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Sharing the Growing Economic Burden of World Order

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Introduction

In 2005, a transatlantic working group entitled “Redefining the economic role of the state in a new international environment: challenges for policy makers” was established with the goal of linking the ongoing debate over economic performance and the role of the state in fostering growth among the Atlantic partners, with a second transatlantic issue that has grown more urgent recently, particularly with the protracted entanglement of the United States in Iraq. That is, can the U.S. sustain its current role as the predominant provider of global security without stronger support from its European allies? Or will European countries have to start refocusing public expenditure on their states’ core tasks, devoting more resources to one of the most important of these tasks, external security?

The working group has been part of a broader project: “Diverging views on World Order? Transatlantic Foreign Policy Discourse in a Globalizing World” (TFPD), which since 2002 has been sponsored by a generous grant from the German Marshall Fund of the United States.

Though it is fairly familiar to policy makers, particularly those involved in determining defense budgets, our subject has seldom been addressed by scholars since it straddles two communities of experts, who rarely interact with each other: macroeconomists on the one hand, and political scientists with a focus on international relations on the other. Moreover, on both sides of the Atlantic scholars as well as practitioners hold divergent views on how to tackle the problem of maintaining a sufficiently high degree of economic growth while meeting the growing challenges of global security and stability.

Given its huge current account deficit, the U.S. is often seen by Europeans as “living beyond its means,” while from an American view most of Europe is grossly underperforming, due to its structural rigidities and entrenched welfare system.

These diverging perceptions were the starting point for the working group’s first meeting at the Institute for International Economics in Washington DC on January 26–27, 2006, under the title “Between underperformance and overstretch. Assessing the Politics of Economic Reform and the Economics of Foreign and Security Policy.” Participants agreed, of course, that the two sides of the Atlantic share common goals: Sustaining global security and guaranteeing solid worldwide economic growth. All participants also agreed that current global economic conditions make for a seemingly stable status quo: The United States attracts large flows of investment from abroad and can afford to project military might around the globe serving everyone’s security needs. By running a sizeable and growing current account deficit, the United States also serves as an

important economic engine to the growth laggards of Europe and Japan. But participants did not agree on whether the transatlantic partners were truly satisfied with this status quo, on whether the macroeconomic imbalances behind the current set-up would soon unravel and on who would and should shoulder the burden of adjustment if the U.S. current account deficit eventually proved unsustainable.

Central questions, therefore, remained: Can the U.S. afford economically to continue its role of provider of global security and stability as an international public good? Can it do so of its own strengths or does it need explicit support? Is Europe at ease with the current division of labor and the current macroeconomic mechanism of sharing the economic burden of America's global role? Can it afford to take over a greater share of the burden? Will it eventually have to?

These questions were addressed more in-depth at our second meeting, which took place on May 11-12, 2006 at the SWP in Berlin, under the title "Sharing the growing economic burden of world order. How to strengthen the economic base of foreign and security policy in the Atlantic Alliance." The Berlin meeting brought together a larger audience of policy makers and practitioners. It focused more strongly on discussing forward-looking policy perspectives and options that might be considered on both sides of the Atlantic *if* the United States' ability to maintain its global security interests *and* to ensure a steady inflow of foreign capital were to diminish.

At the time of the second conference, the International Monetary Fund (IMF) had just published its forecast for the United States external position: For 2007, the IMF economists projected a current account deficit of \$899 billion or 6.5 percent of U.S. gross domestic product (GDP).¹ And in its March trade statistics, the U.S. Bureau of Economic Analysis showed an annualized U.S. trade deficit for 2006 of \$744 billion.² At the same time, attacks against the U.S. occupation and civilians in Iraq had increased significantly over the course of the spring, and violence had flared up anew in Afghanistan.

The present volume contains the revised versions of policy papers presented by working group members at this second conference. With this publication, we hope to stimulate more in depth, interdisciplinary thinking among academics as well as to contribute to a debate among the Euro-American policy making community on an issue that will likely require ever more attention and ingeniousness in the years to come.

The first section juxtaposes two virtually opposite opinions on the sustainability of the transatlantic macroeconomic and security situation: In his paper, *Henry Nau* argues that only big jolts could seriously destabilize the current global geopolitical and economic consensus. In the summer of 2006, Europe relies on a continued U.S. military presence in the Middle East more than ever. And Europe seems still unwilling to play a greater security role beyond its boundaries. Not one of the United States' economic

¹ International Monetary Fund, *World Economic Outlook*, April 2006.

² U.S. Bureau of Economic Analysis, "US International Trade in Goods and Services, March 2006," released May 12, 2006.

partners is seriously interested in challenging the country's economic predominance. Nau stresses the flexibility, vitality and dynamism of the U.S. economy and argues that foreign capital currently has no attractive alternative destinations. Europe and Asia have not yet achieved a sufficient level of domestic consumption and investment to afford foregoing American demand for their goods. Thus, the status quo is in everyone's interest—both from a security and an economic standpoint.

The main premise of *Sebastian Dullien's* paper, on the other hand, is that current global economic imbalances are unsustainable. The United States, he argues, will not be able to run a current account deficit of close to seven percent of its GDP in the long run, because an external deficit of this size implies an unsustainable and growing external debt. Inevitable adjustment may be triggered by a change in foreign investor sentiment and a shift of private capital out of dollar assets or a turnaround in Asian central banks' policy to accumulate dollar reserves. According to Dullien, a correction of global macroeconomic imbalances will weigh heaviest on Europe, because the continent's economic institutions would not allow for the swift and significant policy reactions necessary to counter a major depreciation of the U.S. dollar.

In the ensuing discussion, European working group members insisted that the European Union's (EU) security contributions around the globe have been growing and have played an important part in ensuring the West's security interests. The discussion also showed that economists on both sides of the Atlantic do not agree on the inevitability or size of eventual global macroeconomic adjustment.

The timing and size of this adjustment depends in part on the health of the U.S. economy and its ability to remain an attractive destination for private and official foreign capital. America's economic resilience remains a decisive factor for the nation's exceptional role in shaping and securing the international order. The second section features three papers that look at macro- and microeconomic conditions in the United States in greater depth. *Catherine Mann* and *Katharina Plücker* look at the disaggregated external debt of the country and show why so many have argued that the United States has a 'special status' and has thus been able to sustain larger debt levels than other industrial countries. They also demonstrate, however, that recent data may well indicate a coming shift in foreign investors' preferences—away from dollar-denominated assets.

Martin Mühleisen's paper is an important contribution to understanding the central role of the U.S. financial market in America's economic dominance. He focuses on the market for American private mortgages. After decentralization and regionalization of the American mortgage market, Mühleisen argues, banks have been able to spread their risks better and returns have become much more predictable. For foreign investors whose capital has enabled the recent American housing boom, U.S. mortgages represent stable and quite profitable investments. And in spite of recent interest rates hikes, Mühleisen does not forecast a significant slowing of the housing sector in the United States.

Kent Hughes's contribution addresses that other major pillar of America's outstanding economic performance and military might: technology and innovation. He focuses on the microeconomic conditions behind the American productivity surge that helped make the American economy such an attractive destination for foreign capital in the mid- to late-nineties. He sees America's technological and economic lead in danger, because the country has spent too little of its resources on research and development and on education in the past ten years. Already, the United States is losing talented and highly qualified professionals to India and China and competition with these countries will intensify in the coming years. Hughes admonishes American policy makers to insist on fair global competition, on respect for intellectual property rights and a possible intervention by the IMF to enable smooth exchange rate adjustments.

As expected, working group members disagree on the extent of global challenges to U.S. technological and economic predominance and on whether or not recent data does signal a change in the trend of recent years. A number of commentators continue to place high confidence in the dynamism of U.S. product and capital markets.

The last part of this volume focuses on the European side of the current global economic and security equation. Here the authors more or less agree: Europe cannot and does not want to spend more resources on a greater security role in the world. *Stefan Collignon* argues that it's a faulty macroeconomic policy mix that has slowed investment rates and thus potential growth in the Eurozone and has prevented European countries from playing a greater geopolitical role in the world. In the absence of a central 'European government,' Collignon argues, the European Central Bank's monetary policy and badly coordinated national fiscal policies make for quite unstable and unpredictable investment environments. Not surprisingly then, the United States still plays the role of the world's biggest economic power.

Daniela Schwarzer, in her paper, agrees that separate national or even nationalist attitudes have prevented European countries from adopting more effective security and defense policies. Even though all European countries are spending significantly less than the United States on their militaries, this is not a matter of Europe not being able to afford higher defense spending, but rather of low social preferences for higher defense spending. Nationalist tendencies in countries' defense sectors dominate although most European citizens actually favor greater defense cooperation within the European Union. EU countries should "spend better" if not more on defense, by pooling their resources, by cooperating and specializing instead of duplicating efforts. This intra-European cooperation, for the time being, should take priority over transatlantic cooperation in defense.

Reinhard Wolf's paper mainly focuses on the will of the European people. While many Europeans may favor greater EU-wide defense cooperation, he finds that they certainly do not favor greater spending on defense—mostly because security threats are not a great source of worry to European voters. Many Europeans are wary of the U.S.'s defense spending and think that the

United States' military engagements had made the world less safe in recent years.

Wolf's contribution starkly portrays the differences in European and American preferences for military engagement around the globe. Discussants agree that many of these differences have deep historical roots, but commentators also point out that European distrust of American foreign policy has risen in the years of Bush's presidency. Nevertheless, all conference members agree that the transatlantic relationship is still strong enough to weather differences in approach to global security challenges. The transatlantic partners still do share the same goal of ensuring growing global economic prosperity and worldwide physical stability.

Thus, in this volume's concluding chapter, *Jens van Scherpenberg* strikes a more optimistic, if also more urgent note. The rebalancing of economic performance that seems to be under way among the Atlantic partners—slowed growth in the U.S., rising growth in Europe, notably Germany—may be eroding the current implicit economic burden sharing mechanism based on high import demand by the U.S. and high savings exports by the rest of the world, including Europe. At the same time, van Scherpenberg points out, this rebalancing offers the opportunity, even poses the necessity, of replacing this mechanism with a more explicit arrangement. Europeans will eventually have to refocus a greater share of their public budgets on meeting the challenge to make the world as safe a place as is needed to allow for wealth-enhancing economic initiative everywhere and by every individual. Only then, he argues, will Europeans be able to press their case effectively when their interests diverge with those of their Atlantic partners. They could do so in the context of the Atlantic alliance, but perhaps even more effectively in a strengthened, higher profile bilateral EU-U.S. institutional discourse, which could evolve into the best-suited level for achieving a newly integrated West.

Jens van Scherpenberg and Katharina Plück

Part I
Macroeconomic Imbalances and
Their Foreign Policy Implications

The Political Reasons for Global Economic Imbalances: Why Europe Finances American Military Activities Abroad and Economic Consumption at Home

Henry R. Nau

As violence erupts in the Middle East, Europe is more aware than ever in summer 2006 that the United States provides security for the global economy. But what Europe is less aware of is that America's security and economic roles in the contemporary world are closely linked to global economic imbalances. If Europe insists that these imbalances be corrected, it will have to assume more responsibility for global security, growth and financial integration.

Global economic imbalances have direct implications for international security and domestic economic policies. In 2005 the United States borrowed \$805 billion or 6.5 percent of its GDP from the rest of the world. The conventional wisdom is that it did so to finance tax cuts that reduced public savings (larger budget deficits) and increased private consumption (reducing household savings as well). Critics in Europe and partisan Democrats in the United States criticize these policies as favoring the rich and stoking excessive consumerism. But it can be just as easily argued that the United States borrowed this money because it offered the best investment opportunities for a glut in global savings, spent much of the borrowed money to provide necessary military security for global markets, and created through its imports the economic engine that accounted for 45 percent of all global growth in consumer spending from 1996 to 2005.

If the United States were to correct this payments imbalance quickly, it would mean a sharp drop in the dollar and appreciation of the euro. A high euro would hurt European export-led growth and exacerbate unemployment in Europe that is already double what it is in the United States. It would also require significant further reforms in European financial markets to create the same opportunities for foreign direct investment and sophisticated financial transactions that current U.S. financial markets offer. Moreover, to bring down its current account deficit the U.S. would have to cut back its budget deficit by either reducing expenditures or raising taxes (although, as noted below, reducing budget deficits is no guarantee of reducing current account deficits). Cutting expenditures would reduce U.S. defense outlays, requiring Europe and other advanced countries to worry more about, if not spend more on, defense activities around the world (unless, of course, one assumes that the world would suddenly become peaceful once the United States retreated). Raising taxes would slow U.S. consumption and imports, reducing European and Chinese exports and growth. Slower world growth might increase political unrest, particularly in China, India, and the Middle East.

A sustained decline in U.S. growth might accelerate the pricing of commodities such as oil in euros (or yen), making the euro more attractive for foreign central banks to hold as a reserve currency. But increasing euro lending would also constrain European fiscal and monetary policy options, much as dollar lending does in the United States. And budget deficits in several major countries in Europe (as a percent of GDP) are further out of control than they are in the United States.

For Europe the moral of this story may be: Be careful what you ask for! Through a whole series of decisions Europe has made independently of the United States—to spend less on defense, to depend more on export-led growth, to run higher budget deficits, to maintain less flexible labor markets and tolerate higher unemployment, to deregulate financial and other service markets more slowly—Europe has acquiesced in the complex interdependencies producing current global economic imbalances. Along with U.S. policies, Europe's policies are the political reasons for current global economic imbalances. Implicitly and explicitly the advanced countries have made a bargain to internationalize global security and growth. America provides the security and growth; Europe and other surplus areas pay for these benefits by investing their savings in the United States. How did this bargain come about?

Guns vs. Butter

In a closed economy, if a country spends more on guns or security, it has fewer resources to devote to butter (private consumption) or to investment stimulating economic growth. Its policy options are constrained. The same reasoning is sometimes transposed to the international economy. If a country invests more in guns and butter than the level of domestic savings permits, it has to borrow from abroad and this financial dependence in turn constrains its foreign policy options. Two factors may alleviate these policy constraints: generating additional savings or using resources more efficiently, that is, increasing productivity.

What evidence is there that such policy constraints caused by a trade-off between guns and butter exist? The experience of the Soviet Union appears to confirm the trade-off. But the U.S. experience refutes it.

After the Cuban Missile Crisis in 1962, the Soviet Union gave priority to defense. It maintained this priority right through the end of the 1980s. In 1976 defense expenditures accounted for 13.5 percent of GDP; in 1988 they accounted for 18 percent of GDP.³ From 1980 to 1989 the Soviet Union also increased its nuclear arsenal by 50 percent from 7840 strategic weapons to 11,320.⁴ Meanwhile the Soviet economy headed south. We know now that it peaked already in 1970 at roughly 57 percent of the U.S. economy. At a Politburo meeting in October 1985, Mikhail Gorbachev explicitly acknowledged the trade-off between defense and economic growth:

³ Stephen G. Brooks and William C. Wohlforth, "Power, Globalization, and the End of the Cold War," *International Security*, 25 (Winter 2000/01) 3, 24.

⁴ John J. Mearsheimer, *The Tragedy of Great Power Politics* (New York 2001), 229.

“Our goal is to prevent the next round of the arms race. If we do not accomplish it, the threat to us will only grow. We will be pulled into another round of the arms race that is beyond our capabilities, and we will lose, because we are already at the limits of our capabilities. Moreover, we can expect that Japan and the FRG [West Germany] could very soon join the American potential ... If the new round begins, the pressure on our economy will be unbelievable.”⁵

By contrast, the United States invested in both guns and butter. In the 1980s, the United States implemented an unprecedented buildup in defense capabilities *and* launched a sustained economic expansion that continues to the present day. Real U.S. growth averaged 4.3 percent per year from 1983 to 1989, 3.6 percent per year from 1992 to 1999, and 3.0 percent per year from 2002 to 2005. The two recessions in 1990–91 and 2001 were the mildest since World War II.

How did the United States escape the trade-off? Unlike the Soviet Union it exploited the two factors that help surmount the guns/butter trade-off: additional savings and productivity growth. Higher productivity came from the domestic economy, additional savings, however, were provided by the world economy. Although U.S. budget deficits narrowed and eventually achieved a surplus of 2.4 percent of GDP in 2000, the current account deficit widened and reached 4.2 percent of GDP in 2000, higher than the previous peak of 3.39 percent in 1987. (This performance, along with Japan’s recent experience of budget deficits and current account surpluses, should end forever the argument that budget deficits cause current account deficits.) The United States drew on foreign savings to sustain growth beyond the level of domestic savings. It also drew on sensational domestic productivity growth. U.S. productivity grew from the fourth quarter of 1973 through the second quarter of 1995 at a rate of 1.5 percent per year. From second quarter 1995 through the first quarter of 2001, it accelerated to 2.4 percent per year. And from the first quarter of 2001 through the third quarter of 2005, it jumped further to 3.6 percent per year, notably higher than during any comparable period since 1948. By contrast, between 1995 and 2004, productivity growth averaged 1.4 percent per year in Germany, 1.1 percent per year in Japan, and 2.3 percent per year in the Eurozone countries.⁶ Compared to other advanced countries, the United States used resources much more efficiently.

Policy Implications

So, why did the rest of the world lend its savings to the United States? What did it get in return for these savings? Did other countries gain some leverage over U.S. foreign policies? That is what the conventional trade-off logic would expect. If you borrow more from abroad, you become more leveraged to foreign influences. But, arguably, Europe gained very little, if

⁵ Brooks and Wohlforth, “Power, Globalization, and the End of the Cold War,” p. 29.

⁶ See *Economic Report of the President*, transmitted to Congress, February 2006 (Washington: U.S. Government Printing Office, 2006), pp. 44, 142, and 376.

any, additional leverage over American foreign policy. U.S. foreign policy has been more unilateralist since the 1980s than ever before. Ronald Reagan pursued policies that alarmed Europe, and so has George W. Bush. Although the source of foreign savings has shifted increasingly to developing countries, particularly China (which now holds 15 percent of all U.S. Treasury bonds held by foreign holders), China has been no more willing than Japan or Europe to use the threat of reducing investments in the United States to challenge U.S. foreign policies. Why?

Because Europe, China, Japan and other surplus current account countries, such as the oil exporters, benefit enormously from U.S. policies. Although they genuinely disagree with some of these policies, they are unwilling or unable to challenge them because they would have to change policies of their own that contribute to the current bargain and they prefer not to do that. What are these European policies that contribute to current global economic imbalances?

First, because correcting imbalances implies a higher euro, Europe would have to reduce reliance on export-led growth and generate more domestic demand through internal reforms. If it failed to make this shift, Europe's and global growth would slow as the United States cut back on consumption and imports. Europe's dependence on exports is the flip side of U.S. dependence on domestic consumption. If the U.S. needs to consume less, Europe needs to consume more. The policies that Europe would have to implement are well known: 1) reduce fiscal spending without raising taxes to release public savings for household and industrial consumption and investment, 2) reduce subsidies for agriculture and lower food prices, increasing discretionary income for other expenditures, 3) increase job flexibility and decrease unemployment boosting consumer demand, 4) raise productivity by lowering costs in distribution and transportation sectors that increase the price of final goods, and so on.

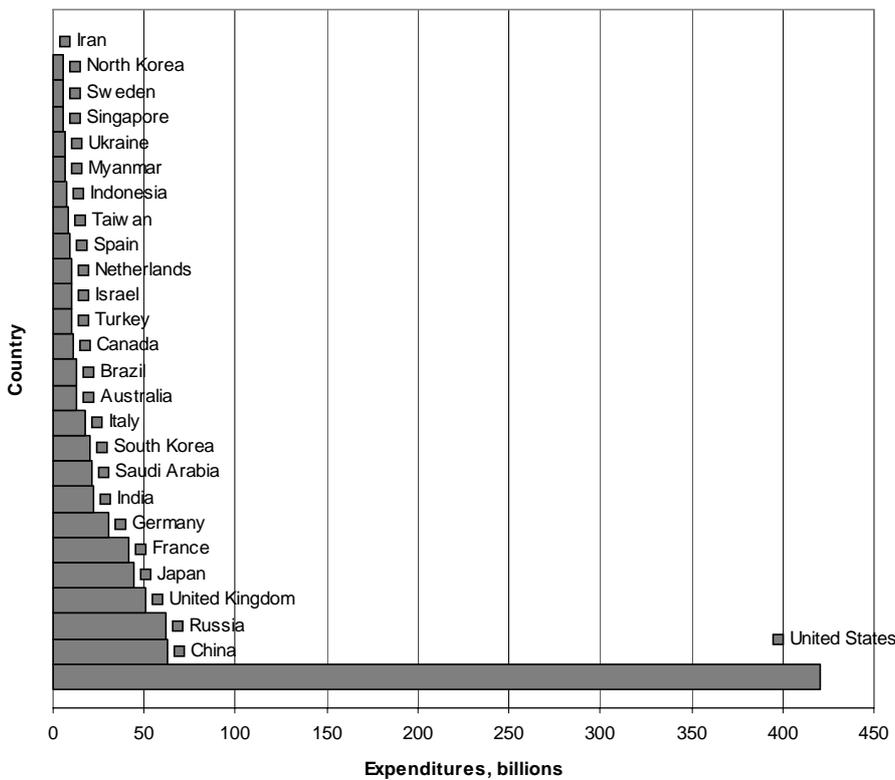
Second, Europe would have to further integrate and liberalize financial markets. Assuming that the United States absorbed less foreign savings and China and other rapidly growing countries did not significantly increase domestic demand, European markets would have to absorb additional foreign savings. To do that, Europe would have to make it easier and more attractive to invest in European companies and financial markets. France, Germany and other European countries would have to give up protectionist resistance to cross-border mergers and acquisitions, which currently impede investments within the EU as well as from foreign sources. And European financial markets would have to deepen and broaden to compete more favorably with the New York and London markets. Foreigners do not hold dollars as a favor to the United States. They do so because they can do more with those dollars in the United States and have greater confidence in U.S. markets than they do in other markets.

Third, foreigners hold dollars and privilege the U.S. currency because they consider their money to be safer in the United States than elsewhere. Safer in this sense means safer not only economically but also politically. U.S. markets offer the most extensive legal protection of foreign assets. The

United States is farthest away from crisis zones in the Middle East (Iraq and Iran) and Asia (North Korea). And the United States is the ultimate arbiter of international crises. When uncertainties increase, U.S. markets are least vulnerable to direct disruption.

Thus, if the United States played a lesser security role in the world, somebody else would have to play a greater role. Is Europe ready to do that? It does not appear so. Even with all the conflicts between the United States and Europe over Iraq and other issues, the European members of NATO continue to spend only half the percentage of GDP on defense that the United States does. As the accompanying bar graph shows, U.S. defense expenditures dwarf those of Europe and other countries, and the chart does not include the additional \$100 billion the United States is spending this year in Iraq. If Europe was truly worried that U.S. policies are untrustworthy, wouldn't it spend more to control its own destiny? And while European troops contribute to peacekeeping around the world, they do not, except for Britain, contribute to combat forces in Afghanistan or Iraq (though that is changing marginally as NATO forces take over the southern region in Afghanistan). Imagine European leaders persuading their citizens to sacrifice the lives of their soldiers to prevent Iraq or now Iran from acquiring nuclear weapons.

Figure 1
Measures of Power: Defense Expenditures, 2006



February 6, 2006

Policy Futures

My argument is not that present economic imbalances are the consequence of an explicit bargain between the United States and Europe with which all sides are happy. That is patently not the case. Rather it is to point out that security and domestic policies of both the United States and Europe (plus other countries) underwrite the existing global economic imbalances and that changes in these policies have to complement one another if the imbalances are to be reduced without crippling growth or creating other instabilities in the world. Europe will have to move toward domestic reforms that spur consumption, as the United States moves toward fiscal reforms that reduce consumption. Europe will have to integrate and reform investment and financial markets if the euro is to become more important as a reserve currency. And Europe is going to have to put more defense chips on the table if it wants to have greater influence over American security policies around the world or if it has to shoulder more defense burdens should the U.S. pull back. No one seeks perfect balance. Europe has a lower import propensity than the United States and will never be able to spur global growth with its domestic market the way the United States does. The euro will supplement, not replace, the dollar for a long time to come, as the yen is doing. And Europe is slowly developing a common security and foreign policy, even though the United States is and will remain militarily dominant.

Three powerful pressures are building up in the system to push these adjustments further. The first is a bump, possibly big bump, in China's road to development. Investment in China is grotesquely inefficient, and the banking system that supports current levels of investment is notoriously weak. China is building up a backlog of unused and probably unusable production and infrastructure. As higher interest rates in the United States, Europe and Japan squeeze worldwide liquidity, the day of reckoning for China is probably drawing closer. How will China cope with slower growth given the increasing level of protest and violence among Chinese peasants (87,000 incidents in 2005 alone)?

A second pressure is continuing uncertainty in the Middle East and world oil markets. American policies have sharpened divisions in the region between moderates and extremists. Iraq is a tipping point for moderation if it survives. Iran and Syria know this and back extremists, such as Hamas and Hezbollah, to engulf Lebanon and the region in a wider war. If Russia and the West, the new G-8, divide on these issues, geopolitical rivalries may once again seriously compromise integrated global markets.

The third pressure is a slow drifting apart of the United States and Europe. Europe is most affected by the Middle East, the United States by Asia as well as the Middle East. China, North Korea, and Taiwan are big items on America's agenda. They are not on Europe's. Europe's narrower focus is also evident in the Doha Round. Europe's common agricultural policy is more important than opening global agricultural markets for African and Asian developing nations. The United States has also reduced

Doha priorities by reassigning the U.S. Trade Representative to the Office of Management and Budget just one year before the Round is scheduled to be completed and U.S. negotiating authority expires. If the United States had to choose because of resource constraints, which region will get priority? At the moment the United States straddles the Middle East and Asia. But given that oil is fungible and the United States gets much less of its oil from the Middle East, it may be Asia tomorrow.

The third pressure is the only one the United States and Europe can influence significantly. That's why it's critical for them to understand the implicit bargain that underwrites current economic imbalances. The United States provides the security umbrella, economic engine and financial intermediation for world growth. Europe and Japan (as well as China and surplus oil producers) pay for these services with their savings, generated in part by their reluctance to reform domestic markets to deepen consumer as well as financial markets. At the moment, it is apparently an acceptable trade-off. But how will the Atlantic countries react to the other two potential global market breakers—a serious collapse in China or disruption in the Middle East? If they don't understand the geopolitics of global economic ties, cooperation may suffer, and the Western world will lose its greatest source of leverage on future world crises.

Who Is Going to Foot the Bill? Economic Consequences of a Disorderly Dollar Adjustment for the United States, Europe and Asia

Sebastian Dullien

Introduction

For years, Europe and Asia have not only relied on the United States as provider of global security as Henry R. Nau points out in his contribution, but also as a provider of aggregate global demand of last resort. As a consequence, the U.S. current account deficit has swollen to \$805 billion or roughly 6.5 percent of GDP in 2005. Given the magnitude of this financing requirement, a heated debate has developed around the question if and when a sharp correction of the U.S. dollar and the immense external deficit of the United States might occur. While some economists have argued that the growing U.S. current account deficit is sustainable,¹ the majority of economists feels a growing unease with the magnitude of current account imbalances today and considers them to be unsustainable². One of the horror scenarios often pictured is a sudden loss of confidence in the U.S. dollar, followed by a massive capital flight out of U.S. assets and a sharp fall in the greenback's external value.

This paper evaluates the economic consequences of such a scenario for the United States, Europe and Asia and gives some policy recommendations for how Europe could prepare for such an event. I will first look at possible trigger events which could send the U.S. dollar downward. In the second section, I assess the economic consequences for the three regions. I will argue that the euro area runs the risk of bearing the main burden of a dollar adjustment, given self-imposed limitations in the euro area's governance structure and relative inexperience of euro area policy makers with large exchange rate adjustments. Finally, I will discuss what Europe could do to make a possible exchange rate turmoil less costly.

Possible Trigger Points for a Dollar Adjustment

Currently there are two major groups of buyers of U.S. assets who help to finance the U.S. current account deficit: foreign private investors and foreign central banks, among which the Chinese central bank played the largest role in 2005. According to the balance of payment statistics for 2005, foreign central banks and governments bought roughly \$220 billion of U.S.

¹ Richard N. Cooper, *Living with Global Imbalances: A Contrarian View*, Washington, DC: Institute for International Economics 2005 (Policy Briefs in International Economics PB05-3); Ricardo Hausmann and Federico Sturzenegger, *Global Imbalances or Bad Accounting? The Missing Dark Matter in the Wealth of Nations*, Cambridge, MA: Kennedy School of Government, 2006 (Faculty research working paper series).

² Willem Buiter, *Dark Matter or Cold Fusion?*, Goldman Sachs Global Economics Paper No. 136, New York 2006.

assets, thus financing 27.5 percent of the U.S. current account deficit, down from 60 percent in 2004, when foreign central banks were the most important financier of American profligacy. The remaining 72.5 percent (about \$580 billion) were financed by net private capital inflows.

Any adjustment of the dollar will be triggered by a change in either the private investors' or the central banks' behavior. Private investors can be expected to be much more sensitive to prospective changes in the dollar's value. Any shift by monetary authorities out of the dollar should result in a shift of private capital away from U.S. assets while a shift in private investors' sentiment need not necessarily lead to an end of central bank financing of the U.S. current account deficit. In fact, as foreign central banks buy dollars—at least to a certain extent—in order to prevent their own currency from appreciating against the U.S. currency, they might even react with an increase in their dollar purchases should private investors lose appetite for U.S. assets.

A Peak of the U.S. Business Cycle

One possible trigger for a turn-around of private capital inflow into the United States could be a slowdown in economic activity. Private investors have been attracted to U.S. assets in recent years due to the higher yield. Both long and short term interest rates have been higher in the United States than in the Eurozone or in Japan over the past years. Moreover, a strong recovery from the short recession in 2001 in the United States has led to a large increase in companies' profits whereas profits in the euro economy took much longer to recover.

Should, however, the U.S. economy slow sharply, or should the recovery in the rest of the world turn out to be stronger than anticipated and thus monetary policy tighten more strongly in Europe or Japan, investors might reconsider the relative attractiveness of U.S. assets and might rebalance their portfolios. Over the past months, news or speculations of possible interest rate increases in Europe or Japan have regularly led to a depreciation of the U.S. dollar while signs both of a continuing strong economic growth as well as rising inflationary pressure in the United States have led to an appreciation of the American currency. In this context, a pronounced slowdown of housing activity in the United States in 2006 or 2007 in particular might have the potential to trigger a dollar depreciation: There are increasing signs that housing prices have peaked in early 2006 and a downturn in the housing industry has set in. If the slowdown in residential investment proves to be long-lasting and business investment (especially non-residential construction) will not be able to make up for the shortfall in demand, the U.S. economy might decelerate sharply, possibly even triggering new cuts in U.S. interest rates. If at the same time economic recovery in Europe and Japan continues at the pace suggested by leading indicators, inducing both the ECB and the BoJ to increase interest rates further, the yield advantage of U.S. assets might vanish, triggering a flight from the dollar.

An End to Asian Dollar Purchases

However, whether such a scenario will lead to a pronounced fall in the dollar exchange rate will depend to a large extent on the reaction of Asian central banks. Over the past years, the central banks of Japan, emerging Asia including China and the oil exporting countries have bought large amounts of U.S. treasuries, thus supporting the U.S. dollar even when private demand for dollar assets slackened.

Whether Asian central banks will decide to continue their interventions in support of the dollar depends on the priority monetary authorities will give to either stimulating external demand, or controlling inflationary pressure or preventing potential losses to their foreign exchange portfolio. With Chinese foreign reserves amounting to more than \$900 billion or 40 percent of GDP, most of them denominated in U.S. dollars, any further appreciation of the renminbi against the dollar translates into a significant loss for the central bank. Thus, Asian monetary authorities can be expected to grow more reluctant to further add to the stock of their dollar-denominated reserves, particularly as inflationary pressure in Asia increases with strong domestic growth dynamics.

Moreover, legislation currently pending in the U.S. Congress may result in additional pressure on China to let the renminbi appreciate faster. To the extent that such appreciation results in smaller purchases of U.S. assets, this might lead to a depreciation of the dollar against a wide range of currencies. If private investors perceive such a move as a beginning of a longer downward trend, this might actually become a trigger point of the dollar crash.

Economic Consequences of a Disorderly Dollar Adjustment

To get a rough idea of the magnitude of adjustment necessary to bring the U.S. current account deficit down to a sustainable level, a simple back-of-the-envelope calculation is applied. The calculation assumes that none of the more recent arguments as to why America's current account deficit might be sustainable at its current level applies. Specifically, it assumes that "dark matter" does not play a major role in making a large U.S. current account deficit sustainable as it has been claimed by Hausmann and Sturzenegger, that Asian countries will not permanently act as buyers-of-last-resort of U.S. treasuries in order to keep their own currencies from appreciating as has been claimed by the proponents of the "revived Bretton-Woods System,"³ and that the United States is not a natural borrower whom the rest of the world will allow to run a current account deficit of

³ Michael P. Dooley, David Folkerts-Landau, and Peter Garber, *An Essay on the Revived Bretton Woods System*, Cambridge, MA: National Bureau of Economic Research, 2003 (NBER Working Paper 9971); Michael P. Dooley, David Folkerts-Landau, and Peter Garber, *The Revived Bretton Woods System: The Effects of Periphery Intervention and Reserve Management on Interest Rates and Exchange Rates in Center Countries*, Cambridge, MA: National Bureau of Economic Research, 2004 (NBER Working Paper 10332).

\$600 billion annually indefinitely as has been claimed by Cooper. Moreover, we will disregard possible second-round effects such as recession in Europe or Asia induced by the initial dollar depreciation, which again would increase the North American trade deficit.

Let us assume that the U.S. economy is growing with a real trend rate of about 3 to 3.5 percent, and that inflation is running on trend at 2 to 2.5 percent, which gives us a nominal GDP growth of between 5 to 6 percent annually. Let us further assume that the rest of the world is willing to accept a net negative foreign asset position of the United States of 40 percent of its GDP, still clear above the roughly 20 percent it exhibits today. Under these assumptions, the United States could run a permanent current account deficit of between 2 and 2.4 percent of its GDP and the foreign-debt-to-GDP ratio would stabilize at 40 percent.

There are a number of estimates available of how much the dollar would have to depreciate so that the United States could reach such a current account position. According to the OECD,⁴ bringing the current account deficit of 6.4 percent of GDP in 2005 down to 2.4 percent would require a depreciation of the real effective dollar exchange rate of roughly 45 percent. Other estimates range from as low as 20 percent⁵ to a high of up to 90 percent⁶.

However, for assessing the economic consequences of a U.S. dollar correction on the rest of the world, the magnitude of the depreciation is only of secondary interest. What matters more is the shift in aggregate demand, which the rest of the world would have to cope with during this adjustment process. Cutting the U.S. current account deficit from today's 6.4 percent of GDP deficit to 2 to 2.4 percent would reduce aggregate U.S. external demand by \$440 billion to \$500 billion U.S. dollar (measured in 2005 prices and exchange rates).⁷

Consequences for Asia and Europe

For Asia and Europe, the central question is how this adjustment burden will be distributed and how well national economies can absorb such a large external shock. In the short and medium term, the reaction of macroeconomic policy makers will play a major role. The impact of the adjustment depends largely on the extent to which each country or region

⁴ OECD, "The Challenges of Narrowing the US Current Account Deficit," *Economic Outlook*, 75 (2004), pp. 149–168.

⁵ Michael Mussa, "Exchange Rate Adjustments Needed to Reduce Global Payments Imbalances," in: C. Fred Bergsten and John Williamson (eds.), *Dollar Adjustment: How Far? Against What?*, Washington, DC: Institute for International Economics 2004, pp. 113–138.

⁶ Olivier Blanchard, Francesco Giavazzi, and Filipa Sa, *The U.S. Currentaccount and the Dollar*, Cambridge, MA: National Bureau of Economic Research, 2005 (NBER Working Paper No. 11137).

⁷ Note that this estimate is considerably smaller than that of Alan Ahearne and Jürgen von Hagen, *Global Current Account Imbalances: How to Manage the Risk for Europe*, Brussels: Bruegel 2005 (Bruegel Policy Brief), as the two authors assume a larger correction of the U.S. currentaccount, bringing the financing requirements down to zero percent.

will allow its respective currency to appreciate. The ability to cope with the shock in the short and medium run depends on the magnitude and speed of reaction of monetary and fiscal policy. In the long run, the flexibility of product and labour markets will determine how well each of the regions will deal with a possible dollar crash.

As to accepting a major appreciation of their currency against the U.S. dollar, macroeconomic policy actors in Asia can be expected to react very differently from their European counterparts. While the European Central Bank so far has been extremely slow in intervening in the foreign exchange market—there is only one reported instance in 2000 of four minor interventions—, the Japanese and Chinese have been much less hesitant. Japan's experience of the mid 1990s when a large and rapid appreciation of the yen ended a fragile recovery and pushed the economy back into deflation has led to a reconsideration of foreign exchange interventions. From 2001 to early 2004, the Bank of Japan intervened heavily in the foreign exchange market to keep the yen weak even though this meant a huge increase in the domestic money supply. A similar argument applies to China: Over the past years, the People's Bank of China (PBC) has bought more than \$800 billion to prevent the renminbi from appreciating strongly. Chinese officials' concern for social cohesion and their fear of economic disruption from erratic exchange rate movements suggest that China would intervene on indications of a dollar crash, in order to at least limit the dollar's depreciation against the renminbi.

It should be noted that such an intervention is not necessarily incompatible with the Asians' aim of diversifying their central bank portfolios nor with a scenario in which U.S. policy has pushed Beijing into letting the renminbi appreciate: As we know both from portfolio theory⁸ as well as from financial market history, the Chinese could well weaken their own currency against the dollar by buying euro instead of dollar. Buying euros with freshly printed renminbi would bring the Chinese a double dividend: They could prevent an excessive appreciation of their own currency. Second, they would be able to diversify their central bank portfolio: With the share of euro assets in the portfolio increasing, and both renminbi and dollar depreciating against the euro, they could limit their portfolio's valuation losses. Moreover, as soon as the renminbi has appreciated by an additional 10 to 15 percent against the dollar, one could expect political pressure from Washington to ebb.

In such a scenario, the euro would appreciate very strongly against the dollar and still quite strongly against the Asian currencies. The short-term adjustment burden could thus be expected to fall disproportionately on

⁸ For a description of the workings of large foreign exchange interventions in a simple portfolio model following William H. Branson and D. W. Henderson (1985), "The Specification and Influence of Asset Markets," in: Ronald W. Jones and Peter B. Kenen (eds.) *Handbook of International Economics*, Amsterdam/New York 1985 (Vol. 2); see Sebastian Dullien, *The Revived Bretton Woods System seen from the Benches – Lessons for Europe from a Three-Asset-Portfolio Model*, 2005, working paper, available online at the EconWPA, access via <http://ideas.repec.org/p/wpa/wuwpif/0505003.html>.

the euro zone. If all of the adjustment fell on Europe alone—an extreme assumption which would imply a massive Asian build-up of euro reserves—the resulting shock to external demand would amount to almost 6 percent of the euro area’s GDP. If the burden would be distributed according to the share of non-petrol U.S. imports—the most benign outcome, assuming basically no foreign exchange intervention by other countries—the Eurozone would bear 15 percent of the shock, still amounting to \$65 billion to \$75 billion, or almost 1 percent of its GDP.⁹ Given past experience, a sudden appreciation of the euro can be expected to hurt firms’ profits, slow employment growth and hurt disposable income as well as consumers’ confidence. If a large part of the adjustment falls on Europe, even a slide into deflation similar to that experienced by Japan in the 1990s after a large yen appreciation could not be entirely ruled out.

Of course, such a shock could be mitigated by activist monetary and fiscal policy: A large cut in interest rates, tax cuts or additional public investments might help to stabilize aggregate demand, thus bolstering both business and consumer’ confidence. However, the euro area and Japan are not in a good position to enact such policies. With Japan only just emerging from deflation, the short term interest rate is still close to 0 percent and will remain close to that level for some time. In addition, with a government debt well in excess of 100 percent of GDP and budget deficit in excess of 6 percent of GDP, scope for fiscal policy is limited.

In the Eurozone, institutions might stand in the way of an appropriate reaction. First Italy, Germany and France already are close to or above the budget deficit threshold of 3 percent of GDP, leaving them little room for fiscal expansion. Second, so far the ECB has been slow in reacting to an economic slowdown or an appreciation of the euro with interest rate cuts, given the relative lack of experience with the economic mechanisms of the euro economy. Moreover, it is not quite clear whether nominal interest rates are high enough at the moment to provide room for an appropriate interest rate cut: According to a simulation from Morgan Stanley, even a 20 percent depreciation of the U.S. dollar could make a ZIRP (zero interest rate policy) in the euro area necessary, should the adjustment burden fall excessively on Europe.¹⁰

The problems of the Eurozone might be aggravated by two facts: First, a large depreciation of the U.S. dollar might signal the beginning of an end to the dollar’s role as the dominant global reserve currency and the ascent of the euro to a global role as international transaction and reserve currency. Japan has prevented the yen from ever coming to close to a major international reserve currency role and the Chinese renminbi will not be a

⁹ Ahearne and von Hagen (2005) [see fn. 7] assume that the adjustment is equally shared between Europe, China, and the oil exporting countries. However, this assumption seems to be quite implausible as oil demand is rather inelastic to price movements and it would thus not be clear why the oil-exporters current account deficit with the United States should react similarly to that of Europe or China should the dollar depreciate.

¹⁰ Stephen L. Jen, *The Math of the Coming Decline in the Dollar*, Morgan Stanley Research Global Note, April 12, 2006.

viable alternative to the dollar for a very long time: Not only is the Chinese capital account still closed to many types of investment transactions. China is also completely lacking liquid and transparent financial markets and potential reserve assets. While there are still some doubts as to whether the euro is really institutionally capable of taking on the role of the dominant global currency,¹¹ the euro is clearly the only possible alternative to the dollar. If international investors, central banks and traders were to shift a significant part of their dollar holdings into euro, this would result in a prolonged appreciation of the euro against the dollar beyond some initial adjustment, making the above mentioned structural impediments for an appropriate policy reaction even more disadvantageous. Second, product-market flexibility in Europe does not bode well for a quick adjustment to a shift from external to internal demand. Especially service markets are still considered to be more rigid than in the United States, with a number of barriers to entry for new companies.

China might be best prepared to use monetary and fiscal policy to counteract any shock from a dollar crash: First, the central bank has formerly proved quite willing to use both interest rates and changes in credit guidelines to influence aggregate investment. Moreover, with relatively sound public finances, it could easily increase government spending, supplying additional demand should an appreciation hurt export demand.

Consequences for the U.S.

It has often been suggested that a sharp fall of the dollar would hurt the U.S. economy most, leading to a sharp fall in asset and real estate prices, a significant increase in long term interest rates and a deep recession.¹² However, while some detrimental effects can well be expected, theoretical as well as empirical considerations suggest that the consequences might be relatively benign compared to those for the rest of the world.

Skeptics such as Ferguson argue that a fall in the foreign appetite for U.S. assets and thus in the willingness to finance the U.S. current account deficit would lead to a crash both in stock and bond prices, which in turn means an increase in long term interest rates. Higher interest rates not only dampen investment, they also put a burden on the highly indebted U.S. consumer who would cut back on expenditures and residential construction. Consequently, the U.S. economy would suffer a deep recession which in turn would make investments in the United States even less attractive. As Ferguson puts it, “interest rates could spike immediately, creating a self-reinforcing cycle of a falling dollar exchange rate and rising U.S. interest rates. The United States, then, would face a crisis not unlike the ones that afflicted the Mexican peso in 1994 or the Thai baht in 1997.”

¹¹ For an overview of possible obstacles, see Benjamin J. Cohen, “Global Currency Rivalry: Can the Euro ever Challenge the Dollar?,” in *Journal of Common Market Studies*, 41 (2003), pp. 575–595.

¹² N. Ferguson, “A Dollar Crash? Euro Trashing,” *The New Republic*, June 21, 2004.

Empirically, compared to this scenario, the United States has weathered past depreciations and current account adjustments quite well, not least the fall of the U.S. dollar by almost 50 percent against the G10-currencies between 1985 and 1987 and by almost 30 percent against major currencies between 2002 and 2004.¹³ Indeed, the U.S. economy emerged from the dollar crash of the 1980s to embark on the longest peace time expansion in recent history, lasting 128 months.

Theoretically, there are a number of reasons why one could expect a rather benign outcome for the United States. First, a depreciation of the magnitude described above would provide a strong stimulus to external demand and, at the same time, improve the competitiveness of U.S. firms in the domestic U.S. market, leading to additional investment.

This will be even more true as a depreciation of the U.S. dollar will not lead to systemic problems of the banking system as was the case in Mexico in 1994 or in Thailand in 1997. Quite to the contrary, a fall in the U.S. dollar might even improve the U.S. economy's balance sheet and strengthen nominal consumption. In Mexico or Thailand (or Brazil in 2002), firms and banks had large liabilities in foreign currency. The depreciation led to balance sheet problems both at the corporate as well as at the banking level, both depressing fixed investment and consumption.

The situation is completely different for the United States: While the United States is a net debtor to the rest of the world, its liabilities are mostly denominated in U.S. dollars or composed of foreign claims against real assets in the United States. At the same time, most of the U.S. assets abroad are denominated in foreign currency or are a claim to a real asset abroad. According to official data for the U.S. net international investment position at the end of 2004, as provided by the Bureau of Economic Analysis, U.S. residents' foreign direct investment amounted to \$3287 billion, holdings in corporate stocks to \$2520 billion and holdings in foreign bonds to \$917 billion. Any depreciation of the U.S. dollar thus increases the net wealth of the United States: The dollar value of assets abroad rises while liabilities remain constant. A 20 percent depreciation would thus increase the U.S. net wealth by roughly \$1200 billion or 10 percent of U.S. GDP. With the companies' and banks' balance sheets under no adverse pressure, growing demand might quickly lead to an increase in non-residential fixed asset investment.

Thus, while *real* wages and *real* consumption can be expected to fall in the process of the current account adjustment (after all, domestic absorption *must* fall in order to correct the external deficit), it is far from clear whether the economy necessarily will experience a recession since increased export demand and the shift from import demand to domestic producers may provide enough stimulus to prevent a strong economic slow-down. The crucial question will probably be how much long-term interest rates would increase in this process. This will depend on the labor

¹³ Definition for "G-10 currencies" and "major currencies" according to the Federal Reserve Board.

market's and the Federal Reserve's reaction to the depreciation. If wage growth does not react to the temporary surge in inflation induced by the depreciation and the Federal Reserve does not need to react with higher interest rates, inflationary expectations as well as expectations for the future course of monetary policy will remain roughly unaltered, thus keeping long-term interest rates stable. Even as inflation surged to four percent in the wake of the oil price increase and of the depreciation of the dollar between 2002 and 2004, wage pressure has remained rather benign over the past years. This provides hope that the adjustment impact on long-term interest rates will remain benign.

Policy Conclusions: Risk Control for the Eurozone

A scenario of a sudden adjustment of the dollar exchange rate thus poses a number of challenges for the eurozone. The foremost task would be to limit the short-run damage from a large appreciation of the euro. A second challenge would be how to deal with the euro possibly dethroning the U.S. dollar as the key global currency.

International Cooperation

One of Europe's main aims would be to prevent an overly quick dollar adjustment and especially an overshooting of the exchange rate. The back-of-the-envelope computations above assume that there is no overshooting once the dollar begins to slide. However, past experiences suggest that exchange rates tend to overshoot. It is thus possible that the U.S. dollar and consequently the U.S. current account will correct beyond the point which would be necessary to attain sustainability. In such a scenario, the aggregate demand shock for the euro zone could be much bigger than estimated above.

One of the top priorities of European policy makers in the case of a sudden dollar slide would thus be to seek international cooperation to prevent overshooting. The major central banks would have to signal clearly that they will only accept a certain depreciation of the dollar, intervening accordingly on the exchange markets to transmit this signal to market participants.¹⁴

While at the time of the Plaza and Louvre accords¹⁵, responsibilities were clearly distributed with each of the national central banks speaking for itself, the situation today, however, is more complicated. While formally the European Council has been given the right to negotiate exchange

¹⁴ For an interesting proposal how Europe could stabilize exchange rates only with the cooperation of Asian central banks, see Stefan Collignon, "Adjusting the US Current Account Deficit: What Role for the Dollar, Euro and Yen?" *Asia Pacific Business Review*, 12 (forthcoming 2006) 1.

¹⁵ With the Plaza Accord, the G-5 nations agreed on September 22, 1985 to bring about a devaluation of the U.S. dollar. The Louvre Accord on February 22, 1987, brought about a stop of the slide in the dollar exchange rate.

rate agreements with third countries, an agreement with non-EU states would be a novelty. Especially if some members of the ECB governing council were skeptical of foreign exchange interventions, given their primary objective to maintain price stability and the priority given to this objective by the treaty, desirable interventions or international agreements might be delayed.

This problem is further complicated by the fact that as yet no international institution exists in which such a coordinated intervention to stabilize the dollar could be negotiated. China is not part of the G7 group of finance ministers and central bank governors who have negotiated such deals in the past. However, without China at the table, any agreement to stabilize the dollar is doomed to failure as China has not only become the world's largest holder of dollar reserves, but also a major source of global imbalances. Europe should thus invest its political capital into putting institutions into place in which issues of international exchange rate movements and misalignments can be constructively discussed.

Fiscal Policy

As has been argued above, a smooth rebalancing of global demand in the course of a major American current account adjustment would require a strong increase of domestic demand in both the euro zone and Asia. In particular, Europe would have to take over, in part at least, the U.S. role of "importer of last resort." Thus, an expansionary macroeconomic policy in Europe would be needed to limit negative consequences from a fall of the dollar. As monetary policy only works with lags and is also limited by the zero-bound of nominal interest rates, part of this policy should be some stimulating fiscal policy. Given the current state of government finances with deficits in the euro area close to 3 percent of GDP, the stability and growth pact should be applied even more flexibly. One possibility would be to allow a temporary suspension of the stability and growth pact in cases of imminent economic danger to the euro area which could be alleviated with fiscal policy instruments. As a dollar crash might occur rather rapidly and quick action might be needed, such an option should be agreed upon in advance, possibly with a pre-defined threshold of euro appreciation, beyond which the SGP would be suspended. Over the medium term, the best way to increase the room for maneuver would be a consolidation of fiscal balances in the euro area.

Monetary Policy

Given the experience over the past years, there is reason to be concerned that the ECB will react too slowly and too timidly to the challenge of a significant dollar depreciation. Given the institutional degree of the ECB's independence and the fact that after the imminent nomination of Jürgen Stark to the executive board, the board's members will remain in office until the end of the decade, there is not much European governments or

the European commission could do to prepare monetary policy for a possible dollar slide.

However, national governments, the European Commission and the European Parliament should push forward the discussion to drop the second pillar from the ECB's monetary strategy. With this pillar, the ECB gives special attention to the growth in the broader money stock M3. If however a strong adjustment of the U.S. dollar were to lead to a global shift into euro assets, implying a more or less gradual ascent of the euro as one of the main global reserve currencies, the ECB should adjust to this new role. Rising foreign demand for liquid euro assets would increase the demand for money without creating any inflationary pressure. In such a situation, sticking to the monetary pillar in the ECB's strategy would increase the probability of policy mistakes by the ECB governing council. This is true even though the ECB has increasingly tried to exclude holdings of foreigners from M3 figures. With a global shift in a preference towards euro assets, euro residents can also be expected to rebalance their portfolios towards euro holdings. An outright shift of the ECB's strategy to a regime of inflation targeting would provide the better framework should the international role of the euro grow.

Service Markets Deregulation

Ultimately, given the possibility of a permanent appreciation of the euro as a result of an ascent of the European currency as a key global currency, the economy of the euro area needs to be better prepared for structural change: A permanent euro appreciation would make the current reliance of some euro zone countries such as Germany on manufacturing industries rather dangerous. Instead, it would be necessary to shift value added from the manufacturing to the service sector. Currently, service sector regulation in Europe and the fragmentation of service markets across national borders slow the expansion of this sector by inhibiting companies from profiting from economies of scale, thus making transition from a manufacturing economy to a service economy unnecessarily costly. To overcome this problem, the recently amended proposal of a service directive is a step in the right direction. However, further steps might be needed in the future.

Part II
How Resilient Is the U.S. Economy?

The United States As Net Debtor: How Much Longer the “Exorbitant Privilege?”

Katharina Plück and Catherine L. Mann

Introduction

Globalization, the process of ever-closer integration of nations’ economic activities facilitated by the removal of trade barriers, the reduction of transportation costs and technological progress, has made for high growth rates in world merchandise trade since the end of the Cold War. A no less salient feature of intensifying global economic integration is the even higher growth in the volume of cross-border financial flows, as stressed in a recent paper by two International Monetary Fund (IMF) economists.¹

Greater international financial integration has allowed countries to move beyond the constraints of their own macro-economies and has enabled them to sustain larger external imbalances than they could have sustained twenty or thirty years ago. Net creditors have been able to channel their excess savings to countries with more attractive or more abundant investment opportunities; net debtors can invest at greater levels than domestic savings rates would otherwise permit and grow their capital stock and potential output beyond what might have been possible otherwise.

Financial globalization has enabled emerging market countries to tap into a larger pool of global savings as well. In recent years cross-border equity positions for emerging market economies have grown just as fast as they have for industrial countries, and local financial market development has attracted foreign direct investment (FDI) flows.²

The most recent Economic Report of the President demonstrates that while the *provision* of capital to global financial markets has been more and more dispersed, the *destinations* of global financial flows have become increasingly concentrated.

In 1995, 6 countries provided 75 percent of the world’s capital flows, with Japan exporting 39 percent. In 2005, 12 countries provided three-quarters of global capital flows and Japan’s share of this outflow had shrunk to 14 percent (see Table 1, p. 34). In contrast, just before the Asian financial crises in 1995, 12 countries received 75 percent of global capital inflows, the United States then accounting for 34 percent. The number of net debtors had sharply contracted by the end of 2005—from twelve to just three (the United States, Spain and the United Kingdom): U.S. capital imports made for 65 percent of the world’s financial inflows (see Table 2, p. 34).

1 Philip R. Lane and Gian Maria Milesi-Ferretti, *The External Wealth of Nations Mark II. Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004*, Washington: International Monetary Fund, 2006 (IMF Working Paper WP/06/96).

2 Lane and Milesi-Ferretti, *The External Wealth of Nations*, pp. 16–17.

Table 1
Capital Exporters, 1995 and 2005 (top 75 percent)

1995			2005		
Country	Capital exports (\$billions)	Cumulative sum (percent)	Country	Capital exports (\$billions)	Cumulative sum (percent)
Japan	111,4	39	Japan	163,9	14
Netherlands	25,8	48	China	158,6	28
Italy	25,1	57	Germany	114,8	38
Switzerland	21,5	64	Saudi Arabia	87,2	45
Belgium	15,4	70	Russia	86,6	53
Singapore	14,4	75	Switzerland	50,7	57
			Norway	49,7	61
			Netherlands	40,0	65
			Singapore	33,6	68
			Kuwait	32,3	71
			United Arab Emirates	29,5	73
			Venezuela	25,4	75

Source: International Monetary Fund, *World Economic Outlook Database*, April 2006.

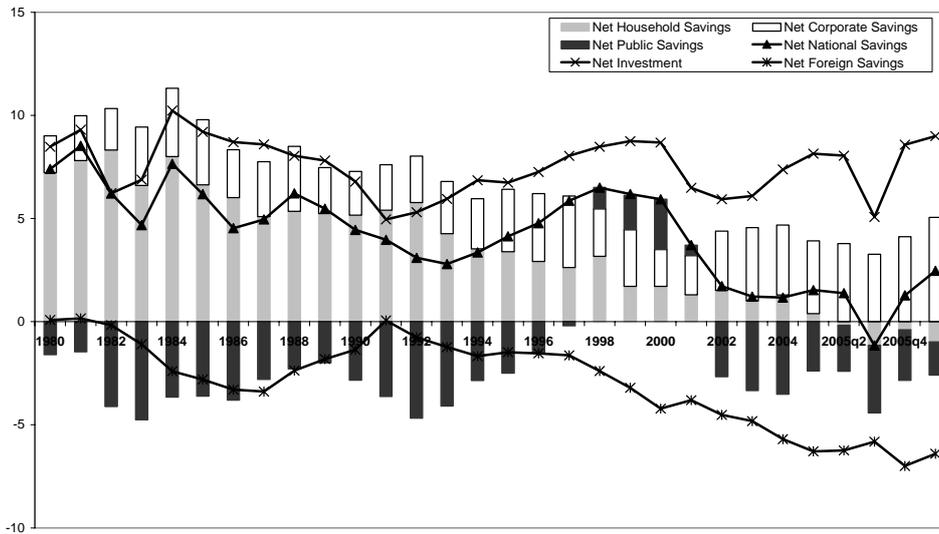
Table 2
Capital Importers, 1995 and 2005 (top 75 percent)

1995			2005		
Country	Capital imports (\$billions)	Cumulative sum (percent)	Country	Capital imports (\$billions)	Cumulative sum (percent)
United States	113,7	34	United States	805	65
Germany	29,8	43	Spain	86	72
Australia	19,2	48	United Kingdom	58,1	76
Brazil	18,0	54			
United Kingdom	14,2	58			
Thailand	13,2	62			
Hong Kong	9,1	65			
Korea	8,7	67			
Malaysia	8,6	70			
Indonesia	6,8	72			
Austria	6,1	74			
India	5,6	75			

Source: International Monetary Fund, *World Economic Outlook Database*, April 2006.

The United States, then, has benefited greatly from financial globalization. As the recipient of 70 percent of the global excess savings³, the country has been able to sustain large levels of private and public consumption without crowding out investment through rapidly rising interest rates (see Figure 1).

Figure 1
U.S. Savings and Investment (as percent of GDP)



Source: Bureau of Economic Analysis, *National Income and Product Accounts*; *International Transactions Account*.

By borrowing 6.4 percent of GDP (or 1.8 percent of world GDP) from abroad, the United States was able to maintain a total net investment rate of 7.5 percent, even though household and public saving rates were negative in 2005. While interest rates have risen since late 2005, they are still low when compared to historical levels.

Is this situation sustainable? At low interest rates, solid investment rates, negative household savings, a projected 2006 budget deficit of over \$370 billion, and with foreigners’ appetite for U.S. assets unabated, the U.S. current account deficit could easily reach 7 percent of GDP by the end of 2007. A sustained current account deficit of this magnitude implies that the country’s Net International Investment Position (NIIP) will eventually stabilize at 140 percent of GDP—a ratio that most economists regard as unrealistic for the world’s largest economy.⁴ This means that the United States’ current account deficit will have to contract, and that foreign

³ When net debtor shares are expressed as percentages of global capital exports, they differ slightly from the data presented in tables 1 and 2—because of statistical discrepancies. Expressed thus, the United States received 25, 40 and 70 percent of the world’s capital outflows in 1992, 1995, and 2005 respectively.

⁴ Michael Mussa, “Exchange Rate Adjustments Needed to Reduce Global Payments Imbalance,” in: C. Fred Bergsten and John Williamson (eds.), *Dollar Adjustment: How Far? Against What?* Washington: Institute for International Economics, 2004, pp. 116–119.

capital inflows to the country will have to slow. Economists differ on the size of an excessive NIIP and on how quickly the country's current account imbalance will adjust. Some worry that adjustment will happen quickly with a sudden shift in investors' preferences for dollar-denominated assets and grave consequences for the United States, if not the world economy. Others predict a benign adjustment process with a slow and even depreciation of the U.S. dollar, no sudden rise in interest rates, and a long-term sustainable NIIP to GDP ratio of above 50 percent—because, they say, foreigners will always prefer the United States as an attractive destination for their excess savings.

Looking at the U.S.-side of global imbalances, the decomposition of capital flows and net external assets, some authors argue that the United States economy has special features allowing it to run large current account deficits without significant strain on its external position. Some analysts suggest that it is the currency composition of U.S. external assets and liabilities that has helped the United States contain its external debt position. It is often shown that the United States enjoys special advantages from its role as the world's liquidity provider. Other authors point to the United States' continually positive income streams as evidence that U.S. investors are savvier and more efficient than their foreign counterparts. And yet others insist that it is mostly the attractiveness of the U.S. economy—rapid productivity growth rates, good treatment of foreign investors, a sound and efficient financial market and a stable economy—that lure foreign capital towards American assets. While all of these features are evident in the available data, the decomposition of assets and liabilities as well as of financial flows also prompts some economists to predict future strains and the possible end of America's "exorbitant privilege."

Global external positions and capital flows may also be examined from the perspective of those foreigners who have supplied the United States with their massive excess savings in recent years. From this perspective, one might ask why there is so much additional saving (or lack of investment) in the rest of the world. Researchers have looked at the investment behavior of central banks around the world and how their investment decisions will impact global financial flows. Other analyses have focused on whether foreigners' portfolios have reached their limits in terms of absorbing additional dollar-denominated assets. Again, some authors examining global financial flows from a rest-of-the-world-perspective see no reason for concern. Foreigners will have no other alternatives but to invest in the United States, they say. Still others point to recent trends observed in different categories of flows and net assets that suggest that adjustment is not so far off.

Is the United States Special? On the World’s Banker, the “Shrewd Capitalist” and U.S. Productivity Growth Rates

The World’s Banker (or Venture Capitalist)

One can decompose a country’s external portfolio along the different currencies in which assets and liabilities are denominated. This analysis helps trace how exchange rate changes have affected the value of a country’s NIIP in the past and determine how such changes might affect external debt sustainability going forward. The currency composition of countries’ assets and liabilities is hard to pin down with certainty. There are no consistent time series that would allow researchers to track the development of currency shares in countries’ external portfolios over a longer period of time. Still, it is known that most of the United States’ assets are denominated in *foreign* currencies and that most of its liabilities are denominated in *U.S. dollars*. As the dollar is the world’s most important international currency—it acts as medium of exchange in trade transactions and as store of value in the form of fairly liquid United States treasury bonds—foreigners are content to hold their claims on the United States in the country’s currency. Exchange rate changes then have a stabilizing effect on the U.S. NIIP: A depreciation of the dollar—necessary to bring about an adjustment in the country’s current account deficit—will offset the negative effects of imbalances on the NIIP.⁵ Gourinchas and Rey show that in the face of significant external positions such exchange rate effects can be substantial.⁶ They estimate that a ten percent depreciation of the dollar would result in an effective transfer to the United States from the rest of the world of around 5.9 percent of GDP—about the size of the U.S. current account deficit in 2004 (p 2). Indeed, between 2002 and 2004, the United States’ cumulated current account deficits would have worsened the country’s external position by more than \$1.6 trillion (or 14 percent of 2004 nominal GDP). Because of the dollar’s depreciation over the course of those 36 months however,⁷ valuation effects offset more than \$900 billion or more than 50 percent of this external deterioration (see Figure 2, p. 38).⁸

Some economists take the currency composition of U.S. net external assets and the counter-balancing effects of exchange rate changes on the

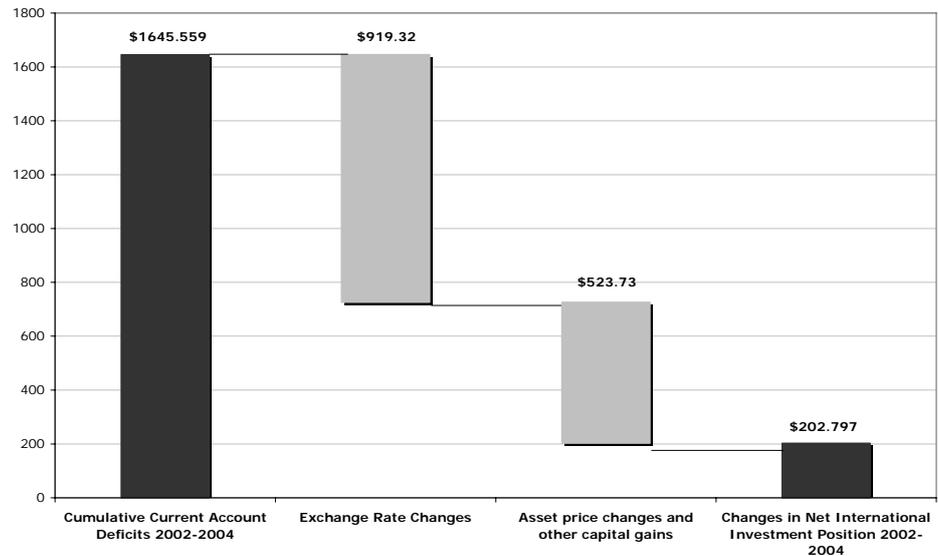
⁵ The opposite is of course true for most developing countries whose loans are mostly denominated in foreign currencies and whose NIIP will worsen dramatically not only due to a widening current account deficit but also due to a depreciation in their currencies that would accompany a possible balance of payments crisis.

⁶ Olivier Gourinchas and H el ene Rey, “From World Banker to World Venture Capitalist: U.S. External Adjustment and the Exorbitant Privilege,” in: Richard Clarida and Martin Feldstein (eds.), *G7 Current Account Imbalances. Sustainability and Adjustment*, Cambridge: National Bureau for Economic Research, 2005 (Books on the Web, NBER website).

⁷ Between February 2002 and December 2004, the Federal Reserve Board’s broad real effective dollar index depreciated by more than 15 percent.

⁸ Asset price changes and other capital gains reduced the negative effects of the cumulative current account balances on the NIIP by another \$524 billion or 32 percent of cumulative current account deficits.

Figure 2
Valuation Changes* in the U.S. Net International Investment Position



* Note that exchange rate valuation changes in 2005 came to negative \$227 billion.

Source: Bureau for Economic Analysis.

value of the NIIP as signs that substantial future current account imbalances will be sustainable for quite some time. Others, however, point out that appreciations of the dollar will have quite damaging effects on U.S. external debt.⁹ On the other hand, recent exchange rate valuation effects imposed heavy losses on foreign holders of dollar denominated assets. If the dollar is likely to decline even further in the near future, one might expect that this depreciation would eventually be incorporated into investors' expectations and reflected in the interest rates they demand, thus offsetting any further exchange rate valuation effects.

The United States does not only enjoy advantages from the currency composition of its external portfolio; the differences in shares of different asset types in the NIIP have also had important implications for the sustainability of the country's external debt. The United States exports mostly private equity and foreign direct investment, whereas its liabilities are primarily in fixed-income securities.¹⁰

⁹ Portes for example speculates that the 14 percent depreciation of the euro against the dollar over the course of 2005 will have had substantial negative effects on U.S. debt. See Richard Portes, "Comment on Philip R. Lane and Gian Maria Milesi-Ferretti," in: Clarida and Feldstein (eds.), *G7 Current Account Imbalances* [see fn. 6]. Indeed, according to the latest release by the U.S. Bureau for Economic Analysis, the deterioration in the U.S. NIIP due to exchange rate valuation effects in 2005 was larger than 225 billion dollars (the largest such deterioration in over 15 years).

¹⁰ On the importance of analyzing the US net external asset position from a disaggregated perspective—distinguishing between different asset types, see Catherine Mann, "The Current Account and the Budget Deficit: A Disaggregated Perspective," in: Richard W. Kopcke, Geoffrey M. B. Tootell, and Robert K. Triest (eds.), *The Macroeconomics of Fiscal Policy*, Cambridge: MIT Press, 2006.

At the end of 2005, the United States held about 45 percent of its claims on foreigners in the form of interest-bearing assets. In contrast, since 1976 between 64 and 69 percent of the country’s liabilities have been in interest-bearing debt. FDI and corporate equity—which constitute the bulk of U.S. foreign assets, generally achieve much higher returns than fixed-income debt securities. American investors take on a greater risk when they invest in foreign companies and will only do so if they can expect reasonably higher returns as a result. In contrast, U.S. treasury bills or corporate bonds are considered safe investments and thus yield relatively lower returns to foreign investors. During a period of global low interest rates, such “asset composition effects” are especially pronounced. Between 1973 and 2004, the structure of U.S. assets and liabilities contributed 0.86 percentage points to the 3.36 percentage point return differential the United States enjoys on all of its foreign investments.¹¹ Gourinchas and Rey liken the United States to a venture capitalist who predominantly borrows short and at low interest rates and lends long at higher rates of return. Indeed, the United States’ external position can be called a “hedge fund position.”¹²

Whereas the United States’ external portfolio structure has thus worked to the country’s advantage in recent years (especially at low interest rates), concerns are growing about the United States’ increasing reliance on debt finance.¹³ A recent IMF study points out that the United States stands out from other industrial countries with its significant negative position in foreign debt.¹⁴ Debt financing makes the country more vulnerable to sudden shifts in investor sentiment. And with a rise in interest rates, the debt burden is of course expected to grow. A study from the Federal Reserve Bank in New York estimates that at 2000 interest rates, for example, U.S. net foreign interest payments would have been significantly higher and the famously “still-positive” U.S. income balance would have been negative.¹⁵

The Shrewd Capitalist

Aside from “composition effects,” which may or may not dissipate as global interest rates rise to more normal levels, significant rates of return differentials have so far allowed income payments on U.S. net external assets to remain positive.¹⁶ Since at least the 1960s, the United States has

11 See Gourinchas and Rey, “From World Banker,” p. 60, table 2.

12 See Lane and Milesi-Ferretti, *External Wealth* [see fn. 1], p. 5.

13 *Ibid.*, p. 16.

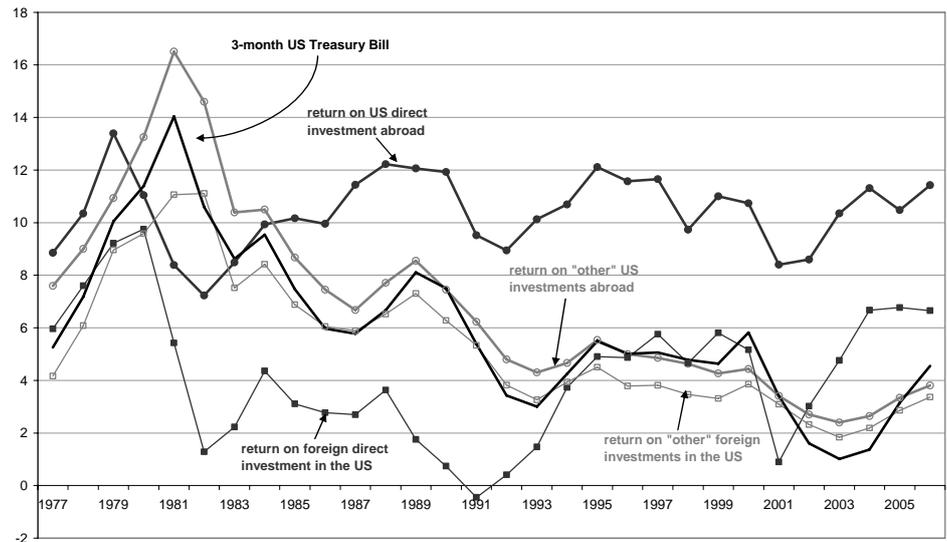
14 Andrew Swiston, *A Global View of the US Investment Position*, Washington: International Monetary Fund, September 2005 (IMF Working Paper WP 05/181).

15 Matthew Higgins, Thomas Klitgaard, and Cédric Tille, *The Income Implications of Rising U.S. International Liabilities*, New York: Federal Reserve Bank of New York City, 2005 (Current Issues in Economics And Finance 11).

16 Gourinchas and Rey estimate that total return differentials (on debt, equity, fdi and ‘other’ investments), came to about 2.5 percentage points between 1973 and 2004 (p. 60, table 2). They find that these differentials have increased significantly since the end of

had to pay less income on its liabilities to foreigners than it received in return on its foreign investments. As long as these income payments remain positive, the negative NIIP will not add to growing current account deficits. As shown in figure 3, the difference in returns between U.S. direct investments abroad and foreign direct investment in the United States (calculated without taking account of valuation effects) has always been particularly pronounced.

Figure 3
Implied Rates of Return on U.S. Assets and Liabilities (in percent)



Source: Bureau of Economic Analysis and Federal Reserve Board.

These large differentials in FDI returns, according to one U.S. economist¹⁷ are evidence of extraordinary savvy on the part of U.S. investors who have been “shrewd capitalists” in their external investments. By incorporating the exchange rate valuation changes discussed above and the Bureau of Economic Analysis’s “other” price and capital gains changes into a calculation for a total return differential, he estimates that by 2016 the Americans will make net payments of about \$57 billion (or of ¼ percent of GDP) on a net external debt of \$10 trillion (or 45 percent of GDP). He is confident that persisting imbalances will not have the devastating affects on the U.S. external position that many other observers fear—because of the skills of U.S. investors.¹⁸

Exactly why the United States has been able to earn such high returns on its foreign investments is unclear. A recent study from the U.S. Con-

Bretton Woods. Note that their calculations of different rates of return incorporate price valuation and capital gains effects.

¹⁷ John Kitchen, *Sharecroppers or Shrewd Capitalists? Projections of the U.S. Current Account, International Income Flows, and Net International Debt*, Washington: Office of Management and Budget, February 2006 (unpublished manuscript).

¹⁸ See Kitchen, *Sharecroppers*, p. 30f.

gressional Budget Office (CBO) discusses several explanations for the return differentials in FDI.¹⁹ The CBO report does not find that risk effects account for a large share of the U.S. investment advantage. Some of the returns posted by U.S. multinationals suggest that U.S. companies engage in profit shifting to avoid taxation.²⁰ But data to prove this behavior systematically is scant. The report posits that differences in age or maturity of investments—many U.S. investments abroad are at least 20 years older than foreigners’ investments in the United States—may contribute to differences in the profitability of investments. The authors point out that as foreign-controlled companies in the United States mature, this “age advantage” could easily diminish.

U.S. Productivity Growth

Those who are not as concerned about current account sustainability argue that the United States is such an attractive destination for foreigners’ excess savings that financial inflows are unlikely to cease in the near future.²¹ High recent rates of U.S. productivity growth and strong overall growth rates are contributing to higher potential corporate earnings and promise high future returns on foreign portfolios.²² Moreover, the United States also presents investors with efficient and especially well-developed financial markets and very attractive, high-quality financial claims. Naturally, global investors will channel their excess savings towards these markets and assets rather than investing them in inferior claims at less favorable economic conditions.²³

Figure 4 (see p. 42) shows net financial inflows for the U.S. economy between 1984 and 2005. During the late 1990s (and 2000 and 2001), private investments into the United States—presumably attracted by a booming economy—exceeded official inflows by up to 10 times.

But when the dollar started depreciating in early 2002, private investments quickly leveled off and net official inflows had more than tripled by the end of 2004. Certainly now, as Lane and Milesi-Ferretti note, “the notion that the United States attracts foreign capital because it offers high returns to foreign investors appears [...] rather shaky.” And they show:

¹⁹ Congressional Budget Office, *Why does U.S. Investment Abroad Earn Higher Returns than Foreign Investment in the United States?*, Washington: CBO, November 30, 2005 (Economic and Budget Issue Brief); For the original study see Juann H. Hung and Angelo Mascaro, *Return on Cross-Border Investment: Why Does U.S. Investment Abroad Do Better?* Washington: Congressional Budget Office, 2004 (CBO Technical Paper 2004-17).

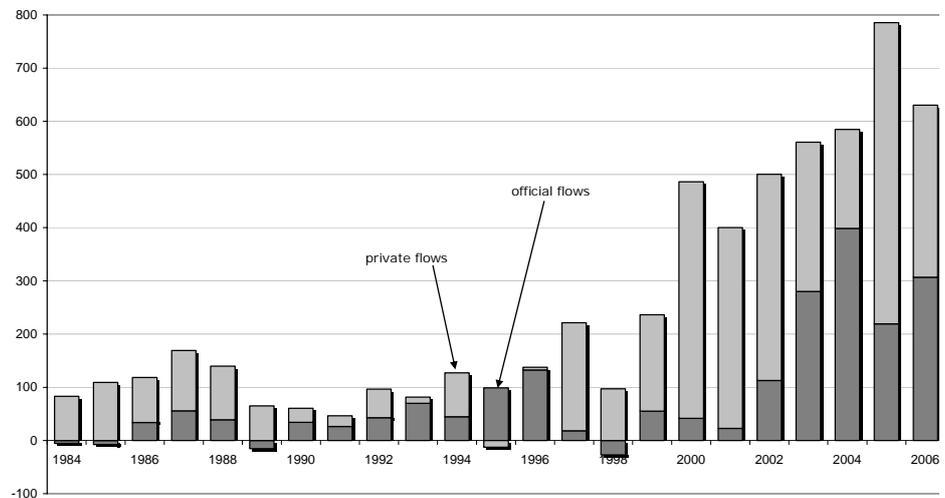
²⁰ For example, returns on investments in Ireland and Bermuda have exceeded overall average foreign returns between 1999 and 2003.

²¹ See for example Henry Nau’s contribution to this volume.

²² See for example the most recent *Economic Report of the President*: “[...] capital inflows broadly reflect the attractiveness of investing in one economy relative to other economies,” p. 130.

²³ Richard N. Cooper, *Living with Global Imbalances: A Contrarian View*, Washington: Institute for International Economics, 2005 (Policy Briefs in International Economics PB05-3).

Figure 4
Net Private and Official Capital Flows to the United States, (\$billions),
1984–2006*



Source: Bureau for Economic Analysis. * 2006 first quarter annualized

“Real dollar returns on foreign investment in the United States have on average been negative over the past four years, and even more so when expressed in the currencies of most foreign investor countries.”²⁴

As the world’s largest economy, the provider of a stable global currency and secure, liquid reserve assets, the United States is a “special” case. And it is reasonable to assume that the country can sustain a sizeable negative NIIP going forward.²⁵ Still, recent developments suggest that the advantages the United States has enjoyed so far, the stabilizing exchange rate effects and the sizeable rate of return differentials, may not last forever. In the face of persistent dollar depreciation, foreign investors will eventually demand higher returns on their dollar-denominated assets. Other return differentials may narrow, as foreign investments in the United States mature and become more profitable. The phenomenal real GDP and productivity growth rates that lured foreign investments to the country in the late 1990s have flattened.²⁶ Arguably, productivity growth in parts of Asia today exceeds productivity growth in the United States.²⁷

²⁴ Lane and Milesi-Ferretti, *External Wealth* [see fn. 1], p. 19. Also see Barry Eichengreen, “Global Imbalances: The New Economy, the Dark Matter, the Savvy Investor, and the Standard Analysis,” *The Journal of Policy Modelling* (forthcoming) for a discussion of the inconsistency between the “savvy investor” and the “new economy” views on the future sustainability of US external imbalances.

²⁵ Mussa, “Exchange Rate Adjustments” [see fn. 4], pp. 118–119.

²⁶ Michael Mussa and Martin Baily predict that US potential GDP growth will slow to 2.7 percent by 2007, see Michael Mussa, “Global Economic Prospects 2006/2007: Continued Solid Growth in 2006, Rising Risks for Inflation, Financial Markets, and Growth for 2007,” and Martin Neil Baily, “The U.S. Economic Outlook: April 2006,” Washington: Institute for International Economics, 2006 (Presentations at the Institute); Also see Barry Eichengreen, *The Blind Men and the Elephant*, Washington: Brookings Institution, 2006 (Issues in

Today, foreign private and official investors predominantly hold U.S. debt instruments. When interest rates rise, U.S. payments on these liabilities will become more burdensome and add to the deteriorating current account balance. As most economists agree that the U.S. NIIP cannot stabilize at 100 percent or more of GDP, real adjustment will be inevitable.

How Much Longer Will They Take a Beating? Official and Private Investors and Their Appetite for U.S. Assets

An alternative strategy for analyzing the sustainability of future financial inflows into the United States is to look at global capital flows from the perspective of the rest of the world. Recently, observers have expressed varying degrees of concern for the accumulation of reserves on the part of emerging market economies. Central banks in Asia have buttressed the value of the dollar when private investments to the United States slowed down. Now, many worry that the reliance on large official flows makes the U.S. economy too vulnerable to the actions of non-market actors going forward.

While private investors still make for the bulk of global financial flows, their actions, too, have come under scrutiny. Some recent studies have addressed the worry that with growing U.S. liabilities the room for further increases in dollar-denominated assets in the global portfolio is limited.

The Official Sector

As figure 4 shows, official claims on the United States have been on the rise since 2000. By 2004, reserve holdings by central banks in emerging market countries exceeded reserve holdings in industrial countries by about \$900 billion.²⁸ Reserve holdings increased especially in Asia (including in Japan), when those countries started to amass reserves in the aftermath of the Asian financial crises to insure against further speculative threats. These countries have also tried to prevent their exchange rates from rising against a depreciating dollar (see Table 3, p. 44).

Although not all countries publish the currency denomination of their reserve assets,²⁹ it is clear that many of these official flows have gone to the United States. For example, the Congressional Budget Office reports that more than 99 percent of Japan’s official foreign exchange transactions

Economic Policy, No. 1), who points out that for a long-term NIIP-to-GDP ratio of 50 percent and continuing current account balances of 7 percent of GDP, nominal growth would have to accelerate to 12 percent—a figure that is not likely.

²⁷ Eichengreen, *Blind Men*; Kent Hughes (this volume).

²⁸ Lane and Milesi-Ferretti, *External Wealth* [see fn. 1].

²⁹ See Edwin Truman and Anna Wong, *The Case for an International Reserve Diversification Standard*, Washington: Institute for International Economics, 2006 (IIE Working Paper Series WP06-2) for a discussion on data availability and an argument for why publication of this information is advisable.

Table 3
Top Ten Holders of Foreign Exchange Reserves

Country	Amount (\$billions)		Share of	Share of	Change	Share of
	2001	2005	World Total (percent)	GDP (percent)	(percent)	World Change
Japan	388	847	21,1	18	118	23,4
China	212	819	20,4	43	286	30,9
Taiwan	122	253	6,2	76	105	6,5
Korea	102	210	5,2	26	105	5,5
Russia	33	176	4,4	23	440	7,3
India	45	137	3,3	18	189	4,4
Hong Kong	111	124	3,1	72	12	0,7
Singapore	75	117	2,9	101	56	2,1
Malaysia	30	71	1,8	53	138	2,1
Mexico	44	69	1,7	9	55	1,2

Source: Ted Truman and Anna Wong, *The Case for an International Reserve Diversification Standard*, Washington: Institute for International Economics, 2006 (Working Paper).

between 2002 and 2004 were net purchases of dollar-denominated assets and that the rise in China's reserves has almost exclusively been a rise in U.S. dollar holdings.³⁰

Some observers have pointed out that the United States' increasing reliance on official financial flows has made the country vulnerable to actors whose decisions do not depend on rate of return considerations only. As shown above, Asian central banks' higher purchases of U.S. assets were in part an insurance against future balance of payments crises of the kind these countries experienced in the late 1990s. But now, "everything in these countries points to a reduction in their level of demand for U.S. debt securities via greater currency diversification in reserves, modifications of exchange rate strategies, and an improving climate for domestic investment after several years of post-crisis retrenchment, reform and restructuring."³¹

Critics also say that foreign central banks will not continue amassing holdings of a depreciating currency indefinitely—even if their actions might precipitate a further decline in the dollar and thus in the value of their assets.

The specter of Asian central banks diversifying their portfolios has caused many to doubt the sustainability of the large U.S. current account deficit. But Truman and Wong warn of ascribing too much importance to recent official flows.³² First, they note that foreign official claims on the

³⁰ Congressional Budget Office, *Recent Shifts in Financing the U.S. Current Account Deficit*, Washington: CBO, July 12, 2005 (Economic and Budget Issue Brief), p. 4.

³¹ Philip R. Lane and Gian Maria Milesi-Ferretti, "A Global Perspective on External Positions," in: Clarida and Feldstein (eds.), *G7 Current Account Imbalances* [see fn. 6], p. 17.

³² Truman and Wong, *The Case for an International Reserve Diversification Standard* [see fn. 29].

United States were much higher in the 1970s than they are now. They stress that only a very small number of countries has reserve holdings large enough for diversification of their portfolio to be noticed on world financial markets. They also find very little evidence of active reserve diversification on the part of foreign central banks—but note inertia instead. Furthermore, their analysis shows that official holders of dollar-denominated debt often intervene in the market to counterbalance any exchange rate effect in order to keep the value shares of the dollar in their portfolio steady. (So when the dollar depreciates, they *buy* dollars and do not *sell* them). Nevertheless, the writers acknowledge that *rumors* of reserve diversification may cause significant instability in global financial markets—certainly this must be true in a context of growing dollar liabilities and the prospect of further dollar depreciation.

Private Investors

Other authors agree that it is private investors whose decisions will determine the fate of the dollar and of U.S. asset prices and interest rates.³³ One explanation for why private savings have been flowing to the United States in such large amounts during recent years, is of course Bernanke’s “global saving glut” thesis.³⁴ Countries in the rest of the world experience particularly high saving levels, Bernanke argues, and the United States presents a profitable destination for these savings. Other economists prefer to stress the fact that it is not savings that have been particularly high in recent years, but that investment rates have dropped significantly.³⁵ In Japan, the latest *Economic Report of the President* notes, the domestic investment rate fell due to a declining population and hence a more slowly growing work force and due to over-investment in the late 1980s. In Germany structural rigidities still not overcome by recent reform efforts have discouraged corporate investments. And investors might still be weary of investing in the rest of Asia and other emerging market economies after the financial crises of the 1990s. In China, private financial markets are not yet sufficiently developed to offer domestic investors safe and efficient options for domestic investments.

However, things may change going forward, as the *Report* acknowledges. Strong future growth rates will most likely slow future capital outflows from Japan; and if Germany succeeds in reforms, growth there too, might very likely slow the country’s capital exports. Asian investors might grow more confident in their own markets again as the effects of the 1990s crises wear off.³⁶ The oil exporting countries whose capital exports have in-

³³ CBO, *Recent Shifts* [see fn. 30].

³⁴ Ben S. Bernanke, “The Global Saving Glut and the U.S. Current Account Deficit,” Richmond: Virginia Association of Economics, March 2005 (Sandridge Lecture); Ben S. Bernanke, “The Global Saving Glut and the U.S. Current Account Deficit,” St. Louis: April 14, 2005 (Homer Jones Lecture).

³⁵ Eichengreen, *The Blind Men* [see fn. 26].

³⁶ CBO, *Recent Shifts* [see fn. 30].

creased dramatically in the last few years (see table 1), might also see their capital exports flatten as higher oil revenues will eventually be invested in domestic markets.³⁷ Lastly, ageing populations in Asia and Europe will eventually contribute to decreasing savings rates in the rest of the world.

Moreover, foreign investors might not want to increase their dollar holdings because dollar denominated assets already make for a large share in their portfolios. Catherine Mann notes that during the mid to late 1990s, the U.S. share of equity assets in global private portfolios rose dramatically and stabilized at about 55 percent in late 2002.³⁸ She also estimates that marginal investment in U.S. assets as a share of the increase in global net financial wealth became dramatically large between 2000 and 2002, reaching 100 percent in 2002.

Since 2002, the U.S. current account deficit has grown substantially and so has the offer of U.S. financial assets to the global investor. The key question addressed by many writers then is: “Is the capacity of the rest of the world to absorb U.S. liabilities diminishing?”³⁹ The decrease in investor home bias has certainly helped to sustain relatively larger dollar shares in global portfolios. The September 2005 IMF *World Economic Outlook (WEO)* notes that global investors are *not* overweight in U.S. equity.⁴⁰ An IMF economist notes that global investors are underweight in U.S. equity and FDI and market weight in U.S. debt securities and thus finds “little indication that the foreign absorption capacity of claims on the United States would be constrained in the near future.”⁴¹ Still skeptics insist that in spite of greater financial integration, home bias on the part of investors has not disappeared and that “accommodation of further increases in U.S. net external liabilities should not be taken for granted.”⁴²

If the share of U.S. assets in global portfolios continues to increase, investors will eventually ask for higher returns and as their demand for U.S. financial instruments becomes satiated, the dollar will fall, imposing further risks on their already dollar-heavy holdings. Martin Feldstein speculates that portfolio investors “could now decide at any time that the small interest differentials—1 percent for euro bonds and 3 percent for yen bonds—are not enough compensation for the risk of a major dollar decline.”⁴³ Lane and Milesi-Ferretti also appear certain that global inves-

³⁷ International Monetary Fund, “Chapter II. Oil Prices and Global Imbalances,” *World Economic Outlook. Globalization and Inflation*, Washington: IMF, April 2006.

³⁸ Catherina Mann, “How Long the Strong Dollar?,” in: C. Fred Bergsten and John Williamson (eds.), *Dollar Overvaluation and the World Economy*, Washington: Institute for International Economics, 2003, p. 67. The latest available Economist Portfolio Poll reports that fund managers shares of US assets were at around 56 percent of their total holdings at the end of the second quarter in 2005. See “Portfolio Poll,” *The Economist* July 21, 2005.

³⁹ Lane and Milesi-Ferretti, “A Global Perspective” [see fn. 31], p. 11.

⁴⁰ IMF, *World Economic Outlook. Building Institutions*, Washington: September 2005, p. 116.

⁴¹ Swiston, *A Global View* [see fn. 14], p. 57.

⁴² IMF, *World Economic Outlook. Building Institutions*, p. 143.

⁴³ Martin Feldstein, *The 2006 Economic Report of the President: Comment on Chapter One (The Year in Review) and Chapter Six (The Capital Account Surplus)*, Cambridge: National Bureau for Economic Research, April 2006 (NBER Working Paper No. 12168), p. 10.

tors will begin to require more significant risk premiums on U.S.-issued liabilities as they are facing greater and greater portfolio losses induced by persistent dollar declines.⁴⁴ Further dollar depreciation and rises in interest rates could mean painful adjustment on the real side of the U.S. economy.

Conclusion

With astonishing rates of growth in cross-border trade of global financial assets, the United States so far has been able to sustain large current account deficits and an increasingly negative NIIP at surprisingly benign conditions: global interest rates have been at historic lows; the United States still enjoys significant rates of return advantages that have allowed net income payments to stay positive in spite of a rising external debt; and global investors seem happy for the moment to keep adding U.S. liabilities to their portfolio. Still, most economists agree that the present situation—a current account deficit of almost 7 percent of GDP—is not sustainable, as this would imply an NIIP to GDP ratio of more than 100 percent and may raise serious protectionist sentiment and a public outcry in the country.

As dollar liabilities take an ever greater share of the global portfolio, the dollar is more and more likely to depreciate further and investors will start to demand higher rates of return. The exchange rate change then will help adjustment in the trade sector. So far, curiously, financial markets have not disciplined the world’s largest debtor through higher interest rates. Adjustment in financial markets for now does not seem immediate. Mann also points out that policy changes on the real side of the economy can contribute to a smooth and gradual adjustment process. The rest of the industrial world can push through reforms that would promote higher economic growth, sustain domestic demand and allow for more domestic capital investments instead of continuous capital outflows.⁴⁵ In the United States, policy must aim to increase household savings and to restore fiscal discipline. A growing reliance on financing in the form of foreign purchases of treasury bonds will not add to the U.S. capital stock in the long run; it is financing excess U.S. consumption; it will not help potential output growth; and a slowing U.S. economy will make continued long-term foreign capital inflows less and less likely.

⁴⁴ Lane and Milesi-Ferretti, “A Global Perspective” [see fn. 31], p. 18.

⁴⁵ This strategy would also make these economies less dependent on their ability to export to American consumers—something that becomes important with the dollar depreciating and expenditure switching in the United States.

Home Mortgages and the Attractiveness of U.S. Financial Markets

*Martin Mühleisen**

The economic performance of the United States since the mid-1990s has been remarkable. The strength of demand from U.S. households has been central to this performance, boosted by strong income growth, tax cuts, and a rise in personal equity and housing wealth. The global economy also benefited, with the steady widening of the U.S. trade deficit testimony to the rise in U.S. imports that supported growth in many partner countries.¹ The United States' role as locomotive for the global economy has consequently become again a major factor in securing U.S. foreign and security policy leverage.

The widening U.S. trade deficit has been financed by significant inflows of foreign capital into the United States. Foreigners held an estimated \$3.3 trillion in net U.S. assets (25 percent of GDP) at the end of 2005, and another \$800–900 billion (6–7 percent of GDP) are likely to be added by the end of 2006. These inflows reflect strong economic fundamentals and a sound monetary policy, but it has also been the ability of U.S. financial markets to efficiently intermediate domestic credit demand with the supply of foreign funds that has helped sustain foreign inflows and support the dollar exchange rate.

As an example, this contribution discusses how financial innovation turned U.S. mortgages into an asset class with world-wide investor appeal, enabling households to tap foreign savings and satisfying foreign investors' demand for higher returns on safe investments.

The chapter is divided into three sections. The first section argues that the increasing securitization of U.S. mortgages has created an asset class with broad investor appeal while reducing the likelihood of volatile housing market moves. The second section looks into structural advantages, which the U.S. bond market enjoys over other markets, and which have made mortgage-backed securities an attractive vehicle for foreign investors. The last section asks whether house prices and household balance sheets have become overstretched as easy global financing conditions helped bring U.S. mortgage rates to historic lows. The answer is “probably not,” but regulatory vigilance remains essential to limit the potential fall-

* International Monetary Fund, Washington, DC. The views expressed in this paper are those of the author and should not be attributed to the IMF, its Executive Board, or its management. Without implication, the author would like to thank Chris Faulkner-McDonagh, Martin Kaufman, Calvin Schnure, Christopher Towe, and colleagues in the IMF's North American Division for their insights and helpful comments.

¹ The debate of risks associated with the widening of the U.S. trade deficit is well documented, including the IMF's call for a coordinated strategy of the United States and major European and Asian countries to ensure their smooth resolution.

out from a downturn—especially among smaller banks that have built up exposures to mortgage and construction loans.

Structure and Volatility in the Housing Market²

The U.S. housing market was historically composed of many local markets, and lending volumes depended on the strength of balance sheets of depositories in the region. The availability of financing varied with economic conditions, which created uncertainties for borrowers and builders alike. Developers tended to build up housing inventories in anticipation of stronger demand when mortgage conditions would improve, contributing to regional boom and bust cycles and leaving the overall market relatively inefficient.

The securitization, or pooling, of home loans into mortgage-backed securities (MBS)—close to bond-like financial instruments—has made the nationwide mortgage market significantly more efficient and less volatile over the past 20 years:

- ▶ Banks and other mortgage originators have been able to shift significant amounts of credit and market risk to MBS holders, decoupling funding conditions from local deposit growth rates. Funding conditions are now primarily determined in the national and international markets, and are therefore less volatile than before.
- ▶ The incentives for homebuilders to carry large inventories have greatly diminished. There has been a trend decline in speculative housing starts and an increase in the share of houses sold while yet to be built.
- ▶ This has helped housing activity and price developments to become less cyclical and converge across the United States.

Securitization benefited from the fact that standard U.S. mortgages carry fixed interest rates for up to 30 years, much longer than in most other countries. Their long maturity makes them relatively easy to bundle, notwithstanding the fact that mortgages can also be easily refinanced or prepaid. Initially, the MBS' success also owes much to the role of government-sponsored housing enterprises (GSEs), such as Fannie Mae and Freddie Mac:

- ▶ Most of the pooling was historically done by the GSEs, who also guarantee the underlying debt. These companies promoted greater uniformity in lending standards and lowered transaction costs, which contributed to improved market access for lower-income households.
- ▶ The GSEs provided liquidity and market-making in the early stages of the market, as well as during periods of market turmoil in the 1990s. Given their favorable rating and low funding costs, the GSEs also gained

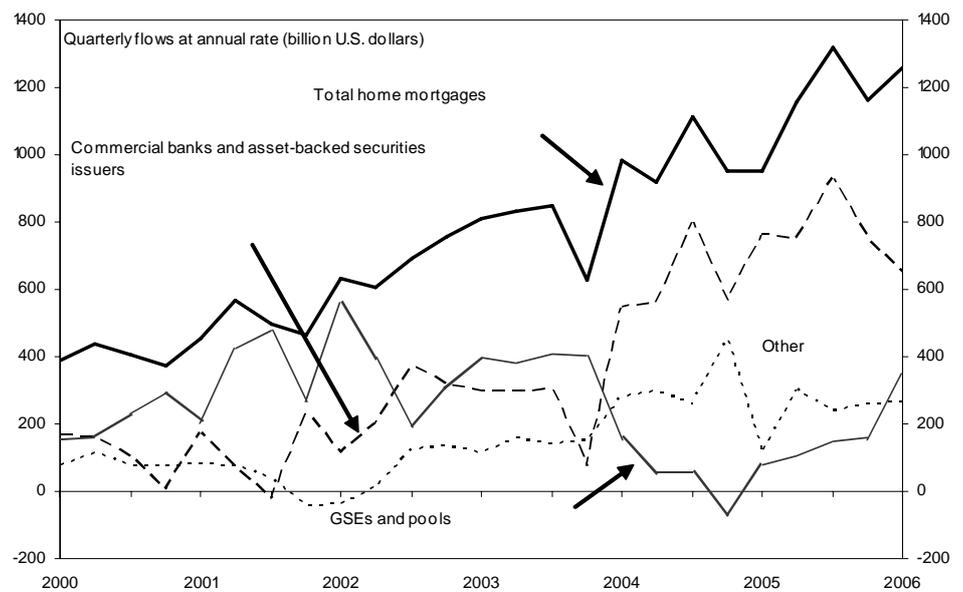
² This section draws on Joe Peek and James A. Wilcox, "Housing, Credit Constraints, and Macro Stability: The Secondary Mortgage Market and Reduced Cyclicalities of Residential Investment," *American Economic Review*, Vol. 96, May 2006, pp. 135–40; and Calvin Schnure, "Boom-Bust Cycles in Housing: The Changing Role of Financial Structure," Washington, DC: IMF, 2005 (Working Paper 05/200).

from issuing commercial bonds and investing the proceeds in their own MBS issues and other securities.

- ▶ More recently, supervisors have become concerned that the GSEs' large MBS portfolios could pose systemic risks, given that their significant interest rate exposures are being hedged with other financial institutions. As of end-2005, the GSEs still held a combined 25 percent of MBS issued with their backing, down from the peak of 37 percent in 2003.

The bulk of securitization has lately been done by private mortgage institutions. Among other factors, this reflects both an increase in “jumbo” mortgages and a rising share of loans to non-prime borrowers, both of which cannot be included in a security with a GSE-backed default guarantee. This niche has been filled by private institutions, which also securitize mortgages and home equity with still riskier characteristics. For example, the declining affordability of housing has boosted demand for mortgages with strongly discounted initial rates and negative amortization options, allowing more expensive purchases for a given monthly payment.

Figure 1
Mortgage Issuance by Institution



Source: Haver Analytics.

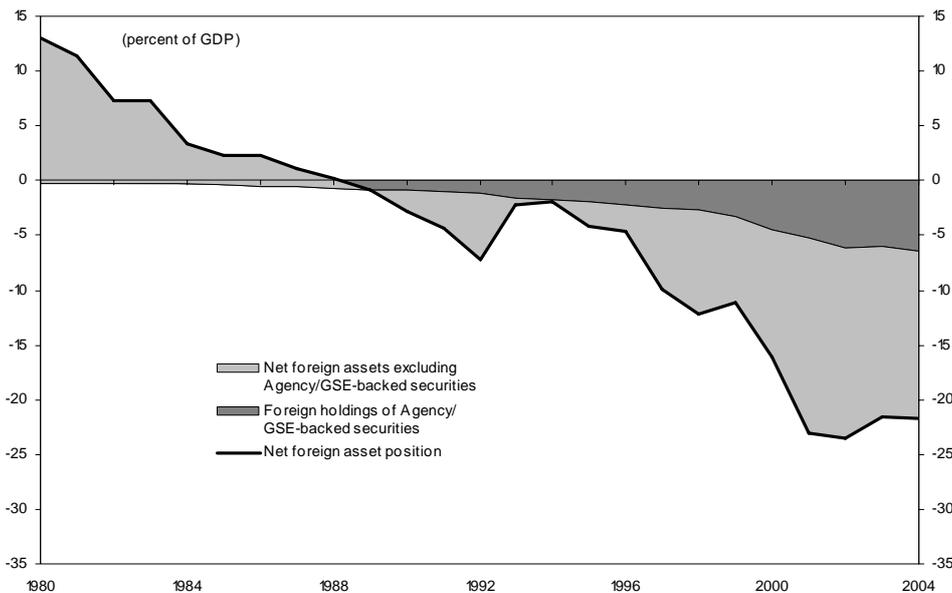
These “exotic” mortgage products have begun to play a well-publicized role in some of the hottest U.S. real estate markets, especially in the condominium market. Their strong take-up during 2004/05 has prompted U.S. regulators to emphasize the need for banks to improve risk management procedures and maintain prudential exposure limits. Overall risks from exotic mortgages still appear limited, given their relatively recent appearance, relatively diversified ownership, and signs of a return to more

conservative lending practices in 2006.³ On the other hand, smaller banks appear to have become more revenue-dependent on private and commercial construction activity. This may not be as much of an issue in the “hottest” markets—where price increases are driven by the limited availability of land—but more in peripheral markets with significant construction of new housing.

U.S. Housing Finance and Global Investors⁴

Mortgage-related financial products have been highly sought after by foreign investors, who held more than \$1 trillion in MBS issued in the United States by the end of 2005, an amount equivalent to about a third of the increase in U.S. net foreign debt since the 1980s. To understand the strong foreign interest in these securities, it is instructive to first look at the attractiveness of the U.S. financial market for foreign investors in general.

Figure 2
U.S. Net Foreign Asset Position and Foreign Holdings of Agency and GSE Securities



Sources: Haver Analytics; International Financial Statistics; and Fund staff calculations.

Reflecting its size, market-based structure, and favorable economic conditions, the United States has the deepest and most liquid financial market

³ Exotic mortgages have begun to spread as more refined financial tools have become available to lenders, including complex behavioral models and sophisticated financial innovations that allow the tailoring of attendant risks to dedicated investor classes.

⁴ This section partly draws on Garry J. Schinasi, Charles F. Kramer, and R. Todd Smith, *Financial Implications of the Shrinking Supply of U.S. Treasury Securities*, Washington, D.C.: IMF, 2001.

in the world. The amount of bonds denominated in U.S. dollars was \$22.5 trillion in March 2004, equal to more than 40 percent of outstanding global bond issues. Next to the large U.S. Treasury market, the U.S. private debt securities market is also the dominant corporate debt market in the world. As of 2003, the amount of outstanding corporate bonds issued in the United States amounted to \$6.5 trillion, or half the global market. The U.S. equity market enjoys a similarly dominant position, in part because of the high degree of protection afforded to financial investors by the U.S. legal system.

Besides their size, U.S. securities markets have a number of structural advantages over other markets. For example, the U.S. market offers ample liquidity in benchmark issues covering the full range of maturities at intervals along the yield curve. This ranges from the very short-term—T-bills and the repo market—to the long-term, recently underpinned by the reintroduction of 30-year bonds. Many other countries have concentrated benchmark issuance on specific segments of the yield curve—largely 5 or 10-year maturities—and short-term markets are not always as fully developed as in the United States. The United States also has a large network of primary dealers and specialized financial institutions that have created liquid markets in repos, futures, options, and, more recently, credit derivatives. By facilitating ways of splicing and combining risks associated with different securities, the market provides for efficient risk pricing mechanisms and allows investors to structure exposures closely in line with their desired risk-return tradeoffs.

Moreover, the U.S. Treasury market has historically been highly internationalized, given the U.S. dollar's role as global reserve currency. Treasuries have been sought as instruments for hedging and collateral, and as the currency of choice for official foreign exchange reserves. As of mid-2004, the U.S. dollar has therefore been involved in about 90 percent of the \$1.9 trillion worth of daily global foreign exchange transaction, and an estimated \$1.8 trillion of U.S. dollar holdings constitute two thirds of official foreign exchange reserves reported to the IMF. U.S. markets have also been an important source of funds for firms from other countries—the US\$–Eurobond market is of similar size as the U.S. corporate bond market, both in outstandings and relative magnitude.

The attractiveness of U.S. markets for foreign investors is borne out by a comparative analysis with other large financial markets. Between 2000 and 2004, the amount of U.S. debt securities held by foreigners increased by close to 20 percent per year, compared to growth rates of around 8 percent or less of either domestic or international securities holdings of European and Japanese securities. Although the euro area had seen increases in foreign holdings in similar magnitude in the late 1990s, foreigners now account for 36 percent of GDP in holdings of U.S. debt securities, compared to only about 27 percent of GDP in the euro area. The larger size of the U.S. market explains why the overall market share held by foreigners is about equal, however. On the equity side, growth in foreign investments in the

United States has also been stronger in recent years, although on a much smaller scale than in the debt market.

With their 20-100 basis points spread over Treasury bonds in recent years, MBS issues have been one of the key instruments purchased by foreign investors. Payment flows relating to the underlying mortgage portfolios are regarded as highly secure. Indeed, as the supply of U.S. Treasury bonds declined in the late 1990s, MBS were considered as a possible alternative for long-term benchmark bonds. Although MBSs are subject to duration risk—for example, a drop in interest rates tends to cause a surge in re-financing and prepayments—this can be hedged in interest rate derivatives markets. It is therefore not surprising that a large part of funds flowing into global fixed-income markets have found their way into the U.S. mortgage market. Reflecting their low risk rating, about one third of GSE-backed MBS held abroad are included in official foreign exchange reserves, while asset-liability management concerns have prompted global pension funds to invest in MBSs, fulfilling both a need for longer-term securities and stepped-up income flows.

All this suggests that the U.S. financial system, and the mortgage market in particular, has put itself into a prime spot for tapping the increasing supply of funds provided by foreign investors.⁵ U.S. markets had the infrastructure in place to intermediate large foreign inflows at a time when demographic and other factors created significant demand for housing loans. U.S. financial institutions have also proved adept at creating instruments that catered to investors' demands. To some extent this has been matched by European covered bonds ("Pfandbriefe") which have MBS features, except that the underlying loans remain on banks' balance sheets, and have also been high in demand. However, the market for covered bonds, measured by outstanding amounts, is only an estimated one tenth the size of the MBS market, and issuance has been sluggish owing to depressed conditions in the German housing sector.

Has It Gone Too Far?

Many observers are wondering whether foreign capital inflows into the U.S. housing market have kept interest rates artificially low, contributing to a housing bubble. There is some evidence that long-term interest rates in the United States might have been higher in the absence of bond purchases by foreign investors. However, long-term interest rates, and by implication mortgage rates, were low throughout the industrialized world, and recent issues of the IMF's *World Economic Outlook* have identified a number of structural reasons for this phenomenon, including high corporate saving, low inflation expectations, and reduced financial market volatility. Nevertheless, it needs to be asked whether risk and credit alloca-

⁵ Data on portfolio allocations suggest that foreign investors are not overweight U.S. assets, although the size of U.S. net foreign liabilities has become large compared to other countries even when factors such as the size and openness of the U.S. economy are taken account of.

tion in the United States have remained efficient in the face of abundant capital availability. This requires a look at house prices and the condition of household balance sheets.

House Prices

Are house prices overvalued? Going through the third major cycle in 30 years, national house prices have on average risen by 7 percent per year since 1995—10 percent since 2000—accompanied by a strong surge in sales volumes. There is ample anecdotal evidence of overvalued property and speculative activities in some of the hottest local housing markets, including along the Pacific and Atlantic coast lines. Trends in other regions have been considerably less dynamic, however, and a number of factors indeed supported an increase in prices in recent years:

- ▶ Reflecting demographic and immigration trends, the home ownership rate reached a record 69.4 percent in 2004.
- ▶ The combination of strong disposable income growth, low interest rates, and large capital gains has provided a powerful boost to the financial situation of households. Housing affordability has recently declined but remains near its long-term average.
- ▶ Price increases appear to reflect a growing demand for higher-quality housing in terms of size, features, and appliances. Moreover, house price inflation has been concentrated at the higher end of the real estate market.

Empirical investigations suggest that long-run price trends are most closely associated with household income, whereas the level of mortgage rates and the unemployment rate seem to affect mostly the short-term dynamics. Although estimation results are relatively sensitive to sample periods and the type of house price index used, IMF models indicate that national house prices were about 15–20 percent above a range consistent with fundamentals in 2005.⁶

Amid higher long-term interest rates, the market has recently entered into an adjustment phase. The 30-year mortgage rate is back at a five-year high, mortgage applications have slowed, sales have dropped substantially, and price increases have retreated from last year's peak. However, past experience suggests that aggregate house prices are much more likely to trade sideways than go through a prolonged decline unless economic conditions deteriorate, causing sharp increases in unemployment. It is not clear to what extent such precedents provide guidance in a market that has seen considerable structural changes in recent years. In particular, the rapid expansion of "exotic" mortgage products may have increased the exposure of both borrowers and lenders to an economic downswing. On the other hand, some of these potentially negative effects could be offset

⁶ See Martin Mühleisen and Martin Kaufman, "Are U.S. House Prices Overvalued?," in: *United States: Selected Issues*, Washington, DC: IMF, 2003 (IMF Country Report No. 03/245).

by structural changes in favor of lower volatility that have been mentioned above.

Household Balance Sheets

A second question is whether U.S. households have taken on excessive debt, and if so, whether U.S. consumption and the economy are headed for a significant correction. A number of indicators give reason for concern:

- ▶ Although many households took advantage of cheap refinancing to lock in low fixed rates, the steep yield curve early in the decade encouraged other borrowers to switch to adjustable rate mortgages, implying a higher debt-service burden as interest rates go up.
- ▶ The rise in “exotic” mortgages implies higher interest-rate sensitivity on the part of households.
- ▶ A recent survey found about 30 percent of mortgages originated in 2005 with negative homeowner equity, compared to 10 percent for mortgages issued prior to that year.

Aggregate balance sheet indicators, however, suggest that U.S. households remain in a relatively strong financial position. The recovery in the equity market and the increase in real estate valuations have restored household net worth to close to six times disposable income by the end of 2005. Although there has been a sharp rise in mortgage debt from 0.6 to 0.95 times disposable income over the past 8 years, low interest rates have implied an almost constant debt service burden for homeowners. Similarly, the Federal Reserve’s household financial obligation ratio (which includes insurance and real estate tax payments) has risen very slowly from 15 percent to around 17 percent over the past 15 years.

Amid a continued drop in the personal saving rate, U.S. flow of funds data indicate that U.S. households have further diversified asset portfolios in recent years. Low interest rates and house price appreciation have supported a rise in tax-advantaged mortgage equity withdrawals (MEW) to around 8 percent of personal disposable income, including though a rise in home equity loans. While surveys suggest that about one fifth of MEW has been used to finance consumption, the rise in MEW has coincided with an increase in the acquisition of financial assets by households, reducing the relative exposure of households to a downturn in the real estate market.

This is not to say that slowing house prices could not impose a significant drag on balance sheets. Using traditional model estimates, a flat nominal housing market could subtract about 1 percentage point from GDP in 2006, slowing both consumption and residential investment.⁷ It is possible that the wealth effect could be further amplified by eroding confidence and increasing strains on stretched borrowers. On the other hand, some of the impact of a slower housing market on the overall economy

⁷ Empirical estimates generally find that 3–7 cents out of every dollar of housing wealth are spent on consumption.

could be cushioned by bank and corporate balance sheets, which remain in the strongest position they have been for considerable time.

Summing up

This paper suggests that U.S. financial markets have been skilful in developing tools that have helped households exploit favorable global financing conditions to boost homeownership and acquire housing wealth. This is likely to have contributed to a rising U.S. current account deficit, but indications are that credit and risk allocation mechanisms in the United States have remained relatively efficient. This should provide comfort as the real estate market has entered what so far appears to be a cyclical downswing, and help maintain the attractiveness of U.S. financial markets for foreign investors.

Can Technology Power American Leadership? Meeting the Challenges of the 21st Century

Kent H. Hughes

Introduction

Innovation is widely hailed as the guiding star of 21st century America—supporting national security, underlying economic prosperity, and bringing the ability to solve global problems that range from pandemic diseases to terrorism. Innovation is also woven into America's concept of itself, its dream of broad-based opportunity for all through educational and technological progress. Innovation fueled productivity growth has helped support the centuries long effort to make America a City on a Hill¹ and the decades long American commitment to global engagement.

America entered the 21st century with some reason to celebrate its technological prowess. A complex system made up of research universities, national laboratories, venture capitalists, and a culture that encourages risk taking had brought America decades of Nobel Laureates and a strong position in information technology, bio-technology, and aerospace. Universities and entrepreneurs continue to change the course of the economy with new ideas and inventions.

However, American technological leadership is now challenged by a mix of home grown weaknesses, a growing global competition for talent, and the rise of new competitors. Looking at the future through the prism of innovation raises three broad questions: How will the United States respond to the new competition and the new competitors that have emerged in the early 21st century? Can a strengthened U.S. innovation system in and of itself ensure global economic leadership throughout this century? Will U.S.-based innovations translate into U.S.-based production, employment, and rising income in an era when innovation is going global.

New Competition and New Competitors

Since the fall of the Berlin Wall in 1989, roughly three billion people have joined the global economy. China's shift from a centrally planned autarky to a focus on markets and export led growth has turned China into a manufacturing power. With a crisis driven turn toward global markets in 1991, India has emerged as a major provider of on-line services and is gradually adopting reforms to become a more competitive manufacturer. The former Soviet Union and a number of countries in Eastern Europe

¹ The phrase often used by American politicians including President Ronald Reagan dates to a "A Model of Christian Charity," written by John Winthrop in 1630 onboard the ship *Arabella* somewhere on the Atlantic Ocean; available at <http://history.hanover.edu/texts/winthmod.html>.

have also left central planning behind in favor of a market economy where they are a factor in everything from on-line services to agriculture. Latin American and Asian countries, too, are recognizing the importance of building a capacity for domestic innovation as they seek to improve their own economies. Established competitors in Europe and Japan are moving to strengthen their approach to innovation, often by adapting elements of the U.S. system.

The international economy, new competition in the form of digitally delivered services, and the increasingly global nature of innovation raise several interrelated challenges. The rapid shift of manufacturing from the United States to overseas locations is already attracting investment in complementary R&D activities. With more than half of total U.S. spending on R&D originating in manufacturing, the new division of labor could seriously affect the U.S. innovation system.

Since before World War II, talented scientists, engineers, and other creative people have sought refuge or opportunity in the United States. The flow of talent continued after the war with Europeans being joined by scientists and students from many other countries. In recent years, many immigrant professionals and top students have come from India and China. The United States was often their top choice for study and professional careers.

For the first time in several decades, the United States now faces serious competition for these talented professionals and students. European countries are actively seeking to attract top students from India and China to their universities and are gradually making the changes that will make European research universities and laboratories attractive to scientists and students from outside the European Union. China is intent on developing top quality domestic universities that allow Chinese students to secure scientific and engineering degrees without having to study abroad. India already has high quality institutes of technology and is under pressure to improve its overall education system. Both countries are achieving success in encouraging their scientists and engineers who have gone overseas to return home. China and India have developed to the point where they can offer challenging, well paid positions that bring members of their respective diasporas closer to family, friends, and their native culture.

Innovation has gone global. Research laboratories are already following manufacturing much as parts suppliers gradually follow the overseas investments of an original equipment manufacturer (OEM). In other cases, the quality of overseas researchers combines with lower wages to lure R&D facilities. When a firm can hire three or four scientists in China or India for the price of one in the United States, it allows the company to pursue more than one avenue of inquiry without adding to the cost of exploration.

In parallel with overseas R&D investments and the growth of a worldwide talent pool, global networks are becoming an integral part of the innovation process. The development of international networks has been particularly pronounced in the United States. For a number of years, half

or more than half of the U.S. doctorates in the physical sciences, engineering, and computer science have gone to international students.² Many have stayed in the United States but also retain links with colleagues in their home countries. Immigrants from China, India, and elsewhere are having some success in transferring Silicon Valley-like institutions to their home countries.³

The emergence of high quality, low-paid (by advanced country standards) overseas scientists and engineers may indirectly discourage young Americans, Europeans and Japanese from choosing specific kinds of technical careers. In a broad-band, digital world, the idea that more technical education promises greater rewards is not as obvious as it once was.⁴ The analytic and research aspects of many disciplines can now be done anywhere in the world that has the infrastructure and the talent. Future developed country engineers may have to move more in the direction of training in systems solutions, multiple disciplines, or adding a non-engineering skill (say Hindi or entrepreneurship).

Can a Strengthened Innovation System Ensure American Leadership?

Strengthening the System

While Tom Friedman and others have thrust the rise of China and India into popular conversation, business, academic, and political leaders have proposed specific steps to strengthen the U.S. innovation system. The private sector Council on Competitiveness, a leader in the 1980's effort to respond to slow productivity growth and rising international competition, led the way with its National Innovation Initiative and the ensuing report, *Innovate America*.⁵ Many of the reports proposals have taken legislative form in the National Innovation Act, a bill introduced by Senators Lieberman and Ensign.⁶

In late 2005, the National Academies of Science and Engineering and the National Institutes of Health gathered a group of experienced analysts from around the country to focus on what needed to be done to build U.S. innovative capacity in the early 21st century. A senior committee of experts chaired by former Lockheed-Martin CEO, Norman Augustine, weighed the various proposals and produced their own set of recommendations in *Rising Above the Gathering Storm*. The National Academies had acted in

² National Science Board, *Science and Engineering Indicators 2006*, Arlington, VA: National Science Foundation, 2006 (vol. I, NSB 04-1; vol. 2, NSB 04-1A).

³ Anna Lee Saxenian, "From Brain Drain to Brain Circulation: Transnational Communities and Regional Upgrading in India and China," *Studies in Comparative International Development* (Fall 2005).

⁴ See for instance, Alan S. Blinder, "Offshoring: The Next Industrial Revolution?," in: *Foreign Affairs* (March/April 2006), pp. 113-128.

⁵ Council on Competitiveness, *Innovate America*, Washington, DC, December 2004.

⁶ National Innovation Act (S.2109).

response to a request from Senators Lamar Alexander (R-TN) and Jeff Bingaman (NM). Alexander, Bingaman, and Senator Pete V. Domenici with considerable bi-partisan support introduced the Augustine report in legislative form in early 2006.⁷

In general terms, both reports call for making innovation a national priority, increasing support for investments in the physical sciences, significantly improving the quality of America's K-12 education system, and continuing to attract talent from around the world while increasing the number of native born Americans choosing careers in science and engineering. The two reports both emphasized preparing workers for the 21st century while the Augustine report identified creating high-quality jobs for Americans as one of two key challenges. *Innovate America* also focused on health care as a test bed for applying technology to a critical national problem. The Augustine report pointed to the country's need to develop "clear, reliable, and affordable" energy.

The Council on Competitiveness Report, the Augustine Report, and other proposals had a clear influence on President Bush's State of the Union Address.⁸ In the course of his report to the Congress, the President announced the American Competitiveness Initiative, which includes increased funding for research in the physical sciences funded by three separate agencies.⁹ In addition, the President announced an Advanced Energy Initiative designed to develop new sources of power and break the country's addiction to oil.

The President's proposed 2006 budget did include added funding for the three agencies mentioned in the State of the Union, but reductions in research funding in other agencies would move government support in the opposite direction. In the United States, Presidential rhetoric can sometimes take on a life of its own and lead to more ambitious legislative action and other private sector initiatives. In this instance, President Bush's words may have led to Senator Richard G. Lugar's (R-IN) recent speech spelling out an ambitious approach to developing alternative forms of energy including a proposal to establish a \$35 dollar a barrel of oil floor price as a way of attracting private sector investment.¹⁰

Innovation has played such an important role in America's past and will be equally critical to the future that the country should not have to rely on occasional reports or periodic swings in interest.¹¹ Instead, the President should give a regular "State of the Innovation System" address. As part of

⁷ Protecting America's Competitive Edge Acts, Energy (S.2197), Education (S.2198), and Finance (S.2199)

⁸ President Bush, *State of the Union Address 2006*.

⁹ The three agencies are the Office of Science in the Department of Energy, the National Institute of Standards and Technology of the Department of Commerce, and the National Science Foundation.

¹⁰ Senator Dick Lugar (R-IN), "Energy is the Albatross of U.S. National Security," March 13, 2006, <http://www.lugar.senate.gov/pressapp/record.cfm?id=252509>.

¹¹ The following material is adapted from the author's *Building the Next American Century: The Past and Future of American Economic Competitiveness*, Washington, DC: Woodrow Wilson Center Press, 2005.

that address, the President should stress the importance of investments in the physical sciences to the academic, defense and commercial worlds.¹² The President might note that venture capital, a valued element of the overall U.S. innovation system, can, at times, move in one direction while neglecting other fields—say emphasizing biotechnology at the expense of medical devices or new semiconductor chips. An independent, publicly funded, privately run institution could act as a balance wheel to push the frontiers of innovation in a variety of areas.

The race for the future critically depends on innovation and education. In addition to making sure that all students meet the state minimums developed under the No Child Left Behind legislation, the President will need to modify current visa regulations for highly qualified students and, at the same time, attract more American students to technical careers. The proposed “State of the Innovation System” address should take a leaf from America’s response to the challenge posed by the Soviet Union’s 1957 launch of Sputnik. The lure of the space program was paralleled by a major increase in research funding—matching a rising supply with sustained demand. In the 21st century, the challenge of finding clean energy or tackling global diseases should attract today’s youth and needs to be matched with another major government commitment to research.

Innovation as Part of a Larger National System

U.S. innovation takes place in the context of domestic economic trends that are increasingly linked to the global economy. Fiscal and monetary policy, private investments in capital equipment, and public investments in research and education will all have an impact on the pace of economic activity and innovation. The international flows of capital, the relative value of the dollar exchange rate, and economic strategies of key competitors will influence the locus of manufacturing, specific services, and research labs.

For several years, the United States has been able to run large fiscal deficits without triggering inflation or driving up long-term interest rates. The inflow of foreign capital has kept interest rates low and the dollar high—adding low-cost imports to competitive markets that have helped keep inflation in check. Low interest rates help foster a positive climate for investment—including in new research facilities.

But the record trade deficit (\$723.6 billion in 2005) and an overly strong dollar, coupled with low wages in China and elsewhere, have resulted in a shift of manufacturing from the United States to overseas locations. Research facilities—drawn by well-trained less expensive scientific talent,

¹² See for instance, “Funding the Foundation: Basic Science at the Crossroad,” Woodrow Wilson Center, 2006, in which Dr. Shirley Ann Jackson calls for more funding of the physical sciences and Dr. Robert Helms, Dean of Engineering at the University of Texas at Dallas, Dr. Robert Doering of Texas Instruments, and Jon Stratton of Lockheed Martin Aeronautics Company all stressed the importance of basic research to their respective institutions.

modern manufacturing facilities, and overseas customers—have begun to follow.

While Europe has maintained a roughly balanced current account, the United States current account deficits and growing external debt finds its counterparts in large current account surpluses in Asia and, more recently, the oil exporting countries. The United States has a particular interest in moving back toward current account balance but the global economy has a stake in avoiding a precipitous fall in the value of the dollar that could trigger recession or worse in countries that have come to depend on the still vibrant U.S. market.

To secure a rebalancing, countries with significant current account surpluses will have to adjust their economic policies to increase imports by stimulating domestic demand while reducing dependence on exports. As part of this shift, the United States will need to move in the opposite direction by increasing overall savings, moving to a more competitive dollar, and adding to domestic production to substitute for reduced imports and added exports.

The U.S. innovation system is built on flexible institutions, a mobile population, and a cultural celebration of risk taking. If the United States adopted universal and totally portable pension and health care systems, a mobile population would be even more likely to move to new opportunities. Risk takers would no longer be constrained by concerns for their families' economic security or health care.

Over the long-term, the United States, Europe, and Japan face the fiscal demands of an aging population. In the case of the United States, projections suggest that at some point in the future, publicly supported pensions and health care for the elderly and those with low incomes will equal the size of the entire federal budget—potentially squeezing out public investments in research and education.

Innovation in a Global Economy

Scientific disciplines are already building on global networks to foster basic scientific research. The same network phenomenon now characterizes other parts of the innovation system, as expatriates in Silicon Valley are forming venture capital funds to invest in their home countries.

The global spread of innovative capacity will allow more top scientists and engineers to attack problems of global interest such as diseases, pollution, or agricultural yields. While the United States will remain a major innovator, U.S.-based scientists, engineers, and entrepreneurs will need to become adept at utilizing discoveries made by overseas universities and companies.

Innovation, Domestic Growth, and the Global Economy

The current focus on U.S. innovation is timely. But the emphasis on innovation raises two additional questions. How much can a strengthened

innovation system do to drive the economy forward? Second and perhaps even more difficult, when do U.S.-based innovations translate into quality jobs and rising incomes for Americans?

Can Innovation Drive the Economic Future?

Continued investments in science, technology, and a strengthened innovation system are critical for future productivity growth. Today's productivity growth is based on scientific and technological developments in information technology, biology, and materials that were, in some cases, made decades ago.

What can we expect from an improved innovation system? U.S. productivity growth accelerated rapidly after World War I, slowed in the 1970s and 1980s, and has experienced a decade of rapid growth starting in the mid-1990s. We are now more than meeting the past average pace of productivity growth.¹³ Nor is there an easy one-to-one relationship between added investments in research or other improvements in the overall system and increased innovation or productivity growth. Even doubling the current high rate of productivity growth would neither fully reduce today's fiscal deficit nor fully prepare the country for the rising costs of retirement. In addition, to the extent that major shifts come in waves, we will, to some degree, be dependent on the emergence of the next big thing.¹⁴

Targeting innovation at specific problems could have a major impact on the economy and the fiscal outlook. For instance, concentrating research dollars on reducing the costs of an effective health care remedy could significantly reduce the current and future burden on the budget and the economy while also improving the nation's health. The same is true with regard to research on new approaches to energy.

Can U.S. Innovation Translate into U.S. Jobs and Rising Incomes?

There is no longer a presumption that invented here means produced or serviced here. The demand for manufactures can be met in China, a host of services can be provided on line by India, Brazil, Poland or Russia. Venture capitalists are reported to ask prospective clients whether or not their business plan takes advantage of the savings offered by drawing on Chinese or Indian labor. As multinational firms become more global in their thinking and their operations, the decision of where to research and where to produce will be driven by some combination of the current economics, expected trends, and likely risks.

¹³ William J. Baumol, Sue Anne Batey Blackman, and Edward N. Wolff, *Productivity and American Leadership: The Long View*, Cambridge, MA: The MIT Press, 1989.

¹⁴ For a Schumpeterian look at long waves of innovation and their impact on the U.S. economy, see Robert D. Atkinson, *The Past and Future of America's Economy: Long Waves of Innovation that Power Cycles of Growth*, Cheltenham, UK: Edward Elgar, 2004.

The United States and other national governments cannot be indifferent to the impact of the domestic economy on innovation. National governments need to create a domestic climate that encourages investment and rapid commercialization. In the U.S. context, the government needs to reduce global imbalances, reduce the fiscal deficit, and prepare for the long run fiscal challenge posed by an aging population. Reducing the current level of trade imbalances can have a positive long-run impact on innovation. If, for example, the United States simply halved its current trade deficit while maintaining the level of domestic demand, it would produce more than \$350 billion in additional goods and services. As manufacturers and service providers expand their capacity to meet rising domestic and international demand, their activity would create an attractive climate for incorporating and applying new technologies.

In the current climate of severe economic imbalances, the United States will need to think about the creative use of tax incentives. The U.S. Treasury should explore how a mix of research, investment, and employment tax credits could help translate innovations into domestic employment without permanently eroding the tax base. Expanding policy and financial support for innovative small businesses could speed innovation and provide quality jobs for Americans.

The decision to locate production or research facilities can also be affected by the economic strategies of the host country. In some cases, market access or government permits will be conditioned on an agreement to produce in the host country and to share technology. In other cases, a general absence of intellectual property protection will erode the economic standing of an American producer and affect the future course of investments in research and development.

Generally focused on geopolitical priorities, the United States will need to develop a greater capacity for geo-economic strategy. Where geopolitical priorities dictate turning a blind eye to the violation of trade agreements, the federal government will need to compensate the firm or institution or, over time, accept a diminished economic capacity.

Policy Conclusions

There is no questioning the importance of technology to the modern world. Economists often talk about high social rates of return or the importance of technology to productivity growth. Engineers often have a simpler test pointing to how technology drives the average day from the automatic coffee maker to the morning TV news, to the subway system to the daily routine of word processing, email, and video conferencing.

For the United States, technology has been important for national security, economic prosperity, and a host of national goals from health to the environment. The currently strong U.S. innovation system does not depend on research alone. It is part of a globalizing economy whose long-term health depends on reducing the trade, current account, and fiscal deficits.

The innovation system contributes to and depends on the domestic education system and, in the case of the United States, a flow of talent from around the world. Faced with a growing global competition for scientists, engineers, and talented students, the United States must work to attract talented researchers and, at the same, attract more American students to science and engineering. A national commitment to developing new sources of energy could excite the interest of young Americans. If matched by a commitment to funding public and private sector research and development, interested students will be more likely to turn their interest into a career.

Flexibility will be key to the 21st century global economy. Perhaps because of their nation's immigrant and pioneer past, Americans are particularly mobile. Adopting a portable safety net would make the most of their culture of mobility and risk taking.

The global spread of innovation and the rise of many centers of scientific excellence will require U.S. institutions to be more effective at borrowing and adapting innovations as well as creating them. The development of truly global institutions means that the United States will need to adopt macroeconomic, tax, and other policies to make sure that research dollars eventually support quality jobs in the United States.

Part III
Europe's Role and Realities

Burden-sharing and Strategic Policy Options for Europe

Stefan Collignon

Are the costs for providing collective security a burden to be shared or do they make up for the price one has to pay for buying a public good? And if the latter is the case, who is buying how much? Who is making the buying decisions? Democracy theory tells us that governments are agents which make these decisions on behalf of the sovereign, the citizens. But this implies that citizens form an agreement on what they perceive as their collective public good through the established democratic processes. However, in the case of international public goods, this democratic feedback mechanism is weakened or inoperative. Governments negotiate amongst themselves and trust that citizens will follow. Often this is the case. But the theory of collective action also informs us that agreement about the optimal provision of public goods is becoming less likely when the number of decision-makers increases. Therefore, burden sharing and the efficient provision of public goods is dependent on procedures of decision-making and forms of governance. Powerful actors may assume responsibility for weaker ones, but they may also impose choices and costs unequally, without respecting the preferences of others. In this short paper I will argue that Europe's capacity to shoulder a fair share in providing international public goods of security and prosperity necessitates the creation of a democratic government at the European level. I will illustrate this argument in three cases: international security, European economic policy and international exchange rate regimes.

International Security

For half a century, the shield of American military power has safeguarded Europe's security and the Europeans have contributed to the financial burden of providing security. With the fall of the Berlin Wall, their willingness to pay for military capacities has diminished, while the U.S. commands the most efficient military machine in the world. From a conventional point of view, Europeans have an interest to support the U.S. as a provider of security and, naturally, they should pay a price for that. The intervention in Kosovo and the war against Yugoslavia are vivid demonstrations for this approach.

However, this approach requires agreement on what security means. September 11, 2001, has fundamentally changed the perception of strategic interests between Europe and America. It is not that Europeans would not experience the terrorist attacks in New York, Madrid or London as a threat to their values and their way of life, but rather that material interests between Europe and America diverge. The War on Terror differs funda-

mentally in character from the conventional understanding of security as maintaining the geo-strategic balance of power, or of suppressing civil war in clearly defined regions¹. The War on Terror is not a confrontation between nation-states but the attempt to suppress dispersed non-state networks of terrorists, who are called freedom-fighters in a different cultural context. This war is simultaneously a clash of civilizations, a media event and an individual form of warfare. Psychology matters at least as much as military might in winning this war. In this conflict, Europe is placed in a different strategic position than the USA. Due to its large Muslim population, open borders and geographic proximity to the Middle East, Europe is more vulnerable to terrorist attacks. Difficulties with integrating immigrants loom larger here than possible attacks by belligerent neighbors or the need to prevail militarily. Dependence on natural resources and fossil energy is of prime concern for the European economy. Not surprisingly its response to the terrorist threat is following a different philosophy than America.

A simplistic dichotomy claims that Americans intend to win the War on Terror by military means, while Europeans are tempted by appeasement. Although this is by far too simplistic, it does reflect certain ideological and economic realities. European post-war history has been driven by ideas of trust-building through institutions and the submission of national sovereignty under a regime of international law. Europeans have fought too many "just wars" in their history to have understood that all wars are a disaster and defense their only justification. From the burden-sharing point, appeasement would be cheaper, as European governments would have to pay less. America's more virile strategy is based on its economic capacity to maintain a high-performing military machine. So far the U.S. has been able to achieve this objective admirably, while Europe is both economically and militarily incapable of following suit.

America's military superiority has allowed U.S.-authorities after September 11, to make a strategic choice that is fundamentally divisive: America's overall strategy is to keep the military conflict outside the U.S. territory and "to preempt adversaries before they can attack" (National Military Strategy 2002, p. 2). It aims at protecting the homeland by externalizing the threat. Resources devoted to counterterrorism have increased, the Patriotic Act has given the administration the means of better controlling the population and tightening immigration, while the war in Afghanistan and Iraq has deprived terrorist networks of refuge. Although this strategy is closely linked to the administration of George W. Bush, it reflects a fundamental interest of the United States and will, in all likelihood, be continued by any new administration.

This strategy poses fundamental problems for Europeans. What is an "externality" for America, is automatically an "internality" for Europeans. As a consequence, the traditional alliance of interests between Europeans

¹ Joint Chiefs of Staff, *The National Military Strategy*, Washington DC, 2004. U.S. Department of Defense, *Quadrennial Defense Review Report*, Washington DC, February 6, 2006.

and Americans, supported by common values, is breaking up. Europe's strategic interest is peace in the Middle East, reconciliation between European and Muslim civilizations and prosperity around the Mediterranean. American policy makers would certainly agree, but contrary to their European partners, they are willing to incur costs of transition on the way of achieving this objective that would fall more heavily on Europeans. By externalizing the terrorist threat, away from the American homeland the War on Terror mobilizes resistance in the Mid-Eastern population against the Western world, which Europeans cannot "externalize" to the same degree. To the extent that U.S. foreign policy, misguided or not, launches preemptive strikes against the terrorists, it also excites anti-Western sentiments in other parts of the region. Angry Muslim fundamentalists will strike back at targets, more easily found in Europe than in the U.S. In the context of obvious grievances against European governments by insufficiently integrated Muslim minorities, the American War on Terror contributes to destabilizing Europe.

While conventional military strategy during the Cold War was driven by a common purpose (containing the Soviet threat) that required convergent and cooperative action, the new geo-strategic situation is still characterized by a common objective (eliminating the terrorist threat), but no longer by a complementary and convergent understanding of optimal action. The American strategy of externalizing the threat carries the risk of a break-up in the traditional strategic alliance between the United States and Europe. Europe will, therefore, have to take care of its own security concerns. Given Europe's geopolitical position, the potential threats are not necessarily the same for Europe as for the USA. Europeans will have to make significant improvements in their capacity to design an integrated common foreign policy as well as having the practical and military means for pursuing it. They will have to formulate their own strategic interests, which may converge in many cases and conflict in others with American interests.

Adequate security depends to a large extent on Europe's capacity to react. This capacity is greatly impeded by the poor economic performance of the European economies. It is obstructed by Europe's intergovernmental mode of governance, which is based on cooperation between autonomous states. These two obstacles are related. Like foreign and security policy, European economic growth suffers from the weak governance without a government. Intergovernmental bargaining does not allow for rapid and energetic decision-making. Instead, it yields compromises at the lowest common denominator, collective action problems where individual short-term interests prevent collective welfare, and lack of action where other countries can move. Europe's foremost problem is how to handle the inefficiency of its governance. This is a necessary condition not only for its immediate security concerns, but also for its long-term prosperity and any possible cooperation with the USA. Only if its economic difficulties are solved, will Europe be able to endow itself with necessary means for a coherent external security policy. But if it fails, it will disappear into political

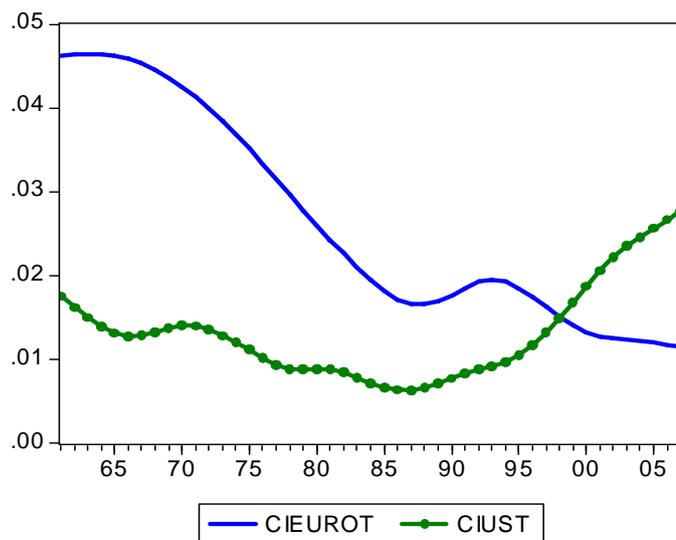
irrelevance as a political actor in the world, preoccupied by random political shocks that disturb the population and prevent economic prosperity.

Europe's Economic Problems

For ten years, Europe's economic trend growth has now been lagging behind the United States. Over the last decade, the U.S. growth rate has been nearly 50 percent higher than Euroland's. Nevertheless, due to catch-up growth in the new member states, the EU25 has not performed dramatically worse than the U.S.

The problem, therefore, is in the Euro-area. Closer analysis reveals that the prime reason for the better U.S. performance is higher growth in labor productivity since the mid 1990s.² This development is best explained by the significant increases in capital deepening of the U.S. economy (Figure 1). In other words, the United States has accumulated capital over and above the rate of population growth. The main problem for the economy of Euroland is the low growth rate of investment (Figure 2).

Figure 1
Capital Deepening Trend Growth (Hodrick-Prescott Filter)

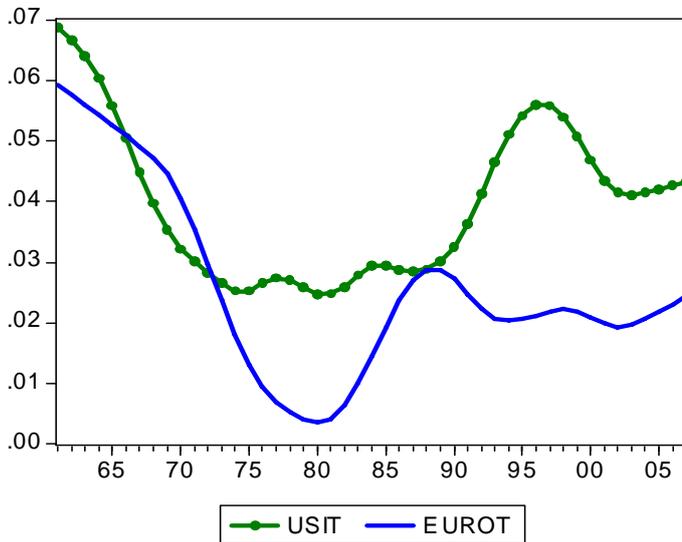


Policy-makers in the European Union have responded to these shortcomings in two ways. First by creating European Monetary Union, they sought to reduce the endemic instability that prevailed in the European Single Market with the existence of separate monetary and exchange rate policies. Unifying European monetary economy was a necessary complement to the creation of a Single European Market and the first prerequisite for the implementation of a coherent macroeconomic stabilization policy.

² See also ECB, *Monthly Bulletin*, April 2006, p. 49-51.

However, this institutional framework is incomplete as fiscal policy remains under the full autonomy of national governments, subject to the soft constraints of the Stability and Growth Pact. Note also, that a *constraint* on national fiscal policies is not the same as an *integrated proactive policy*.

Figure 2
Gross Investment Trend Growth (Hodrick-Prescott Filter)

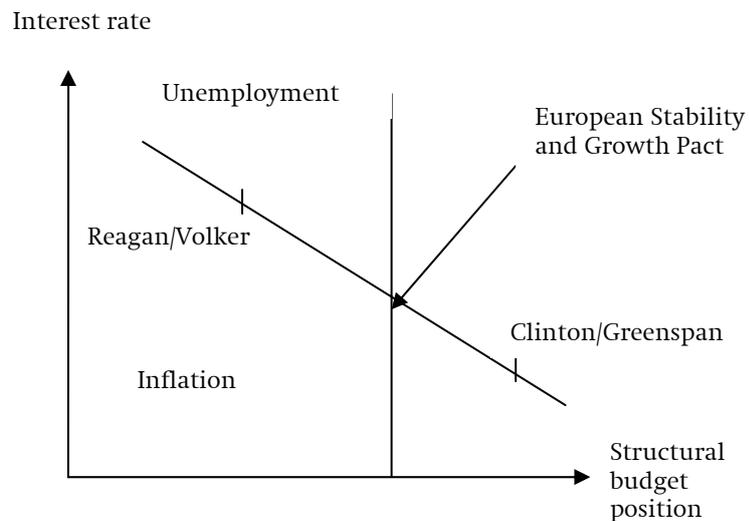


Instead of completing the institutional arrangements for a unified monetary economy, policy-makers have focused on structural reforms. The Lisbon Strategy of 2000 formulated for Europe the goal of becoming “one of the most dynamic economies in the world within the period of one decade.” However, halfway through, the results have been disappointing. Average growth rates in the Euro-area have actually fallen in the six years since the launch of the Euro, compared to the six years before. The reasons for this failure are multiple. A major cause must be attributed to collective action problems in designing European economic policies. A collective action problem implies that individual countries are delaying unpopular reforms in the hope of benefiting from the better economic environment created by reforms undertaken in their neighboring countries. It is questionable that the “open method of coordination,” whereby member states set specific policy goals, is sufficiently constraining to assure proper implementation by autonomous states. Instead, it is more likely that the member states’ governments feel constrained by the legitimacy of policy decision, that only emerges from national constituencies and not from a European constituency where collective European interests can be debated and decided.

Probably the most important single factor in Europe’s negative growth and investment performance is the lack of effective macroeconomic policy. This fact is often denied by policy-makers in the European Union. Yet, as every businessman knows, in a market economy, investment is dependent

on profitable business opportunities. The profitability of firms depends on supply-side factors such as the level of wages relative to prices, productivity, technological innovation, etc. No doubt institutional factors related to the welfare state, pension and health protection as well as labor market flexibility in the sense of hiring and firing, have effects on the cost of labor and therefore, on companies' profitability. However, the cost factor is only one element in the profit equation that yields investment. The other is the price level and the effective demand for the goods and services produced by companies and this is dependant on macroeconomic policy. While monetary policy aims at stabilizing the price level, fiscal policy can compensate temporarily negative shocks in effective demand. However, in the long run, it is the interaction of fiscal and monetary policy that sets the long-term interest rate and therefore, the cost of capital, which is the benchmark for private investment. Under conditions of price stability, excessive public deficits are pushing interest rates up and, therefore, reduce economic growth. Hence, an active macroeconomic stabilization policy, aimed at price stability *and* full employment, must under no circumstance be confounded with the bias towards excessive deficits that dominated Keynesian policies in the 1970s.

Figure 3
The Policy Mix



The relationship between fiscal and monetary can be shown in Figure 3. The monetary policy stance is represented on the x-axis, fiscal policy on the y-axis. The downward sloping curve represents the efficient policy mix, which realizes simultaneously price stability and full employment. Combinations above the line produce stagnation, recession and unemployment, below the line inflation. Any point on the curve is efficient, in the sense of macroeconomic stability, but the choice of a particular point on the line reflects a collective preference for the intergenerational burden

sharing of present and future taxes. In the United States, Republican governments have tended to pick high deficits, high interest rate combinations; Democratic governments chose low deficits or even surpluses with low interest rates. In Europe, the choice is fixed at balanced budgets, regardless what citizens' preferences would yield.

The experience from the United States has shown that the transition from the Reagan-Volker policy mix with high deficits and high interest rates to the Clinton-Greenspan policy mix of budget surpluses and low interest rates has been a prime mover behind the economic dynamism of the U.S. economy³ but probably also in some European countries⁴. At the same time, fiscal policy has been more active in the United States in response to exogenous shocks, particularly after September 11th.

Here is some evidence. Figures 4 and 5 show the dimensions of fiscal and monetary policy interaction. We find U.S. monetary policy to be dominated by counter-cyclical monetary policy (Figure 4a, p. 76). The Federal Reserve System counter-cyclically loosened monetary policy 9 times out of 19 years, mainly in the glorious 1990s. Pro-cyclical tightening mainly occurred in recent years. The interesting mirror image is that fiscal policy was pro-cyclically tightened in the 1990s and counter-cyclically loosened in the 2000s (Figure 4b, p. 76). These two opposite policies reflect movements on the policy mix trade-off curve and therefore collective preferences about the intergenerational justice of tax burden sharing. Figure 4c (see p. 77) shows interacting movements between fiscal and monetary policies mainly in the North-West/South-East direction, with little shifts to accommodate shocks. This negative trade-off is exactly what theory would let us expect (see Figure 3).

Europe's picture is very different. Both monetary and fiscal policies are less active (the amplitudes of the charts are flat and smaller than in the U.S.). They are also dominated by pro-cyclical movements. The ECB (and the Bundesbank before 1999) has a bias to pro-cyclical tightening (8 out of 19 years), and loosens pro-cyclically only occasionally in crisis years (1990 German unification, 1992 ERM crisis, 2001 September 11). Countercyclical monetary policy in either direction has only happened in 6 years (see Figure 5a, p. 78). But the same is true for fiscal policy (Figure 5b, p. 78). Counter-cyclical budget impulses are generally weak and close to neutrality, while pro-cyclical tightening in the years before EMU and pro-cyclical loosening after 1999 show the policy choices of autonomous member states. As a consequence, the European policy mix in Figure 5c (p. 79) seems to oscillate between combined fiscal and monetary loosening and tightening (North-West/South-East movements). But this is odd. Theory tells us that the trade-off should be negative and not positive.

The explanation is found in the collective action problem. Assume we start in equilibrium and one government decides to borrow at the low pre-

³ Richard W. Kopcke, Geoffrey M. B. Tootell, and Robert K. Triest (eds.), *The Macroeconomics of Fiscal Policy*, Cambridge, MA: MIT Press, 2006.

⁴ See ECB, *Monthly Bulletin*, April 2006, p. 61–73.

Figure 4a
US Monetary Stance

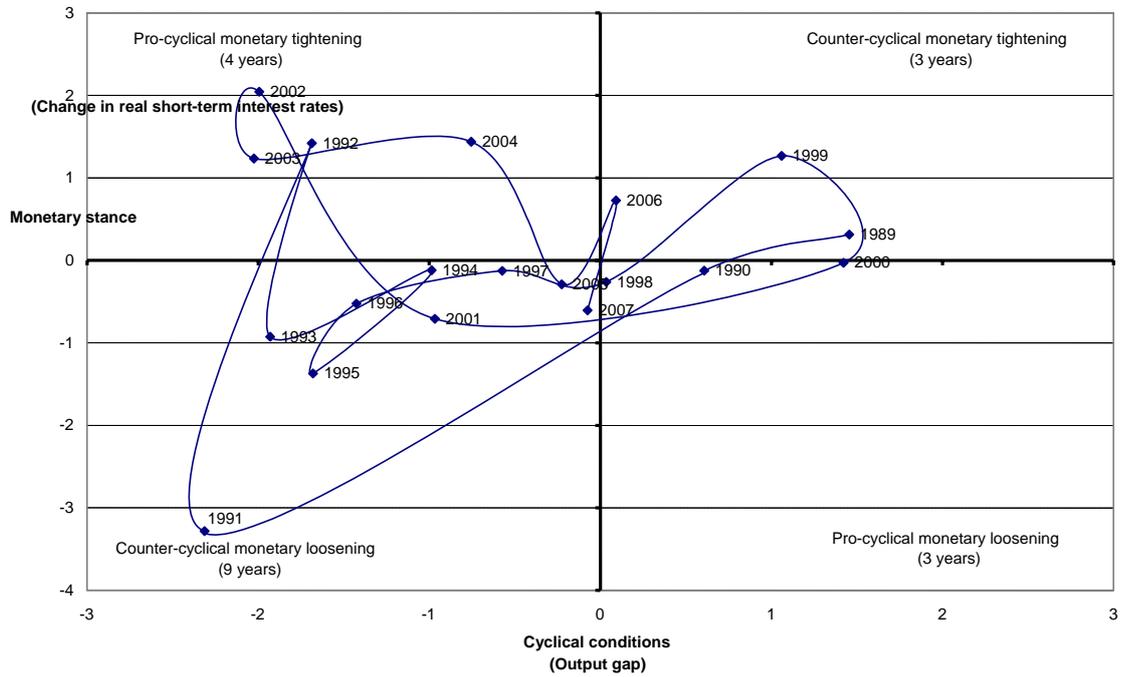


Figure 4b
US Fiscal Stance

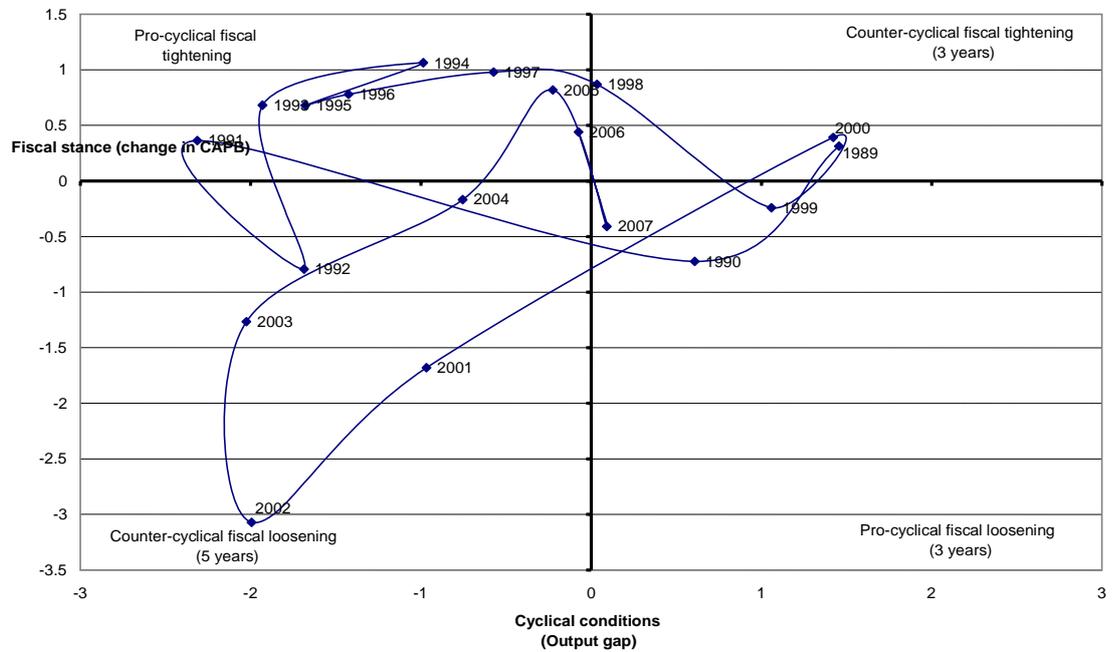
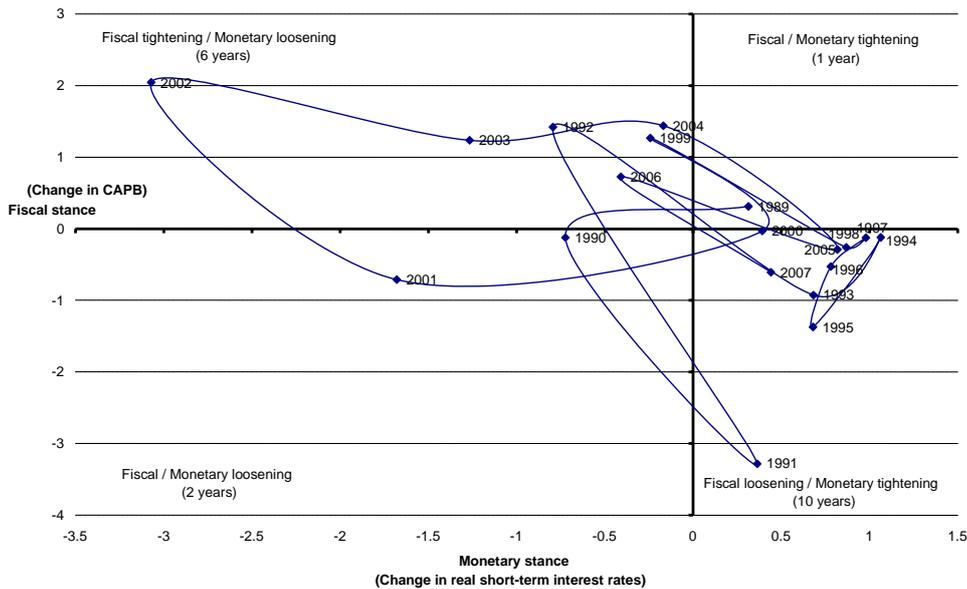


Figure 4c
US Policy Mix



vailing rates. This is a shock that pushes the whole system into an inflationary disequilibrium and requires macroeconomic tightening. However, because fiscal policy stances are automatically determined by each member state, they cannot be used as stabilization policy instruments. Only monetary policy has the flexibility to respond at the European level. However, the monetary tightening affects economic growth in all member states, so that all national budgets are now pushed into deficits. The picture of fiscal indiscipline emerges. But in reality a new equilibrium point on the trade-off curve has been reached, although the curve has shifted relative to its original position. The new equilibrium, caused by the free-riding behavior of one actor, reflects a higher aggregate structural deficit and higher interest rates for all. Because Euroland's citizens cannot determine democratically the aggregate policy mix along a stable trade-off curve, the curve itself jumps randomly as a function of autonomous national policy choices.

Increasing the efficiency of the policy mix would require turning the aggregate budget stance into a policy tool and at the same time imposing strict discipline on individual member states to stick to the defined policy. Thus, the correct reform would be *more flexibility for the aggregate fiscal policy position and less discretion for individual member states*. But in recent years, the EU has gone in exactly the opposite direction: individual countries have more leeway to justify higher deficits, while the aggregate position is the more or less random outcome of uncoordinated free riding. The consequence will be higher interest rates, lower growth and more unemployment. Europe will remain the least dynamic region in the world economy, unless it centralizes macroeconomic policy at the European level.

Figure 5a
Euroland Monetary Stance

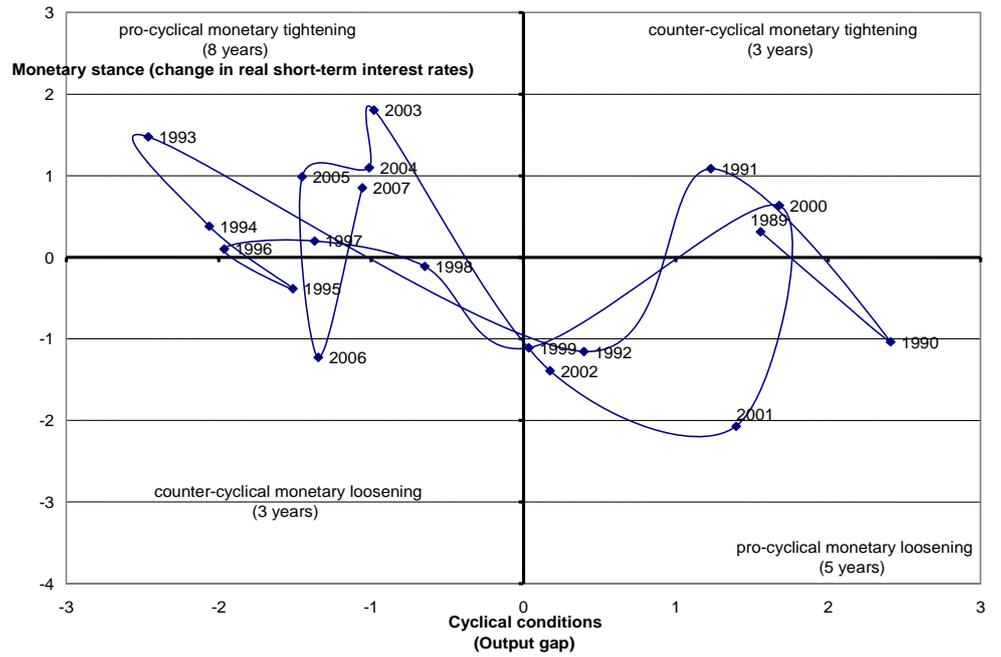


Figure 5b
Euroland Fiscal Stance

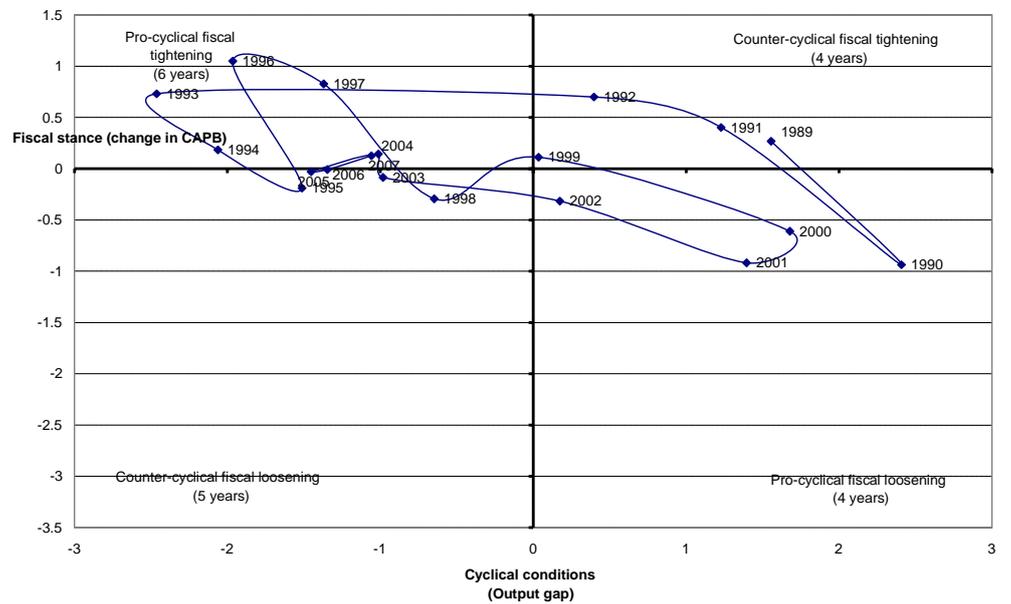
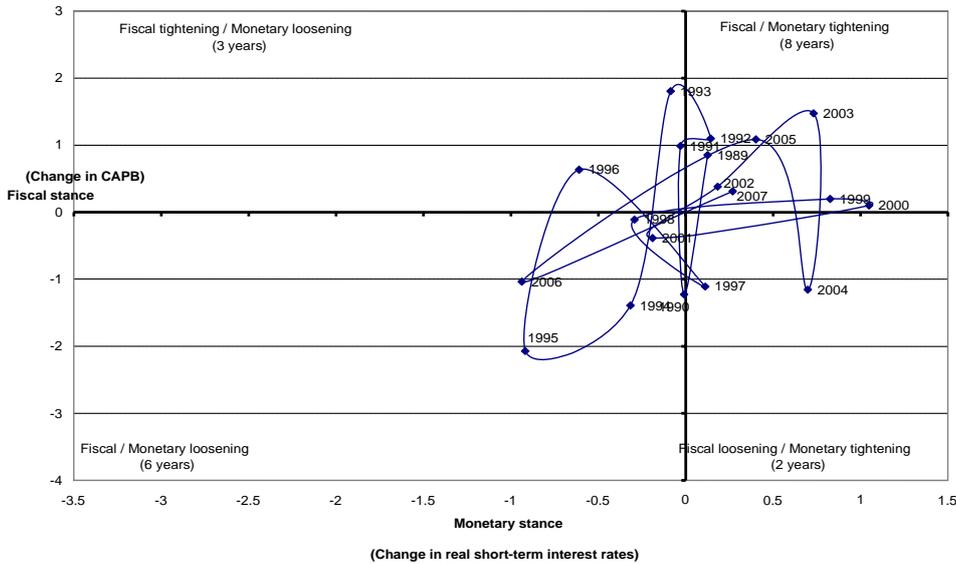


Figure 5c
Euroland Policy Mix



Simple ideas on how to design coherent, yet flexible institutional arrangements for fiscal policy in Euroland have been put forward (see Amato, 2002; Casella, 2001; Collignon, 2003, 2004). For example, one may define the optimal aggregate fiscal stance at the Euro-level by transforming the Broad Economic Policy Guidelines into a “DPDF europeo.”⁵ This would give more flexibility to policies reacting to macroeconomic shocks. The aggregate stance would then need to be broken down into national (and even regional) deficit quota for which each jurisdiction would obtain deficit permits. If one jurisdiction does not use its quota, it would be allowed to sell the permits to another authority that wishes to borrow more. This system, inspired by tradable pollution permits, would achieve vertical flexibility reflecting fundamental preferences for borrowing and taxes, horizontal flexibility between different jurisdictions and overall coherence in the fiscal position.

Exchange Rate Policy

Another element of macroeconomic policy is exchange rate policy. The dollar gained in value during the Clinton years, mainly in response to the higher growth rates. However, due to the low savings rate of American consumers, a large part of the high investment was financed by capital inflows creating huge imbalances between domestic demand and supply in the U.S. economy. The U.S. current account deficit has achieved historically unprecedented levels, financed by the ever-rising creditor positions in Asia. It could be argued that the capacity of the USA to finance such large

⁵ See Amato, 2002. DPDF is the Italian macroeconomic framework law, which gets voted before the finance minister can out forward his annual budget. France’s Vth Republic introduced a similar tool to overcome the inconsistencies of the IVth Republic.

deficits are a consequence of the high confidence of private over public investors in the American economy. In this perspective, the high current accounts are also a return on capital invested into military capacity and therefore represent a form of burden sharing. However, they are hardly sustainable in the long run.

It has been calculated that a correction of these current account imbalances may require a devaluation of the U.S. dollar of up to 40 percent. However, given that the bilateral trade balance between Europe and the U.S. is close to equilibrium, the major adjustment would have to take place with respect to the Asian economies, in particular with respect to China. Yet, the Chinese economic miracle is largely dependent on its integration into the world economy through the stable undervalued exchange rate to the dollar. Even if Chinese authorities in the recent years have allowed a few minor appreciations of the RMB relative to the dollar and introduced a small band of exchange rate flexibility, the export-led growth model requires reasonable exchange rate stability. In other words, a large devaluation of the U.S. dollar, would undermine the causes of the Chinese economic success and cause major economic recessions in the world economy. This can be in no-one's interest.

The first best solution to handle this potential crisis would be some coordinated exchange rate management in the world economy. Stable exchange rates are in the interest of Asia as well as Europe. One option could consist in re-pegging of the Chinese and other Asian currencies to a basket consisting largely of the euro and the Japanese Yen⁶. However, such policy decisions are presently not possible given the handicaps of intergovernmental policy-making in Europe. Germany, France, Italy and the UK are present in the G7, while China is not. Here again, efficient policy making would require for Europe not only to speak with one voice, but also to act as a single actor. What is necessary is a single government for the single currency area that is capable of implementing coherent policies and will take up the traditional places of national governments in international organizations.

The Constitutional Issue: Creating a European Government

We have seen three major policy areas where Europe is not capable of acting efficiently: security and foreign affairs, fiscal policy, and exchange rate policy. Regardless of what specific policies one favors, it is clear that in each of these areas, Europe is handicapped when pursuing its interests through the intergovernmental model of governance, which prevents efficient, coherent and homogenous policy decisions.

The Belgian prime minister, Guy Verhofstadt, has recently called for the creation of a European government as the answer to this and similar prob-

⁶ See Stefan Collignon, "Adjusting the Current Account Deficit: When Roll for the Dollar, Euro and Yen?" 2006, forthcoming in *Asia Pacific Business Review*. Download from www.stefancollignon.de.

lems.⁷ It is time that Europe comes to realize that it cannot go on with institutional arrangements that have served it well in the past, but are no longer adequate for today's world. However, greater centralization of certain policy areas at the European level also requires more democratic accountability. Otherwise, European citizens will not be willing to accept policies emanating from the European level. The lack of democratic legitimacy would undermine the European project. This has already become apparent during the Constitutional referenda in France and the Netherlands. In this respect, it is interesting that Eurobarometer has shown voters in Europe and particularly in France and the Netherlands to be in favor of the new constitution. European citizens are not against European integration as such. They are against a form of European governance that they feel they can no longer control. Thus, burden-sharing in Europe requires first of all decision-sharing by the European citizens in the context of full European democracy. Once this has been achieved, Europe can become a valuable partner for the United States in preserving the values on which modern Europe and the United States of America have been built.

⁷ Guy Verhofstadt, *The United States of Europe*, London: Federal Trust, 2006.

Foreign Policy Spending – Recent Trends and Explanations in a Transatlantic Perspective

Daniela Schwarzer

When discussing the economic basis of foreign policy making and the question of how the burden of maintaining a stable and secure world order is or should be shared in a transatlantic perspective, national budgets devoted to funding foreign policy action are usually mentioned as a key variable. U.S. politicians regularly criticize that EU member state governments are devoting insufficient budgets to their foreign policy action (notably in the military field) and are hence “free riding” on the United States’ provision of security as a global public good. One of the latest examples of such American critique is the “Quadrennial Defense Review Report” of the U.S. Department of Defense of February 2006. The report criticizes that the EU member states curb “defense spending on capabilities they need to conduct operations alongside the U.S. military effectively.”¹ This is one of the reasons why, from an American point of view, the European allies are losing strategic importance to the United States in their global war on terrorism.²

Spending on defense and foreign policy clearly is one indicator for transatlantic burden sharing in international politics. However, to explain the huge divergences in defense spending, which have been growing even more since September 11, 2001, differing threat perceptions and social preferences with regard to security have to be analyzed. Looking at the domestic debate in two EU countries, Germany and France, the chapter attempts to reach some conclusions on developments likely to happen in the EU regarding foreign policy budgets and the way in which money is spent, as well as on strategic implications for the transatlantic partnership.

Foreign Policy and Defense Budgets as Indicators for Transatlantic Burden Sharing

There are at least three reasons why budgetary figures tell us a lot, though not everything, about transatlantic burden sharing. *First*, the traditional definition of military expenditure as the cost of providing security has always been quite narrow. Given the comprehensive approach taken to security worldwide and the increasingly blurred line between external and internal security and between domestic and international dimensions of national security since the attacks of September 11, this concept has

¹ U.S. Department of Defense, *Quadrennial Defense Review Report*, February 6, 2006, p. 88, <http://www.defenselink.mil/qdr/report/Report20060203.pdf>.

² Others are the growing importance of strategic partnerships in the Asia-Pacific region (notably with Japan, Australia and South Korea). See Benjamin Schreer, “Quadrennial Defense Review Report: A mixed picture,” SWP Comments, 2006/05, March 2006.

recently become even more problematic. In order to obtain a comprehensive picture of the costs of addressing security problems by force, data on military spending should be supplemented by data on expenditure on intelligence services, but also on the global fight against poverty, health spending etc. This raises the analytical problem that the impact and input of soft power may be measured only with difficulty (i.e. which other seemingly unrelated policy fields have a foreign policy impact).

Second, figures on military spending are only a measure of the financial resources that are allocated to the military sector, but tell us nothing about the effectiveness of the money spent. The size or capability of the military depends on variables such as the level of military technology, the mix of equipment, manpower paid for in the military budget and a host of other factors. For instance, Germany's defense expenditure still goes to a large degree into military and civilian personnel, while the overall level of investment in innovation and technology remains comparatively low. Activities to modernize defense systems are today considered to be of key importance, given notably the new definition of security threats after 9/11. Coletta argues for the case of Spain that its actual participation in geopolitical affairs has been more consequential than overarching statistics for the EU and in particular Spanish defense spending suggests.³ While these statistics hint to a capabilities deficit, he explains how Spain, without equally drastic upswings in defense budgets, has brought about dramatic improvements in the quality of defense acquisitions: Spain has centralized the acquisition authority, pooled resources across the public-private threshold and across bureaucratic demarcations within the government, and at least attempts to have fair competition in awarding defense contracts.

The achievements Coletta identifies in the Spanish case also have an important potential for the European Union. European defense expenditure is regularly criticized as little efficient. The way development aid is spent through the EU member states which still rely strongly on traditional patterns of cooperation and institutionalization, plus the parallel structures on the EU level, notably the European Commission's Directorate-General for Humanitarian Aid (ECHO) are likewise criticized as not always optimally exploiting synergies or avoiding duplication. If cooperation within the EU were to increase and to lead to more efficient expenditures on a trans-European scale, and in the military field to an improved interoperability, the EU could strengthen its declining position as a U.S. ally without necessarily increasing its budget. This is the *third* dimension of the gap between the EU and the U.S. which is not rigidly dependent on budget-based measures (or total numbers of tanks, ships, aircrafts).

Despite these three arguments, the conclusion should not be that it makes no or little sense to look at foreign policy expenditure. Foreign policy budgets can indeed be an important starting point for the analysis

³ Damon Coletta, "Managing the Transatlantic Gap: The Rise of Spain," *Foreign Policy Analysis* (2005), pp. 229–247.

of transatlantic burden sharing—provided certain points are taken into account. First, both the expenditure for military and civilian burden-sharing should be considered in order to take into account the different means identified by different actors to achieve their foreign policy goals. As a start this paper supplements the comparison of military spending with Official Development Aid (ODA). Second, the development of budgets should be treated as *one indicator among several* (such as effectiveness of expenditure, success of measures taken etc.) when it comes to assessing foreign policy burden sharing in a transatlantic comparison.

If these aspects are taken into account, expenditure on foreign policy can and should indeed be examined as an important indicator for how burdens are shared in the transatlantic relationship. The way expenditure levels relate to the economic well-being of the country and the debates surrounding these budgetary decisions reveal important information about the voters' social preferences regarding levels and objectives of foreign policy expenditure and, related to this, about the trade-offs voters are willing to make between foreign and domestic expenditure notably because the money put into foreign policy is not (or only very indirectly) spent on domestic policies, the effects of which are usually more directly felt by voters. Especially in times of economic downturn, rising unemployment and tight public finances, these trade-offs are likely to be a real test-case for foreign policy preferences. Foreign policy budgets are hence indicators of both the economic performance of the member countries and the political preferences reflecting certain international security developments.

Taking Stock: Defense Spending and Official Development Aid in the EU

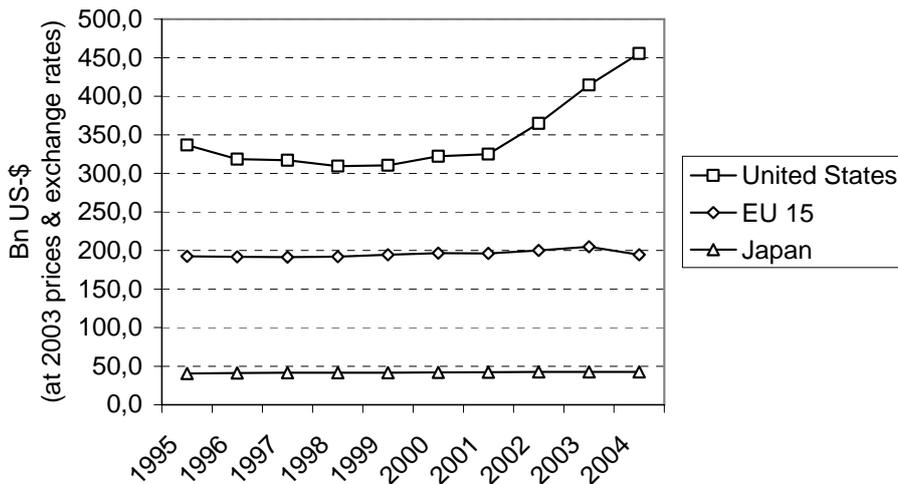
In the following, the evolution of defense expenditure and official development assistance (ODA) in the EU, compared to that of the U.S. in the last decade, are analyzed, introduced by a brief overview of the general trends in security threats and policies since the end of the Cold War. Military expenditure and ODA are not only the most important positions in external relations budgets. They can also be treated as proxies for the two forms of external action often treated as distinct strategies: the exertion of hard and soft power—which are increasingly seen as two inseparable pillars of international security policy.

The end of the Cold War in 1989 constituted a dramatic change in the global security environment. There were initially high hopes for far-reaching disarmament after the vanishing of the Warsaw Pact from Western threat perceptions. Expectations of a major peace dividend grew and the new focus lay on arms reduction and the conversion of resources and facilities from military to civil use. Thus, the first ten years after the cold war saw military spending fall by one third in real terms. In 1999, world military expenditure began to increase again, notably because pressures to spend grew from the development of military technology and the transformation of military forces which became increasingly involved in peace-

keeping and peace enforcement.⁴ The attacks of September 11 marked a significant turning point in the international security environment. New security measures were aimed at preventing a recurrence of the attacks in the United States or other parts of the Western world. New threat perceptions gave rise to new national (and European) security strategies, which had been lacking in most Western countries since 1989. The subsequent wars in Afghanistan and Iraq have been responsible for the rapid increase in U.S. military expenditure since 2001.

As to developing countries, the attacks of September 11 accelerated other existing trends, such as alleviating poverty (which was identified as a major source for terrorism), notably in (post-)conflict states but also in weak or failing states, largely neglected in the post-Cold-War period. Hence, not only the North-South security interdependence was largely recognized and translated into action. Also a broader security concept gained ground. It included internal security alongside external defense and development issues, and led to a re-categorization of military action as part of a larger security concept.⁵

Figure 1
U.S., European and Japanese Defense Spending 1995–2004



Source: SIPRI Yearbook 2005.

Figure 1 shows a steep increase of U.S. expenditures on defense after the attacks of September 11. The EU-15 aggregate remains rather stable, while the picture is less homogeneous when we look at individual countries' developments in the EU-15⁶. Here, we can see that the UK and France

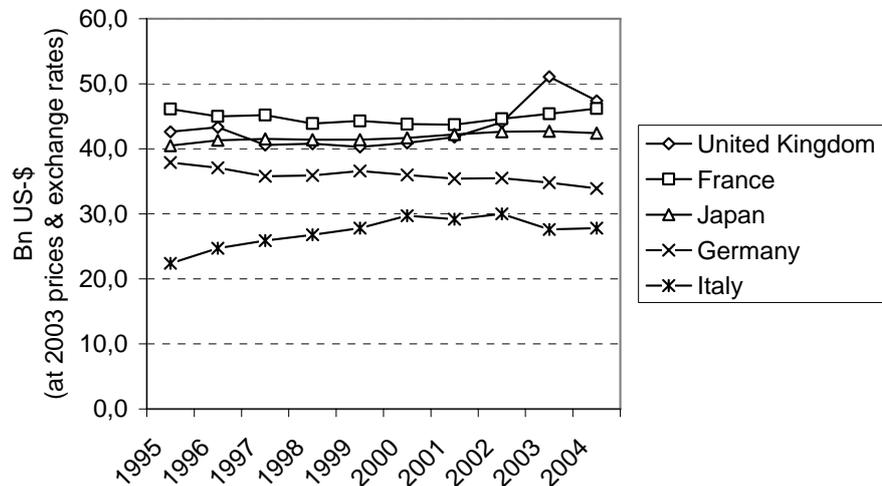
⁴ Wuyi Omitoogun and Elisabeth Sköns, "Military expenditure data: a 40-year overview," *SIPRI Yearbook 2006: Armaments, Disarmament and International Security*, pp. 269–324, pp. 279ff.

⁵ Omitoogun and Sköns, 2006, p. 293.

⁶ The EU-15 was enlarged to an EU-25 on May 1, 2004. This graph takes into account the aggregate of the 15 member states' defense budgets only, even though 10 more member states joined in May 2004. Their budgetary contribution is negligible.

slightly increased defense budgets, while Germany (and Italy) continued cutting defense budgets (Figure 2).

Figure 2
Defense Spending of EU countries and Japan 1995-2004



Source: SIPRI Yearbook 2005.

In Official Development Aid, the expenditure trend in the United States and the EU is comparable. Both show steep increases of ODA in real terms since the year 2000.⁷ This trend started before the attacks of September 11 (which would have their first visible budgetary effects in the year 2002), but has accelerated in the case of the United States which has seen a steeper increase in defense expenditures since 2002 (Figure 3).

A closer look at defense and ODA expenditures as a percentage of GDP in the year 2004, however, makes clear how far the United States and the EU diverge on the relative importance given to both. Despite increasing ODA spending, U.S. defense expenditures are ten times as high as its ODA expenditures, compared to a multiple of less than five for the major EU countries (Figure 4).

In a nutshell, the data show a clear gap (in absolute and in GDP-relative terms) between the United States and the EU (member states) in defense spending. The United States places a relatively higher priority on defense spending and the EU places a relatively higher priority on development spending. The turning point for the defense expenditure developments in the United States clearly was September 11, 2001. While the gap in defense spending is getting larger between the EU and the United States, the U.S. is following the same trend as the EU in terms of ODA spending. However, total ODA in the United States amounts to just half of the money spent by the EU member states.

⁷ Japan is the only country among the larger ODA-payers following the opposite strategy and decreasing ODA in absolute terms.

Figure 3
Official Development Aid (ODA) 1995–2004

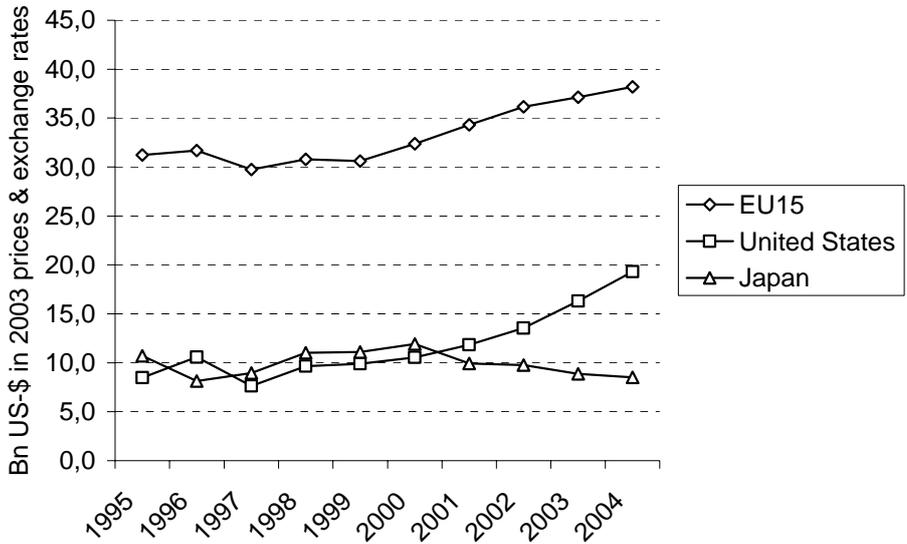
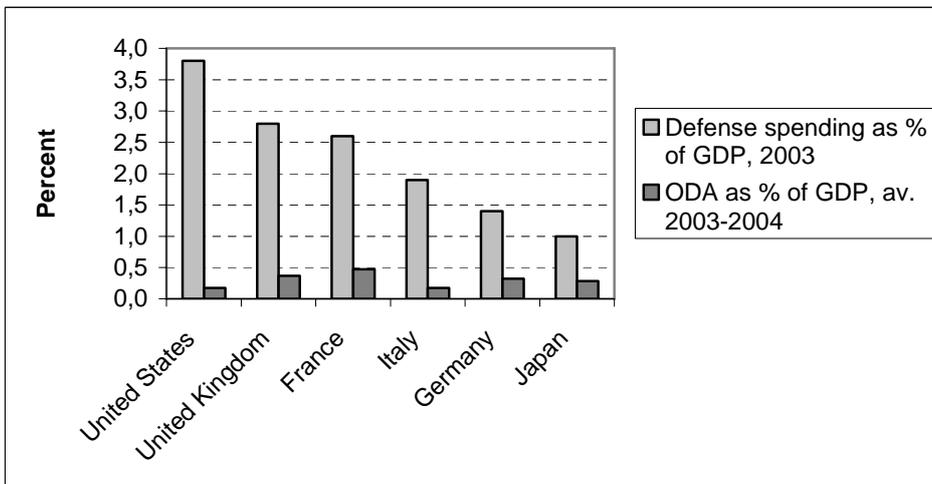


Figure 4
Defense and ODA Spending in Percent of GDP 2003/2004



Source: OECD, DAC; SIPRI Yearbook 2005.

Diverging Reactions to September 11

Given that the main differences between EU and U.S. foreign policy expenditures lie in the trend for defense spending, this section concentrates on the preferences related to security policy. A first investigation is to understand how expenditures relate to the tasks assigned to foreign and security policy. Some take low defense expenditures in the EU as evidence of Euro-

pean “free-riding” on a presumed U.S. provision of global stability. The idea of Europe as “free riding” on the United States implies that both identify the same objectives and means for foreign policy making. However, different expenditure patterns can of course also be a function of other objectives assigned to foreign policy and other means identified to achieve these objective. This section looks at objectives and means of foreign and defense policy in a transatlantic comparison.

The View of the Security Environment – The U.S. National Security Strategy and the European Security Strategy

After the Cold War the number and character of threats has multiplied, just like the actors (state and non-state) from which they originate. The perceived threat is an essential factor of national spending on security. Both the U.S. National Security Strategy (NSS) and the European Security Strategy (ESS) identify the same high priority threats: terrorism, the proliferation of weapons of mass destruction, regional conflicts. Both strategies emphasize in particular the intersection of terrorism and weapons of mass destruction (i.e. radicalism and technology). With these priorities, their outlook is in line with the UN High-Level Panel report on Threats, Challenges and Change.

Despite many similarities there are, however, substantial differences between the NSS and the ESS in how security challenges are defined and addressed. One difference lies in the way terrorism is dealt with—the U.S. in its own words is involved in a “war on terrorism” relying on military power to ensure national security, while Europeans refer to it as a “fight” or “struggle” against terrorism. Priority here is given to the use of civilian tools (such as information sharing or judicial cooperation).

Both the NSS and the ESS focus on states, which face internal challenges that hamper their ability to function properly at the international level. However, the U.S. describes these states as “rogue states,” while the EU calls them “failing states.” This is more than semantics, as it impacts the means chosen to address a situation. “Failed states” will be given direct assistance (economic, through peace keeping initiatives etc.) in order to be stabilized. “Rogue states” are assumed to maintain control over the state apparatus, but to violate international rules and norms. Isolation and the use of sticks (rather than carrots), for instance through sanctions or military intervention, are the preferred instruments. These are examples of how different perceptions and interpretations of threats affect the choice of policies—and hence spending. Moreover, both sides rely on instruments that reflect their comparative advantages and that thus have been built up over many decades.

The Quadrennial Defense Review Report of February 2006 complements the NSS by identifying four major challenges: irregular challenges (such as terrorism), catastrophic challenges (use of weapons of mass destruction by non-state actors), disruptive challenges (use of breakthrough technologies by adversaries), traditional challenges (military action against state actors).

The new focus on fighting a long war against terrorism and hence on strengthening the Special Operations Forces by one third translates into a higher draft defense budget 2007.⁸ While the importance assigned to long-term stabilization efforts is comparatively low for the U.S. side, the European allies are predominantly seen as providers of troops for long-term stabilization efforts. This means, on the other hand, that the static alliance in NATO has lost strategic importance to the U.S. as the military value of potential contributions from EU member states is seen as low in American defense policy. For the EU, this means that—if it wants to continue being a strategic partner to the U.S.—it has to improve its own efficiency and flexibility, e.g. by developing flexible “tool boxes” to efficiently use its complementary instruments. Given the new U.S. orientation away from its traditionally close Western allies, the EU member states may have an increased interest to develop autonomous military capabilities within the European Security and Defense Policy.

The Decline of the United States’ Global Image

Underlying the United States’ long war against terrorism under the current leadership is a strong missionary zeal for the global spread of democracy, which has no parallels in EU member states or at the EU level as such. The “aim to build and preserve a community of free and independent nations”⁹ was emphasized from the start as a theme for foreign policy during George W. Bush’s second term. Despite the Bush administration’s missionary zeal, western democracies, notably the European Union, did not fully support the U.S. fight against terrorism in the aftermath of September 11.

The divisions over the Iraq war in the EU are just one example, but a highly important and symbolic one in that regard: While the EU member governments were divided on whether to support the U.S. military intervention in Iraq, public opinion was largely against this intervention. This is also true for countries such as the UK and Spain, whose governments initially gave strong support to the U.S. intervention.

Skepticism towards U.S. foreign policy has grown significantly since the military intervention in Iraq. 53 percent of Europeans polled for the Pew Trends 2005 thought that U.S. foreign policy has a negative impact on world peace. 74 percent of the French and 47 percent of the Germans said the United States would not solve the world’s problems. Against this background and given the growing criticism voiced by EU governments towards the U.S. intervention in Iraq, it has become increasingly harder to argue that U.S. military expenditures to fund these operations are actually contributing to global security—an effort on which the EU member states are supposedly free-riding.

⁸ See Schreer, “Quadrennial Defense Review Report” [fn. 2], for details.

⁹ George W. Bush, *State of the Union Address*, News release, Washington DC, 2 February 2005, <http://www.whitehouse.gov/news/releases/2005/02/20050202-11.html>, p. 2.

The low standing of the United States in world opinion has given rise to a debate within the United States on the need for legitimacy of U.S. leadership, notably military intervention, as a precondition for its success.¹⁰

Public Opinion on European Independence

Together these developments have led to a situation where European public opinion questions the “old” assumption of the U.S. being a guarantor of global security. Never before in post-World War II history were potential conflicts of interest between the United States and the EU or some European countries (e.g. regarding trade disputes, also in the defense sector, competition for energy resources, strategic presence on other continents, the sustainability of multilateral security architecture) so openly discussed. Recent public opinion data show that while the image of the United States in the EU plummeted with the Iraq war, with Guantanamo and the inefficient reaction to “Katrina,” European public opinion now mandates the EU’s independence from the United States. Since the year 2000, the proportion of Europeans who consider that Europe should have the capacity for military intervention independently from the United States has steadily grown to 80 percent in a recent EU-wide poll.¹¹ Likewise, the feeling is growing among Europeans that the EU has the means at its disposal to intervene independently. 65 percent of the people questioned said that the EU definitely (31 percent) or probably (34 percent) has the means in the field of defense technology and equipment to act without the support of the United States. 82 percent of the people questioned in early 2006 said that a common EU defense policy today is essential (38 percent) or desirable (44 percent). These trends are confirmed by the Pew Global Attitudes Project which finds that in the eyes of 63 percent of the citizens polled, the EU (in contrast to the United States) could have a positive impact on world peace.

The Perceived Ability to Pay for Security: Is Europe Too Poor to Pay?

This clear majority for a stronger and more European defense policy, so far has not translated into higher defense spending in the EU member states, adequate financing for the CFSP on the EU level, and, most importantly, increased efforts to improve the efficiency of foreign policy spending (ranging from defense/armament policy to ODA, diplomatic services, measures to fight terrorism, etc.).

Two major EU countries—Germany and France—will be taken as examples of how political priorities are defined in Europe, how the willingness to set up capabilities is effected by financial constraints, and how political

¹⁰ Pál Dunay and Zdzislaw Lachowski, “Euro-Atlantic security and institutions,” in *SIPRI Yearbook 2006: Armaments, Disarmament and International Security*, pp. 33–76.

¹¹ Ipsos Public Affairs and EADS, “Europe and its means of defence,” wave 5, February 2006.

support for foreign policy evolves. With the UK, these are the largest foreign policy spenders in the EU and among the top 10 armaments spenders in the world. Furthermore, in the group of EU countries which reacted rather homogeneously to the attacks of September 11th, Germany and France show diverse reactions notably to the translation of fiscal constraints on spending decisions in the years 2002 to 2004. And finally, despite their common refusal to join or support U.S.-led military action in Iraq, both countries traditionally have divergent approaches to transatlantic cooperation.¹²

Germany

The German defense budget has seen a decrease in recent years. Germany was hence acting as all of other European states who figure among the world's 15 biggest spenders (France, Germany, Italy, Spain and the UK—with the exception of Russia who increased spending). Together, they cut military spending by a total of \$7,854 million in 2005.

Especially in Germany, expenditure cuts were deemed necessary with a view to complying with the deficit criteria of the Stability and Growth Pact. Moreover, the second red-green government (2002–2005) found itself politically unable to argue for higher defense spending while economic reform packages were cutting down social benefits—despite the ongoing reform and modernization requirements of the Bundeswehr, and despite the growing deployment of German military forces abroad following the redefinition of Germany's international and European role. This redefinition included replacing the mission of territorial defense with a mission of crisis prevention and management, in line with new U.S., NATO, and EU doctrines.

In this tight context of economic and social reform, it is interesting to see that the German debate totally discards the question of whether defense expenditure, especially in the field of research and development, may have growth enhancing effects. Rather empirical analyses suggest that for Germany, the causality goes the other way around: economic growth along with sound public finances is a prerequisite for German governments to increase defense spending.

Experts regularly criticize this restrictive approach to defense spending. They argue that the close limits on defense spending have been hindering the process of transforming the Bundeswehr into a highly flexible and professionally organized armed force, a Crisis Reaction Force. A second point of critique concerns Germany's failure to comply with the Helsinki Headline goals for ESDP as it has fallen short of proposed or promised financial contributions and risks to halt reforms.

The overall debate on the defense budget can be characterized as essentially focusing on how to freeze expenditures in a way that is compatible

¹² Daniela Schwarzer, *Duo ohne Führungswillen: Deutschland und Frankreich in der erweiterten EU*, Berlin: Stiftung Wissenschaft und Politik, June 2006 (SWP Study), p. 9.

with the immediate needs of modernizing the German army. A strategic debate has been largely absent. This may change under the current government, if the White Paper on Defense announced for the year 2006 is seized as an opportunity to discuss broader strategic issues for German and EU foreign policy and the required means to implement these policies. Indeed, in 2006 exempting the defense budget from a general cut in expenditures has been an issue seriously debated. With more impact than his social-democrat predecessors in recent years, the current Minister of Defense, Franz Josef Jung, has asked for more resources to fund Germany's growing international obligations, such as the missions in Afghanistan, the Balkans or in the Congo.¹³ Germany hence debates whether it should follow the French case, which has ranked defense (just like Development aid) as political priorities to be exempted from expenditure cuts. However, even stabilizing defense expenditure would still mean a decline relative to GDP.

France

In contrast to Germany, defense expenditure was a matter of election campaigning in France. In the wake of September 11, Jacques Chirac promised an increase of defense expenditures by 40 billion euros from 2003 to 2008 (or 2.3 percent of GDP) when he stood for re-election in the spring of 2002, a policy subsequently adopted by the French government. The call for increased defense expenditures was linked to concrete projects, notably the order of a second aircraft carrier, the re-emphasis of the importance of atomic weapons and the nuclear retaliation shield (*Loi de programmation militaire 2002*, which increased military spending), and the reaffirmation of the French nuclear doctrine in January 2006. Also, since 2002, France has been moving from conscription towards the goal of a fully professional army which is to be operational in 2008. This new professional force is supposed to be better equipped to face new threats and should be able to participate fully in and lead European out-of-area military operations. The *Loi de la Programmation Militaire 2003–2008* provides for this transformation with annual increases in military spending and a growing share devoted to procurement.

Despite budgetary figures, which were in even stronger breach of the budgetary targets set out in the Stability and Growth Pact controlling deficits in the EMU countries, national debates on defense expenditures were almost not concerned with these external budgetary constraints. France made an effort to curb the national deficit by freezing public expenditure in real terms in 2002/2004—but explicitly excluded defense expenditures (and development aid, apart from Justice and Home Affairs and Research and Development) from the overall rule to freeze expenses in all policy fields. The country even went further in requesting the fellow member

¹³ Speech of the Federal Minister of Defense, Dr. Franz Josef Jung, on June 21, 2006 at the occasion of the general debate in the Bundestag on the Federal Budget, to be found on the website of the Federal Ministry of Defence: <http://www.bmvg.de>.

governments of the EU and EMU to exclude defense expenditure from the 3 percent deficit threshold of the Stability and Growth Pact. In that context, the French Minister of Defense, Michèle Alliot-Marie also tried to convince the EU partners to use the military economy as a driving force for economic growth, arguing that higher defense budgets would give the EU the then strongly needed growth impetus.¹⁴ However, this position was not shared by France's partners, so France was not able to get these points acknowledged when the Stability and Growth Pact was reformed in 2004/2005.

Outlook

Given the tight budget constraints and the continuous absence of a truly strategic debate on the EU's and the EU member states future roles in international security policy and globalizing and increasingly flexible alliances, it is unrealistic to assume that EU member states increase their defense budgets considerably in the near future. Despite the increased expectations of the citizens, there are no indications of public support for increased defense spending, and at least from the two country examples briefly treated here, no political leadership on this issue can be discerned. However, new missions, tensions in transatlantic cooperation and a public demand for independent and effective European action will put pressure on the governments to re-think their activities. Given the demand for a European defense capacity formulated by public opinion and the political objectives defined in various documents and contexts, the only adequate level to improve abilities seems to be the European level.

There is indeed a potential for the EU member countries to spend "better," instead of spending more. Discussions have long circled around the question of how to fight duplication and the fragmentation of defense spending. With only 25 percent spent on research and development, the EU has a low share of funds going into these activities. Pooling them would make a lot of sense, especially given the necessity to enhance and upgrade capacities in terms of strategic airlift, satellite surveillance, smart weapons etc. Moreover, it should be a prime objective to enhance interoperability, not only in the EU, but also in the context of NATO. Finally, although highly sensitive and symbolic for the national sovereignty of member states, the European armaments industry should be consolidated on an EU scale and the role of the European Defence Agency should be improved to ensure a European procurement policy for military hardware and the creation of a single EU defense market. This would involve a division of labor not only along different categories of military hardware, but also between defense R&D and production across countries.

Overall, the member states should develop their readiness to investigate cooperation, pooling of resources and the need for specialization in the

¹⁴ K. Bennhold, "A French call for the EU to raise military outlays," *International Herald Tribune*, June 10, 2005, <http://www.iht.com/articles/2005/06/09/news/defense.php>.

EU, but not necessarily in a transatlantic perspective. The crisis over Iraq and the related re-definition of the U.S. security strategy and U.S. cooperation with its allies (notably in Europe and the Asian-Pacific region) has left the EU (public opinion and its politicians) less certain of its Atlantic pillar and more oriented towards its European partners in its foreign and security policy orientation. The EU has reached a decisive point, at which it will have to decide whether it puts considerable efforts into the attempt to make its own military policy more effective, modern and independent, so as to become a stronger and more constructive partner for the U.S. and other allies in the pursuit of strategies for global security, or whether it decides to remain more passive, and stay in the role of the junior partner to the United States, knowing the U.S. already seeks new partnerships and may eventually lose interest in cooperating with the European Union member states.

Redressing the World's Imbalance? European Public Discourses and the Prospects for Transatlantic Burden-sharing

Reinhard Wolf

Nobody would deny that the United States' relationship with the rest of the world has become unbalanced in many respects: On the one hand, America has probably turned into the most dominant power the world has ever seen. Due to its clear technological superiority and its huge defense expenditures, American military power is unrivalled today and could remain so for a long time to come. With defense expenditures almost as large as those of the rest of the world combined, the United States may indeed be regarded as a "hyper power," which largely determines the global security order.¹ With the deepest financial market and the most important international currency the U.S. also is the paramount actor in the world of international finance. On the other hand, the American economy has become highly dependent on other nations and thus increasingly vulnerable to decisions taken by foreign investors and their governments. Both the ever rising current account imbalance and the soaring public debt are increasingly financed by Asian countries whose longer term interests and concerns need not match those of Wall Street or Washington.

Indeed, if current economic trends were to continue unabated, a major adjustment crisis seems all but inevitable.² Sooner or later, foreign investors will lose confidence in the dollar and start to rush for the exit. With treasury bonds dumped on the market interest rates will jump, causing a major recession in the U.S. and probably the world beyond. Apart from America itself, the crisis would especially hit those economies whose exports to the U.S. would be simultaneously crippled by an American recession and the falling dollar. The resulting economic upheaval would probably be exacerbated by a sudden decline in U.S. political leadership. Given past experiences with similar crises it is to be expected that Washington would reduce its defense and foreign expenditures and would follow a more inward looking and selfish foreign policy approach. This would destabilize the economic and security order at the same time, with dire consequences for almost every nation on the globe.

In light of these risks, it seems obvious that correcting these economic imbalances by way of a "soft landing" is in almost everybody's interest and that Europe in particular should adjust its policies to that effect. A more dynamic European economy would gradually attract more imports and capital inflows. It would thereby tend to alleviate the burdens and risks

¹ According to SIPRI, in 2004 the U.S. spent 47 percent of the world's total military expenditures (based on exchange rates). See "Recent trends in military expenditures," http://www.sipri.org/contents/milap/milex/mex_trends.html; accessed May 6, 2006.

² Jeffrey Frankel, "Could the Twin Deficits Jeopardize US Hegemony?," *Journal of Policy Modeling* (forthcoming special issue).

that accompany the United States' role as prime destination for emerging economies' exports of goods and capital. However, since its Lisbon summit in 2000 the EU is struggling to become the most dynamic region in the world with rather mixed results up to now.³ Therefore, it appears only natural to call upon the EU to engage in burden sharing efforts by offering more support to U.S. efforts aimed at stabilizing the global security order. In doing so, the Europeans could help to reduce both the fiscal burdens caused by high U.S. defense expenditures and the prospects for political backlashes resulting from American perceptions of an EU "free ride" on America's provision of global order.

Yet, as I shall argue in this chapter, the near-term prospects for this kind of transatlantic burden sharing seem rather bleak. For several reasons European tax payers are very unlikely to finance a greater contribution to common efforts aimed at stabilizing the current international order. Three factors stand out in this regard: First of all, today's European publics are preoccupied with economic and internal issues. Hence they seem unwilling to increase spending on the military or on foreign policy. Second, Europeans favor a looser transatlantic relationship as they have come to see U.S. global policies as exacerbating global problems instead of solving them. Finally, Europeans would hardly be prepared to help Americans cope with deficits that appear to them to result from "tax cuts for the rich" as much as from ambitious (if not to say "adventurous") global policies. In light of these perceptions European leaders calling for this kind of burden sharing would face an uphill battle with their electorates and thus confront severe risks at the ballot box. In order to secure the necessary support for these expenditures, decision makers on both sides of the Atlantic first would have to return to traditional habits of policy coordination. Only when European electorates develop a stronger sense of "ownership" with regard to current world order policies will they come to favor increased contributions for common transatlantic efforts.

Security and Defense are Low on the European Priority List

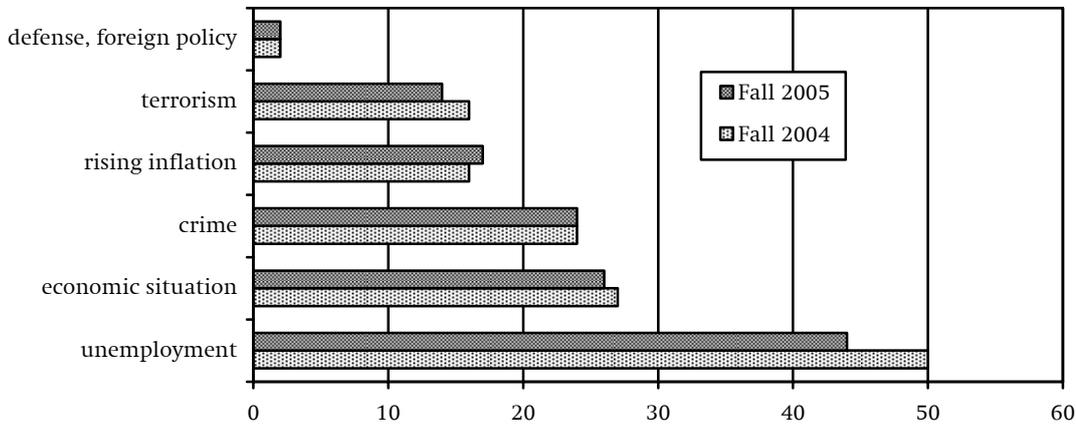
In general, judging by recent polls, Europeans will hardly appreciate government efforts to increase external expenditures, particularly additional outlays for the military. When Eurobarometer asked Europeans in the fall of 2005 about the two most important problems their country faces, external concerns were clearly eclipsed by domestic and economic issues. While only 2 percent chose defense and foreign affairs as one of their prime concerns, 44 percent mentioned unemployment and 26 percent the overall economic situation (Figure 1).

Data from the German Marshall Fund surveys support this priority for domestic and economic questions. Asked what would most influence their vote in the next national election, again most respondents pointed to

³ *Die Herausforderung annehmen. Die Lissabon-Strategie für Wachstum und Beschäftigung*, Bericht der Hochrangigen Sachverständigengruppe unter Vorsitz von Wim Kok, November 2004.

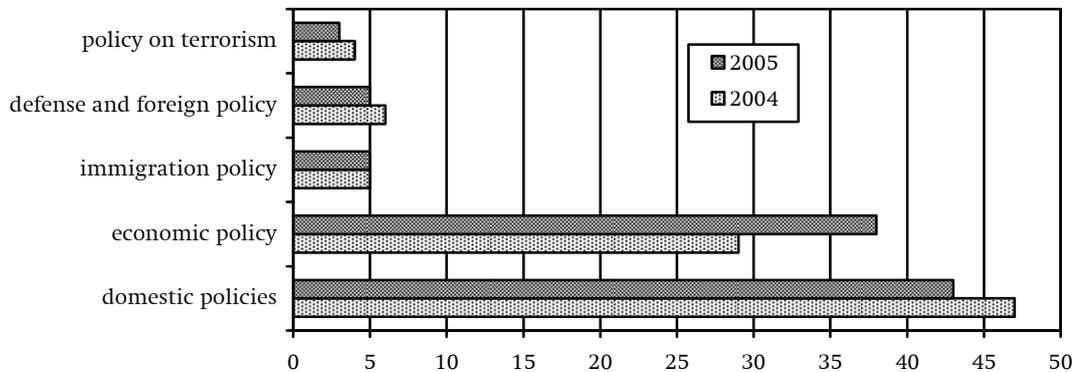
economic and domestic issues (Figure 2). Answers in both the Eurobarometer and German Marshall fund surveys hardly shifted from the preceding year, suggesting that these priorities are quite stable.

Figure 1
The Two Most Important Political Issues



Source: Eurobarometer EB 64, p. 9 (figures relate to the overall average of the EU-25).

Figure 2
Most Important Issue for Personal Vote



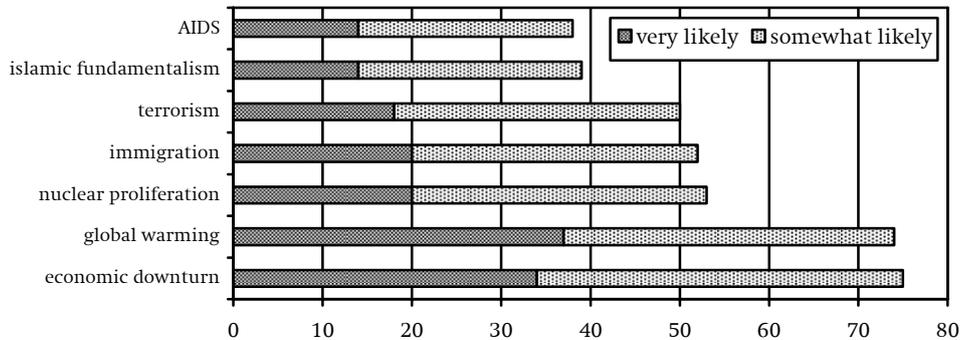
Source: Transatlantic Trends 2005, Top Line Data, German version, p. 66 (figures relate to the average of the EU-7, that is Britain, France, Germany, Italy, the Netherlands, Poland and Portugal).

This order of priority is well in line with European threat perceptions. When asked to what extent a given threat seems likely to affect personal security over the next decade, economic and environmental concerns topped the list (Figure 3, p. 98).

In Europe's biggest economy this contrast between perceived personal risks is even more striking. Interrogated about their personal threat perceptions, almost 60 percent of Germans felt threatened by economic and

social risks, whereas 14 percent felt threatened by an armed attack on Germany, 25 percent by a terrorist attack and 29 percent by weapons of mass destruction and by wars in general.⁴

Figure 3
International Threat Most likely to Affect Oneself



Source: *Transatlantic Trends 2005, Top Line Data*, German version, pp. 22–28.

In light of these priorities it is hardly surprising that Europeans do not support higher EU defense expenditures. Only 40 percent in the EU-7 countries would support a stronger European military if this would require higher defense expenditures, whereas 58 percent would oppose such a shift. This discrepancy is even larger if one looks only at those who have strong opinions about this issue: While only 11 percent strongly support greater military outlays 25 percent strongly oppose them.⁵

Overall then it is more than obvious that European politicians would need to embark on concerted efforts to change their publics' preferences before they could propose higher expenditures for foreign and defense purposes.

Europeans Do Not Favour Support for U.S. Global Policies

Yet, as things stand now, it would be even more difficult to gain European voters' support for spending increases by appealing to the need to support U.S. global policies. Over the last couple of years many polls have indicated that European electorates have increasingly come to question the value of Washington's international leadership. For example, data from the German Marshall Fund's Transatlantic Trends project show a steep decline in the numbers of those Europeans who deem strong U.S. leadership in international politics desirable (Figure 4).

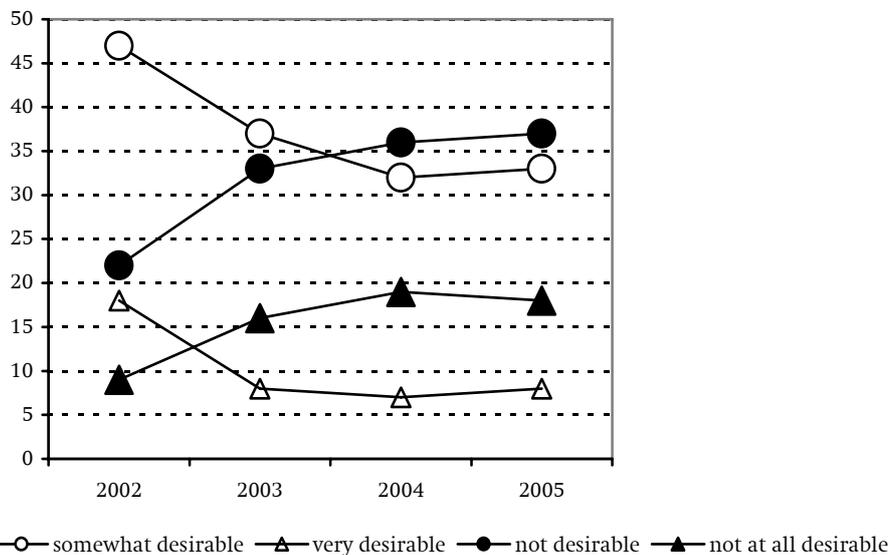
This skepticism towards U.S. foreign policy seems to be due to both its substance and approach. In terms of substance, Europeans question the

⁴ Thomas Bulmahn, *Bevölkerungsumfrage 2005: repräsentative Befragung zum sicherheits- und verteidigungspolitischen Meinungsbild in Deutschland; Ergebnisbericht*, Strausberg: Sozialwissenschaftliches Institut der Bundeswehr, 2005, pp. 3–5.

⁵ *Transatlantic Trends 2005, Top Line Data*, German version, p. 10.

positive impact of Washington's policies on the state of the world. According to a recent poll conducted for the Pew Global Attitudes Project, 74 percent of the French, 60 percent of both Britons and Italians, and 47 percent of the Germans supported the notion that the United States does not solve the world's problems.⁶ Even more striking, a majority of Europeans (53 percent) thinks that American policies have a negative impact on world peace while almost two thirds of them (63 percent) see the EU's respective role in a positive light.⁷ In the three major continental economies negative views clearly outnumber more positive assessments of the United States' impact on world peace (Figure 5, p. 100).

Figure 4
European Attitudes Concerning Strong U.S. Leadership



Source: Transatlantic Trends 2005, Top Line Data, German version, p. 4.

Given these perceptions, European voters would probably not appreciate demands for greater European contributions to U.S. global policies.

Consistent with this divergent assessment of European and American foreign policies, is the European impression that the United States does not pay much attention to the interests of other countries. In the more populous European nations clear majorities hold this unilateralist interpretation of U.S. decision making (Figure 6, p. 100).

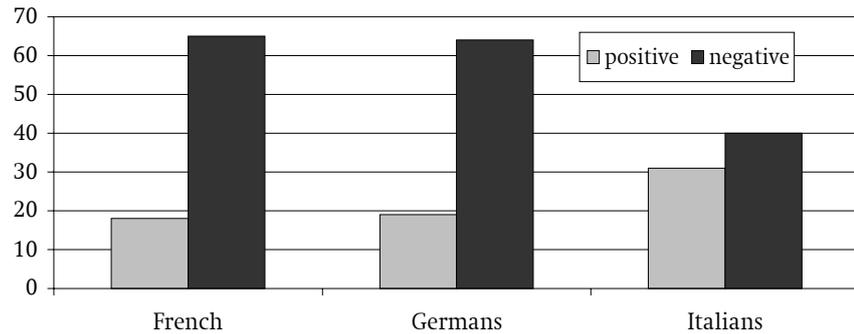
In light of these perceptions it is hardly surprising that a majority of Europeans oppose closer relations with the United States. While this attitude is by far strongest in France, it is true of all major European nations polled by the Pew researchers.⁸

⁶ Pew, *Trends 2005*, p. 113.

⁷ Eurobarometer 64, *Die öffentliche Meinung in der Europäischen Union*, Nationaler Bericht Deutschland, Herbst 2005, p. 27.

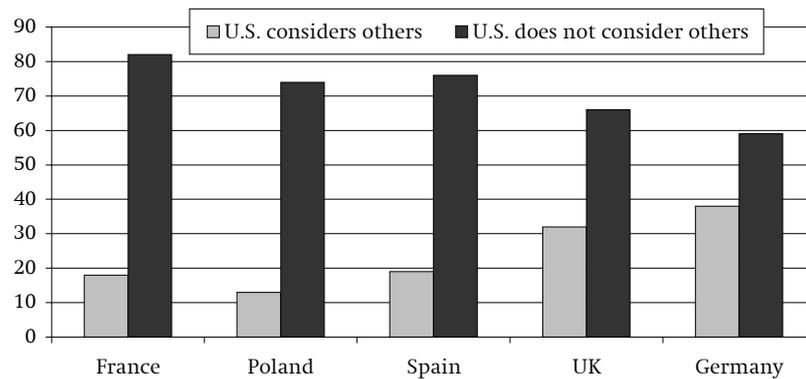
⁸ Pew Global Attitudes Project, *American Character*, p. 30.

Figure 5
Views on the Impact of U.S. Policies on World Peace



Source: Eurobarometer 64. *Die öffentliche Meinung in der Europäischen Union. Nationaler Bericht Deutschland, Herbst 2005*, p. 27; Eurobarometro 64. *Opinione pubblica nell'Unione Europea, Autunno 2005, Rapporto Nazionale Italia*, p. 38; Eurobarometre 64. *L'opinion publique dans l'Union Européenne. Automne 2004 (sic !), Rapport National France*, p. 46.

Figure 6
European Views on U.S. Consideration for other Countries Interests



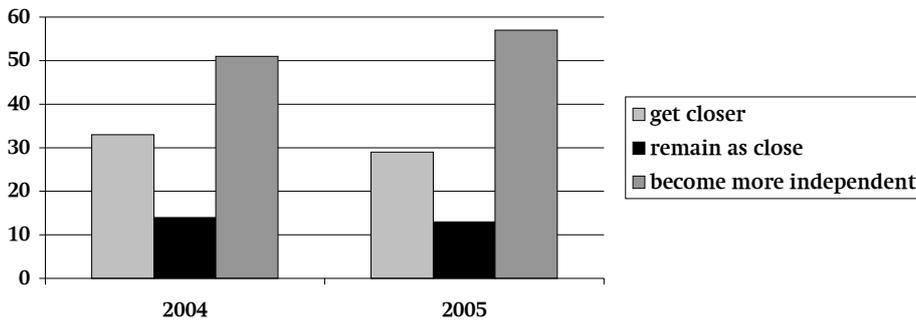
Source: Pew Global Attitudes Project, *American Character Gets Mixed Reviews. U.S. Image up Slightly, But Still Negative*, June 23rd 2005, p. 23. In France and Germany the negative views were even higher in 2004. See *Trends 2005*, p. 108. There were no data for Italy.

Once again this picture is supported by data gathered for the German Marshall Fund. According to its Transatlantic Trends figures, among the EU-7 countries, support for a more independent EU policy has even increased since 2004 (Figure 7).

This preference, however, should not be mistaken for an eagerness to see a complete rupture in transatlantic relations. True, Europeans have come to dislike unchecked U.S. predominance. In 2005, roughly two thirds of Western Europeans were in favor of some other power rivaling U.S. military power.⁹ This seems well in line with earlier polls which had examined European views about preferred roles for the EU in global

⁹ Pew Global Attitudes Project, *American Character*, p. 30.

Figure 7
Preferences for Evolution of European Relations with US



Source: *Transatlantic Trends 2005, Top Line Data*, German version, p. 38.

politics. When asked in 2002 if they prefer (a) the EU to become a superpower over (b) the U.S. remaining the only superpower an overwhelming majority (65 percent versus 14 percent) answered in the affirmative. By 2005 even 70 percent supported this vision. However, even among European respondents favoring such a development only a tiny part would want a European superpower to compete with the U.S. Roughly four in five Europeans want an EU superpower chiefly for improving cooperation with the United States! Moreover, as indicated above, the data also reveal that many proponents of such a role would shy away from the increased defense spending it would require.¹⁰ Apparently, Europeans do not want the EU to become the United States' military rival. And they are even less inclined to see an emerging China adopt this role: Solid opposition to such a vision of bipolarity ranges from 71 percent among Britons and French to 82 percent among Germans.¹¹ It seems that Europeans dislike the idea of American supremacy in the abstract, but still prefer U.S. hegemony—even in its current form—to any bipolar military competition. Clearly, Europeans want a greater voice and more respect for European views in transatlantic policy debates. But they definitely shy away from an independent role in security if this were to put the EU against the United States.

Yet in spite of this European ambivalence about the prospects for great power competition, the polling data do not augur well for political efforts to step up European support of U.S. global leadership—to put it mildly. Large majorities in all major societies apparently oppose not only U.S. leadership but also current U.S. policies and the idea of closer transatlantic relations. Moreover, they strongly doubt that decision makers in Washington pay enough attention to foreign interest. While it is true that European skepticism concerning American foreign policy is strongly related to widespread dislike of the current president,¹² sympathies for the United

¹⁰ *Transatlantic Trends 2005, Top Line Data*, German version, pp. 6, 8, 9; Chicago Council on Foreign Relations/German Marshall Fund of the United States, *World Views 2002*, pp. 15–16.

¹¹ Pew Global Attitudes Project, *American Character*, p. 33.

¹² *Ibid.*, p. 16.

States itself and the American people have also declined since 2001.¹³ Moreover, even stronger support for U.S. leadership and specific U.S. policies would not automatically result in greater support for transatlantic burden sharing. Given European preferences for domestic issues (and thus domestic spending) the electorates first would have to be persuaded that greater foreign contributions are a *sine qua non* for continued U.S. efforts aimed at stabilizing the global order. And this view, too, would be hard to sell to European constituencies.

Europeans Would Be Reluctant to Alleviate the Burden for U.S. Tax Payers

Convincing European tax payers of the necessity of helping address the U.S. deficits would be difficult for at least two reasons. For one thing, notwithstanding their preference for the "European social model," Europeans continue to deem the U.S. economy more capable than the European economy. They thus stick to the view that the former can deliver a higher standard of living than its European counterpart.¹⁴ Therefore, on top of all other obstacles to greater support for the U.S., it would not be easy to gain European acquiescence in what would be seen as a redistribution favoring the already more affluent people across the Atlantic. Moreover, during such a debate it would hardly go unnoticed that the twin deficit did not only result from U.S. efforts to stabilize the international order. Consequently, any European politician calling for greater burden sharing would be highly vulnerable to the charge that he or she in fact demands European sacrifices in order to sustain American tax cuts that have increased both American trade deficits and standards of living. It requires little imagination to picture left of center politicians denouncing any such efforts as jeopardizing the European safety net for the mere reason that U.S. political elites are unwilling to revise the Bush administration's tax cuts for the rich. Therefore, for the foreseeable future explicit proposals for greater burden sharing would entail electoral risks few European politicians would like to incur.

The Way Ahead: Some Not So New Proposals

Given this state of affairs, it seems obvious that realistic plans to increase the European support for U.S. global policies presuppose a significant shift in the European public discourse. Decision makers can only promote greater burden sharing after they have carefully prepared their publics for such a move. In particular, European tax payers would need to improve their image of the U.S. and its global policies before they can be expected to support greater expenditures for common policies.

¹³ Ibid., pp. 1, 20; see also *Transatlantic Trends 2005, Top Line Data*, German version, p. 33.

¹⁴ Eurobarometer 64, *Die öffentliche Meinung in der Europäischen Union*, p. 28.

The best way to promote future burden sharing appears to be a renewed transatlantic bargain which would demand closer consultation from the U.S. administration in return for more European loyalty to American leadership once an issue has been decided. If the U.S. wants to improve its image among European electorates it cannot avoid granting European governments once again more influence on the American decision-making process. As indicated by the publics' view on a potential European super-power, Europeans do not want to confront the United States. Yet they want a more powerful EU that can resist the unilateralist tendencies European publics (and their leaders for that matter) notice in Washington.

For American decision makers such a bargain may not look too attractive as long as the European allies will not step up their material contributions to U.S. global policies. However, it would be wrong to ignore the intangible returns Washington would receive. First of all, such a deal would prevent European leaders from undermining U.S. influence by publicly criticizing U.S. initiatives which had been properly discussed and developed with an eye to European preferences. European governments could not openly deny their shared responsibility for these policies. Second, European governments and their constituents would more likely develop a sense of "ownership" in agreed policies which, in turn, should enhance both public, diplomatic and material support. Finally, if common Western policies were gradually to replace unilateral U.S. initiatives in regard to major world problems this would surely help redress growing Anti-Americanism in Europe and beyond. In fact, given the steep decline of the American image around the globe,¹⁵ an effective U.S. diplomacy seems to depend more than ever on the public backing of fellow democracies, as their greater credibility might reduce foreign hostility to Washington's policies.¹⁶ And ultimately, a viable world order must rest on the consent of the majority of those affected. Otherwise, it will become too expensive for the hegemon to hold it up. In that sense, making U.S. approaches look more legitimate may be the best short-term method to lower the price tag for American efforts to stabilize the global order.

In addition, the European allies could also lower the American burden by providing more manpower for peace-keeping and nation building. In the past, a division of labor that left the fighting to the Americans and the post-conflict stabilization to the Europeans was deemed unacceptable beyond the Atlantic. Americans did not appreciate the idea that their soldiers would be sent into harm's way while their allies would confine themselves to escorting children to kindergarten. However, as the Iraq invasion should have made clear by now, post-conflict stabilization often is just as risky and burdensome as forcible entry. And the United States could use more manpower support for such missions because Americans do not

¹⁵ *Trends 2005*, chap. 7.

¹⁶ In 2005, across the globe favorable ratings for the U.S. clearly trailed those for France, Germany and Japan. Only in India and the U.S. itself was the latter more popular than the other three democracies (the one exception being Japan's lower ratings in China). Pew, *American Character*, p. 11.

like long military engagements in Third World countries. America has a tradition of bringing its victorious soldiers back home as soon as possible. "Americans, following a battle, want nothing more than to return home," president Bush rightly claimed in his notorious "mission accomplished" speech on board the USS Abraham Lincoln. If it is an empire, it truly is "an empire without imperialists."¹⁷ Its capital intensive approach needs to be complemented with foreign manpower.

From a European point of view, greater contribution of personnel for peace-keeping and nation building would be more acceptable and at the same time would strengthen European claims for a greater say in the decisions on combat operations. It would be more acceptable because the EU has developed a certain tradition in civilian nation building activities in former Yugoslavia and because European publics habitually prefer these operations to combat missions. And it would enhance the justification for closer consultations with U.S. decision makers since the Europeans can hardly be expected to shoulder a greater part of the post-conflict operations if they had been denied proper influence on the beginnings of such an operation. American analyst David Yost once quipped about European ideas to embark on EU missions without preceding NATO consultations: "If the Americans are supposed to take part in a crash landing they also should be involved in the decision for take-off."¹⁸ Europeans can rightly expect the same treatment when they are supposed to make significant contributions in the later stages of an intervention.

True, the proposed approach is hardly original. And it has been ignored or rejected over the last couple of years. It runs counter to "the mission defines the coalition" rhetoric and stands in clear contradiction to the Bush administration's early concepts of the global role of the United States. Yet since then, political elites in Washington have come to realize both the importance and costs of nation building operations and the costs of America's declining reputation. And ultimately this approach may be the only path to prepare the way for significantly enhanced material contributions from the European allies.

¹⁷ See Niall Fergusson, *Colossus. The Rise and Fall of the American Empire*, London 2004, chap. 6 (the quotes are on pp. 203 and 213).

¹⁸ David S. Yost, "France and West European Defense Identity," *Survival*, 33 (July/August 1991), p. 342.

Conclusion: Forging a Transatlantic Consensus on Economic Burden-sharing

Jens van Scherpenberg

In the last five years, thanks to huge capital inflows from private as well as official foreign sources, the U.S. has been able to finance its ever growing global security commitments and military operations while at the same time stimulating the domestic economy through huge budget deficits and high domestic consumption driven by low domestic interest rates. This implicit burden sharing arrangement, working through international capital markets, may continue for some more time. But it is unlikely to last. Therefore, we should prepare to face the consequences, and mitigate the impact, of its breakdown.

That however, raises some questions. First, who is “we”? Second, what might be the consequences of a breakdown of the current international economic burden sharing arrangement? And third, what can be done to prevent it from happening?

The Atlantic partners—the U.S. and Canada on the one side, the EU and, in particular, the European NATO members, on the other side—clearly are the main actors in fostering global security and stability, with the U.S. taking the dominant position among them. At the same time, the Atlantic economic area continues to be the main hub and center of gravity of the world economy. The U.S. and the EU are the biggest exporters and importers of goods and services; their financial markets are the most developed and sophisticated; moreover, they are home to the two major international reserve currencies, the U.S. dollar and the euro. All of this, however, does not yet constitute the “we”-factor, that common political as well as socio-cultural identity known as “the West.” This project has tacitly assumed that “the West” still exists and that it will continue to be a shaping factor of global order—a bold assumption perhaps,¹ but a pragmatic one so far. When push comes to shove, there is but the Europeans—plus Canada, Australia and Japan—to share the burden with the U.S. These are the countries who have the greatest stake in a rule-based world economy that relies on individual liberty, on the respect of property rights, on open markets and on the safety of international transactions.

This chapter focuses on the rising awareness of problems to come and on the scope for a new and wider Atlantic burden-sharing consensus that makes sensible use of the economic, political and military resources available in the Atlantic community as a whole. In the Atlantic Alliance, the notion of burden-sharing has traditionally been used in a rather narrow sense, such as sharing the financial and human resources burden of for-

¹ Cp. Jeffrey J. Anderson, G. John Ikenberry, and Thomas Risse (eds.), *The End of the West? Exploring the Deep Structure of the Transatlantic Order*, Ithaca, NY: Cornell University Press, forthcoming.

ward deployment of military forces, of war-fighting and peace-keeping operations, etc. This narrow meaning remains valid, as current discussions among allies on military deployment in Afghanistan demonstrate. It should, however, be complemented by a more comprehensive understanding based on the economic term of public goods.

Public goods by definition are goods (or services) that have major benefits for an economy as such, but which will not be produced by private actors since by their very nature nobody can be excluded from enjoying their benefits, hence nobody will pay for them. Examples include domestic and external security, rule of law, and a stable monetary order. Since their production costs, therefore, cannot be recovered in the marketplace, the state will step in and take care of their provision, funding the production costs by way of its authority of taxation. In the international arena, however, no institutional power to tax exists. Therefore, such international or global public goods will only be provided if all or a significant part of beneficiaries agree to share their costs, or if their provider gains sufficient benefits for himself so as to tolerate free-riding by others.

A New Atlantic Burden-sharing Consensus – Rising from the Ashes of Western Cold-War Burden sharing?

With regard to the public good of international security, in the two decades after World War II the U.S. probably enjoyed the best of both alternatives: it gained most from the Western security order centered around the North Atlantic Alliance, which it had established. And among its NATO partners, a basic understanding of burden sharing related to defense became accepted that more or less persisted as long as the security threat from the Soviet Union did. It did show some cracks during the Vietnam War and the economic strains the latter had put on the U.S. economy, leading to the breakdown of the Bretton Woods system. But the fundamental security alliance remained intact, due to the persisting common threat. Nevertheless, the factors that strained the consensus brought the burden sharing debate to a higher level. The Group of Seven (G7) major industrial democracies was constituted in 1975, initially to deal with macroeconomic policy coordination and other international economic and financial issues.

Economic policy coordination between 1978 and 1987, which culminated during the Reagan presidency with the Plaza and Louvre agreements of 1985 and 1987 to manage the dollar exchange rate, not only marked a high point of such Western economic burden sharing, but also the last time it did happen at all.²

One more significant instance of burden sharing did occur, however. This instance resulted in a singular spike into positive territory in the long-term times series of the U.S. current account balance: The substantial

² Cf. C. Randall Henning, "Global Economic Adjustment, the Euro Area and the United States," in: Simon Serfaty (Pub.), *Visions of the Atlantic. The United States, the European Union, and Nato*, Washington, DC: Center for Strategic and International Studies, 2005 (Significant Issues Series, Vol. 27, No. 8), pp. 152–169.

financial contributions to the U.S. budget by Germany and Japan, together with Arab Gulf States, to support the UN-mandated first Gulf war to drive Iraq out of Kuwait.

Since the 1990s, Europe has become much less attractive to the United States as a partner in sharing the burden of maintaining international security and stability. But then, that burden declined significantly in the 1990s, while at the same time a very substantial part of the economic benefits of growing international trade and investment during the “decade of globalization” accrued to the U.S. economy, while the economies of major continental European countries as well as the Japanese economy stagnated.

That outcome silenced those who used to complain about European “free-riding” on the public good of “global security” provided by the U.S. at great expense. But as a result, the value to the U.S. of its European allies and of any European burden sharing declined significantly, as did, consequently, European political influence on U.S. foreign and security policies.

This became evident as the American war on terrorism and, in particular, the Iraq war unfolded.

Since then things have changed. An economically non-performing Europe seems to have become at least as irritating to the United States as an economically strong Europe, free-riding under the U.S. security umbrella, used to be. That alone merits highlighting today. If the U.S. and the EU were just competing economic powers, the U.S. should not and would not be concerned with European underperformance but would regard it as a competitive opportunity to reclaim lost markets—just as Boeing enjoys the competitive advantage from the current woes of Airbus. However, while such sentiment may well exist on the political level, a stronger international security role by Europe, be it through NATO or through EU endeavors, is becoming increasingly desirable to the U.S., not only to convey greater legitimacy, but for economic and budgetary reasons as well.

As to European countries—and Germany in particular—they have come to reassess their economic performance in the light of their waning foreign policy impact. For Germany as the linchpin of European economies, the combination of a dynamic domestic economy with a growing standard of living, highly competitive exports and a strong currency in international demand, used to be a core ingredient of its foreign policy influence within the European Union, among the G-7 countries as well as on the wider international scene. And Germany is just now slowly regaining some of its foreign policy clout lost during years of stagnation and inward orientation.

Indeed, public awareness has been growing in many European countries in recent years that pro-growth economic policies require redressing public expenditures in non-core public activities—activities, which can be taken over at least as efficiently by private actors—concentrating instead on the state’s core activities of providing public goods. Foreign policy and defense expenditure clearly belong to the latter category. Throughout Europe, most notably in Germany, due to its costly unification policies, the

post-Cold-War decade brought about a reallocation of budgets from foreign policy and defense budgets to redistributive and entitlement expenditure. This neither contributed to a more effective foreign and security policy nor, indeed, did it foster economic growth—to the contrary.

The very linkage on which this project has focused has been an explicit driving force of the rather bold (measured against German experiences during the last decades) economic and social reform policies in Germany, which the Schröder government initiated in early 2003, in close—and, indeed, quite explicit—conjunction to the strong foreign policy stand it took against the U.S. government's Iraq policy.

Currently, the European economies, for once led by Germany again, are experiencing an economic rebound that may in part represent the fruits of reform policy endeavors. Moreover, their healthier growth rates have become much less dependent on U.S. import demand and hence, more resilient to any depreciation of the U.S. dollar.

On the other hand, the U.S. economy is showing signs of weakness. Currently, the view is still widespread especially in the U.S. itself that the U.S. economy can continue to rely on importing global savings and thus can continue to supply both guns, for its global role, and butter, for its consumers. Whether this will remain so for the foreseeable future, or whether the signs of weakening growth in fact signal a coming adjustment crisis resulting from its ever growing current account deficit, or from a bursting of an alleged housing market bubble, remains very much a matter of debate, as reflected in the contributions to this volume. Some warning lights, however, have started flashing recently, not least among them the slide into negative territory of the U.S. balance of capital income in the course of 2006, a figure the resilience of which so far has been considered one of the major indicators of an ongoing sustainability of the U.S. current account.³

On both sides of the Atlantic it would be sound policy, therefore, to prepare for the eventuality of a less than optimal outcome, if not for the worst case of a major adjustment crisis and ensuing recession in the U.S. What if the world's—not least Europe's—surplus savings currently flowing into the American financial market dries up, due either to an economic slowdown, or alternatively due to growing investment opportunities at home or in other regions of the world that offer a more favorable risk-reward ratio than the U.S. financial market?

In such a scenario, the U.S. would inevitably increase pressure on others to take up a greater share of the economic burden of global security and stability, by providing more military, more civilian peace keeping and more financial resources to this task. And that pressure will likely not be directed at major surplus countries such as China, the Arab oil producers, Venezuela or Russia. It will be brought to bear on Europe—and rightly so.

³ Cf. Katharina Plück and Catherine L. Mann, "The United States as Net Debtor: How Much Longer the 'Exorbitant Privilege'?", in this volume, p. 35.

Essentially, except for Canada, Australia and perhaps Japan, it is the European countries who attribute the same value as the United States to maintaining a liberal, open and rules-based world economy with functioning markets, reliable transactions and guaranteed property rights, founded in societies that respect basic human rights.

Which Kind of Atlantic Economic Burden-sharing for the Future?

The current situation of a high and growing U.S. current account deficit explicitly financed by mostly Asian central banks in order to prevent their own exchange rates from rising against the dollar has been likened to the Bretton Woods system, being dubbed a “revived Bretton Woods” system or “Bretton Woods II.”⁴ The comparison obviously misses the political dimension of the original Bretton Woods system, which had been a core element of the political and economic world order created by America for its own benefit and for that of such other countries as adhered to its system. As such, it was part of the original system by which the U.S. ensured that it could recoup the costs of providing the international public good of a stable and vigorous environment for the world economy after World War II. The system was discarded when it didn’t serve that purpose anymore. The current macroeconomic arrangement involving oil exporters, China and other Asian surplus countries, as well as the EU, is not explicitly based on any such systemic benefit encompassing the political and security dimension of world order.

If the current regime is not sustainable, what burden sharing regime might replace it? Clearly, America’s allies, primarily Europe and Japan, would have to step in on America’s side in co-providing the global public good of international security and stability of which they are co-profiting, thus bearing a much higher share of its costs.

In this not altogether unlikely case, we will face a new, much tougher, much more explicit burden sharing debate within the alliance—focusing on spending for defense and international security, but also on sharing the costs of adjustment that arise from redressing the global economic imbalances.

When we are talking about global order, three broad, if simplified, concepts of order come to mind as possible, each resulting in a different division of labor and hence sharing of burdens.

► First, the hegemonic order. In this scenario, the U.S., as the—more or less—benevolent hegemon essentially has the monopoly of power/force and accordingly takes care of global order, devoting considerable resources to the task. Other countries grudgingly acquiesce or gladly free ride—or both.

Foreign & security policy expenditure is very unevenly distributed around the world, mostly coming out of the U.S. budget. But the U.S.

⁴ Cf. Sebastian Dullien, “Who is Going to Foot the Bill? Economic Consequences of a Disorderly Dollar Adjustment for the United States, Europe and Asia,” in this volume, p. 22.

attempts to shape international economic and political order—goods markets, service markets, capital markets, and not least energy markets—in such a way as to be able to profit disproportionately, in order to recoup its costs of providing for global security. This is the model which we have seen in place for the last 15 years, but which may have recently begun to erode.

- ▶ Second, the multipolar order. In this scenario, several major actors will by themselves take care of their security interests with others falling in line.

A multipolar world would not necessarily have to result in an arms race spiral. But even if every country were ideally to devote no more than 2 or 3 percent of GDP to defense, the world would not necessarily be a safer place than it is today. Moreover, a multipolar world order, if an order it is, risks eroding the multilateral economic and financial institutions, notably the WTO but also the IMF and World Bank, to the benefit of regional spheres of influence. If this were to happen, the huge positive externalities generated by those multilateral institutions would be lost, resulting in a major loss of global wealth.

- ▶ Third, the multilateral order: This scenario involves a multipolar world characterized by strong multilateral institutions to whom the ultimate decision on the use of legitimate force is delegated.

While providing the environment for further prosperous development of the world economy, this concept would require a rather elaborate regime of burden sharing if sufficient forces and resources are to be available to sustain such a regime and its institutions.

Clearly the latter model seems to be the one favored among European politicians and voters alike. But would Europe be ready to assume the burden that comes with such a model of a more multilateral world order in which it has a greater say on shaping that order? The problems faced not least in Europe by the United Nations but also by NATO in getting enough troops and equipment to sustain and pursue their peace-keeping and peace-enforcing missions bear witness to how difficult it would be to make such a regime work.

Moreover, would Europe be willing to shoulder its share of the burden of maintaining strong and dynamic multilateral economic institutions and of preventing or mitigating a global macroeconomic adjustment crisis?

And which institution will be the place for such a wider burden sharing debate? Will it be NATO? Will it be the G7 (as in the Plaza and Louvre agreements of the late 1980s) or the G8? How will China, Russia and the major oil producers come into play? The G8, as it is today, looks like a highly unsuitable institution for such a debate. The institutional foundation for any such coordination process is weak, and the political rationale for any kind of “Plaza/Louvre II” is even weaker.

However, the bilateral dialogue between the U.S. and the EU, if given a higher profile and deeper institutional structure,⁵ could be the place of choice, possibly complementing a similar process within NATO that otherwise would most likely bear no fruit, due to lack of political support. The rebalancing of economic performance between Europe and the U.S., if it were to result in a more equal balance, would certainly help in bringing about such a strategic and results-oriented burden-sharing dialogue of the Atlantic partners.

“No Taxation without Representation” – and vice versa

When the Thirteen Colonies refused to be taxed by the British Empire without being represented in Parliament, they weren't driven by a desire, economically rational as it would have been, to free-ride on the “imperial public goods” such taxation was to pay for. They insisted on having their fair say in deciding on the provision of those public goods for which they were to be taxed. Obviously, with such representation of its colonies in Parliament, the British Empire would have ceased to be an empire at all.

Today, “no taxation without representation,” that fundamental anti-imperial principle, is a claim occasionally brought forward by Europeans, when asked by their American NATO ally to raise their defense expenditure and shoulder more of the burden to meet common international security challenges. But then, their claim is increasingly heeded in Washington, as demonstrated by the up-to-now common approach towards Iran, or the resolution of the recent Israeli-Lebanese conflict.

The flip side of the coin, however, will not remain hidden. No representation without taxation: In order to participate in shaping the future world security order, so as to bring their views to bear on how that order should evolve, America's European allies (as well as Japan) would have to substantially build up their own capabilities to become credible co-providers of the global public good of international security and stability of which they, as some of the world's major trading nations, are now profiting. This would require reallocating a substantially higher part of public resources to foreign and security policy.

Hence the urgent quest for refocusing the state on its core tasks, away from activities that instead hinder private economic initiative and stymie economic growth.

If the West is to remain a meaningful concept at all, Western countries will have to remain economically vibrant. They will have to remain technologically the most innovative, financially the most sophisticated, socially the most stable countries in order to set the standards along which world order will continue to evolve.

⁵ The scope for bilateral deeper institutional integration between the U.S. and the EU has been explored in detail in: Jens van Scherpenberg, *Integrating the Atlantic Economic Area*, Berlin: Stiftung Wissenschaft und Politik, October 2006 (SWP Research Paper 8/06).

About the Authors

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