levels consistent with fundamentals and desired policies. Although the overall assessment of a country's external position hinges on the current account and real exchange rate (REER) in a given year, it takes other indicators into consideration. These include the financial account balances, the international investment position, reserve adequacy, and other competitiveness measures, such as the unit-labor-cost-based REER. The overall external position is judged to be weaker (stronger) than warranted by fundamentals and desired policies when the current account balance is low (high) and/or the REER is deemed overvalued (undervalued).

Even though overall imbalances across the world have come down, they still show strong persistence and little rotation between deficit and surplus economies, and the sum of creditor and debtor positions is at record levels. The trade imbalance between the US and Germany may not be a cause of instability per se. However, the accumulation of bilateral imbalances over decades may be the cause of serious financial problems. As highlighted in the IMF external report, "Despite the narrowing of global current account imbalances, stock imbalances have continued to widen to reach record levels. At 40 percent of world GDP, the world's net international investment position—the sum of net creditor and net debtor positions—is now at a historical peak and four times larger than in the early 1990s." Among the top debtors, the net international investment position of the United States is now close to –50 percent of GDP, down about 40 percentage points since 2007, but still the highest in the world.

The policy response suggested to the German government by the IMF is highly significant for the economic governance of the euro area: A more growth-oriented fiscal policy that promotes potential growth, structural reforms to foster entrepreneurship (for example, expanding access to venture capital, stronger tax incentives for research and development, and more investment in digital infrastructure), additional tax relief for lower-income households, thus boosting their purchasing power, and pension reforms prolonging working lives would help reduce excess saving, stimulate investment, and reduce external imbalances.

Given the political pressure that the US Administration is capable of enacting, a bilateral trade negotiation between the US and Germany or Italy might have counterproductive outcomes. Reducing the export of German cars or of Italian goods would reduce the current account deficits of the US vis-à-vis the euro area, but would also aggravate the structural weaknesses of the two countries.

Italy's weakness depends on declining overall investment (partly due to weak credit growth). Weak investments accounted for two-thirds of the improvement in the CA since 2010, with higher public saving contributing the rest. Relaunching investments – rather than reducing them – would be helpful for the US's external position too. Similarly, Germany needs to relaunch its domestic demand without fear that this would give free rein to fiscal discipline in other countries. All in all, the core of European economic governance is being questioned. A more stable economic and monetary union would give investors the confidence in Italy they currently lack. A common fiscal budget for the euro area would also supplement fiscal discipline at national level.

Germany and Italy are thus well advised to anticipate the retaliatory trade tactics that the US could enact by reforming the economic governance of the euro area.