The EU and the US: Partnership in search of leadership

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Introduction

The global economic and financial crisis has shown that the transatlantic partners remain at the centre of the global economy and of international negotiations. But it has also highlighted the role and importance of emerging market economies within the world economy: China experienced an average GDP growth rate of 9.6 per cent a year between 2008 and 2011. The crisis has demonstrated the importance of Europe for the U.S., given the role that the on-going eurozone crisis played in the U.S. presidential campaign. Even though risks to one economy are immediately transmitted to the other, the relationship has moved far away from the 'London consensus' reached in 2009 when world leaders, thanks to a transatlantic push, agreed on coordinated efforts to solve long-term sustainability issues and adopt measures to restore market confidence and growth. While the U.S. waits for the eurozone to solve its own crisis, the European Union continues to show an inability to carry out concerted action and the euro-club still lacks a formal body that can represent it in international discussions.

The first section of this paper examines the current status of the transatlantic partnership and assesses recent developments that have resulted from the global financial crisis. The U.S. was severely hit in the initial phases of the crisis and has been showing signs of recovery since late 2010. Europe, on the other hand, has experienced multiple crises since summer 2011 (Subacchi and Pickford 2011). The next section reviews the challenges currently faced by the EU and the U.S. and the risks of spillovers and crisis transmission within the partnership. This section also touches on the proposed EU-U.S. Free Trade Agreement. The paper concludes with a discussion of the role and weight of the transatlantic relationship in global institutions, particularly within the G-20 and the IMF.

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Today's relationship

A strong foundation

Cooperation between the U.S. and the EU rests on extensive historic political and economic ties, but it was only in the last two decades that this cooperation was formalised.[2] Now, the relationship forms part of the broader EU strategy of engaging with key world players by means of so-called strategic partnerships. Although the partnerships' specific purposes and objectives are still to be precisely defined, the U.S. has undoubtedly been a 'true' strategic ally for the European Union (Van Rompuy 2010). Already in 2003, when the European Security Strategy (ESS) first envisioned strategic partnerships as a foreign policy tool for the Union, the U.S. was defined as the 'irreplaceable partner' (Renard 2011). The Transatlantic Economic Council (TEC) was created in 2007 to move forward efforts to boost the transatlantic economy, though it initially had limited success. Discussions are under way to identify policies and measures that can increase U.S.-EU trade and investment and support mutually beneficial job creation, economic growth and international competitiveness. Specifically, a High-Level Working Group on Jobs and Growth was established in November 2011; it will report its recommendations and conclusions by the end of 2012, and it released an interim report in June 2012 (see section II).

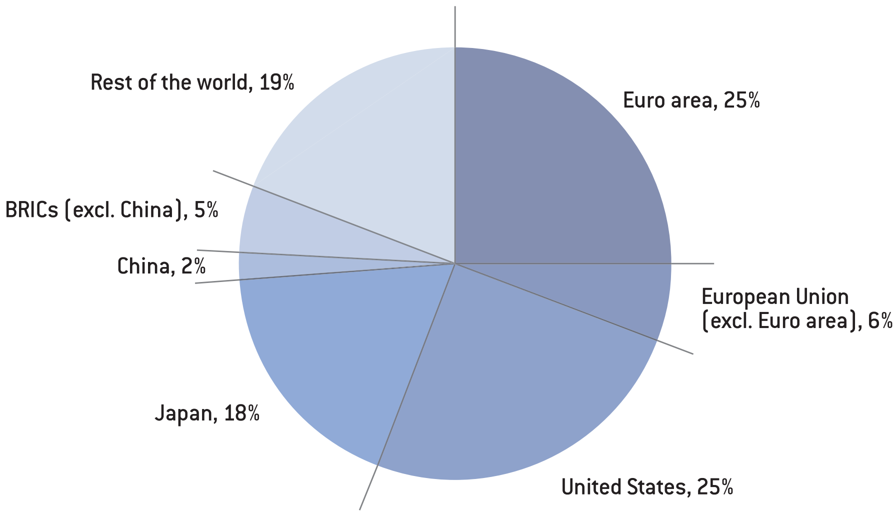
Together, the economies of the EU and the U.S. accounted for almost half of world GDP in 2011 at market exchange rates (see figure 1).[3] EU-U.S. trade has almost doubled since 2000 – it was estimated at $632 billion in 2011. Financial integration has also deepened. Transatlantic financial markets continue to play the most significant role in the global financial sector. They account for over two-thirds of global banking assets and of private and public debt securities. They make up more than three-quarters of global financial services and of all new international debt securities. And they represent almost 80 per cent of interest-rate and equity-linked derivatives (Hamilton and Quinlan 2012).

[2] Formal cooperation between the U.S. and the EU is based on the 1990 Transatlantic Declaration, followed by the establishment of the wide-ranging New Transatlantic Agenda (NTA) in 1995. A Transatlantic Economic Partnership (TEP) was launched in 1998.

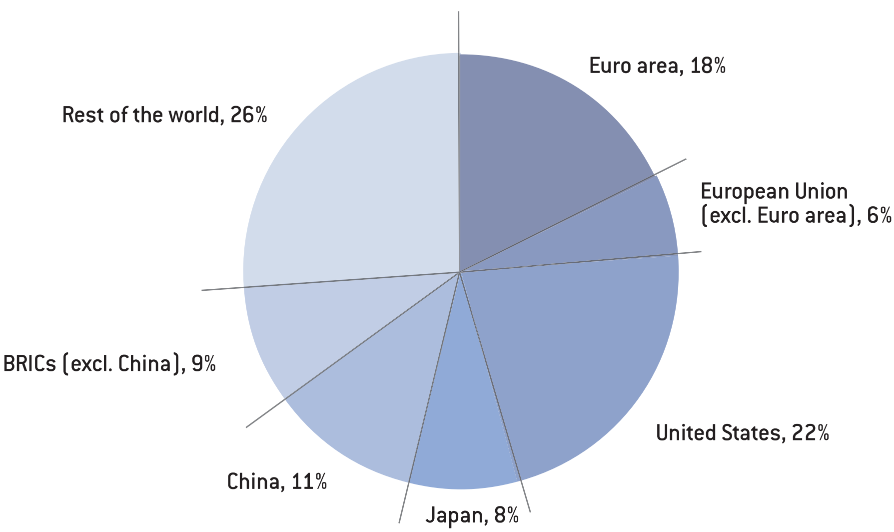
[3] In the long term, some estimates suggest that rising developing Asian countries will take over the dominant position of the transatlantic partners in the world economy, accounting for almost half of world real GDP in 2050. In this scenario, the share of the EU and the U.S. combined is expected to fall to just over a quarter of world GDP (Buiter and Rahbari 2011).

Figure 1. Share of World GDP (%, 1995 and 2012 at Market Exchange Rates)
Source: IMF World Economic Outlook, April 2012

1995



2012



Ebbing and flowing

Over the last five years, crisis management at a multilateral level has betrayed the ups and downs in the current state of the relationship between the U.S. and the EU. The strong cooperation that emerged in the early stages of the crisis began to weaken as both partners moved towards different paths and paces of recovery.

The risk of a global financial and economic collapse sharpened everyone's focus in the early stages of the crisis, resulting in a coordinated common response and an exceptional level of cooperation. For instance, the European Central Bank (ECB) and the U.S. Federal Reserve signed an unprecedented 50-basis-point interest rate cut in early October 2008.[4] Coordinated policies at the G-20 level culminated in agreements on crisis resolution through increases in liquidity, as well as on measures to prevent future crises, which included the call to reform the international financial and monetary architecture made at the London summit in April 2009. Later that year, the establishment of a Mutual Assessment Process (MAP) within a new 'Framework for Strong, Sustainable and Balanced Growth' seemed to pave the way for increased and effective concerted action.

However, the multiplication of international gatherings since the start of the crisis has made these meetings less significant in the long run, allowing them to be overwhelmed by more urgent issues. For example, at the G-20 Cannes meeting in November 2011, the European debt crisis became the priority. Together with the lack of drive from the U.S., this caused the thoroughly conceived and wide-ranging agenda of the French presidency to be put aside. So, viewing the U.S.-EU relationship through the lens of multilateral activities in the last five years might hint at a relationship that is stalling. No country is willing to take the lead and push for necessary structural reforms or immediate growth enhancement, least of all the U.S.; the presidential elections meant that the U.S. had to prioritise domestic issues. The potentially dramatic global effects of the multiple crises in the eurozone do not seem to have caused enough international concern to trigger a new round of concerted action, as illustrated by the weak recommendations of the latest meeting of G-20 leaders, held in Mexico in June 2012.

Diverging attitudes

Different countries reacted to the crisis at different speeds, and traditional divergences on macroeconomic policy priorities re-emerged. For instance, the U.S. called for a gradual

[4] Along with the ECB and the Federal Reserve, the measure was agreed by the central banks of Canada, Sweden, Switzerland and the United Kingdom.

exit from fiscal stimulus and for extended tax cuts.[5] But European countries, bolstered by the Sarkozy-Merkel axis, continued to issue fiscal consolidation packages differentiated to national circumstances (The G-20 2010).

Monetary policy measures by the European Central Bank (ECB) and the Federal Reserve System (Fed) followed a similar pattern on many occasions in the last five years, such as when they made substantial cuts in interest rates. However, actual coordinated action was limited to currency swap agreements, which were put in place after the Lehman collapse and have been retained ever since. Monetary policy measures reflected the different sources of financing of respective economies, as well as the central banks' mandates and aims, and so had different consequences at the global level. The Fed aimed at increasing internal demand and turned to quantitative easing, purchasing government bonds and asset-backed securities, to avoid the liquidity trap.[6] The ECB is not allowed to directly finance government debt, but it expanded its role and provided financial institutions with liquidity against collateral, in order to improve the monetary transmission mechanism and to achieve financial stability.

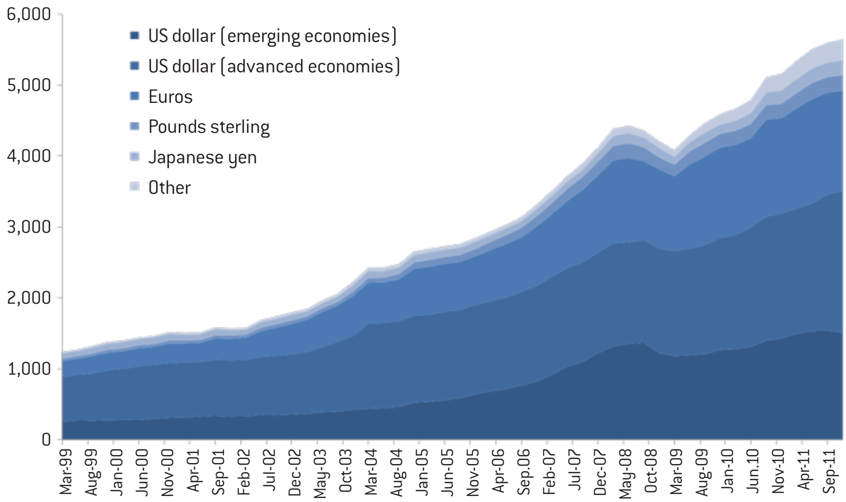
Monetary policy decisions help explain the significant impact of different governance structures on shaping policy choices. The distribution of responsibility for fiscal and banking policy within the eurozone is opaque: it lies partly with the ECB and partly with the eurozone group of finance ministers. The cacophony of the voices of eurozone members dissipates much of the potential for realising a key international role (Bergsten 2005). Within the ECB's governing council, members often tend to stick to a national perspective and, in more than one case, strong disagreement has even led to resignation.[7] In general, the EU has a more interventionist outlook on the role of market regulation and supervision by the government, seeing these issues as the domain of public authorities. The American doctrine, on the other hand, has always favoured a market-oriented regulatory environment and independent regulatory institutions, to limit political intervention. This attitude is also reflected in the case of bank failures, with the U.S. having a more tolerant view towards corporate insolvency than most European cultures, which see them as 'politically ominous disasters to be avoided at all costs' (Goldstein and Veron 2011).

5 In July 2012, the Bush administration's tax cuts were further extended by the Obama administration for one year for Americans with annual income of less than $250,000 a year. Instead, taxes for the wealthiest 3 per cent of Americans will move up from 35 per cent to 39.6 per cent.

6 Interest rates are close to the Zero Lower Bound (ZLB).

7 European Central Bank Governing Council member Axel Weber quit the post in April 2011, in part because of his long-standing discomfort at the ECB's initial decision to embark on bond purchases in 2010. Jürgen Stark, an executive board member at the ECB, also resigned in September 2011, as a protest at the ECB's crisis management, again with regard to the bank's bond-buying programme.

Figure 2. **Currency Composition of Known Allocated Reserves ($ billion)**
Source: IMF COFER database



Today's challenges

Growth

The changing epicentre and shifting nature of the global crisis required differentiated policy responses at different times on both sides of the Atlantic. After the crisis, the two sides were left with different underlying economic situations. Engaging with new partners to look for new sources of growth across the world poses a challenge to the extent and scope of the transatlantic strategic partnership. It also presents a challenge to the global pre-eminence of the U.S, economy, which is likely to shift towards a position of 'primus inter pares' in a multipolar economic order (Subacchi 2010).

The impact of the global financial crisis is expected to linger on, leaving transatlantic economies with low growth prospects for a prolonged period. However, the U.S. reached its pre-crisis GDP levels of 2007 in mid-2010, with an estimated tepid GDP growth of just 2 per cent in 2012 (IMF 2012). Meanwhile, Europe has suffered heavily since summer 2011, with the emergence of a sovereign debt crisis in several eurozone countries. These crises are likely to bring with them negative growth in the euro area in 2012 and lead to a feeble recovery in 2013 (IMF 2012). Nevertheless, there are clear divergences among the economies of the single currency union, which is often referred to as a 'two-speed' Europe.

Troubled finances

Public finances still remain a challenge for economies on both sides of the Atlantic, which are struggling to strike a balance between austerity measures and growth-boosting stimulus. The combination of a deepening EMU crisis with a lack of action in dealing with the so-called fiscal cliff, the potential U.S. fiscal crisis set for the beginning of 2013, could cause major stress to the world economy.[8] Spillovers and direct transmissions from one economy to the other are also possible. The Congressional Budget Office (CBO) warned in August 2012 that if new legislation is not produced to prevent the George W. Bush-era tax rates from expiring and automatic spending cuts from being implemented, the U.S. economy will contract by 0.5 per cent in 2013 and unemployment will rise by almost 1 point to 9.1 per cent next year (Congress of the United States Congressional Budget Office 2012). At the same time, U.S. debt is expected to continue growing, after hitting an estimated 105 per cent in 2011 (IMF 2012).

Mutual exposure

The eurozone crisis poses risks to the U.S. economy through different channels, which might be magnified by a weak and still recovering domestic economy that is burdened by high and increasing amounts of debt and worrying deficit levels. Given the economic interdependence between Europe and the U.S., it is not surprising that spillover effects to the U.S. economy are a relatively large concern in America. Concerns about a deepening or an easing of the eurozone crisis have a swift effect on volatile U.S. stock prices. In 2011, 6 out of the 10 biggest moves in the U.S. stock market were due to European events, according to the Bloomberg market wrap (Harris 2012). On the day of the ECB's announcement in early September 2012 that the bank was ready to begin its bond-buying programme, the move pushed the benchmark American stock index to a four-year high (Popper 2012). Given the uncertain evolution of the sovereign debt crisis in the Monetary Union, no unanimous assessment has emerged on its implications for the U.S. economy. While a modest contraction in the eurozone would adversely affect U.S. exports and the sales of U.S. companies, the impact on overall U.S. GDP growth would probably be minimal (Ahearn et al. 2012).

[8] The fiscal cliff is a term used to describe the conundrum that the U.S. government will face at the end of 2012, when tax breaks will expire and tax increases and spending cuts will be introduced. They include automatic spending cuts triggered by the August 2011 deal to raise the debt ceiling; the expiration of the Bush-era tax rates; a sharp cut in Medicare doctor payments; and the failure to index the Alternative Minimum Tax for inflation, which would raise taxes for many households.

Particularly worrying, however, is the potential mutual exposure of financial institutions. The U.S. remembers how the collapse of Lehman Brothers directly affected European financial institutions. American banks have been reducing exposure to stressed markets over the past year.[9] But direct and other potential exposure to the troubled eurozone countries of Greece, Ireland, Italy, Portugal and Spain was estimated at around 7.5 per cent of their total exposure overseas, accounting for $765 billion at the end of 2011 (Bank for International Settlements 2012).[10]

Towards an EU-U.S. FTA?

A comprehensive transatlantic economic initiative has long been advocated and is especially supported by the private sector, which knows the benefits that could arise from the reduction of trade barriers and the creation of a more stable and transparent trading and investment environment. In November 2011, a High-Level Working Group on Jobs and Growth was created to identify policies and measures that could increase bilateral trade and investment, with the final aim of full transatlantic market integration. The interim report released in June 2012 highlights 'the greatest potential for supporting jobs and promoting growth and competitiveness across the Atlantic' (EU-US HLWG 2012). Though no concrete recommendations have been made, talks about a Free Trade Agreement between the US and the EU are likely to start in 2013, as recently stated by the European Council (General Secretariat of the European Council 2012). A study for the European Commission in 2009 estimated that even partial successes, which would involve aligning half of relevant non-tariff barriers and regulatory differences, would push EU GDP 0.7 per cent higher in 2018, while U.S. GDP would gain 0.3 per cent per year compared to the baseline. This represents a potential annual gain of €41 billion (Berden et al. 2009).

These talks are likely to revive the transatlantic relationship. Aside from technicalities about market access, they have the geopolitical aim of maintaining the relationship's preeminent

[9] Since 2010, U.S. domestic banks have reduced their investments in Greece by more than two-thirds, from $18 billion to only $5.8 billion at the end of 2011. They have also downsized their exposure to other troubled countries, including Spain (down 21 per cent), Ireland (down 16 per cent) and Italy (down 14 per cent) (see Appelbaum 2012).

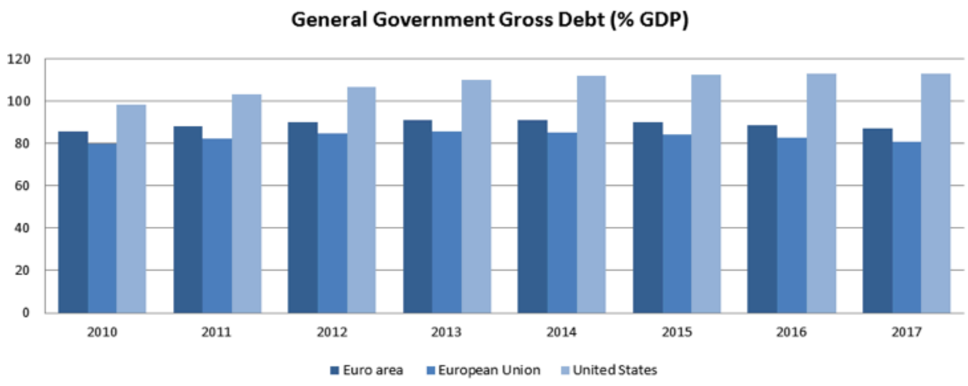
[10] 'Direct exposure' refers to exposure to public and private sectors. 'Other potential exposures' includes derivative contracts, guarantees extended, and credit commitments. It is generally believed that the Bank for International Settlements' 'other potential exposures' data capture gross exposures, rather than net. It is also worth noticing that BIS data capture the exposure of banking institutions, and do not include the exposures of other financial institutions, such as money market, insurance and pension funds. They also ignore secondary exposures. BIS data may suggest that U.S. banks have higher levels of 'other potential exposures' to eurozone countries facing market pressures. In particular, whereas direct exposures to Greece, Ireland, Italy, Portugal and Spain (sovereign and private sector) totalled $135 billion in September 2011, BIS figures indicate that other potential exposures for U.S. banks to these economies (sovereign and private sector) totalled $582 billion in September 2011. Again, this figure is not believed to reflect net exposures, and analysts disagree about whether BIS data overstate or accurately represent the exposures of U.S. banks overseas.

role in the world economy, by showing that the transatlantic partners can compete with rapid developing economies. Previous efforts within the Transatlantic Economic Council (TEC) and the High-Level Regulatory Cooperation Forum have proved that the process is likely to be difficult and time consuming.

Officials on both sides fear getting bogged down in endless discussions about the technical details of the agreement, which could end up damaging the overall relationship. If agreement is reached in a reasonable amount of time, however, it would represent a trade-driven boost to economic growth and give confidence both to the private sector and to struggling leaders.

However, engagement at the bilateral level runs the risk of providing the nail in the coffin of the multilateral approach, which has already faded after the initial 'burden sharing' policy coordination that characterised the early stages of the crisis.[11] Again, this would signal that both the EU and the U.S. will only engage internationally when specific domestic interests are concerned and when the issue in question is on top of either region's domestic agenda.

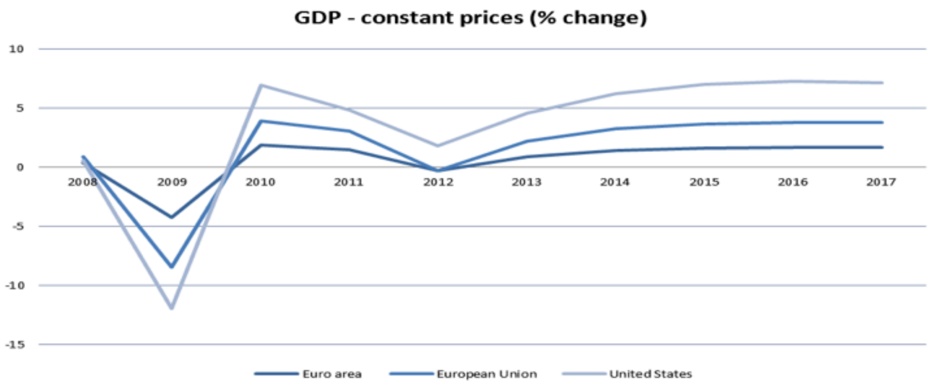
Figure 3. General Government Gross Debt (% GDP)
Source: IMF, WEO Database, April 2012



[11] Moreover, both parties are engaged in several bilateral and multilateral talks with other strategic partners. For instance, a Free Trade Agreement between the EU and India, which would represent the single biggest trade agreement in the world and would benefit 1.7 billion people, is in an advanced stage of negotiation.The Trans-Pacific Partnership (TPP) FTA negotiations, which aim to bring together economies across the Pacific into a single trading community, are part of the bigger realigning and shifting strategy of the U.S. towards the Asia-Pacific region.

Figure 4. Growth Prospects

Source: IMF, WEO Database, April 2012.



Multilateral engagement

The bilateral relationship also plays out within the multilateral institutions in which both the EU and the U.S. are involved, most of which were founded with American impetus and are still led by either American or European nationals.[12] The appointment of the World Bank president and the International Monetary Fund (IMF) managing director in 2011 showed how jealously the U.S. and Europe guard their predominant position in international fora.[13]

The bilateral into the multilateral: new impetus…

Much needed political drive and vigour could be injected into multilateral arrangements by a joint transatlantic effort. Multilateral initiatives can be better implemented using the leverage of the partnership, as evidenced by the call from President Bush, which was also endorsed by the European partners, to convene an emergency G-20 summit after the Lehman collapse. Favoured by circumstances that called for urgent and decisive action, the transatlantic-driven revamp of the G-20 framework, which brought with it an increased role for the IMF, proved that transatlantic leadership in a multilateral system was possible. Likewise, it was President Obama who suggested designating the G-20 as the 'premier

[12] Under the terms of an unwritten agreement, the IMF is usually led by a European and the World Bank president is an American.

[13] The U.S. nominee for the World Bank's chief post, Jim Yong Kim, was chosen on 16 April 2012. However, for the first time in its 66 years of history, there were other nominees, namely Nigerian Finance Minister Ngozi Okonjo-Iweala and José Antonio Ocampo (a former Colombian finance minister), signifying the increasing clout of emerging markets on a global level. According to World Bank officials, however, China and India backed the U.S. nominee (see Lowrey 2012).

forum for international economic cooperation' in September 2009, as the Pittsburgh summit communiqué reports (The G-20 2009).

However, transatlantic-driven policy coordination efforts showed signs of short-term thinking when national economic conditions started to diverge and the initial peak of the crisis was overcome. In consequence, the comprehensive London summit agenda was not fully implemented. Specifically, at the G-20 level, the main obstacle to a coordinated approach was transatlantic differences on financial regulation, with both sides pursuing different policies with regard to liquidity rules for global banks and fiscal policies, where the U.S. differed from European countries' emphasis on austerity.

…or detriment?

The multilateral framework also has the potential to prove detrimental to the partnership. Firstly, the EU has yet again shown its inability to speak with one voice, and there are signs of an inward looking attitude on the part of its members that hint at a renationalisation of policymaking (Kupchan 2010). Even if Europe is indeed seen as overrepresented in many gatherings, including the G-20 – where it holds a single seat for the Union plus four EU members, and Spain as a permanent invitee – it has not taken advantage of its position. The forum has emphasised the role of the major European economies instead of the Union as a whole, perpetuating the debate on the intergovernmental versus supranational approach. This offers more evidence of the lack of political will and coordination among the EU member countries in putting forward a unified response (Giovannini et al. 2012).

Secondly, the approach of the Americans and the Europeans on the multilateral stage may differ, as in the case of the on-going reform of the IMF's quota system and governance. The reform was initially slowed by an undercurrent of European opposition, with EU members reluctant to dilute their influence in one of the world's most important financial institutions. But in August 2010, the U.S. suddenly turned its back on its traditional partner and forced the reform process to move forward by effectively vetoing the renewal of the Executive Board's seats. This pushed European countries to accept a reduction from eight to six seats on the Executive Board, with the surrendered seats going to emerging countries.[14] National agendas (and domestic disagreements) also prevailed when the U.S. Congress blocked

[14] In August 2010, the U.S. abstained from the biannual renewal of the IMF's Executive Board seats, which would have permitted European countries to retain their dominant position on the board. This meant that the U.S. effectively vetoed the decision, since the U.S. holds 16.74 per cent of the votes in the Fund, in which the majority is 85 per cent. The U.S.'s manoeuvre highlighted the division between the U.S. and emerging countries on the one hand and European countries on the other. Moreover, it brought to light subtle tensions between big European countries and smaller ones, which were more likely to be damaged by a potential reduction of seats in the Executive Board.

finance promised for an increase of the IMF fund in April 2012, which was perceived as only benefiting troubled eurozone countries.

The G-20 framework, which was heavily championed by European leaders in its early days, is now in part turning against the Union. Ahead of the G-20 summit in Los Cabos in June 2012, Europe was put under pressure by its American partner, which feared its vulnerability to a potential European downturn and was focused on its own domestic issues. Facing criticism from emerging economies as well, European Commission President Barroso felt the need to underline that the EU was not going to the summit 'to receive lessons in terms of democracy or in terms of how to handle the economy' (BBC 2012).

This friction reflects the fading, or at least the current lack, of effectiveness and legitimacy of the G-20. Mainly due to the lack of commitment and leadership by the transatlantic partners, and in particular the United States, it has not turned into the promised world's 'permanent steering committee' (Subacchi and Jenkins 2011). It may also point to a U.S. strategy of turning to bilateral relations with 'strategic' European countries, such as Germany and France, to make use of the key role they can play in the unfolding of the eurozone crisis, instead of fully committing to an overall 'strategic partnership' with the European Union.

At the same time, improving both the governance and legitimacy of the G-20 is in the interest of all its members – first and foremost, the U.S. and the EU. An empowered G-20 would help the EU leverage its role internationally and with its transatlantic ally. The U.S. should see the group as a suitable forum to continue to exert its de facto world economic leadership. The U.S. would benefit from a forum in which it is still the premier partner and the leading decision maker, through which it could engage with pivotal emerging economies within a flexible – that is, non-binding – framework.

Conclusion

The transatlantic powers' role is not just an artefact of the past, but is of paramount importance in handling the global economic and financial crisis. The relationship rests on solid trade and financial linkages, which are supported by shared values and ideas. The two partners also use their link to lead international discussions and push forward the multilateral agenda. When they lack impetus or a shared vision, international institutions are easily brought to a standstill, as seen in the stalemate in broadening and deepening the G-20 agenda in the last few months.[15] Domestic issues are currently at the top of the agendas of both partners, which has contributed to differences between them. In the final months of the presidential campaign, U.S. hands were tied, especially where congressional action was required.[16] On their side, European countries are devoting all their attention to future scenarios in the core 17 euro area countries, consumed as they are by their own financial and economic problems. Though U.S. banks have reduced their direct exposure to troubled economies, the U.S. domestic economy remains vulnerable to disruptions in Europe. Europe is the destination of around one-quarter of exports from the U.S. and $1.4 trillion of the securities of eurozone companies and countries are held by the U.S.

Although they are at a different stage of recovery and have dissimilar underlying economic and institutional conditions, the transatlantic powers are still at the top of the world economy and at the forefront in setting the global agenda. The importance of their relationship must surely be one of the lessons to be learnt from the global economic and financial crisis. Given the crisis that the partners are facing and the rise of other powerful actors on the world stage, it is in the mutual interest of the EU and the U.S. to ensure that they are on the right track to recovery and to promote tighter and more stringent relations between them.

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[15] In addition to this, even China seems to have put the reform of international institutions, and of the G-20, at the bottom of its national agenda, in view of fears of a possible economic slowdown and in the run-up to a very sensitive change of its political leadership (see Smith 2012).

[16] Ibid.

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