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Summary: Europe's sovereign debt crisis has had, and continues to have, a profound effect on the transatlantic economy. But in the long run, the lasting effects of the sovereign debt in Europe are harder to discern. How are risks in Europe being channeled to the rest of the world, notably to the United States? This policy brief discusses both the near-term (cyclical) and potential long-term (structural) effects of the European debt crisis on the transatlantic economy.

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Your Pain is Our Pain: The United States and the European Debt Crisis

by Joseph Quinlan

Europe's sovereign debt crisis has had, and continues to have, a profound effect on the transatlantic economy — the highly integrated economic space inhabited by the United States and Europe. The crisis has reduced the cross-border transatlantic flow of capital, credit, and commerce, and impaired economic growth on both sides of the Atlantic, as well as around the world. The euro zone is slipping into recession, with the depth and duration of the unfolding economic downturn still unknown. At a minimum, the transatlantic economy confronts a year of slow or no economic growth.

In the long run, the lasting effects of the sovereign debt in Europe are harder to discern. A total breakup of the euro zone would effectively obliterate the transatlantic integration of the past six decades and deal a sharp blow to Europe, the United States, and the global economy. This worst-case scenario is unlikely, however. Yet the risks of a "black swan" event — Greece leaving the euro zone or a Greek, Portuguese, Italian, or Spanish default — are still quite real. The euro debt crisis could still produce deep fissures in the foundation of the transatlantic partnership, undermining the global clout of the United States and Europe.

This policy brief discusses both the near-term (cyclical) and potential long-term (structural) effects of the European debt crisis on the transatlantic economy.

Cyclical Transmissions of Euro Zone Contagion

Europe's sovereign debt crisis has entered its third year, and like past financial crises, the longer it takes Europe to come to grips with its financial challenges, the greater the collateral damage to Europe, the United States, and the global economy. It was in May 2010 that the European Union first had to come to the financial rescue of Greece, followed by Ireland in November of the same year and Portugal in April 2011. As the financial crisis spread among Europe's periphery last year, the financial markets lost confidence in Europe's other heavily indebted nations — notably Italy and Spain — causing sovereign bond yields and spreads to soar across the continent. The combination of sky high interest rates and fiscal austerity pushed Europe into recession late in the year.

The world economy stands on the brink of another economic downturn, with the euro zone financial turmoil throttling global growth, trade, and investment. The IMF expects real global GDP growth of only 3.3% this year, down from 3.8% in 2011 and 5.2% in 2010. Not unexpectedly, growth in the developed nations will be much weaker than the global average; the IMF expects output in the euro zone to contract this year by 0.5%, and forecasts growth of just 1.2% for the world's developed nations.

The risk facing the world economy is another Lehman-type moment that could freeze the global capital markets, trigger a collapse in global trade, and precipitate a global recession. A disorderly default in either Greece or Portugal, or political dithering in Washington over the budget deficit, which results in another credit downgrade of the United States, are events that could be a trigger for another bout of financial paralysis on a global scale and weaker-than-expected global growth. How are risks in Europe being channeled to the rest of the world, notably to the United States?

Channel One: The Credit and Capital Markets

Europe's financial turmoil has manifested itself in different ways, most directly through the global capital markets. Because European banks are large holders of sovereign debt, when the sovereign dominoes in Europe toppled last year, bank lending and credit creation came to a virtual standstill. Rising risk aversion among banks lead to widening credit spreads for sovereigns and throttled lending to the private sector. Existing sovereign debt became more difficult to roll over, with Italy, for instance, forced to pay punishing yields in excess of 7% last year. As the year progressed, governments across the continent — including even Germany at one time — found it increasingly difficult to refinance debt. It has not helped that, since September 2011, a series of ratings downgrades and negative outlooks for many euro nations have contributed to the rising cost of capital and increased volatility. To calm the financial markets, fiscal austerity has become the norm in Europe, although belt-tightening has only weakened an already fragile euro zone.

Given the interdependence of the transatlantic capital markets, Wall Street has not been spared Europe's financial crisis. U.S. banks are not overly exposed to Greece and Portugal, with outstanding U.S. loans or claims in Greece totaling $8.3 billion and Portugal $5.5 billion last year, according to the Bank of International Settlements. But U.S. financial institutions are heavily exposed to banks in the United Kingdom, Italy, France, and Germany, who in turn are highly leveraged to some of Europe's most indebted nations. Transatlantic financial links, in other words, are thick and very much entangled across borders, meaning that a financial problem in one corner of the euro zone is a problem not just for the entire continent, but also for the United States.

Financial contagion in Europe has added more volatility to the U.S. capital markets. Worse still, it has triggered financial deleveraging among European banks in the United States. Over the past year, European banks have shed U.S. assets by selling or scaling back their North American businesses, paring their U.S. workforces, and reducing the level of capital inflow to the States. Cross-border capital flows have reversed, with more European capital leaving the United States than flowing in. As part of this dynamic, foreign direct investment from Europe to the United States — after nearly doubling in 2010 from the depressed levels of 2009 — plunged 28% in the first nine months of 2011 from the same period a year ago.

In general, European capital is being called home because of Europe's acute capital needs and more stringent capital requirements, including European banks raising their Tier

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I capital ratios to 9% by the middle of 2012.[1] Broadly put, as Europe struggles to contain its financial crisis, the risk is of a full blown global retreat in global finance — or financial deglobalization — a scenario that entails greatly reduced cross-border flows of capital and ever-rising risks to the transatlantic economy.

Channel Two: Cross-Border Trade

As global finance has dried up over the past year, so has global trade. Global trade volumes decreased dramatically in 2011, and will continue to weaken if Europe's crisis — like the financial crisis spawned in the United States in 2008 — ultimately drags the global economy into recession. Notably at risk is the United States, which relies on Europe to consume roughly one-fifth of total U.S. exports.

Last year U.S. exports to the European Union totaled an estimated $270 billion, off only slightly from the pre-crisis peak of $277 billion in 2008; however, U.S. exports to Europe weakened in the later months of 2011, a trend directly tied to Europe's sovereign debt crisis.

U.S. exports to the European Union expanded 13.1% in the first 11 months of the year from the same period a year ago. That is a robust figure, but it masks the fact that by November 2011, U.S. exports to the EU were expanding by just 4.8% on a year-over-year basis. In November, U.S. exports to France, Germany, and Ireland actually declined, by 8.8%, 7%, and 8.5%, respectively, from a year ago. Exports to the Netherlands rose by just 1.5% in November after surging over most of the year.

All this is indicative of a continent losing its economic vitality, with a direct effect on U.S. trade. As part of this process, the United States' merchandise trade deficit with EU surged from $73 billion in the January-November period of 2010 to roughly $90 billion last year, a near 23% rise. The United States' trade deficit with Germany, Europe's largest economy, exploded by around 43% last year, rising to roughly $45 billion. Meanwhile, its trade deficit with Belgium surged 30.2%, while rising 20% with Ireland, 25% with Italy, 22.9% with the Netherlands and 11.6% with Sweden.

In sum: Europe's pain is the United States' pain, a dynamic all too evident by slumping U.S. exports to the region. U.S. exports had been on an upward trajectory over most of 2011, acting as a key pillar of growth for a U.S. economy struggling with weak housing sales and construction activity, as well as soft consumer spending. In November, however, Europe's sovereign debt crisis helped throttle a key component of U.S. growth.

Channel Three: U.S. Corporate Earnings

Finally, the impact of the European crisis has also become painfully evident in the earnings — or the bottom line — of many U.S. corporations. Tiffany's (high-end retail), General Electric (industrial products), Baxter International (health care), Alcoa (materials), National Instruments (technology), and numerous other U.S. companies from across different swathes of U.S. industry have all recently highlighted the damage to their earnings from deteriorating profits and sales in Europe. Indeed, in the fourth quarter of 2011, the earnings of the companies listed in the S&P 500 index (an industry benchmark) were among the weakest in years because of Europe's economic and financial crisis and its follow-on effects on the rest of the world. More troublingly, many U.S. firms singled out Europe as the key risk to their earnings outlook for 2012, underscoring the deep commercial ties that bind the corporate United States and Europe together.

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Indeed, no other region of the world is as important to the global success of U.S. multinationals as Europe, for the simple reason that over the past decades, no place in the world has attracted more U.S. foreign direct investment (FDI) than Europe. Over the 1980s, for instance, Europe accounted for 55% of total cumulative outflows from the United States. Europe's aggregate share of U.S. investment dipped to 53.5% in the 1990s, but rebounded in the first decade of this century, edging up to 56% of the global total.

[1] The Tier 1 capital ratio refers to a bank's core equity capital as related to its total risk-weighted assets; this metric is a core measurement of a bank's financial strength and health, with many regulators imposing higher capital ratios on banks in the post-crisis climate to avoid the global credit freeze of the 2008 and the use of excess leverage.

And not much has changed in the new decade underway. Since the start of 2010, Europe has captured 55.2% of total U.S. investment. This is a surprisingly robust share considering the emergence of the developing nations, notably China and Brazil, and all the hype about U.S. firms decamping from high-cost locales — the United States and Europe — for cheaper destinations. The evidence suggests that nothing of the sort is happening.

By whatever measure, whether it is the number of foreign affiliates, affiliate employment, R&D expenditures, affiliate income, compensation, or total assets, Europe ranks at the top of the list, underscoring the exposure of U.S. firms to the region. Put another way, when things go wrong in Europe, as they have in the past two years, the adverse effects are quickly transmitted to the bottom line of many U.S. multinationals.

Consequently, a key risk in 2012 will be that the U.S. earnings slowdown becomes more pronounced this year as a direct result of Europe's recession, a scenario that could very well lead to less hiring and investing among U.S. firms, and weaker-than-expected U.S. growth.

Structural Risks to the Transatlantic Partnership

While there is still a chance that Europe could emerge stronger from the current sovereign debt crisis, the odds of this happening are slim. At the moment, there is too much debt, too much political indecisiveness, and too much popular resistance to painful austerity measures to justify the assumption that the euro zone of today will be stronger and more united tomorrow. Fears that Europe continues to crumble under the mountain of debt it has accumulated over the past decades are unfortunately much more realistic. In that case, the United States will see the influence and clout of its foremost global economic partner dwindle and decline.

At risk is nothing less than the combined weight of the transatlantic economy, and by extension, the stability of the global economy. After all, the foundation of the world economy has rested squarely on the shoulders of the United States and Europe for the past 60 years, with Western economic cooperation and cohesion key to one of the longest running periods of global prosperity.

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Prior to the financial crisis of 2008, the global economy was largely groomed and managed by the United States and Europe on the basis of the central tenets of globalization — industry deregulation, unfettered global capital flows, trade and investment liberalization, and the primacy of the private sector. And it worked. The global economy, from the early 1980s onward, experienced a golden era of muted inflation, low unemployment, and only infrequent and shallow recessions. Global trade and investment rose sharply over this period, helping to lift millions of people in China, India, Brazil, and elsewhere out of poverty. There were periodic financial crises during this time, but never at the core of the global economy —the United States or Europe.

All of this has changed, however. The economic legitimacy of the transatlantic partnership has been undermined by the U.S. financial crisis of 2008 and its encore, the European sovereign debt crisis of 2010-2011.

Europe's sovereign debt crisis and the United States' fragile economic recovery have stunted transatlantic cooperation in a number of trade and commerce-related initiatives, with policymakers on both sides of the Atlantic too busy at home to worry about things abroad. Meanwhile, transatlantic financial troubles have also weakened and handicapped the United States and Europe in their efforts to shape the global economic agenda. The transatlantic-centric global economy of the past three decades is being recast. New economic powers are on the ascent — led by nations like China, India, Brazil, and Turkey — with these emerging players less inclined to follow the global rules laid out by the United States and the West. State capitalism is back in vogue in many parts of the world. Meanwhile, skilled labor, capital, and natural resources — critical economic inputs — are increasingly under the control of the developing nations, whose ideas of economic order differ significantly from those of the United States and Europe.

In the end, Europe's financial crisis not only threatens to weaken the transatlantic economy but also to radically reshape how and who runs the global economy.

Policy Recommendations

Obviously, the first order of the day for the United States and Europe to regain their effectiveness and credibility as leaders and shapers of global economic order is to implement painful but necessary economic reforms at home. For the United States, that means reducing the federal budget deficit to more manageable levels, and scaling back the nation's dependence on foreign capital and oil. For Europe, it requires taking steps to halt the continent's sovereign debt crisis and, beyond that, to construct a stronger fiscal and economic union to complement Europe's political union.

Saddled with onerous levels of public sector debt, the challenge for both the United States and Europe is to craft medium-term growth policies while implementing near-term deficit-reduction measures. This entails a mix of revenue enhancements and spending cuts, as well as a wider public safety net for the less-well off and long-term investment in infrastructure and R&D. This tricky challenge is the price the United States and much of Europe must pay for living well beyond their means for decades. The era of economic growth via excess leverage is over.

That said, while easy money has helped fuel growth on both sides of the Atlantic for years, other factors have contributed as well. Chief among them have been the ever-expanding transatlantic ties in trade, investment, and capital, with the steady rise in the integration of the transatlantic economy over the past decades hugely beneficial to the primary shareholders of the United States and Europe — consumers, workers, companies, and governments. Stronger economic ties have resulted in more cross-border trade and investment, greater access to each other's markets and resources, lower-cost imports for transatlantic consumers, more jobs and income for workers, and more profits for corporations, among other things. In short, the making of the transatlantic economy over the past half century — the most integrated economic bloc in the world — has been a win-win dynamic for both the United States and Europe.

Against this backdrop, it is time for Europe and the United States to redouble their efforts at creating a deeper and more integrated transatlantic economy — not least in order to create enough growth to counter necessary austerity policies. This is the time to commit to a transatlantic free trade zone, with an urgent focus on reducing existing tariff barriers, regulatory obstacles, and investment restrictions in a host of industries, ranging from aviation, to banking to e-commerce. Removing tariffs and nontariff barriers in the agriculture and services sectors, in particular, would have the largest impact on growth — and hence send the strongest political signal that policymakers on both sides of the pond are finally serious about deeper economic integration.

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Neither the United State nor Europe can afford expensive farm subsidies anymore, so a coordinated move to reduce trade-distorting agricultural subsidies would ultimately reduce spending and open new markets for farmers on both sides of the pond. Even larger benefits would be achieved by opening and awakening Europe's sleeping giant: services. The latter accounts for 70% of Europe's output but less than one-quarter of Europe's trade, with many service markets in Europe tightly controlled and constrained by national rules and regulations. The end result: higher prices for consumers, lower productivity levels due to the lack of competition, and less cross-border trade and investment in a host of industries. Empirical research shows that if the EU Services Directive were fully implemented, it could deliver more than 600,000 new jobs and economic gains ranging between €60 and 140 billion, resulting in an annual growth boost of at least 0.6-1.5% of GDP.[2] With a "digital single market" now a priority of the European Commission, and with just 3-4% of Europe's products and services sold on-line, there is no better time for the United States and Europe to coordinate and craft policies that spur growth in a range of digital and service-

[2] See Daniel Hamilton's "Europe 2020: Competitive or Complacent?" page xii.

related activities.[3] In the end, because Europe has been slow to grasp the opportunity of service deregulation, the growth of the transatlantic service economy has been stunted. Cooperation in these two highly sensitive sectors could pave the way for more integration in other sectors and industries.

It is also high time for leaders on both sides of the Atlantic to ensure the success and effectiveness of the Transatlantic Economic Council (TEC) by creating a high profile Secretariat and working groups tasked with specific goals and timetables for strengthening and deepening bilateral trade and investment ties. Given the deep linkages between U.S. and European banks, financial sector reform should be high on the TEC's to-do list. Other important issues to address are information technology, biotechnology, and health and medical services — all key areas of growth and innovation in the future. Collaboration in all these fields would allow the United States and Europe to create economies of scale and increase R&D funding.

Time is short and the challenges great on both sides of the Atlantic. The longer Europe struggles to contain and overcome its sovereign debt crisis, the greater the risks to the primacy of the transatlantic partnership and the economic well-being of both the United States and Europe.

[3] See "The Coming Retail Boom," Schumpeter, *The Economist*, February 4, 2012, p. 72.

About the Author

Joseph Quinlan, a non-resident Transatlantic Fellow with GMF since 2003, is a leading expert on the transatlantic economy and well-known global economist. His research centers on regional and global trade and investment flows. In addition to his duties with The German Marshall Fund, Quinlan is the Chief Market Strategist of Bank of America Capital Management, where he is charged with the development and implementation of domestic and global investment strategies. He has also worked as a Global Economist at Morgan Stanley, as Director of Economic Research for Sea-Land Services, and as an International Management Consultant. Quinlan started his career with Merrill Lynch Economics.

About The EuroFuture Project

The German Marshall Fund of the United States understands the twin crisis in Europe and the United States to be a defining moment that will shape the transatlantic partnership and its interactions with the wider world for thelong term. GMF's EuroFuture Project therefore aims to understand and explore the economic, governance and geostrategic dimensions of the EuroCrisis from a transatlantic perspective. The Project addresses the impact, implications, and ripple effects of the crisis — in Europe, for the United States and the world.

GMF does this through a combination of initiatives on both sides of the Atlantic, including large and small convening, regional seminars, study tours, paper series, polling, briefings, and media interviews. The Project also integrates its work on the EuroCrisis into several of GMF's existing programs. The Project is led by Thomas Kleine-Brockhoff, Senior Transatlantic Fellow and Senior Director for Strategy. The group of GMF experts involved in the project consists of several Transatlantic Fellows as well as program staff on both sides of the Atlantic.