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The transatlantic link and its future

Deep interdependence: the transatlantic economy and its prospects

Remarks by the Governor of the Bank of Italy
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1. *Is there still a "transatlantic economy"?*

How deep is the interdependence between the European and the American economies, actually? Since the preferential transatlantic link was forged with the Marshall Plan sixty and more years ago, the global landscape has been transformed. The economic distress of the European economies, especially in the countries defeated in war, implied the risk of global political instability in the face of the nascent Soviet bloc. The idea for financial aid to Europe was conceived. In December 1947 President Truman had proclaimed that "Our deepest concern with European recovery … is that it is essential to the maintenance of the civilization in which the American way of life is rooted."

For the United States, the Marshall Plan was also an investment in its own security and prosperity. And quite an economical investment at that. The first fifteen months of the Plan's application cost no more than one month of war[1]. While America offered aid, it called on the Europeans themselves, together, to organize a plan for the reconstruction of an open Europe capable of sustaining its own growth. The American stimulus for Europe's gradual and multilateral liberalization of foreign trade was crucial.

Italy played a special role in transatlantic relations. Through the mid-1960s its trade with the United States was relatively more intense than that of the other large continental countries. America provided 14 per cent of Italy's imports and took 10 per cent of its exports. For France and Germany these shares were at least five points lower; Germany reached the Italian level only at the end of the period.

1 US Department of State, Office of Public Affairs, Current Development Report on European Recovery, no. 3, 1948.

US leadership in direct industrial investment in Italy was strengthened during the 1950s.

In the decades since, more than anything else the transatlantic link has meant cultural fertilization. The United States, for centuries the beneficiary of European culture, found the way to repay this debt, fecundating a war-wracked Old World not only with material aid but above all with the culture of the market, the programme of spreading prosperity to the masses, and innovative entrepreneurial approaches.

The Marshall Plan's Overseas Technical Assistance and Productivity Program was designed to boost productivity by training and the transfer of American industrial practices to western Europe. Even after the end of the Plan, US experts continued their missions to Europe as industrial consultants, and European engineers continued to visit the United States for training.

A good number of Italian public administrators took advantage, including the Bank of Italy's Salvatore Guidotti, who learned "modern" national accounts methods in Washington. A number of management schools on the Harvard pattern were founded in Italy. Two of the leading figures in the Italian industrial renaissance, Vittorio Valletta and Adriano Olivetti, were influenced by this climate.

Today the European economic community is an established fact, the Soviet adversary has dissolved, Asia has stridden purposefully onto the world stage and other regions too are clamouring for a larger role. The economic supremacy of the United States remains, but now it must come to grips with a series of other economic power centres. How, and how profoundly, have these developments affected the interdependence between the economies on the two sides of the Atlantic?

Let us examine the facts. Economic interdependence must be assessed in three respects: the real economy (trade and direct investment); the financial economy; and economic policy (reciprocal influence and cooperation).

2. *Trade and foreign direct investment*

2.1 On trade. First, a premise: both the US and Europe were and are still relatively “closed” economies. For the United States, foreign trade in goods represents scarcely a fourth of GDP today. The openness of today’s 27-member European Union is of about the same order of magnitude.

However, this similarity conceals significant differences in trend. The United States built its internal market much earlier than Europe, in the nineteenth century; and even in the 1950s and 1960s American foreign trade was much more modest than now, accounting for just one tenth of GDP.

The dynamics was very different. The US were a closed economy with a predominant internal market until recently. The single countries of Europe were much more open versus the US than vice versa before European integration. As this took off the ground, the internal market replaced external trade.

America’s “discovery” of the importance of the world around it is historically recent. It has been fostered by globalization and spurred by the deficit of domestic saving. But the secular dominance of the US domestic market makes American firms and policymakers alike primarily inward-looking.

Europe does still consist of sovereign states, but every one has a strong propensity for foreign trade, historically rooted both in corporate strategies and in economic policy philosophy. A good part of that propensity has been channelled into the relatively recent phenomenon of an opening up of national markets to bring them together in one single market.

Transatlantic trade nevertheless remains the largest component of both areas’ external economic dealings. In 2007 each side took about a fifth of the other’s exports; the United States supplied 12 per cent of Europe’s imports, Europe 18 per cent of America’s. These shares are still large, but smaller than just a decade ago. They have been lowered by the emergence of major new trading powers outside the Atlantic area.

2.2 In the flow of productive capital too, the once very close interdependence between Europe and the United States has been affected by the emergence of major new countries that both receive and make foreign direct investments. However, the figures on the stock of investment – which reflect the past and not, like flows, only the present – paint a picture of still intense interdependence.

Today as thirty years ago, the United States and the European Union are the greatest sources of foreign direct investment in the world, the origin of 70 per cent of the world stock. They have been and still are highly attractive for foreign investment. Despite the competition of the emerging economies, they are host to 60 per cent of the world's outstanding foreign direct investment. The interdependence between them is evident. The value of American capital in Europe and European capital in America now amounts to nearly one trillion euros.

Italy's overall foreign direct investment has been marginal, with annual flows amounting to just 2 per cent of our GDP on average in the past 10 years, far below the levels recorded in Germany, France or Spain. FDI in Italy have averaged 1 per cent of GDP, as little as in Germany, against over 3 per cent in France and Spain.

3. Finance

In the financial sphere, the interdependence between the two sides of the Atlantic is harder to isolate. Certainly, the American model deeply influenced developments in the financial services industry and its legal infrastructure in Europe.

But finance is now global, not only transatlantic. In the past 20 years the financial markets of the main advanced and emerging countries have become more and more closely integrated, in response to technological progress and liberalization. Physical production too has played a role. Today, the components of many industrial products are ordinarily made in one country, assembled in another, and then sold throughout the world. This unbundling of production requires high international capital mobility; but the global financial opening has far exceeded that of foreign trade.

The co-movement, on a world scale, of national stock exchange indexes and bond yields is empirically significant. Since the 1990s until now, the price variability of a stock has been better explained by the company's industry than its country.

Transatlantic ties are less visible in today's global financial system than in the past. Good examples are foreign exchange dealing and portfolio investment. The dollar and the euro are still the most heavily traded currencies, being involved in 86 and 37 per cent of the exchange rate transactions, respectively; but the share of the emerging currencies is rapidly rising, and it is now equal to nearly 20 per cent. Europeans still own more than a third of all the US stocks and bonds held by non-residents, but emerging-country investors are moving up rapidly. The portion in Chinese hands has quadrupled since the turn of the decade to almost 10 per cent, owing above all to China's build-up of foreign currency reserves. That of investors from Latin America has doubled to over 6 per cent.

4. Economic policies

Taken all together, the stylized facts I have set out so far make a composite picture. Transatlantic links are still important, but less than in the past, in a globalized and polycentric world. In the field of economic policy, however, they remain today more than ever the centre of international relations.

The economic and financial governance of the world rests on a delicate balance between competition and cooperation. The global economy sprang from the success of a model of "democracy and market" that now – admittedly, differing in extent and varying in mix – inspires a growing number of national systems around the world. The first and leading purveyors of this model since

World War II have been the United States and Europe. And it is still up to them to set the example of good, fruitful cooperation.

Two major questions are on the order of the day: free trade and international monetary and financial stability.

4.1 Free trade is under fire today as it has never been since the 1980s. The 2001 Doha Round of talks for further liberalization has stalled. There is widespread disillusion and alarm over globalization. The task facing governments is not an easy one. The prices of essential goods are rising, the purchasing power of wages and salaries is decreasing, the tranquility of savings is being threatened. And it is true that the fruits of the globalized economy have been distributed unequally among the different social groups. Public opinion is bewildered by a confused world; in the crisis citizens seek reassurance. I understand that governments rediscover the value of protectionist formulas. Freedom of trade may appear a risk, protectionism a form of relief. But problems of income distribution cannot be solved by drying up one of the main sources of income.

Both sides of the Atlantic have an interest in preserving a climate propitious to the orderly growth of international trade and investment, based on a set of rules that are above all equitable.

The main emerging countries, which have benefited so greatly from global integration, should undertake more substantial commitments to open their markets and accept stricter international rules. Also it is hard to imagine that the transatlantic partners would not be able to find a compromise solution involving a balanced reduction of European import tariff barriers and US farm subsidies.

4.2 In recent months, we have been engaged in assessing the risks and malfunctions of financial innovation and integration. Financial instability has revealed, among other major flaws, serious regulatory inadequacies. Since the onset of the crisis, the G-7 Finance Ministers have asked the Financial Stability Forum to review existing regulation with a view to making the global financial system more resilient to future shocks. The FSF Report was endorsed by the G-7.

It addresses the perverse incentives that have produced a level of leverage both excessive and misperceived, and introduces new capital and liquidity requirements.

On the foreign exchange front, the dollar, in spite of its present weakness, remains the currency of the world's largest economy, with deep, open and liquid financial markets and a central bank with a firmly established reputation for independence.

Today, however, these same qualities can be claimed by the euro and the area that has adopted it as single currency. Already the euro is widely used internationally for commercial invoices and as currency of denomination of debt instruments. Since 1999, for instance, the share of instruments denominated in euros has risen by more than 10 percentage points to over 30 per cent of the world total; that of the dollar stands at 44 per cent. For the time being the currency is still mainly regional, its use outside the area being largely confined to bordering countries. But the premises would appear to be in place for an extension of its international role in both trade and finance.

The transatlantic link is extremely precious and must be cultivated at the policy level. New prospects will open up shortly. To overcome today's challenges, it will be necessary for objectives to be shared and decision-making to be based on solidarity. The United States and Europe, more closely united, are a guarantee for the world's stability.