The Transatlantic Economic Partnership: *Current Trends & Prospects*

By Dario Zuddu

Dario Zuddu, citizen of Italy, is a Streit Council Frank Fund Fellow. In this capacity, together with Michalis Persianis, he conducted a thorough survey of current proposals for strengthening the trans-Atlantic relationship. Their full survey is published on our website. In the article below, he presents some results and conclusions of the survey in the economic sphere. We preserve his currency denomination choices, which remind us that, as a "modern" Italian, he thinks neither in lira nor in dollars but in euros. – Ed.

The recent US-EU meeting in Washington and the current trade talks in Switzerland relaunched the dialogue for deepening transatlantic trade. Fortunately, the economic relationship between the US and the EU seems solid, almost enough to appear indifferent to the political tensions over Iraq which recently strained transatlantic liaisons.

The EU and the US are one another's main trading partners and account for the largest bilateral trade relationship in the world. They are also the largest players in global trade.

The EU and the US both account for around one fifth of each other's bilateral trade, a matter of €1 billion *($1.2 bn – Ed.)* a day. In 2003, exports of EU goods to the US amounted to € 226 billion (25.8% of total EU exports), while imports from the US amounted to € 157.2 billion (16.8 % of total EU imports).

The investment links are even more substantial. The EU and the US are each other's largest trade and investment partner. The total amount of two-way investment amounts to over € 1.5 trillion *($1.8 trillion – Ed.)*, with each partner employing directly and indirectly about 6 million people in the other. *Figure 1* shows how the stream of US investment in

Figure 1. U.S. Direct Investment Abroad

in millions of dollars, on a historical-cost basis, 1990 to 2003

[U.S. investment abroad is defined here as the ownership or control by one U.S. person of 10% or more of the voting securities of an incorporated foreign business enterprise or an equivalent interest in an unincorporated foreign business enterprise. A negative position can occur when a U.S. parent company's liabilities to the foreign affiliate are greater than its equity in and loans to the foreign affiliate]

Country	1990	1995	1998	1999	2000	2001	2002	2003
All countries	430,521	699,015	1,000,703	1,215,960	1,316,247	1,460,352	1,601,414	1,788,911
Europe.	214,739	344,596	518,433	627,754	687,320	771,936	848,599	963,087
Canada	69,508	83,498	98,200	119,590	132,472	152,601	170,169	192,409
Latin America and other Western Hemisphere. . . .	71,413	131,377	196,755	253,928	266,576	279,611	284,561	304,023
Africa	3,650	6,017	14,061	13,118	11,891	15,574	16,290	18,960
Middle East.	3,959	7,198	10,739	10,950	10,863	13,212	14,671	16,942
Asia and Pacific	64,716	122,712	159,678	190,621	207,125	227,418	267,125	293,490

Source: U.S. Bureau of Economic Analysis, Survey of Current Business, July 2003, and earlier issues.
See also http://www.bea.doc.gov/bea/ARTICLES/2004/07July/0704DirectInvest.pdf> (released July 2004).

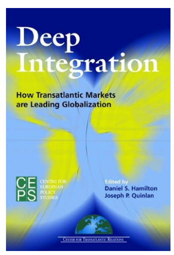
Europe by far and large outweighs American financial outflows to other trading areas.

The share of EU investment in the US amounted to more than 52% of EU Foreign Direct Investment over the period 1998-2001 (€ 162,663 million a year in average), while US investment in the EU amounted to more than 61% of EU FDI inflows over 1998-2001 (€72,041 million a year in average).

Our two economies are interdependent to a high degree. Close to a quarter of all US-EU trade consists of transactions within firms based on their investments on either side of the Atlantic.

Potential and benefits of additional transatlantic integration

Nevertheless, as Daniel Hamilton and David Quinlan argue in ***Deep Integration: How Transatlantic Markets Are Leading Globalization,*** transatlantic economic integration still has enormous additional potential. They point out that greater benefits could be achieved, reporting the OECD as saying that "further transatlantic liberalization could lead to permanent gains in GDP per capita on both sides of the Atlantic of 3 to 3½."



Trade in service is actually at its start. Liberalization of services is associated with a number of legal and political problems. Services are heavily regulated, especially in the EU. Barriers to trade in services remain high in the legal and accounting sector and include both foreign providers' discrimination and intra-union barriers. Important constitutional norms dealing with education and health care services also tend to prevent a more accentuated integration.

By the same token, trade in services is the sleeping giant of US-EU economic relations. The service sector accounts for the bulk of job creation in both sides of the Atlantic. A further liberalization of trade in services could result in a sharp increase of employment levels and economic growth. Hamilton and Quinlan remark the rise and the change of transatlantic trade in service: "Following in the footsteps of manufacturers, US and European service companies now deliver their services more through foreign affiliate sales than through trade. In the 1970s and 1980s, firms delivered services primarily via trade. In the 1990s, foreign affiliate sales became the chief mode of delivery. Sales of services by US foreign affiliates in Europe soared from $85 billion in 1994 to roughly $212 billion in 2002 – a 150% increase, well ahead of the roughly 65% rise in US service exports to Europe over the same period. US foreign affiliate sales of services in Europe – after being roughly equal to US service exports to Europe in 1992 – were nearly double the value of US service exports in 2002."

On March 2004 the European Commission elaborated a Directive proposal, the so-called Services-directive. It is an ambitious project, as rather than providing for sector-by-sector liberalization, the Directive provides a legal framework for a *general liberalization of services within the EU*. According to a study of the Copenhagen Economics, the application of the Services Directive could result in up to new 600,000 jobs and in a rise of foreign direct investment up to 34%.

Undoubtedly, a pointed expansion of trade in services between the two sides of the Atlantic, comparable to that of investment, will not take place anytime soon. Yet, not necessarily this process will meet the same problems affecting the liberalization of services in the multilateral system. It is well known that within the WTO liberalization of services has faced a vehement opposition, resulting in a very cautious negotiation process. WTO member countries have so far submitted quite a limited list of services they "commit" to liberalize.

Still, in this as in many other fields, the situation of the US-EU enjoys the advantage of a consolidated integration and a closer cultural understanding. The schedule system, by which parties carefully select the service sectors they are willing to trade freely, is much more likely to succeed in the transatlantic partnership than it did in the world-trading arena.

A most immediate achievement: the coordination of technical standard in a neo-functionalist perspective

In terms of what could be done in the very short term, the harmonization of technical and safety standards between the US and the EU could result in immediate, tangible benefits. For sure, it offers the best cost-benefit performance.

Non-tariff, rather than tariff barriers are still the most relevant impediment to the expansion of transatlantic trade. Transatlantic tariff barriers are generally low, averaging between 3-4% of the €500 billion in annual transatlantic trade.

Among non-tariff barriers, differences in technical and food safety standards represent a stumble stone in a further integration of US-EU economies. This issue is partly covered by WTO agreements, such as the agreement on the technical barriers to trade (TBT), but progress in the field has been insufficient.

Many important trade disputes under the WTO settlement system, such as that about genetically modified organisms (GMOs), concerned non tariff-barriers. Harmonization or at least coordination of technical and safety standards could not only improve transatlantic trade, but also bring about additional institutional integration.

Hamilton and Quinlan do not call for specific institutional changes in order to enhance US-EU economic cooperation. They basically argue that transatlantic trade is a firm-to-firm relationship. Foreign investment accounts for the bulk of transatlantic commerce, rather than trade in goods, which represents less than 20% of US-EU commerce. Institutional changes, especially the expansion of the institutional framework, would be not only unnecessary, but also potentially harmful.

This doesn't mean their case may not fit a federalist or functionalist goal. In particular, the harmonization of technical and safety standards would require a sort of institution, such as the Codex Alimentarius Commission for the WTO, overseeing the implementation of the standard setting agreement.

This institution could assess whether a Member's measure is against the common standards or, in a further step, formulating new technical standards by thus getting closer to an actual intergovernmental entity. A step toward standards-setting could thus signify a first move toward a more permanent transatlantic forum dealing with economic integration.

The impact of the exchange rate: a G-2?

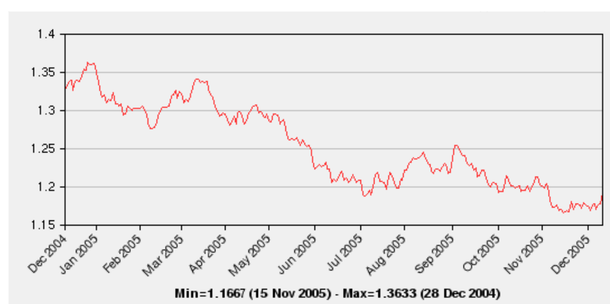
Progress in transatlantic integration requires a solid monetary foundation. The exchange rate, by affecting the relative price of goods and services, powerfully influences international trade; excessive changes in it can be disruptive to efficiency and continuity of work. As a matter of fact, the need for securing the effectiveness of the EU's internal market trade was one of the driving factors behind the institution of the euro. The instability of the euro-dollar exchange rates depresses the progress of the common US-EU economy; an excessive instability might adversely affect the existing level of common economy.

Figure 2 displays the fluctuation of the euro against the dollar in the past year. The volatility of the exchange rate was even sharper in precedent years.

With this in mind, the Institute for International Economics (IIE), in its study *The Euro at Five: Ready for a Global Role*, makes a case for the formation of a G-2 monetary regime, with an informal steering committee, which should manage transatlantic monetary cooperation. The authors point out that the current set of G-7 meetings is inadequate to serve the above purpose and that a deeper and more stable cooperation is required.

The G-7 always had this purpose, to be sure, in the very different conditions under which it was formed in the 1970s. However, the last time it was seriously refurbished by James Baker in the mid-1980s. Monetary cooperation helped at that time in heading off trade wars between Europe, America, and Japan, but was not formalized and dropped off as the sense receded of a Japanese threat and a crisis of "America in decline". Gaps in cooperation re-emerged. The advent of the euro gives the gaps in G-7 cooperation a new and sharper poignancy; the traditional purpose of the G-7 regime requires another institutional adaptation.

Figure 2. December 2004-2205 €/$ exchange rate fluctuation. The graph shows the sharp instability of the dollar against the single currency.



Source: European Central Bank

The authors suggest the G-2 might set a wide range within which the euro/dollar exchange rate might fluctuate. They mention previous US-Japan understanding as an example of bilateral cooperation in monetary policy. The authors go on to consider how such an agreement may prompt further transatlantic cooperation and stabilize the relationship between the Fed and the ECB. Central banks would be charged with managing the exchange rate agreement with proper sterilized intervention and also jawboning arrangements. However, the authors remark that a closer US-EU cooperation in monetary policy would require a consolidation of the decision making process in Euroland, in particular in the field of fiscal policy, which is still subject to the unanimity rule.

The US and the EU may thus act as pioneers -- as the "federalist nucleus" so to speak, borrowing from Streit's conceptual innovation -- with the possibility of expanding a managed US-EU exchange rate mechanism to other countries.

The authors here seem to follow the logic of spillover, by which the institutionalization of an agreement, here on fixed euro dollar exchange rate, would boost further political cooperation. In particular, they point to a possible acceleration of the turn to majority rule within the EU, in sensitive areas such as fiscal and labor polices. In fact, the adoption of a controlled exchange rate regime, even with a very broad fluctuation range, implies a need for significant macroeconomic coordination on both sides of the Atlantic.

This proposal is particularly important as it falls within a wider debate. 1990s financial crises in South East Asia and the recent instability of a dollar unveiled the shortcomings of the current international monetary system. Authoritative economists have urged the reintroduction of a managed monetary system, something like a Bretton Woods II, as did the *Financial Times'* Martin Wolf in his piece "A Global Market Economy Needs a Global Currency."

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The drawbacks of this proposal are related to the debate about fixed-flexible exchange rates. To be true, a fixed exchange rate has serious flaws as well as benefits. Past experiences like Bretton Woods itself showed how difficult is to coordinate a system of pegged currencies. However, the level of transatlantic economic integration is far higher than in the past; so is the degree of integration of European economy, which now has, unlike in he Bretton Woods era, a common currency. The above-mentioned flexibility of a target zone is meant to avoid the difficulties of a fixed exchange rate. A joint US-EU exchange rate system, flexibly harmonized rather than strictly pegged, is more needed, and more likely to be successful today, than in the past.

The sustainability of US foreign deficit: a gathering storm?

In this rosy picture, however, there are thorns. A large debate is going on about the sustainability of the US current account deficit. Americans themselves are as much worried about this as Europeans: Americans too have a nagging concern that their country has become too free from the traditional near-term disciplining factors. There is a community of worry; unfortunately it would not spare damage to the practical economic community if a crash landing were to ensue. A community of policy disciplines, on the other hand, could be reassuring to all parties.

Most economists agree upon that deficits are not necessarily harmful. A recent article in the *The Economist*, not by chance, titled "In defense of deficits". Paradoxical as it may sound, trade deficits can be an indicator of the good shape of an economic system. That all very much depends on what the deficit is actually serving.

Developing countries such as Mexico used heavily foreign borrowing to finance productive investment. International capital markets provide an indispensable source for countries with an insufficient banking and financial system.

Problems arise when, on the contrary, external deficits aim at financing domestic consumption, both private and from the government. In this case the external imbalance might turn unsustainable in the long term, as the economy is not producing the income which is necessary to pay off foreign borrowing. That actually seems to be exactly the case of the USA.

The agenda of the current US administration has resulted in a sharp increase in government expenditure and a significant tax cut. Beside the parenthesis of the 2001 recession, private borrowing, also necessary to cover the huge US consumption, has boomed in the US. The resulting financial gap required the US heavily borrowing from abroad, especially from Japan and China. According to the Census Bureau, “the Nation’s international deficit in goods and services increased to $59.0 billion in August from $58.0 billion (revised) in July, as imports increased more than exports.”

Domestic industrial system does not actually help the situation, as the manufacturing base has faced erosion. From 2000 to 2003 jobs in the manufacturing sector declined by almost 3 millions. The economic growth in the service sector has thus not been followed by an adequate rise in the industrial sector. This would further deteriorate the US foreign debt, if US consumption kept running high.

All the above is the rationale of the current, endless debate about the US trade imbalance with China, accused of keeping the Yuan overvalued. Such a debate has received a strong political connotation and has rapidly heated up. There is ground to sustain that similar disagreements might affect the transatlantic dialogue as to the US deficit with the EU.

Conclusions

An expansion of US-EU economic and institutional ties is feasible, but US deficit is a problem that any proposal of further transatlantic economic integration should address very carefully.

Given the depth of Atlantic interdependence, it is unlikely that US deficit issues would result in a trade or currency war. Nevertheless history is not reassuring: the U.S. and Britain were always deeply interdependent, yet the dollar and sterling clashed sharply in the periods when they were comparable in power, doing tremendous damage to the world economy, particularly during the Great Depression.

The rise of the euro to a currency comparable in strength to the dollar could bring new clashes, at first almost accidental, later taking on a political coloration, with untold damage to the economies on both sides and around the world. If the euro competed with the dollar as a reserve currency or as the currency in use for oil transactions, serious tensions might arise.

Europe and America could head this off by organizing to coordinate their exchange rates and related indicators and reserve systems more closely. European Federalists have long held that a common European currency, as an institution finally restoring European equality with America and producing a balance of power, even if in a limited sphere, should impel America to take cooperation more seriously and enable the two continents to reach a new level of integrative agreements.

The advent of the euro puts this theory to the test; it becomes a matter of finding the political will to put theory into practice. As yet America has moved little from an undisciplined free float, Europe has prodded it little, and America has been little receptive to diplomatic prodding. It is in the coming period when it will be determined whether the euro will lead to a new level of Atlantic economic integration with considerable benefits to all parties; an intermediate mix of advances, crises, costs, conflicts, and restraints on conflict, with limited benefits and constrained advances; or in the worst case a reversion to what we had all thought were outlived levels of trans-Atlantic conflict, with costs to the world’s economy and stability that could potentially exceed that of the Great Depression. □

The OECD estimates that further transatlantic liberalization and coordination could lead to permanent per capita income gains in the US and EU of about 3.3%.

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