CHAPTER 1

A TESTING TIME FOR THE TRANSATLANTIC ECONOMY

The transatlantic economy in 2016 remains the largest and wealthiest of the global economy, and home to the largest skilled labor force in the world. Yet, in the post-crisis era, the United States and Europe have remained largely out of sync with each other, with key metrics such as monetary policies, growth, employment and trade diverging over the past few years. These divergences, not surprisingly, have generated skepticism and uncertainty about the cohesion and durability of transatlantic ties at a time when the diffusion of economic power and weakening of the rules-based international economic order demand closer transatlantic coordination and cooperation.

The good news is that real growth in both the United States and Europe is expected to accelerate in 2016. The growth gap, in other words, is set to narrow, although other transatlantic gaps remain and are highlighted below.

Minding the Transatlantic Gaps

The growth gap is narrowing

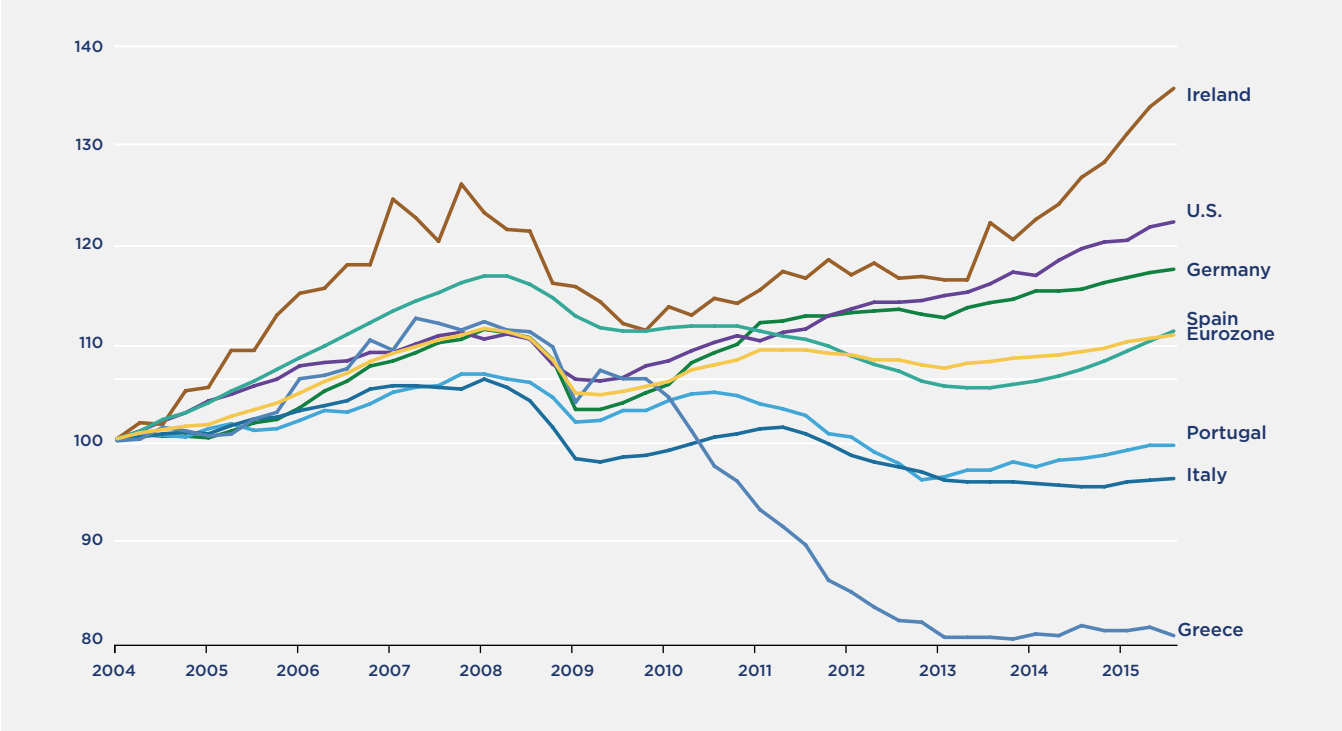
The gap in real growth between the United States and EU is closing: with roughly 2% growth this year in the EU and 2.5% in the United States, the growth gap of 0.5% percentage points is far narrower than the 3% gap experienced in 2012. A key difference between the two parties, of course, is that the United States is well into an elongated economic expansion, while the post-crisis economic performance of the European Union has been uneven at best, with much of Europe in or near recession in 2012 and 2013. Only recently has real growth in the euro area reached pre-crisis levels (see Table 1). Real growth across Europe is now accelerating, however, due to easier monetary policies, lower oil prices, and a weaker euro relative to the U.S. dollar.

Meanwhile, while the U.S. economy has been expanding since mid-2009, the current economic expansion remains one of the weakest on record. Indeed, it has been ten years since the economy expanded at a 3% annual clip, with 2015 growth again falling well short of that mark. Weak manufacturing activity, the recession in the U.S. energy patch, and softening U.S. export growth—all of these factors converged in the second half of 2015 to take some steam out of the U.S. economy. In the fourth quarter of 2015, the U.S. economy expanded by annualized rate of only 0.7%. For the year, the economy grew by 2.4%, the same level as the year before. Bright spots include consumption-led drivers such as the U.S. housing market and record automobile sales.

The U.S. recovery remains sub-par by historical standards, a situation unlikely to change this year. The U.S. consumer is leading growth in 2016, as falling unemployment boosts consumer confidence across the nation. However, political polarization continues to take its economic toll on the confidence of American companies and consumers. As the November 2016 Presidential election nears, the political rhetoric will only heat up and weigh on consumer confidence. Meanwhile, the downturn in the U.S. energy sector is weighing on growth via lower corporate earnings, rising layoffs, and rising credit stress in the financial sector. Manufacturing activity slowed considerably in the second half of 2015 thanks to the stronger dollar and softening exports. On the positive side, lower oil prices have acted like a tax cut for U.S. consumers, although income/wage growth for U.S. workers remains fragile. Add in distressed national infrastructure, widening income inequality and massive student loan debt, and the U.S. economy hardly presents a picture of robust economic health. Plenty of challenges lie ahead.

Challenges also abound in Europe, despite a noticeable rebound in economic growth over the past year. The good news is that monetary easing, a weaker euro, falling oil prices, and potentially more spending due to Europe's refugee crisis have all combined to give Europe a cyclical lift in real growth. 2016 should be a cyclically strong year for the economy. Long term challenges remain, however, and include mounting deflationary pressures, stubbornly high unemployment levels, uncomfortably high debt levels and low productivity. While real growth is set to accelerate

TABLE 1: DEVELOPED ECONOMIES BACK ABOVE PRE-RECESSION OUTPUT LEVELS (REAL GDP LEVEL, Q1 2004 = 100)



Source: Haver Analytics.
Data through Q3 2015.

in Europe to 2% this year, the underlying strength and durability of the expansion remains in question.

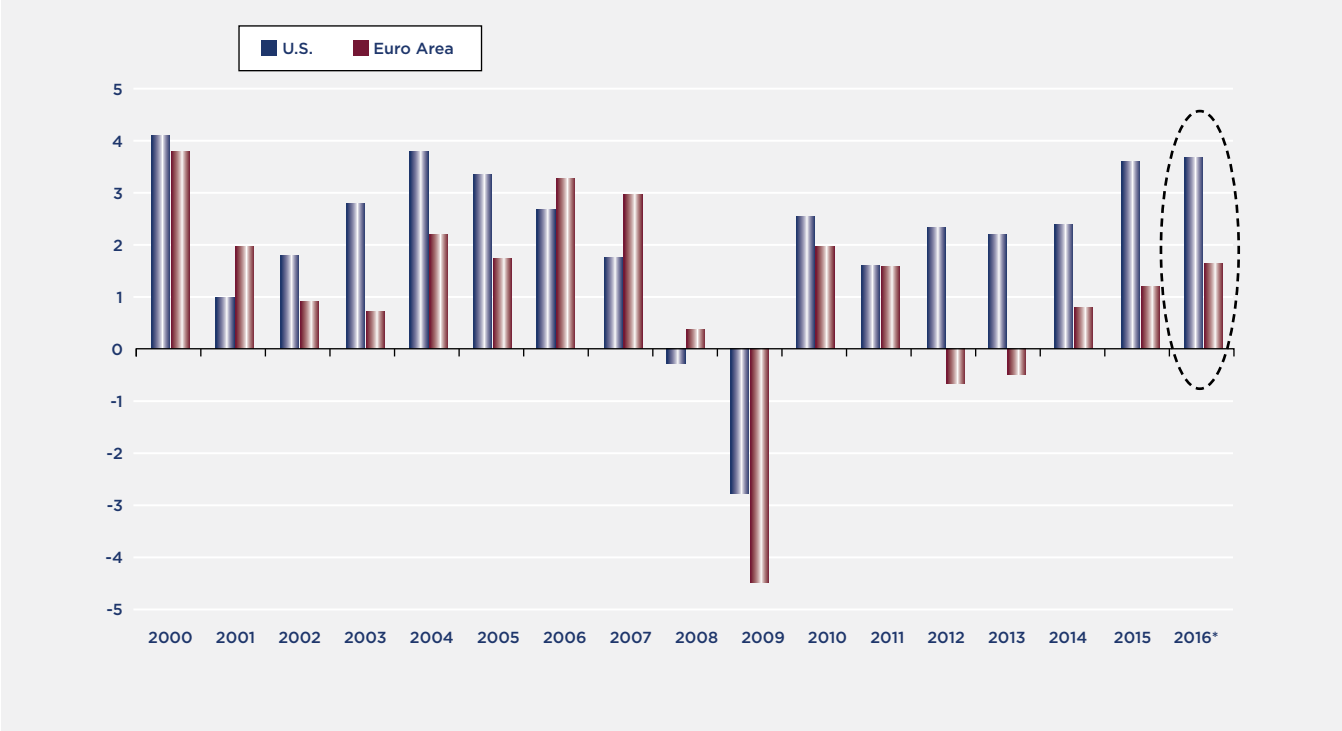
One final note about current growth levels. It is interestingly to note that of the "Big Three" economies in the world—the United States, the European Union and China—it is the latter, China, that is creating the most distress and concern for investors and corporations this year. The country is in the midst of a painful and turbulent economic transition away from export- and investment-led growth toward more consumption- and service-led activities. This shift has resulted in much slower growth of 6-7%, and, in turn, has created all sorts of stress among the world's top commodity producers and exporters. China's muddled exchange rate policies have only added to the uncertainty. Some $1 trillion in capital left China in 2015.

What does China's secular slowdown mean for the United States and Europe? While both parties are hardly immune to the negative side effects of China's economic slowdown, the United States and Europe rely more on each other than on the Middle Kingdom. China, for instance, accounted for only 7.6% of U.S. exports and 3.1% of the European Union's exports in 2014, the last year of available data. Of Europe's larger economies, China accounted for 5.8% of Germany's total exports, 3.7% of France's total exports, 3.5% of total British exports, and 1.7% of Spain's exports. In the end, China matters hugely to the world economy, but given the deep and breadth of the transatlantic partnership, the United States and Europe are hedged, to a significant degree, from China's economic tumult.

Transatlantic gaps in employment, trade and monetary policies continue

While the jobs picture in Europe has improved over the past year, the improvement has been nowhere near the extent and pace of the United States. The U.S. jobless rate has been cut in half, from a peak of 10% in October 2009 to 5% at the end of 2015. For the year, the U.S. economy added over two million new jobs, although wage gains have remained relatively subdued. The U.S. unemployment rate is expected to trend lower this year, to around 4.5%, well ahead of projected jobless rates in most European countries. According to Eurostat, the unemployment rate in the euro area was roughly 10.5% at year-end 2015, with a number of nations struggling to combat joblessness. In November 2015, the unemployment rate in Spain was a staggering 21.4%, 11.3% in Italy, 12.4% in Portugal, and 10.1% in France.

TABLE 2: U.S. VS. EURO AREA - (REAL GDP, ANNUAL PERCENT CHANGE)



**2015 estimate. 2016 forecast.*
Data os of January 2016.
Source: IMF

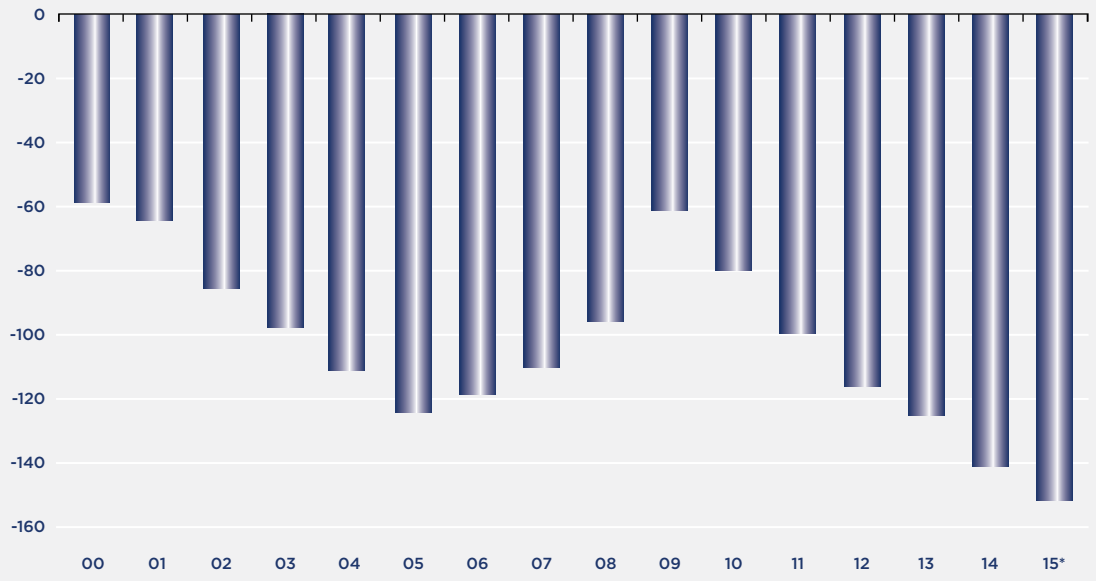
On the trade front, divergent growth and the depreciation of the euro against the U.S. dollar have manifested themselves in America's widening trade gap in goods with the European Union. The trade gap reached $153 billion for the year, another record high. America's trade deficit with the EU has increased six years in a row, and more than doubled between 2009 and 2015. In the first eleven months of 2015, U.S. imports from the EU rose 2.1% from the prior year, while U.S. exports slipped 1.2% from the same period, boosting America's trade deficit with the EU by 8.6%.

Reflecting the growth differential between the United States and Europe over the past few years, U.S. exports to EU last year — estimated at $275 billion — slipped below the pre-crisis levels of $277 billion recorded in 2008. Notable spots of weakness: U.S. exports to Germany, Greece, Portugal and Spain, which still remain below pre-crisis levels. Nearly half of America's EU trade deficit in 2015 emanated from Germany — Europe's largest economy and largest trader. For the year, the U.S. merchandise trade deficit with Germany totaled $74.2 billion in 2015, relatively flat from the year before. However, America's trade deficit with Germany lastyear was larger than America's trade gap with Japan.

Another key difference between the United States and the eurozone lies with monetary policy. In this realm, American and European officials are working in opposite directions. While the U.S. Federal Reserve, after raising rates in December, is expected to raise rates at least two more times in 2016, the ECB is expected to stand pat, and maintain ultra-low interest rates over the balance of 2016. This monetary divergence reflects the different growth paths of the United States and Europe, with America's economic expansion well established and entrenched versus Europe's nascent and less than robust recovery. As the U.S. Federal Reserve raises rates this year while the ECB remains on hold, one consequence could be an even stronger U.S. dollar relative to the euro.

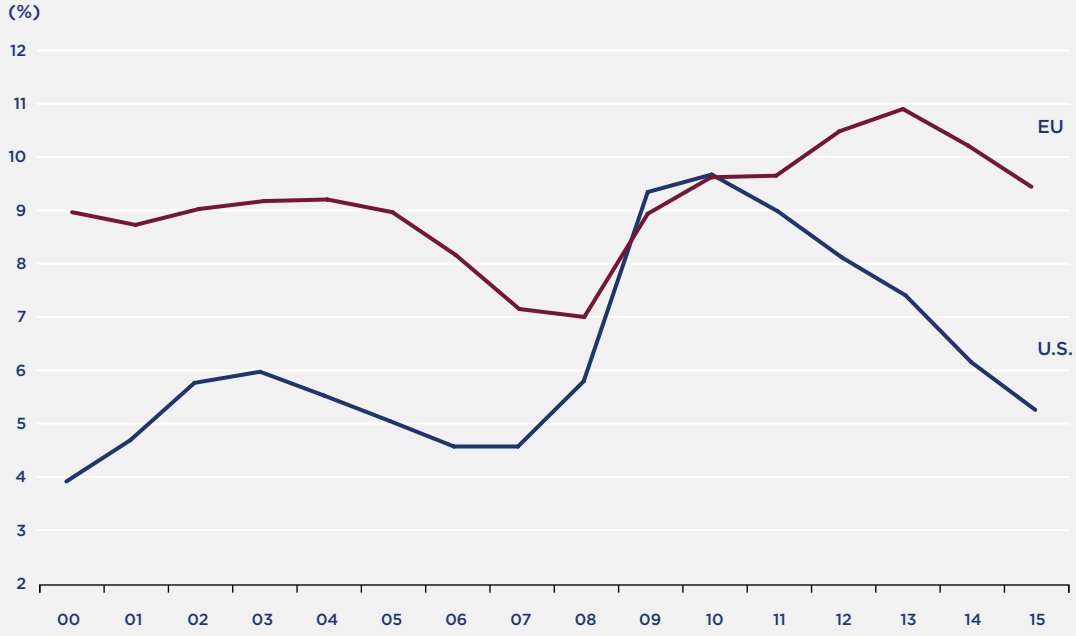
In the end, seven years after the global economic meltdown of 2008-09, the transatlantic economy is gradually healing, albeit slowly. There are still gaps to be closed, policies to be coordinated, and work to be done in tightening the bonds of the United States and Europe. The cyclical rebound in Europe will assist in all three areas; importantly, the transatlantic economy is gaining some cyclical steam, which should engender rising capital inflows and outflows across the Atlantic.

TABLE 3: U.S. MERCHANDISE TRADE BALANCE WITH THE EU - (BILLIONS OF $)



Source: United States Census Bureau.
**2015: Annualized based on eleven months data.*

TABLE 4: U.S. VS. EU UNEMPLOYMENT RATE



**EU average monthly employment rate through November 2015. U.S. data for full year 2015.*
Source: OECD.

TTIP: Not Just Another Trade Agreement

The Transatlantic Trade and Investment Partnership (TTIP) currently under negotiation by the United States and the EU promises to unleash significant opportunities to generate jobs, trade and investment across the Atlantic. Twelve negotiating rounds have been concluded since the talks first commenced in 2013, and more rounds are scheduled for 2016. Odds are slim that the negotiations will be completed before the end of the Obama Administration, and even if the negotiations themselves would be completed, the process of legislative ratification will certainly extend into 2017 and beyond.[1]

TTIP is not just another free trade agreement. While negotiators intend to reduce traditional barriers to transatlantic trade, trade in goods accounts for only about 20% of transatlantic commerce. Even greater gains could be had if TTIP opens the transatlantic services economy, where most jobs could be created; ensures an open rules-based order for investment; tackles technical and other non-tariff barriers and regulatory differences; and repositions the United States and the EU to respond more effectively to greater global competition. These dimensions are central to the TTIP negotiations and explain why TTIP is more than just another free trade agreement.

There are three lines of TTIP negotiations: market access, regulatory cooperation and 'rules'. TTIP's market-access pillar could potentially result in clearer, more straightforward and transparent rules-of-origin arrangements that could serve as the basis for future preferential rules of origin. Clear, simple and aligned rules of origin would facilitate global trade and thus serve as a common public good.

TTIP's second pillar could pioneer new ways for countries to ensure high standards for consumers, workers, companies and the environment while sustaining the benefits of an open global economy. New consultative mechanisms among regulatory agencies, including as part of TTIP's 'living agreement' provisions, could eliminate redundant regulations, identify more efficient procedures and avoid conflicts that create unnecessary costs for companies and consumers, while ensuring high standards that can prevail not only across the Atlantic but around the world.

The standards being negotiated as part of TTIP's third pillar are intended to be more rigorous than comparable rules found in the WTO. Agreement on such issues as intellectual property, services, discriminatory industrial policies or state-owned enterprises could strengthen the normative underpinnings of the multilateral system by creating benchmarks for possible future multilateral liberalisation under the WTO. US-EU agreement on such principles, and agreement to act together to advance such norms globally, could not only take the international trading system further but

establish broader political principles regarding the rule of law, human rights, labour, environmental and consumer standards.

TTIP negotiations continue to be tough. Remaining transatlantic tariff barriers, especially in agriculture, often reflect the most politically difficult cases. Some of the most intense transatlantic disagreements have arisen over differences in regulatory policy. Issues such as food safety or environmental standards have strong public constituencies and are often extremely sensitive in the domestic political arena. Responsibility for regulation is split in the EU between European and national levels, and in the United States among federal, state and even local governments as well as a range of independent regulatory agencies. Investment barriers, especially in terms of infrastructure and transport-sector ownership, could be very difficult to change. Critics charge that a transatlantic agreement could well subvert the multilateral economic system.

In short, the issues are complex. TTIP could very well fail to achieve its potential. The potential payoff for jobs and growth, however, is high. At its core, TTIP is about far more than trade. It is about creating a more strategic, dynamic and holistic US-EU relationship that is more confident, more effective at engaging third countries and addressing regional and global challenges, and better able to strengthen the ground rules of the international order.

Table 5 demonstrates that TTIP stacks far more favorably in many metrics than either the recently concluded Trans-Pacific Partnership or NAFTA. The combined GDP of TTIP members, for instance, is 51% larger than those participants of TPP. TTIP members are also wealthier. The average per capita income of TTIP of $36,294 is more than two-thirds larger than the average for TPP ($21,615). While the latter accounts for 15% of global consumption, TTIP accounts for nearly one-quarter. Whether trade and investment flows, the figures for TTIP are larger than TPP. Finally, U.S. FDI income in TTIP is more than double that of TPP, while foreign affiliate sales in TTIP are nearly 27% larger than comparable figures for TPP.

TABLE 5: COMPARING MEGA-REGIONAL TRADE AGREEMENTS (BILLIONS OF $ UNLESS OTHERWISE SPECIFIED)

	Transatlantic Trade and Investment Partnership	Trans-Pacific Partnership	NAFTA
GDP (Purchasing Power Parity)	18,640	12,325	3,745
% of World Total	17.1%	11.3%	3.4%
Population (thousands)	510,476	491,723	159,324
% of World Total	7.0%	6.8%	2.2%
Per Capita Income ($)	36,294	21,615	19,309
Personal Consumption Expenditures*	10,245	6,540	1,891
% of World Total	23.8%	15.2%	4.4%
Exports	5,914	2,755	872
% of World Total	32.1%	15.0%	4.7%
Imports	5,907	2,898	947
% of World Total	31.5%	15.4%	5.0%
U.S. Outward FDI Stock to...	2,514	1,020	494
% of U.S. Total	51.1%	20.7%	10.0%
U.S. Inward FDI Stock from...	1,724	722	279
% of U.S. Total	59.4%	24.9%	9.6%
U.S. FDI Income Earned Abroad	209	90	40
% of U.S. Total	46.6%	20.1%	8.8%
Foreign FDI Income Earned in the U.S.	95	38	15
% of U.S. Total	58.1%	23.2%	8.9%
Foreign Affiliate Sales of U.S. MNCs in...*	2,315	1,829	879
% of U.S. Total	38.6%	30.5%	14.7%
U.S. Affiliate Sales of Foreign MNCs from...**	2,006	1,073	304
% of U.S. Total	50.7%	27.1%	7.7%

Sources: IMF; UN; BEA.
Data for 2014
**Data for 2013*

Endnotes

1. For a sector by sector analysis, see Daniel S. Hamilton & Jacques Pelkmans, eds, *Rule-Makers or Rule-Takers? Exploring the Transatlantic Trade and Investment Partnership* (Washington DC/Brussels/London: Center for Transatlantic Relations/Center for European Policy Studies/Rowman and Littlefield, 2015).