CEPS COMMENTARY
Thinking ahead for Europe

Can Trump save the euro?

Daniel Gros

9 December 2016

Europe has just endured two more difficult tests. While Austrian voters rejected the possibility of the European Union getting its first far-right head of state, Italians delivered a stinging rebuke to their government – and opened the way for populist forces to come to power. Add to that a Brexit that has yet to unfold and the eurozone's still-lackluster economic performance, and the survival of the common currency is far from guaranteed.

With the euro taking the blame in recent years for Europe's many economic travails (from a double-dip recession to a slow and uneven recovery), nationalist, euro-sceptic and populist political movements have gained ground. Austria has sidestepped their advance, but Italy may not.

Prime Minister Matteo Renzi's decision to make good on his promise to resign if voters rejected his government's proposed constitutional reforms has thrown Italian politics into disarray, and an early general election is likely. At a time of substantial economic challenges – Italy's output has been stagnant for a decade, and its public finances remain precarious – the populist Five Star Movement, which has pledged to hold a referendum on continued euro membership, may well tempt voters.

If the eurozone's breakdown is to be avoided, Italy – indeed, the entire currency area – urgently needs an economic boost. US President-elect Donald Trump may be just the person to deliver it.

Even weeks before Trump takes office, he is beginning to have an impact. Long-term interest rates have risen in the United States and are expected to climb higher. That has contributed to a (much smaller) rate increase in Europe. Yields on German ten-year bunds are in positive territory, having risen by around 50 basis points since the US election. Populists can no longer complain that the European Central Bank is taxing German savers.

Daniel Gros is Director of CEPS. This contribution originally appeared on 6 December 2016, on the Project Syndicate website and syndicated to newspapers worldwide. It is republished here with the kind permission of Project Syndicate.

In the eurozone's periphery, the increase has been more marked; in Italy, for example, ten-year bond yields are up almost a full percentage point. While this might seem problematic, the reality is that the negative impact of higher rates in the periphery is likely to be limited. After all, a large share of the borrowing by households and businesses in the periphery is indexed to short-term rates, which are set by the ECB, not the markets, and therefore have remained low.

Moreover, periphery governments are largely shielded from the increase in the risk premium on long-term bonds, because their central banks continue to purchase their outstanding debt. And the US dollar's substantial appreciation in the wake of Trump's election is likely to make European exports more competitive.

So the immediate impact of Trump's victory has been a net positive for the eurozone – and the benefits seem set to continue. Trump has pledged to implement sweeping tax cuts, including a reduction of the corporate tax rate from 35% to 15%. Add to that plans to subsidise infrastructure investment and increase military spending, and it seems likely that the US will face rapidly rising fiscal deficits and a huge short-term increase in demand. With the US economy already operating at close to full capacity (unemployment is below 5%), higher imports – and a stronger US dollar – will be needed to meet that demand.

All of this will be good for the eurozone, for which the US remains a leading export market. But it is the peripheral countries that are likely to benefit the most. For example, the impact of a euro depreciation is about three times larger in Italy than it is in Germany, because demand for Germany's exports of specialised capital goods is not very price elastic. As a result, rapid demand-fuelled growth in the US, together with the strong dollar, could contribute to a much-needed rebalancing of the eurozone.

Europe may also benefit from Trump's energy policy. During the campaign, Trump pledged to ensure energy self-sufficiency – an effort that would probably entail new subsidies for domestic oil, gas and possibly coal production. That would help to suppress oil prices – a boon for the eurozone's energy-importing countries.

There is a precedent for Trumponomics' potential benefits for Europe. After the collapse of the dollar-based Bretton Woods system of fixed exchange rates in the 1970s, Europe created the European Monetary System to serve as an island of stability in an ocean of widely fluctuating exchange rates. While maintaining stable exchange rates within the EMS initially proved difficult, owing to large differences in national inflation rates and economic-policy priorities, the situation quickly improved, thanks to US President Ronald Reagan.

"Reaganomics" produced large fiscal deficits and an ultra-strong dollar. Together with low oil prices, this put Europe in a strong position to overcome challenging disparities and achieve growth. In fact, it was the last time Italy's GDP grew faster than the EMS average. Trumponomics aims to create precisely the same conditions.

Whatever the potential downsides to Trump's policies, there is one clear upside: they will boost growth and employment in a eurozone where economic dissatisfaction is generating political turmoil – and the gains will be most pronounced in the countries that most need them. As Italians face the prospect of a referendum on eurozone membership, and the French prepare for next year's presidential election, the value of these benefits cannot be overestimated. Indeed, Trump could well end up saving the euro.