

# **Trends and Prospects of Transatlantic Economic Relations**

## **The Glue That Cements a Fraying Partnership?**

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*“The United States and the Enlarged European Union –  
strategic thoughts on new conflicts in an old partnership”*

### **Abstract:**

This paper looks at the trends and prospects of transatlantic economic relations to determine whether they can be relied upon or reinforced to ensure that the historic transatlantic partnership does not fall apart under the stress of conflicts in the foreign policy and security domains. Based on an analysis of past trends and expected future prospect, the paper concludes that the economic partnership can indeed serve as a glue to bind the frayed partnership, but that it will take continued attention by governments on both sides of the Atlantic to areas of common interest and to achieve greater recognition among the general public of the great value of continued economic cooperation. The paper commends and recommends governance structures that can help ensure that common transatlantic interests are effectively pursued in an increasingly multi-polar and complex international economic environment.

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Transatlantic relations have been under stress. In the run-up to the Iraq war and since, it seemed at times that the former partners of Cold War days had turned into hostile camps, as their leaders embarked on unilateral action (the US) or inaction (Germany), threw invectives at each other or each other's supporters (Messrs. Rumsfeld and Chirac), and reinforced popular negative stereotypes. Of course, some of the strains preceded the 9/11/01 tragedy and the Iraq war in the wake of a rising tide of cross-Atlantic complaints, many of them having to do with the perception of US unilateralism on the European side, and of European indecisiveness on the US side.

Since 9/11/01, much of the stress in transatlantic relations has centered on disagreements in the foreign and security policy arenas. Previously, however, a number of high-visibility conflicts had appeared in the economic and related areas (trade, finance and environment). This paper looks at the trends and prospects of transatlantic economic relations to determine whether there is a tendency towards increased stress also in this important aspect of the relationship, or whether transatlantic economic ties can be relied upon or reinforced to ensure that the historic partnership does not fall apart. The paper concludes that the economic partnership can indeed serve as a glue to bind the frayed partnership, but that it will take continued attention by governments on both sides of the Atlantic to areas of common interest and to achieve greater recognition among the general public of the great value of continued economic cooperation. The paper commends and recommends governance structures that can help ensure that common transatlantic interests are effectively pursued in an increasingly multi-polar and complex international economic environment.

### **Recent Trends in Transatlantic Economic Relations**

In the military domain the end of the Cold War left the world in a unipolar mode, with the U.S. as the only remaining military super power. In contrast, in the economic domain the world has become increasingly multipolar since World War II. For the first

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twenty years after the end of World War II the US was the economic powerhouse of the world, but subsequently that dominance was challenged by the rapid recovery of Germany and Japan. Although the German and Japanese economic miracles ran out of steam in the 1980s, and the US staged a major recovery in the 1990s, the expansion and strengthening of the European Union led to emergence of an increasingly strong and cohesive European economy which now roughly equals the US economy in size, while that of Japan is about two-fifth of that.<sup>1</sup> With its huge population and persistently high economic growth China now ranks fourth after the US, the EU and Japan.

Despite the rapid increase of transpacific trade in recent decades<sup>2</sup>, transatlantic economic relations remain the dominant force in international economic relations for both the US and the EU, particularly if one considers not only trade but also foreign direct investment and foreign affiliate sales, employment, research and development, intra-firm trade and income. For each of these categories, according to data assembled by Joseph P. Quinlan, mutual commercial relations between the US and Europe account for 50% or more of the relevant world wide figures for the transatlantic partners: “When it comes to the bottom line, Europe – by a wide but not fully appreciated margin – remains the most important region in the world for corporate America.”<sup>3</sup> – and vice versa. It is of interest to note that while in the first decades after World War II the transatlantic foreign investment flows were predominantly from the US to Europe, in the 1990s Europe invested more heavily in the US.<sup>4</sup>

With such intensive commercial relations, as might be expected, commercial disputes have arisen with some frequency – not only for trade, but increasingly also in the areas of transport, finance, investment, mergers, regulatory regimes, etc. The range of conflicts is so wide that a complete accounting is difficult. In 2002 Hufbauer and Neuman assembled a list of major commercial conflicts under three useful headings: market access, industrial policy and ideology.<sup>5</sup> Under the heading “market access” they listed a total of 16 major ongoing cases, including US complaints involving wine, medicine, government procurement and EU complaints involving tariff peaks for selected products, government procurement, airline industry, maritime services, etc. Under the heading “industrial policy” they included 15 major cases, among them US complaints on aeronautics, shipbuilding, investment barriers, and EU complaints on aeronautics, national security restrictions, digital TV, agricultural export subsidies, etc. Finally, under the heading ideology, they covered 8 unresolved cases, including US complaints on growth hormones, genetically modified organisms (GMOs), so-called “hush kits”(noise mufflers for airplanes) and EU complaints regarding US sanctions in Iran and Libya.

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<sup>1</sup> For an overview of the history of changing relative economic strengths, see Mark A. Pollack and Gregory C. Shaffer, “Transatlantic Governance in Historical and Theoretical Perspective,” in Pollack and Shaffer, eds., Transatlantic Governance in the Global Economy. New York: Rowman and Littlefield, 2001

<sup>2</sup> Since 1981 US exports to Asia have exceeded those to Europe; see Joseph P. Quinlan, Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy Washington, D.C.: Center for Transatlantic Relations, 2003.

<sup>3</sup> Ibid., Executive Summary, p.1.

<sup>4</sup> The Atlantic Council of the United States, “Changing the Terms of Trade: Managing the New Transatlantic Economy.” Policy Paper. Washington, D.C.: April 2001, p. 13

<sup>5</sup> Gary Clyde Hufbauer and Fredric Neuman, “US-EU Trade and Investment: An American Perspective” Paper presented at a conference titled “Transatlantic Perspectives on the US and European Economies: Convergence, Conflict and Cooperation” Kennedy School of Government, Harvard University, April 11-12, 2002.

Interestingly, the number of complaints on each list is roughly balanced between the US and the EU.<sup>6</sup> Hufbauer and Neuman note that market access disputes have been relatively easily solved, with a low public profile and little disruption, while industrial policy disputes are more difficult to resolve, but relatively few complaints are taken to the WTO and OECD. According to them, disputes involving ideological concerns are most difficult to address, since they have high public visibility, emotional content (e.g., growth hormones, GMOs, sanctions, etc.) and increasingly heavy involvement of vocal citizens' advocacy groups.

As the scope and complexity of transatlantic commercial relations has grown and with them scope for conflicts, efforts were made in the 1990s to find suitable ways to address and resolve the conflicts.<sup>7</sup> Aside from using the dispute resolution mechanisms of the WTO and OECD and working together in the context of the G-7/8 summit framework, the US and the EU have tried to develop bilateral fora for intensive consultations on economic and commercial matters. The "Transatlantic Declaration" in February 1990 initiated regular consultative summits of the US and EU presidents. The "New Transatlantic Agenda" in December 1995 intended to further strengthen transatlantic economic cooperation in trade and investment and to involve non-governmental stakeholders in intensive and frequent contacts. According to Pollack and Shaffer, the New Transatlantic Agenda involved two truly new aspects: the creation of a transatlantic governance framework and the involvement of non-governmental agents and networks.<sup>8</sup>

One of the main outcomes of the New Transatlantic Agenda was the agreement to set up four non-governmental fora or "transatlantic dialogues", one each for business (TABD), labor (TALD), environment (TAED) and consumers (TACD).<sup>9</sup> According to Pollack and Shaffer, of these four only the business dialogue has met with regular frequency and intensity, while the other three have languished.<sup>10</sup> Even the TABD, in the opinion of the Federation of German Industry, did not succeed in getting a serious hearing of its recommendations by the relevant governmental bodies.<sup>11</sup> And the semiannual EU-US summits, according to one seasoned observer, C. Fred Bergsten, "have been pitiful failures."<sup>12</sup>

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<sup>6</sup> Ibid., Tables 5-7.

<sup>7</sup> See Pollack and Shaffer, *op.cit.*, pp. 14-17.

<sup>8</sup> Mark A. Pollack and Gregory C. Shaffer, "Who Governs" in Pollack and Shaffer, eds., *op. cit.*, p. 290.

<sup>9</sup> There are of course many other transatlantic fora dedicated to regular consultations on specific issues of economic, commercial or financial relations. One of the more important ones is the "Informal Financial Markets Dialogue" between the US and the EU which works "to narrow differences between the different financial regulatory systems." See Shadow Financial Regulatory Committee, "Toward a Single Trans-Atlantic Market in Financial Services," Statement No. 203. Chicago: February 9, 2004.

<sup>10</sup> See also The Atlantic Council, *op. cit.*, p. 23.

<sup>11</sup> Bundesverband der Deutschen Industrie e.V., "Deutschland und die USA – Partner für das 21. Jahrhundert" Positionspapier. Berlin: Februar 2002, p. 10. However, US Undersecretary of Commerce Grant Aldonas in a speech on "A New Transatlantic Dynamic" given in Brussels on November 24, 2003 praised the contribution of the TABD and announced the imminent start of a new two-year term under a new chairmanship. The United States Mission to the European Union, Brussels, Belgium, [www.useu.be/Categories/Trade/Nov2403AldonasGMF.html](http://www.useu.be/Categories/Trade/Nov2403AldonasGMF.html)

<sup>12</sup> C. Fred Bergsten, "America's Two-Front Conflict," Foreign Affairs 80.2 (Mach/April 2001)

Looking back, one might ask whether transatlantic relations have become more unstable and subject to serious threats of trade wars and commercial conflicts. There is little doubt that the number of cases have risen.<sup>13</sup> And there have been recurrent warnings of looming risks of conflict, especially in the wake of failed trade negotiations and of major conflict events. For example, following the failed WTO meetings in Seattle in December 1999, Bergsten wrote in March/April 2001 that the US and EU “are on the brink of a major trade and economic conflict.”<sup>14</sup> And on the other side of the Atlantic, Renvert and von Essen warned in late 2003: “Beyond the current stalemate in the Doha Round and failure of Cancun looms the potential for a transatlantic clash on approaches to political economy.”<sup>15</sup> Even more recently, Bergsten and Koch-Weser wrote that “there is a real threat of trade war due to several extant cases of threatened retaliation and counter-retaliation” across the Atlantic.<sup>16</sup> Also, following the March 2004 EU ruling against Microsoft, the Senate Majority Leader, Senator Bill Frist, was quoted as saying he fears “that the U.S. and the EU are heading toward a new trade war – and that the commission’s ruling against Microsoft is the first shot.”<sup>17</sup>

In contrast, others, for example Hufbauer and Neuman concluded in 2002, based on the experience of the 1990s, that the outlook for resolving trade conflicts and keeping industrial policy and ideological disputes in bounds was reasonable. Alan Cafruny wrote, also in 2002, that “there is little evidence that disputes portend growing transatlantic economic rivalry or that free trade is threatened. The level of transatlantic conflict has increased, but the present phase of economic relations is no more contentious than in the past.”<sup>18</sup> Jagdish Bhagwati was quite upbeat in his assessment of the outlook for resumption of Doha Round negotiations despite the failure at Cancun and despite subsequent antagonistic statements by the heads of the US and EU delegations.<sup>19</sup> Following the Microsoft ruling by the EU, the Washington Post reported that “[R]egulators on both sides of the Atlantic are quick to say that they have made great strides in their relationship... Particularly in the area of merger approval, both sides are closer than ever on how to evaluate the economic impact of companies joining together.”<sup>20</sup> Finally, Theo Sommer, noted German journalist and long-time and astute observer of transatlantic relations, observed in summer 2003 that “despite all factual and philosophical differences the economy is rather transatlantic glue than transatlantic explosive.”<sup>21</sup>

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<sup>13</sup> See Gary Clyde Hufbauer and Ben Goodrich, “Time for a Grand Bargain in Steel” Policy Brief 02-1. Washington, D.C.: Institute for International Economics, January 2002

<sup>14</sup> Ibid.

<sup>15</sup> Nicole Renvert and Marcus von Essen, “Transatlantic Tristesse – More than Just History Repeating Itself,” The International Spectator 4/2003, p. 104

<sup>16</sup> C. Fred Bergsten, Caio Koch-Weser, “Executive Summary: The Transatlantic Strategy Group on Economics, Finance and Trade,” in Werner Weidenfeld et al., From Alliance to Coalitions – The Future of Transatlantic Relations. Gutersloh: Bertelsmann Foundation Publishers, 2004, p. 51.

<sup>17</sup> The Washington Post, March 31, 2004, p. E5.

<sup>18</sup> Alan W. Cafruny, “Transatlantic Trade and Monetary Relations: The Nature and Limits of Conflict.” The International Spectator, 3/2002, p. 8

<sup>19</sup> Jagdish Bhagwati, “Don’t Cry for Cancun,” Foreign Affairs 83.1 (Jan/Feb 2004).

<sup>20</sup> The Washington Post, March 25, 2004, p. E5

<sup>21</sup> Theo Sommer, “Europa-USA: Ein politischer, ökonomischer und kultureller Systemvergleich”, Speech given at the European Forum Alpbach, Austria, 27 August, 2003.

There is other evidence relevant to answering the question how serious is the risk of transatlantic trade wars and commercial conflicts: First, experts have observed that with trade only about 20% of all transatlantic commercial relations and only maximally 5% of transatlantic trade affected by trade disputes in recent years, at most 1% of all transatlantic commercial relations has been affected by trade disputes.<sup>22</sup> Also, most recent analyses of transatlantic relations, while giving much play to the risks of diplomatic conflicts based on foreign policy and security-related conflicts, do not play up the risk of trade or commercial conflicts.<sup>23</sup> And assessments of the world's economic outlook generally do not highlight transatlantic economic conflicts as major sources of risk.<sup>24</sup> Moreover, a review of recent opinion polls confirms the conclusion of Kull in 2001 that "the exaggerated image [of several high-profile US-EU trade disputes] does not resonate deeply with the public."<sup>25</sup>

Finally, and perhaps most importantly, one has the distinct impression that on both sides of the Atlantic the political leadership has made a deliberate and welcome effort to insulate the economic, financial and commercial dialogue from the stresses of the diplomatic and security conflicts. Schott and Hufbauer commented in February 2003 that "the Bush Administration in Washington and the Prodi Administration in Brussels are managing trade and investment relations with care and deliberation."<sup>26</sup> Speeches by senior trade and commerce officials during the peak of transatlantic tensions over the Iraq war and following the breakdown of WTO negotiations at Cancun are notable for their positive and constructive tone.<sup>27</sup> Also, based on my own contacts and observations, it appears senior US Treasury and German Ministry of Finance officials evidently continued their constructive dialogue and substantive contacts during the height of the Iraq controversy, both within the G-7 framework and beyond.

Looking back, therefore, I conclude that multi-polarity, a high degree of interdependence, and a rich menu of trade and commercial disputes characterize the recent transatlantic relations. At the same time, I would agree with those who do not see from past experience a major threat of trade war or explosive commercial and financial conflict. On the contrary, it is my impression that the leadership on both sides tried very

<sup>22</sup> See e.g., Quinlan, op. cit., Executive Summary, p.1.

<sup>23</sup> See e.g., Henry A. Kissinger, Larry H. Summers, Charles A. Kupchan, "Renewing the Atlantic Partnership," Report of an Independent Task Force Sponsored by the Council on Foreign Relations. New York: Council on Foreign Relations, 2004. Also, Werner Weidenfeld, "The Intertwining of Security and Economics," in Weidenfeld et al., op. cit. For a recent survey of overall transatlantic relations, see Johannes F. Linn, "Rebuilding Transatlantic Relations – It's Time to Repair Damaged Bridges." Washington, DC: Brookings February 21. [www.brookings.edu](http://www.brookings.edu)

<sup>24</sup> For a recent European example see European Economic Advisory Group at CESifo, "Report on the European Economy 2004" Munich: Ifo Institute for Economic Research, 2004.

<sup>25</sup> Steven Kull, "Culture Wars? How Americans and Europeans View Globalization," Brookings Review Fall 2001; recent opinion polls Eurobarometer and Pew Research Center Surveys confirm this conclusion. See Linn, op. cit. for references to relevant survey web sites.

<sup>26</sup> Jeffrey J. Schott and Gary Hufbauer, "Transatlantic Trade Relations: Challenges for 2003." Paper delivered for the second meeting of the Transatlantic Strategy Groups in Miami, February 12-14, 2003, organized by the Bertelsmann Foundation, Guetersloh, and the Center for Applied Policy Research, Munich.

<sup>27</sup> See e.g., US Trade Representative Robert B. Zoellick, "Exerpts from the Keynote Address," at the Munich Economic Summit, Europe in the Global Economy: Matching the US? Munich, 2-3 May 2003, BMW Foundation, Herbert Quandt & CESifo, 2003. Also US Undersecretary of Commerce Grant Aldonas, op. cit.

hard and quite successfully so far not to let the poisonous atmosphere which characterized the transatlantic foreign and security relations impinge on the generally constructive relations in the economic sphere. But what about the future? Is there reason to think that the situation will change substantially for the worse? This is the question to which I will turn next.

## **Future Prospects of Transatlantic Economic Relations**

Economic multipolarity will dramatically increase in the next ten years and beyond. By 2015 China's economy will be about the size of the EU economy, and only about 15% below that of the US. India's economy will be about the size of Japan. Asia's superior future economic weight is reflected in the fact that the combined economies of China, India and Japan in 2015 will exceed that of the US by 50% and that of the EU by 90%.<sup>28</sup>

One of the key factors determining future economic trajectories will be demographic trends. The US population is currently growing at about 1% per year, while India's growth rate is about 1.5% and China's 0.75%. In contrast, Europe's population is growing only at about 0.20% per year, and Japan's is virtually stagnant at this time. Besides affecting the aggregates of economic growth and size, the stagnation in population for Europe and Japan has well known serious implications for economic management as aging populations will put increasing burdens on the pension and health systems and hence will cause significant fiscal, structural and political stress for these economies.

But there is another aspect to the demographic transition which may have important implications for transatlantic relations: According to projections recently released by the US Census Bureau there will be a substantial shift in the composition of the US population. Between 2000 and 2050, the "non-Hispanic white" population will drop from almost 70% of the US population to barely 50%, as the shares of other population groups, especially of Asian and Hispanic and to a lesser extent of Black race or origin, will increase substantially.<sup>29</sup> When one combines this with a demographic shift in the US towards the South, South-West and West of the country, it should not come as a surprise, if there is a lessening of the identification with Europe among the majority of the US population, as by origin and geographic location Europe will seem to matter less and less for many Americans.<sup>30</sup>

In the EU the demographic composition will also shift over time in response to prospective enlargements of the Union and the impact of immigration. The eastward

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<sup>28</sup> These projections are based on CIA estimates of GDP at purchasing power parity; US Central Intelligence Agency, "Global Trends 2015: A Dialogue About the Future with Nongovernment Experts", NIC 2000-02, December 2000. [www.cia.gov/cia/reports/globaltrends2015/375954.gif](http://www.cia.gov/cia/reports/globaltrends2015/375954.gif) Of course, Asia won't become a cohesive partner in global, transcontinental or transpacific relations speaking with a single voice on any issue.

<sup>29</sup> The Financial Times, March 18, 2004, p. 4, and US Census Bureau, [www.fedstats.gov/qf/states/06000.html](http://www.fedstats.gov/qf/states/06000.html)

<sup>30</sup> According to David Gompert "in the last thirty years, German-born Americans have dropped from 10% to 2% of the foreign-born population of the United States." David C. Gompert, "The German-American Relationship: An American's Perspective." In *Atlantik-Bruecke E.V., Jahresbericht 2002/2003*, Berlin 2003, p. 17.

expansion may well appear to bring into the EU populations that are more inclined to look to the US than has been recently the case for the existing EU member countries. However, this should not be overstated, because opinion polls in the new accession countries of Central and South East Europe show clearly that their populations are looking much more towards the EU than the US to help them attain their economic and political aspirations.<sup>31</sup> In addition, there is the demographic factor of the growing Muslim population in Europe.<sup>32</sup> Currently about 15 million Muslims live in the EU. With a Muslim birth rate three times that of non-Muslims, with further immigration, with the increasing political enfranchisement of Muslim Europeans and with the possible eventual accession of Turkey the number of politically active Muslims in Europe is expected to increase very substantially. To the extent European Muslims will in future share some of the currently common anti-American sentiments among Muslims related to the troubles in the Middle East, there could well be a significant and growing anti-US lobby in Europe.<sup>33</sup>

Hence both economic and demographic factors portend increasingly diverse pressures on the transatlantic partners that may point them in different and possibly opposite directions in terms of political and economic interests. As the recent Independent Taskforce on the Atlantic Partnership rightly stressed, it is the commonality of interests that keeps alliances and partnerships together.<sup>34</sup> The question therefore is whether in the economic sphere there will remain strong common transatlantic interests or whether interests will increasingly lie elsewhere. The next paragraphs will briefly review three sets of economic challenges that the U.S. and the EU face in the future: challenges of domestic reform requirements, challenges in transatlantic relations, and challenges in the rest of the world.

## 1. Domestic Policy Challenges

Domestic economic policy challenges will be very serious in the coming years on both sides of the Atlantic. For Europe, the need to manage the economic implications of EU enlargement, promote fundamental structural reforms especially in some of the stagnant large European economies, and tackle the growing fiscal pressures of the aging populations and generous social security systems are major and politically difficult tasks.<sup>35</sup> There can be little doubt that Europe operates way inside its production frontier, as the economist would say.<sup>36</sup> For the US, the key domestic economic challenge in

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<sup>31</sup> See Linn, op. cit., p. 3, for a review of the results of a Eurobarometer poll of May-July 2003 in 13 EU accession countries.

<sup>32</sup> The rest of this paragraph draws on Omer Taspinar, "Europe's Muslim Street," *Foreign Policy*, March 2003

<sup>33</sup> See Pew Research Center, "A Year After the Iraq War: Mistrust of America in Europe Ever Higher, Muslim Anger Persists", March 16, 2004. [www.people-press.org](http://www.people-press.org)

<sup>34</sup> Kissinger, Summers and Kupchan, op. cit., p.4.

<sup>35</sup> See European Economic Advisory Group at CESifo, op. cit. for a recent summary of these challenges. One of the measures of how different the tax and social systems are between Europe and the US is Edward C. Prescott's finding that "Americans now work 50 percent more than do the Germans, French, and Italians." In Edward C. Prescott, "Why Do Americans Work So Much Harder Than Europeans?" *Research Department Staff Report* 321, Federal Reserve Bank of Minneapolis, November 2003. Interestingly this gap in work habits opened up only since the early 1970s. It is important to note that Prescott's data cover only work in the formal, or above-ground taxed economy.

<sup>36</sup> See Jan Svejnar, "Europe's Unexploited Potential," *WDI Policy Brief* No. 3, March 2004, The William Davidson Center, University of Michigan Business School, Ann Arbor, Michigan.



future will lie in assuring a stable and sustainable fiscal and macroeconomic adjustment. The combination of major tax cuts and the rising budget burden of social security and old-age health insurance combine to create very difficult pressures on the federal budget over the coming decades.<sup>37</sup> In addition there are risks to the US economy that emanate from its persistently low private savings rate, its large current account deficit and hence its dependence on public and private investors' willingness to hold US assets. This imbalance reinforces the need for very careful macroeconomic management, if a hard landing with sharp exchange rate and interest rate adjustments, and resulting recessionary pressures is to be avoided.

These domestic policy challenges understandably tend to be the principal occupation of the economic leadership on both sides of the Atlantic. Given the heavy economic interdependence, whether in the foreign exchange and capital markets, or at the firm level, the domestic concerns of one side are of course a transatlantic concern for the other side. Successful management of the domestic economic policy requirements has significant benefits for the transatlantic partner, while domestic policy failure has substantial negative implications. Indeed, I believe it is these transatlantic impacts of key domestic policy choices which are and should be the main focus of transatlantic consultations, although as history has shown, particularly in the context of the G-7 discussions, there tends to be relatively little willingness to carry out such a dialogue in the manner of a serious and constructive peer review.<sup>38</sup>

## 2. Transatlantic Challenges

In contrast, I do not see trade wars or serious commercial conflicts dominating the transatlantic dialogue and driving apart the partnership. There are too many common interests among the business communities on both sides of the Atlantic to let this happen. Moreover many of the current trade issues and conflicts are not principally among the industrial countries, but are more pressing and conflictual between the industrial and the developing countries as the Doha Round, and especially the failure to reach agreement in Cancun have shown. And while conflicts may well arise in other areas of commercial transatlantic relations, there are no reasons to expect that they will be more disruptive than similar disputes have been in the past. Of course, there is always the risk that careless leadership could lead to unexpectedly serious and intractable conflicts. More importantly, there is the risk that a serious recession on either side of the Atlantic, most likely brought about by poor macroeconomic management, would lead to political backlash and protectionism. Particularly in the U.S., where welfare system reforms in recent years have significantly reduced the social safety net

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<sup>37</sup> For an assessment of the short to medium term fiscal pressures in the US, see European Economic Advisory Group at CESifo, op. cit. and IMF, World Economic Outlook, April 2004, [www.imf.org/external/pubs/ft/weo/2004/01/index](http://www.imf.org/external/pubs/ft/weo/2004/01/index). For an analysis of the long-term impact of rising pressures from social security and old-age health benefits programs see Rudolph G. Penner and C. Eugene Steuerle, Budget Crisis at the Door. Washington, DC: The Urban Institute, October 2003. The authors of this study point out that since 1955 Social Security, Medicare and Medicare spending as a share of GDP has increased from about 1% of US GDP to about 8% in 2002, an increase that was offset by a matching decline in military spending declined from 11% to about 4% over the same period. They conclude that further increases of levels and shares of old-age budget outlays, which are driven by the underlying demographics, cannot be readily absorbed by similar reductions elsewhere in the budget.

<sup>38</sup>C. Fred Bergsten and Caio Koch-Weser, "The G-2: A New Conceptual Basis and Operating Modality for Transatlantic Economic Relations," in Weidenfeld et al., op. cit., p. 248.

and increased American's dependence on holding jobs, any serious and protracted spike in the unemployment rate might well cause the kind of political firestorm that would make it attractive for political leaders to seek redress in protectionist responses.<sup>39</sup>

Aside from the need to manage the risks of possible commercial conflicts, there is an important agenda for the two sides in assuring that progress is made in fully integrating the transatlantic market, that trade regimes are further reformed and regulatory regimes are harmonized across the board. Hufbauer and Neuman, and Jeffrey A. Frankel respectively have summarized available estimates of the potential benefits from trade and investment expansion associated with further WTO agreements. Mutual EU and U.S. trade and investments would expand significantly (between 10 and 20 percent) and per capita income in the US could be increased by about 4% over thirty years.<sup>40</sup> Of course, full market integration will take a long time and will require diligent technical and diplomatic exploration of, and negotiations over, many persisting and newly arising transatlantic institutional, legal and political differences.<sup>41</sup> One new area where careful management of transatlantic economic relations is needed is in regard to measures taken, mostly by the U.S., to combat trans-border terrorism. The new finger printing and photographing requirements, the requirements that airlines share fliers' personal information, and protracted delays in processing containers at the borders, are examples of potentially disruptive action, both in terms of free flow of people and goods, and in terms of good transatlantic relations.<sup>42</sup>

### 3. Global Challenges

Finally, the U.S. and EU have many common interests when it comes to the rest of the world. At the most general level, assuring a prosperous and peaceful world for all is an important shared objective. This includes the constructive and productive integration of the major emerging market economies to the international economic system. The successful accession of China to the WTO was a major step in this direction. Other countries, such as Russia and Ukraine remain on the doorstep. Bringing the Doha Round to a peaceful conclusion is another one of them as it would result in substantial benefits to the world (estimated \$ 400-500 billion per annum) and to the transatlantic partners.<sup>43</sup> As mentioned earlier, the main divisive issues in the Doha Round involve North-South conflicts (esp. agricultural subsidies, tariff peaks, etc.), not principally transatlantic issues. Recently, outsourcing has been added to the list of politically contentious international economic issues in the US and Europe. Again, this involves mostly the north-south relationship, because rightly or wrongly, the publics and

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<sup>39</sup> This point is also made by Cafruny, op. cit. p. 17.

<sup>40</sup> Hufbauer and Neuman, op. cit., p. 3; Jeffrey A. Frankel, "Assessing the Efficiency Gains from Further Liberalization," in Roger B. Porter et al., eds., Efficiency, Equity and Legitimacy: The Multilateral Trading System at the Millennium. Washington, DC: Brookings Institution Press, 2001, pp. 100-102; see also in the same volume, F.M. Scherer, "Part Two Summary", p. 151.

<sup>41</sup> For a very good summary of the regulatory challenges in the transatlantic capital markets see Mario Draghi and Robert C. Pozen, "U.S.-EU Regulatory Convergence: Capital Markets Issues," in Weidenfeld et al., op. cit.; see also Shadow Financial Regulatory Committee, op. cit. For a view on the needs for further regulatory alignments in transatlantic relations from German business perspective, see BDI, op. cit.

<sup>42</sup> Another potentially damaging action was the decision of the U.S. administration to limit procurement in the reconstruction of Iraq to those countries that were seen to have been supportive of the Iraq war.

<sup>43</sup> Hufbauer and Neuman, op. cit.; Jeffrey A. Frankel, op. cit.; Bhagwati, op. cit.

the politicians are focused mostly on the presumed loss of jobs to low-wage developing countries (even as economists estimate huge gains for the source countries).<sup>44</sup>

Beyond the emerging market economies, the U.S. and the EU share a common interest in helping the poorer developing countries advance, by implementing the Monterrey and Johannesburg consensus. At these world summits in 2002, agreement was reached on a compact that the developing countries would reform their own policies and institutions while the industrial countries would raise their financial aid contributions in the common pursuit of the achievement of the Millennium Development Goals by 2015.<sup>45</sup> Making this compact work has evidently not been easy in practice, but it remains essential nonetheless for long term global development, peace and stability. Aside from increasing the amounts and concessionality of aid flows, the industrial countries face many other important issues, including how to assure an effective international governance structure for development assistance, including the UN system, the international financial institutions and the bilateral aid agencies and programs.

These traditional development concerns are linked to a number of newer issues of common interest for the transatlantic partnership: how to prevent conflicts, failed states, drug trade, money laundering and terrorism; how to address global environmental issues; and how to manage the world's energy supply (and demand) in a responsible manner that fairly balances the interests of producers and consumers as well as those of today's and future generations. In some of these areas, there has been progress. For example, strong joint U.S. and French leadership in the international Financial Action Task Force on Money Laundering (FATF) has resulted in some notable successes.<sup>46</sup> In the environmental area there has been mixed progress: On the positive side, the Global Environmental Facility has been created and funded with strong U.S. and EU leadership, but other important global environmental initiatives have been stalled or not fully implemented. Most notably the Kyoto Protocol to the Framework Convention on Climate Change is currently on hold, due to a U.S. refusal to support it (and due to Russia still sitting on the fence). Much remains to be done on the other areas, where big global challenges remain and joint leadership by the U.S. and the EU are called for.

In sum, the world will become more multipolar in future and the demographic trends may well act to push the U.S. and Europe apart in terms of popular perceptions of and interest in each other. Moreover, there is clearly some potential for transatlantic conflict and disputes in all three areas – domestic policies, transatlantic economic relations, and global economic development. But I believe a strong case can be made that the commonality of interests by far outweighs the conflicts. In short, like Theo Sommer I believe transatlantic economic relations will be the glue that holds the partnership of America and Europe together even as conflicting interests in other areas may push them apart. The question then is, and the final question to be addressed in

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<sup>44</sup> Some estimates of the cost savings from outsourcing for the world's top one hundred financial institutions could reach \$ 138 billion per year; see Robert Stern, "Quantifying Barriers to Trade in Services." In B. Hoekman, P. English, and A. Mattoo, eds., Development, Trade and the WTO: A Handbook. Washington, DC: The World Bank, 2002.

<sup>45</sup> The Millennium Goals, or MDGs for short, involve quantitative targets in eight important areas of human development in the developing world. The eight areas are: poverty reduction, universal primary education, gender equality, child mortality, HIV/AIDS and other communicable diseases, environment, global partnership. For background and more details, see [www.un.org/millenniumgoals/](http://www.un.org/millenniumgoals/).

<sup>46</sup> See [www1.oecd.org/fatf/](http://www1.oecd.org/fatf/) for more information on the FATF.

this paper, what is the appropriate institutional or governance framework for making sure the glue is applied for maximum benefit of the transatlantic partners and the rest of the world.

## Implications for Transatlantic and Global Governance

Currently there are a number of global and transatlantic governance structures in place: For the global governance there are of course the United Nations and its many specialized agencies. There are the Bretton Woods institutions – the International Monetary Fund and the World Bank –, complemented by a number of regional development banks. And of course there is the WTO for global trade and related matters. At the level of heads of state, there is the G-7/8, consisting of seven principal industrial countries and the EU presidency (G-7), expanded recently to include Russia for G-8 summits (while maintaining the G-7 for regular meetings of ministers of finance). And there is the recently founded G-20, which brings together the ministers of finance and central bank governors of the 20 largest economies in the world, including a number of important emerging market economies.<sup>47</sup> At the transatlantic level there are the processes of consultation set in motion by the 1990 Transatlantic Declaration and by the 1995 New Transatlantic Agenda, notably the transatlantic dialogues previously mentioned and the semiannual U.S.-EU summits. And as previously mentioned there are a number of specialized fora such as the Informal Financial Markets Dialogue. In some ways the G7/8 also serves as a transatlantic forum, given that Japan is in a distinct minority as the only non-Atlantic member of this group.<sup>48</sup> Recently, Bergsten and Koch-Weser proposed the creation of a G-2, consisting of the U.S. and EU for an improved management of transatlantic economic relations.

I put aside for now the truly global fora of the UN with their universal membership and hence cumbersome consultative processes. I also put aside the WTO and the international financial organizations, with their specialized mandates. I will focus here on the three governance structures most specifically designed to address strategic transatlantic and global economic relations in a focused, but comprehensive manner: the G-7/8, the G-2 and finally the G-20. These are the fora best suited in principle to provide the consultative platform at the highest level of government for the overlapping transatlantic and global economic strategic agendas.

The G-7/8 has come in for some justified criticism recently. The so-called “Shadow G-8”<sup>49</sup> concluded in 2003 that “the effectiveness of the G-5/7/8 has declined sharply since the group was originally created.”<sup>50</sup> Because the members of the group have stopped providing serious peer review of their own economic policy requirements and instead have taken to lecture others about their short comings, the group has lost in

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<sup>47</sup> The G-8 includes Canada, France, Germany, Italy, Japan, Russia, the UK and the U.S., as well as the Presidency of the EU. The G-20 includes the G-8, plus Argentina, Australia, Brazil, China, India, Indonesia, South Korea, Mexico, Saudi Arabia, South Africa, and Turkey.

<sup>48</sup> Whether Russia should count among the “Atlantic” members of the G-8 might be a matter of debate.

<sup>49</sup> This is an informal group of distinguished former senior officials and finance experts, chaired by Fred Bergsten and Thierry de Montbrial.

<sup>50</sup> Shadow G-8, “Restoring G-8 Leadership of the World Economy: Recommendations for the Evian Summit from the Shadow G-8”, June 2003. <http://www.iie.com/publications/papers/g8-2003.pdf>

effectiveness and legitimacy, according to the Shadow G-8. And according to Bergsten and Koch-Weser, “the G-7/8 summits often lack substance and have become political rather than economic conclaves.”<sup>51</sup> In addition, the G-7/8 excludes all emerging market economies which play an increasingly important role in the management of the world economy.<sup>52</sup> The lack of effectiveness and inclusiveness are serious handicaps for the G-7/8 as an apex institution for global economic decision making.

Bergsten and Koch-Weser therefore propose that “the European Union and the United States constitute an informal but far-reaching ‘G-2 caucus’ to function as an informal steering committee to both manage their own economic relationship and to provide leadership for the world economy.”<sup>53</sup> This is a useful proposal for rejuvenating the consultative and decision making processes for improved transatlantic relations. And many of the issues which Bergsten and Koch-Weser propose to be placed on the agenda are indeed of key importance.<sup>54</sup> However, in moving forward with this idea it will be important to address a number of questions to which Bergsten and Koch-Weser have not yet provided the answers:

- a) How would the G-2 differ from the semi-annual EU-US president’s summits of the past? And how would they avoid the apparent weakness of those summits as well as those of the G-7/8?
- b) How would the existing Transatlantic Dialogues and other formal and informal consultative procedures be related with the G-2? How would the G-2 bring in the voices of non-governmental stakeholders, one of the advances made in the New Transatlantic Agenda of 1995?
- c) How would a unified voice emerge for Europe? So far the European Commission does not have a unified voice on many of the agenda items which Bergsten and Koch-Weser propose. In fact, it would seem that recently member countries have reasserted their own voices, despite efforts to strengthen the Commission’s formal role in the international arena through constitutional reforms.<sup>55</sup>

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<sup>51</sup> Bergsten and Koch-Weser in Weidenfeld et al., op. cit., p. 248.

<sup>52</sup> Colin I. Bradford and Johannes F. Linn, “Global Economic Governance at a Crossroads: Replacing the G-7 with the G-20.” Policy Brief #131, The Brookings Institution, Washington, D.C., April 2004.

<sup>53</sup> Bergsten and Koch-Weser in Weidenfeld et al., op. cit., p. 52. While accepting the substance of the Bergsten/Koch-Weser proposal, I would caution against their dismissive judgment “that Japan has faded because of its stagnation of the past decade and the rapid ageing of its population.” (ibid.) Japan shouldn’t be written off as irrelevant, as its recent recovery gives some hope that it may regain some of its earlier dynamism and as it will remain a major economic power for the foreseeable future. And if one writes off Japan, then why not also Germany?

<sup>54</sup> Bergsten and Koch-Weser envisage ten issues that could be taken up by the G-2: trade, competition policy, regulatory policy including corporate governance, macroeconomic policy, international monetary policy, international financial markets, energy, the environment, migration and global poverty. In Weidenfeld et al, op. cit., p. 241.

<sup>55</sup> The “Economist,” for example, noted on April 10th 2004 that “the sense of political tides turning against the commission was strengthened by a Franco-German-British summit in Berlin in February” because they proposed the creation of a new “super-commissioner” for economic reform and further more indicated they wanted the job to go to a German candidate, a decision that should in principle be left to the new President of the Commission. The Economist, April 10, 2004, p. 44. The recent disagreement among EU members about the Chancellor Brown’s proposal to double development aid is another example of the difficulty which a G-2 will face.

- d) How would one ensure that the G-2 summits focus less on disputes and conflicts, and more on the constructive steps needed to do away with remaining barriers in the transatlantic market, on finding solutions for the difficult domestic reforms which each side has to make, and on pressing global economic issues?
- e) How would the G-2 relate to the rest of the world in exerting the leadership role that Bergsten and Koch-Weser envisage?

The last among these questions appears to me to be most important. One of the weaknesses of the G-7/8 is that it does not include the rapidly growing emerging market economies. And the Bergsten/Koch-Weser proposal might well be interpreted to increase exclusivity, rather than enhance inclusiveness. In recognition of the weaknesses of the G-7/8 and of the rapidly increasing multipolarity, integration and intercultural diversity in the world economy, Bradford and Linn have recently proposed that the G-7/8 be replaced by the G-20, strengthened and elevated to heads-of-state level.<sup>56</sup> This would be the natural complement to a new G-2, since it would provide the inclusive forum that would provide an opportunity to consult among the major economic players in the world, and gauge their reactions to ideas and proposals worked out in the G-2 and other fora. As in the case of the G-2 proposal, the modalities of the G-20 would have to be further developed to ensure its effective function, and the buy-in would have to be assured for the abolition of the G-7/8 from the members.<sup>57</sup>

With the combination of an effective G-2 and G-20 structure, transatlantic economic relations not only have the potential to be the glue that holds the transatlantic alliance together, but they also have the potential to be the glue that bonds the emerging market economies, the new leaders of the world in decades to come, into a constructive global partnership. What will be needed is effective leadership by the political leaders on both sides of the Atlantic to ensure that the commonality of economic interests is fully realized in policy decision making and implementation and that it is well understood by the publics in America and Europe.

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<sup>56</sup> Colin I. Bradford and Johannes F. Linn, "Global Economic Governance at a Crossroads: Replacing the G-7 with the G-20." Policy Brief #131, The Brookings Institution, Washington, D.C., April 2004.

<sup>57</sup> The Shadow G-8, op. cit., proposed that the G-7/8 invite members of the G-20 for periodic summits, but appears not to have envisaged the formal up-grading of the G-20 to the level of heads-of-state nor the parallel abolition of the G-7/8.