Continental drift? – Transatlantic economic relations in turbulent times

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1 Introduction

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Steven Sokol,
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Ladies and gentlemen,

If our meeting had taken place 200 million years ago, my journey to New York would have been rather short. At that time, all of the land masses on Earth were joined together in the super-continent of Pangaea, including North America and Europe. And New York City, the spot where we are meeting today, would have been at the very heart of our common continent.

Tectonic plate shifts caused Pangaea to break apart and created the world as we now know it.[1] Since then, North America and Europe have been separated by the Atlantic Ocean. Indeed, our continents keep drifting apart by about one inch every year.[2]

Unfortunately, this may be true in the figurative sense as well: when it comes to the matter of mutual understanding on both sides of the Atlantic, the gap appears to be expanding rather than contracting.

But there is a big difference between geology and geopolitics: while the continental drift between the United States and Europe cannot be slowed or halted, the political distance between them is neither inevitable nor irreversible. To bridge the divides, we have to talk to each other. That is why events like today's – and the activities by the Council on Foreign Relations and the American Council on Germany in general – are so important.

I would like to thank you for inviting me here today. It is a great pleasure to be part of a debate with such a distinguished audience. To kick off the forthcoming discussion, I would like to sketch out some thoughts on transatlantic relations from the perspective of a German central banker, in particular on the German current account surplus, trade tensions, and the role of central banks.

2 Germany's current account surplus

We may be separated by an ocean today, but the United States and Europe are held together by strong economic ties, being the foremost trading partners in the world. And Germany in particular is one of the most important trade and investment partners for the US. In 2018, our bilateral trade in goods alone totalled 184 billion US dollars.

This exchange appears lopsided, as German merchandise exports outstrip imports by far, contributing to a surplus in the bilateral current account vis-à-vis the US. However, Germany doesn't just export goods. The flipside is: it also exports capital that fosters growth, jobs and prosperity here. Indeed, about 11 percent of the foreign direct investment stock in the US comes from Germany. [3]

Moreover, purely bilateral considerations are misleading. Nobel laureate Robert Solow hit the nail on the head, when he complained: "I have a chronic deficit with my barber, who doesn't buy a darned thing from me." [4] In a world where the division of labour has global dimensions, bilateral trade balances generally don't have much explanatory value.

This is especially true with respect to the European Union and its single internal market. Not only do German exports contain inputs from other EU Member States: US goods and services may also reach German customers via our partner countries. In fact, vis-à-vis the EU as a whole, the United States has run a current account surplus in every year since 2009, according to official US statistics. [5]

But even beyond the bilateral perspective, Germany runs a current account surplus with the rest of the world. Indeed, this surplus has been very high for an extended period of time now. Its sustainability has been questioned, and rightly so.

Therefore, we have to take a closer look at the driving forces. [6] It's a bit like geoscience: gaining knowledge requires looking beyond the surface and investigating the underlying forces. When a country has a current account surplus, this means that it saves more than it invests.

In Germany, the rise in corporate savings was a key driver of developments after the turn of the millennium. Back then, German firms faced rather high debt levels and responded by reducing the distribution of profits to company owners. [7] Their equity levels are sound again in the meantime, so it would be plausible that they increase their payouts. And indeed, this tendency has already contributed to the decline in the current account surplus since 2015.

But there are also calls for targeted political measures by German authorities to reduce the surplus. However, this is easier said than done. A country's current account is the result of multi-layered market processes that offer few options for policymakers to address distortions.

All eyes are on fiscal policy, and Germany is often called on to increase public spending. It is correct that Germany has built up fiscal space in recent years. But an expansionary fiscal policy is already incorporated in the budget plans of the government.

In the short term, some additional fiscal spending might be possible. However, with respect to macroeconomic stabilisation, any further stimulus appears unnecessary, unless a perceptible deterioration in the economic outlook becomes apparent. Germany's output gap is about to close and forecasts don't foresee a marked deterioration.

It would be important to use the leeway wisely in order to promote sustainable growth in the long run and not just cause a flash in the pan. Targeted investments in infrastructure, expenditure on research and education, and promoting incentives to work and invest by reducing taxation are keywords in that context. Climate change is another important challenge, for which the German government has just proposed a package of measures.

The current account surplus is already in the process of shrinking, and a loosening of fiscal policies may contribute to that. But we shouldn't expect miracles. According to our calculations – and even in a more optimistic scenario – fiscal policy measures of a realistic size would reduce only a smaller part of Germany's current account surplus. They would raise imports only to some extent. And the impact on the current account deficit to GDP ratio in the US would be even far smaller.› [8] One intuitive reason is the difference in sheer economic size: the US economy is roughly five times as large as the German economy.

3 Trade tensions

When considering options beyond fiscal policy, import tariffs in particular seem to be back in fashion. Proponents believe that higher tariffs can solve several problems at once: they claim that raising tariffs can reduce current account deficits, protect jobs, and even make people better off.

This belief is mistaken. Indeed, even the impact of new tariffs on the current account balance is ambiguous.› [9] Intuitively, imports will be reduced. But exports are likely to fall at the same time, due to weaker foreign demand and an appreciation of the domestic currency. More importantly, by introducing new tariffs, a country runs the risk of damaging its own economy. Tariffs increase the prices of imported goods, and this weakens the purchasing power of consumers.

Indeed, American researchers have found that the US tariffs introduced last year were almost completely passed through into US domestic prices.› [10] Retaliatory tariffs adopted by other countries will probably do even further damage. As Roberto Azevêdo, Director General of the World Trade Organization warned: "An eye for an eye will leave us all blind." › [11]

The trade conflict between the United States and China shows what this means. According to Bundesbank simulations, the measures that have been adopted or brought up could cut the output of both countries by more than a half percent over the medium term. World trade would be reduced by 1.5 percent.

Having said that, there are legitimate concerns regarding economic relations with China. Indeed, not only the US is pressing for changes. In a joint communication, the European Commission likewise criticises the lack of reciprocal market access. China shields its domestic companies from competition through numerous measures. For example, European companies have to fulfil several preconditions to access the Chinese market, such as transferring key technologies to Chinese counterparts.› [12]

So one thing is very clear: China's state-led economy poses challenges for both the United States and Europe. This is just one reason why bilateral negotiations are not enough. We need multilateral approaches and rules that ensure fair competition in global trade and investment.

Multilateralism is enshrined in the World Trade Organization. While its rulebook needs an update, the WTO has fostered global trade and prosperity for 25 years now. A particularly important achievement has been its dispute settlement system. The recent ruling by WTO arbitrators regarding trade in civil aircraft demonstrates that the system works.

By contrast, a full-blown trade war between the United States and the European Union could cost both sides dearly. The potential adverse effects might be considerably larger than in the case of the current trade spat with China. For comparison, the value of US exports to the EU is three times greater than the value of its exports to China.

Assuming in a purely hypothetical scenario that new tariffs of 25 percent were imposed on all bilateral trade flows between the US and the EU, a simulation by the Bundesbank suggests that such a trade war could shrink the US output level by 1.5 percent over the medium term. Other countries would also be adversely affected, albeit to a lesser extent, and world trade would be diminished by 3.5 percent.

Of course, such quantitative model exercises should be taken with the proverbial pinch of salt. However, one thing needs to be clear: trade is not a zero-sum game. Erecting trade barriers means distorting the global economy and lowering its level of activity. Retaliatory tariffs may affect the distribution of welfare losses across countries to some extent but will reduce overall output further.

4 The role of central banks

Ladies and gentlemen,

The tariffs enacted since the beginning of last year are already weighing on world trade. Moreover, the ongoing trade spats have undermined business sentiment and contributed to the high level of uncertainty. They are a key factor behind the current weakness in the global economy. And a further escalation of trade conflicts remains one of the most important risks despite the latest signs of progress in the trade talks between China and the US.

In this situation, central banks aiming for price stability have to act if the inflation outlook is affected. Beyond that, I find it worrying when trade policy debates become entangled with monetary issues.

Allegations have been raised that some countries are intentionally devaluing their currencies with the aim of improving domestic price competitiveness at the expense of their trading partners. A series of competitive devaluations, nowadays often called a “currency war”, could erode financial stability and damage all economies involved. However, as far as I can see, no major economy is currently engaging in strategic competitive devaluations, far less in a currency war.

To be clear, from a monetary policy perspective, exchange rates are an important transmission channel, because they may affect inflation via import prices, for example. But neither the Federal Reserve nor the Eurosystem target exchange rates. The Eurosystem’s primary objective is to maintain price stability in the euro area. And the Fed has a similarly domestic mandate which also includes employment. Of course, one could discuss specific monetary policy measures in terms of their effectiveness and side-effects, but that is a different story.

What the debate on competitive devaluations illustrates above all is that political pressures on central banks have risen recently. Attempts by politicians to influence monetary policy are nothing new. What is new, however, is the impression that the classic trade-off between price stability and other economic policy objectives may have vanished for good against the background of low inflation.

In principle, both monetary and fiscal policy might strive to stimulate the economy. Some observers thus claim that monetary policy and fiscal policy should act in concert and that central bankers should bow to politicians. They evidently believe that central bank independence is superfluous in this day and age.

It is true that, at the lower bound of interest rates, fiscal policy is in theory often considered a powerful instrument. And in the current environment the ECB Governing Council reminds governments of their responsibility for macroeconomic stabilisation and longer-term growth. However, the interests of monetary policy and fiscal policy will not overlap forever.

The news magazine “The Economist” asserts in its latest issue that the link between lower unemployment and higher inflation has gone missing, referring to a “strange new world”.[13] But history advises caution. As Alan Greenspan once observed: “[…] history is strewn with visions of such ‘new eras’ that, in the end, have proven to be a mirage.”[14] Indeed, other studies stress that “reports of the death of the [so-called] Phillips curve may be greatly exaggerated”.[15]

A recent Bundesbank analysis finds that, in Germany, the cyclical impact of wages on prices is still intact.[16] While the pass-through of wage changes has diminished since the 1970s, it has been broadly stable lately. Indeed, a 1 percent rise in wage costs would ultimately push up consumer prices by around 0.3 percent. But this pass-through can take several years. A slow firming of inflation shouldn’t (Tonne) really be a surprise.

When central banks have reached their policy aims, at the very latest, monetary policymakers will have to be able to make the autonomous decision to withdraw the monetary policy stimulus. Former Fed Chair William Martin once famously quipped that it was the Fed's job to remove the punch bowl "just when the party was really warming up". [17]

It would be naive to believe that politicians would then relinquish their influence over the central bank or give precedence to the objective of price stability over their own agenda. That is why independent monetary policymakers with a clear mandate remain a key foundation on which to ensure price stability in the future as well.

In my view, it is all the more important for central banks to stick to a narrow interpretation of their mandate. In fact, it's hard to square the independence of a public sector institution with democratic principles. In Europe, it has been granted to monetary policy as an exception for the specific aim of safeguarding price stability. If the mandate were interpreted broadly, independence would be called into question sooner or later, and rightly so.

5 Conclusion

Ladies and gentlemen,

During the era of the Pangaean supercontinent, a mountain range stretched through this very spot. And, in a way, this continues to shape the Manhattan cityscape even today. Under the weight of these mountains, a particularly hard layer of rock was formed. The mountains were eroded by the forces of nature over millions of years. But the remaining hard layer of rock provides the indispensable foundation for today's skyscrapers. [18]

Thus, the Manhattan skyline is also a reminder of the importance of a solid footing. The foundation of the European Monetary Union needs to be rendered firmer still. The sovereign debt crisis in the euro area was borne out of institutional weaknesses, among other things. As far as its resolution and underlying causes are concerned, a lot has happened in recent years. In particular, the creation of the banking union has been an important step.

However, you could still say that the monetary union has a strong leg and a weak leg. From the outset, the strong leg has been its monetary framework with the independence of central banks and the prohibition of monetary financing of governments enshrined in the European Treaties.

The weak leg is its framework for fiscal and economic policy. Decision-making here continues to reside largely with the member states, while joint liability has tended to increase in recent years. To resolve this weakness, some observers have proposed the creation of a true fiscal union, where decision-making powers would be shifted to the European level.

As Thomas Sargent observed in his Nobel Lecture, Americans faced a similar, perhaps even more pressing situation a long time ago, after the Revolutionary War. [19] The Articles of Confederation had placed fiscal sovereignty largely in the hands of the states. But the young republic was creaking under the strain of common war debt.

Following intense debate, Americans eventually opted for fiscal union, but it was embedded in a strong political union resting on democratically legitimised institutions. A new constitution created a federal government with a range of enforceable powers fitted within a sophisticated system of checks and balances.

Is this a model that could work for Europe, too? Surely, American history can teach us important lessons. A key point may be that, even within a federal state, action and liability must be finely balanced, as was highlighted by the default of several US states in the 19th century.

The transatlantic partnership, underpinned by our shared values of freedom and democracy, has given us more than 70 years of peace and prosperity. It is worth preserving and fostering.

Thank you for your attention!

Footnotes:

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