



# €-DIVERGENCES => US TRADE DEFICITS

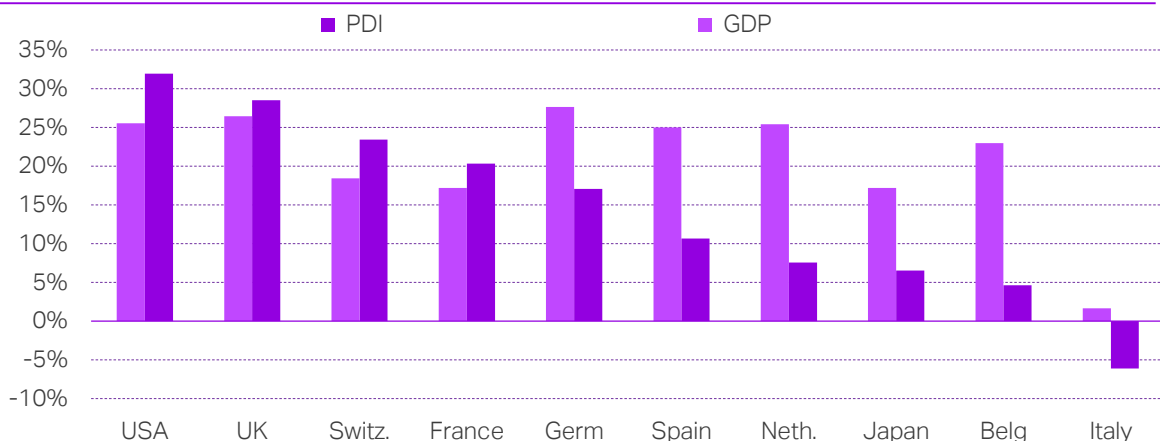
Charles Dumas / Constantine Fraser

- **Italy's massive underperformance under the euro system destabilises the world**
- **Italy's uncompetitive labour costs are the chief reason for an ultra-cheap euro**
- **The ultra-cheap euro is the chief reason for current global trade tensions**
- **The Juncker-Trump "deal" means a temporary armistice on the European front**

## It's global imbalances that matter

The point of the title is to highlight the weakness of much commentary on the trade-war issue. Longing for something concrete to express things simply, political comment focuses on the bilateral US trade deficit with China. For the few that grasp that the chief US trade imbalance is with Europe, the talk suddenly turns to cars, or to tariffs. But bilateral trade imbalances do not matter if there is no overall imbalance – that is what comparative advantage is all about. Neither do imbalances in the car industry matter if other industries offset them. Tariff inequities matter if they are large, but are far less important than prolonged currency over- or under-valuation. This Europe Watch will cover the EA's interactive growth and cost imbalances. These have led to major internal imbalances, and monetary policies that seriously worsen global imbalances.

### Real growth per head, %, 2017/1998



Source: OECD, TS Lombard

## Changes to Europe Watch publishing frequency

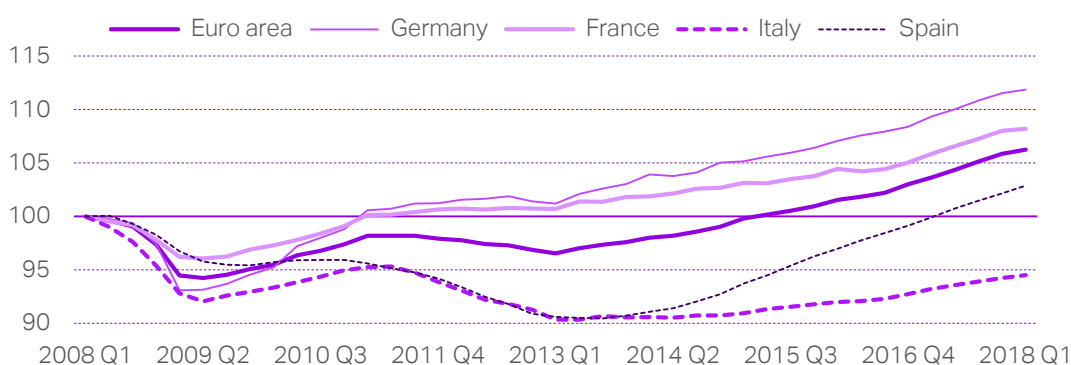
This is the first additional, more timely note, following changes to our publishing frequency. You will still receive a comprehensive piece every fortnight (previously weekly) on Friday. This change will ensure that our analysts have the flexibility required to respond to developments more quickly and deliver more timely advice. If you have any questions please contact your account manager or email [nick.bourne@tslombard.com](mailto:nick.bourne@tslombard.com).

The chart on our first page shows the real growth of GDP and after-tax personal disposable income over the life of the euro, 2017 compared to 1998, in each case per head of population. It shows the huge divergence between different EA countries, with Italian GDP per head scarcely higher in 2017 than 1998, while real disposable household incomes were 6% down.

The chart also shows that real disposable household incomes fell short of real GDP by about ten percentage points for all the EA countries except France. The chief counterpart to this shortfall of disposable income was greater net exports, reflecting both widespread austerity and major euro undervaluation. The analysis here will therefore mostly focus on the cost divergences that have caused this shift into net exports. But first we take a quick look at the divergence of GDP growth, itself partly resulting from these cost divergences, but also reflecting underlying differences in structural performance and productivity growth.

## Growth diverges

### Real GDP, 2008 Q1 = 100



Source: Datastream, TS Lombard

The chart above shows the level of real GDP indexed to 2008 Q1, the pre-crisis peak. The 'double-dip' recession was largely confined to the peripheral countries that hit trouble in the euro crisis of 2010-13. But Spain and Italy have diverged strongly since 2013, though Germany and France were stagnant (and non-euro Britain was also damaged). Spain's growth in the post-2013 recovery has been faster even than Germany's. But Italy's real GDP has only crawled up over the past five years, and remains more than 5% below its pre-crisis peak of ten years ago.

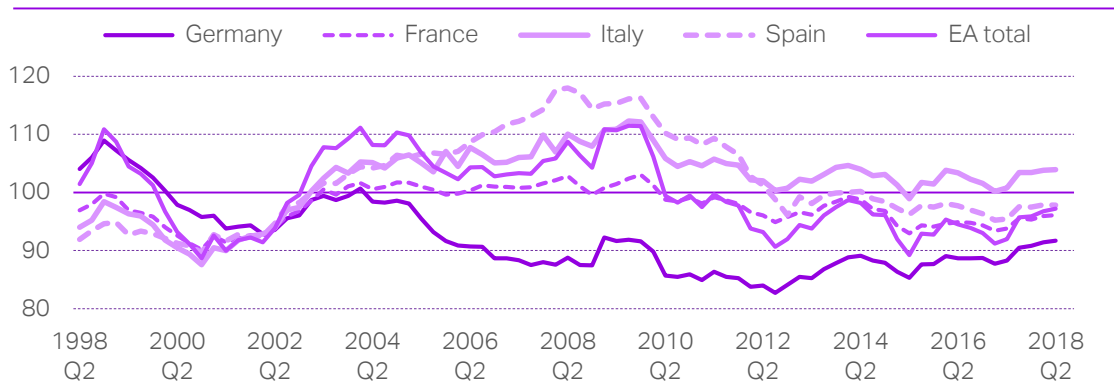
The chief divergence to be examined here will be Italy vis-à-vis Germany. In the chart above it can be seen that over the ten years since the pre-crisis peak, German real GDP is up 12%. With Italy down more than 5%, the divergence is more than 17 percentage points. Though Germany's pre-crisis growth was meagre, it was not as slow as Italy's, so the divergence over the whole life of the euro has been greater than this, more than 25%. These are data per head of population. We have analysed elsewhere why the nature of the euro system has damaged Italy, though a major portion of this divergence has arisen from structural rigidities, aggravated in their effect by the inherent rigidity of the euro.

## Inflation and costs diverge

The chart below shows the most important indicator of cost or inflation divergence within the euro system. For each of Germany, France and Italy it shows the deviation of its unit labour costs (ULCs), relative to its trading partners, and relative to its own position since the start of floating FX rates in 1973, ie the collapse of Bretton Woods. Thus for Germany, France and Italy the comparison of recent relative ULCs in the chart is with what each country respectively has had

as the average over the past 45 years. By this measure, Italy has been overvalued since 2003, and Germany has been undervalued since 2000, and by 10% or more for a dozen years since 2006. France is a little undervalued now, but has mostly been close to its long-run relative cost-competitive position.

### Real £ FX rate, long-term average = 100

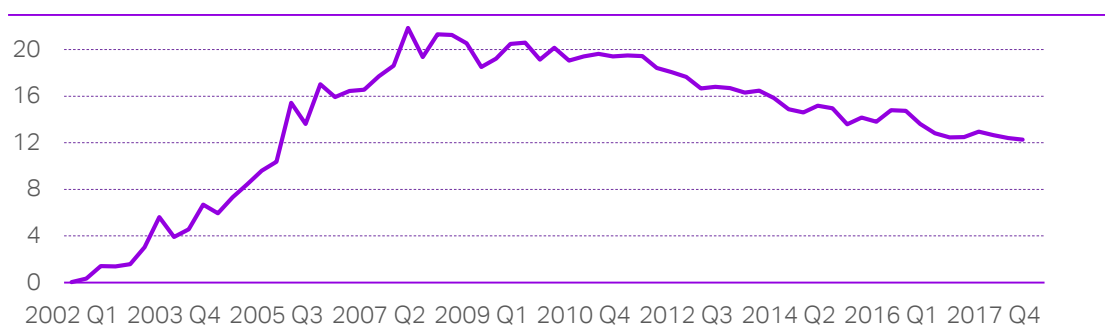


Source: OECD, Datastream, TS Lombard

For Spain, the death of Franco in late-1975 was followed by 15 years of 'sideways' movement as the economy opened up from its 40-year siege. The Barcelona Olympics of 1992 marked the full re-entry of Spain into catch-up growth, so the 1992-2017 average for its real exchange rate is used as the '100 line' in the chart. For similar reasons for the EA as a whole, started in 1999, the most recent 20 years from 1998 Q2 is used as the standard. By these criteria, Spain was more overvalued than Italy by the time of the 1998 financial crisis, but through its violent austerity has become competitive since, aided by the general undervaluation of the euro since 2010.

As may be seen from the chart, France and Spain have converged onto the general euro line in the recovery since 2013. The outliers amongst the big-four EA economies are Italy on the overvalued side, and Germany, undervalued.

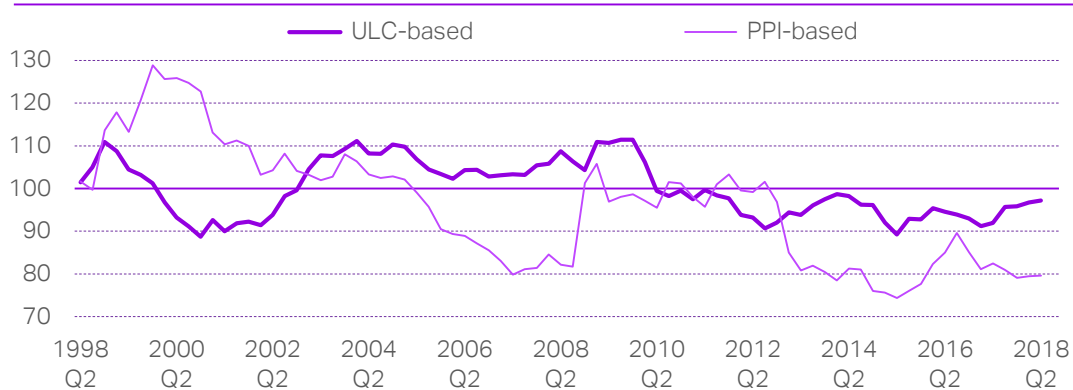
### Italy - Germany, real FX rate difference, %



Source: OECD, TS Lombard

The chart above shows the difference between Italy's real FX valuation, relative to its post-1973 average, and Germany's. From 2002, Germany was subject to strong austerity measures under Finance Minister Hans Eichel, and this is why its undervaluation reached 10% by 2006, despite the modest (3-4%) overvaluation of the euro that year. Italy maintained the inflationary habits of the previous half-century, and by the end of 2007 the differential between Italian overvaluation and German undervaluation exceeded 20%. After four years at about that level it has now fallen back to about 12%. But recent Italian wage hikes may reverse this improvement.

## Real € FX rate, long-term average = 100

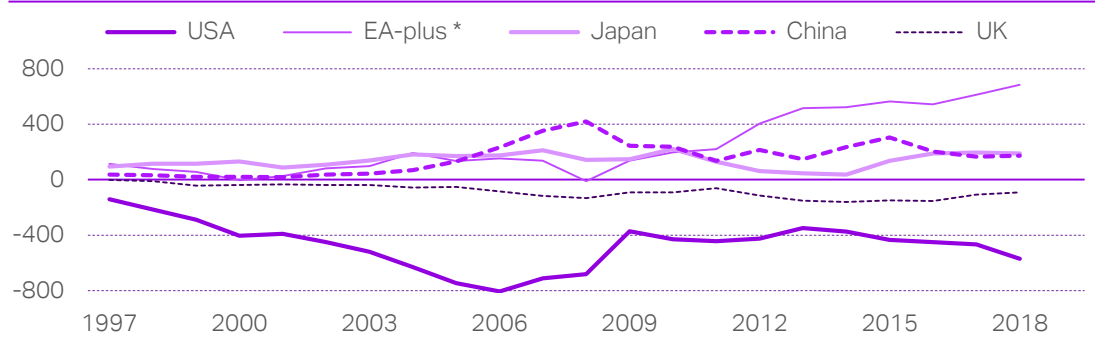


Source: OECD, Datastream, TS Lombard

When we look at the real euro FX rate, we can also use the producer-price (PPI) version, as well as the OECD's ULC-based version, as JP Morgan calculates the PPI version only for the EA as a whole, not for the individual countries. But the ULC version shows much more regular fluctuation about the average, so it is a more reliable indicator of over/under-valuation. The basic point is that from mid-2014 the ECB's monetary policy has been largely motivated by a concern to ensure strong recovery. As the EA had been depressed by massive fiscal austerity and natural excess of saving over investment in most of German-centred Europe, this necessitated a large drop in the real FX rate.

Between mid-2014 and mid-2015 it fell about 10% in ULC terms, and had already become heavily undervalued in PPI terms as profit margins were squeezed by the double-dip recession. So the EA has recovered on the back of export-led growth – ie beggar-my-neighbour dependence on other people's domestic demand, and at the expense of other people's industrial production.

## Current account balances, \$ billion



Source: OECD, TS Lombard

One result of this internal EA imbalance that necessitates the beggar-my-neighbour exchange rate of the euro is the divergence of global trade balances, illustrated above by the current-account balances of key countries and regions. (The 2018 data are OECD forecasts, and 'EA-plus' includes Switzerland, Sweden and Denmark, which are major surplus components of German-centred Europe.) In effect, Italian weakness ensures ECB monetary policies that make Germany's surpluses excessive (and those of its neighbours).

Germany's forecast \$340 billion surplus in 2018 is well over 8% of GDP. German-centred Europe's surplus slightly exceeds the US deficit and is its main counterpart globally. The divergences within the EA are thus the chief potential source of trans-Atlantic trade war.

## A temporary armistice on the European trade front

**Notwithstanding these imbalances, the EU and US have come to a trade truce.** It's fair to say that European hopes were pretty subdued ahead of Jean-Claude Juncker's visit to Washington yesterday. With Trump apparently intent on launching an assault on the German car industry before the autumn, and the US so far appearing uninterested in the EU's various trade offers, Brussels was busily drawing up an €18bn list of American imports for retaliatory tariffs. So the unexpected Juncker-Trump love-in, and the declaration that the EU and US would sign a trade armistice came as much of a surprise to them as it did to the markets.

**The US and EU commitments are exceedingly vague.** The US will hold off from imposing new tariffs on the EU, and will look at lifting its metals tariffs imposed in the spring; while the EU will commit to buying more US soybeans (which are under pressure from Chinese retaliatory tariffs) and LNG. Meanwhile, the two sides will begin negotiations aimed at eliminating non-auto industrial tariffs and subsidies and at reducing non-tariff barriers, while working together "to address unfair trading practises".

**Nothing very substantial will come of these talks.** The LNG promise is mostly meaningless: the EU is building some more import terminals for the sake of energy diversification, but market demand for expensive US LNG will remain limited. And unless the Commission has quietly agreed to expand its permissions for GM soybeans, Europeans buying more US soy is just a straightforward consequence of Chinese tariffs lowering the price. Besides, given the slow pace of trade talks (EU FTAs take on average over 4 years to negotiate, and another 2 to implementation), and the sensitive nature of the issues that will come up in any EU-US trade agreement, it is extremely unlikely that the talks will come to much.

**The two sides have only agreed an off-ramp from escalation.** Under growing pressure from Congressional Republicans with constituents already feeling the pain of the trade war, and perhaps temporarily weakened by the Helsinki episode, Trump apparently came to the meeting clearly wanting a deal. Trade hawk Peter Navarro was apparently absent from proceedings, with the President instead taking his lead from NEC head Larry Kudlow.

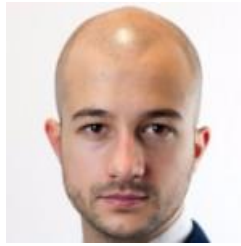
Now Trump has secured a public relations win. He can reassure his Senators that he is not blindly stumbling into a global trade conflict ahead of the midterms, maintain their support for his confrontation with China, and tell rural Republicans that he is looking out for them. For its part, at the cost of rewarding exactly the kind of behaviour of which it disapproves, the EU has secured a provisional reprieve from tariffs. It will now try to tie the US down in talks, in the hope that Trump is distracted by other issues or that the political winds in Washington begin to change.

**US tariffs on Europe are no longer an imminent threat.** The obvious takeaway from the deal must surely be that US tariffs on European cars, and commensurate EU retaliation, are no longer an imminent threat. The Department of Commerce was on course to publish its Section 232 recommendations on car tariffs as soon as August, with tariffs likely following in short order – this will now likely be delayed, or even buried. Of course, Trump is hardly a slave to consistency, and it may not be very long before he starts to beat the trade drum again. But the President's tweets, the joint statement and the press conference with Juncker in the Rose Garden all create public "buy-in" that will make it hard for the President to repudiate the deal in the short-term – at least before the mid-terms. Peace in our time, then?

## Authors



**Charles Dumas**  
Chief Economist



**Constantine  
Fraser**  
Political Analyst