Summary – Transatlantic Colloquium

Between Underperformance and Overstretch: Assessing the Politics of Economic Reform and the Economics of Foreign and Security Policy

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The first colloquium of the *Transatlantic Foreign Policy Discourse*'s (TFPD) working group on foreign and economic policy coordination focused on questions of international macroeconomic burden sharing: Does the current willingness of global partners to sustain or tolerate economic imbalances suggest that burdens are already shared? Do Europeans and Asians perceive the United States as providing an international good (security, a deep and vibrant market) for which they are paying a fair price? Will the American public continue to support the US's global role? Does the United States see Europe as doing its fair share? Participants tried to focus their discussions on two related issues: First, the challenge governments face in choosing between providing external security and domestic welfare; in other words, the guns and butter trade-off. And second, the challenge of defining international "burden sharing" in a wider sense. Discussions thus also focused on the costs and benefits of supplying global public goods that go beyond the provision of physical security, such as sharing the responsibility for global macroeconomic adjustment. Still, most discussions returned to one central theme: the accepted set-up in today's world. The United States provides global physical security, whereas Europe and Asia finance its debt at record-low interest rates.

First Session: Foreign & Security Policy Resource Requirements – How do the US and Europe Cope?

This current global consensus, wherein Asia and Europe willingly fund America's ever-growing current account deficit and the U.S. projects global military might in return appears stable in the short to medium term. With the United States increasingly relying on foreign savings for the financing of its excess consumption, one might think that the classical guns-versus-butter trade-off has gradually been displaced to an international level; that the United States' dependence on foreign capital has constrained or will eventually constrain its foreign policy options. None of the workshop participants saw evidence of such a constraint. The United States' increasing need for a sustained inflow of foreign capital has not prevented Reagan and now Bush from pursuing a decidedly unilateralist foreign policy. Furthermore, Russia, China and the EU do not seem to have the political will and have too much at stake economically to act as serious counterbalancing forces to US power.

The United States' technological advantage, its lead position at the forefront of the IT-revolution, its deep, vibrant, efficient and flexible financial market and its powerful consumers will continue to make the United States the world's most attractive destination for foreign capital – especially, if the European and Japanese economies continue to falter.

Participants did see some challenges to the current status quo, however. In a post-Katrina world, Americans might conclude that their country has spent too little on butter in recent years. The polity's willingness to support continued global engagement might suffer further, if another natural disaster or possible terrorist attack reveals that infrastructure in America's large cities is inadequate. Americans might also question their country's projection of power abroad if the trade-off posed to them is guns vs. medicine (affordable health-care, especially for an aging society). Working group members were most concerned by the emergence of protectionist sentiments in Congress. While these have been fairly contained so far – partly owing to the “Wal-Mart effect”, improved standards of living thanks to cheaper imports – protectionist pressures have risen in recent months, as evidenced by the “Schumer amendment” in the Senate [and now by Congressional reactions to Dubai Port World’s bid to take over management of several American ports].

Continued inflexible markets, lagging economies in Europe and Japan, and inefficient capital investments in China also pose challenges to the current global macroeconomic set-up. A possible resurgence of Great Power rivalries – a US standoff with Russia over oil in the Middle East and competition with China in Asia – also represent possible strains on the system. If these threats materialize one might see an economic crisis leading to a political crisis as in the 1930s or a geo-political crisis leading to global economic instability.

European working group members disputed use of the term “consensus” to describe the current global status quo. For Asia and especially China, the situation might not be as much about paying for physical protection from the United States, as about accumulating reserves to insure against a recurrence of financial crises in the region. For Europe, the term “consensus” implies that Europe both wants (and realizes that it benefits from) the security umbrella supplied by the United States. European publics probably do not perceive the United States as providing *security* but rather as spreading *insecurity* around the globe. Most Europeans probably do not think that they are “free-riding” on the US’s provision of global security but rather that they are confronted with US empire building.

The United States and Europe face the same set of challenges and their threat perceptions have converged in recent years: Common challenges in the economic realm result from economic integration and globalization; common security threats from an increasing “globalization of insecurity”. Both the United States’ and Europe’s national security strategies emphasize the threat of terrorism, nuclear proliferation and especially the intersection of the two.

But while the two security strategies may emphasize common threats, they clearly diverge over the means to be employed to counter these threats. For example, the two sides do not agree on how to allocate resources among “hard” and “soft” security tools, or on whether conflict resolution or conflict prevention should be an objective of their countries’ militaries. American leaders prefer employing hard tools – such as the “war against terror” – to fight “rogue states.” European leaders emphasize assistance for and stabilization of “failed states”. This difference in approaches is apparent in the public resources devoted to the military on both sides of the Atlantic.

There was some disagreement between participants as to whether Europe was in fact “free-riding” on US defense expenditures and force projection around the globe or whether Europeans’ approach to security was adequate. Some insisted that current spending levels (in Germany especially) were simply not enough to sustain necessary military transformation and to also reap the beneficial spillovers into the private sector that often accompanies public investment in the military. Others maintained that the European vision of and approach to security might be better suited to the new security environment than current US strategy. While, these participants too, believed that Europe needs to devote more resources to defense and should make an effort especially to rationalize defense expenditures and avoid duplication, these participants thought that the Union will eventually build up forces capable of projecting power into its immediate neighborhood and of engaging in types of humanitarian interventions that the US military would be reluctant to take on.

Still, regardless of participants' assessments of the adequacy of Europeans' defense expenditures, all agreed that the current global security set-up implied heavy costs on both sides: The United States has to live with the risk of macroeconomic imbalances eventually unwinding with a steep drop in the value of the dollar. The Europeans are sacrificing domestic consumption for their heavy dependence on exports.

Second Session: Public Goods, Public Finance and Structural Reform

Under Bush's watch, military spending increased by 45 percent, 10 percentage points more than during the Reagan years. But non-defense discretionary spending *also* grew by 28 percent since Bush took office (whereas discretionary spending *decreased* under Reagan). Working group members deemed it vital that the US contribute to the reduction of global imbalances by reducing its budget deficit. Since the country's lagging education system and infrastructure problems will continue to exert pressure on public coffers, US policy makers might consider broadening the tax base in an effort to avoid income tax hikes. In the long run, the United States will not be able to outgrow fiscal challenges with increases in productivity growth; entitlement reform will become unavoidable with exploding health care costs threatening the fiscal sustainability of the system already. Participants worried that a Bush successor will have to raise taxes eventually to control the budget. This will most likely hurt the flexible and efficient character of the American economy and endanger growth.

Competition from abroad is likely to put more intense pressure on the domestic economy in the future. America has to brace itself for the entry of 3 billion people onto the stage of the world economy. This means a renewed focus on the country's innovations systems and R&D as well as on the country's investment climate. As pointed out above, the US must shore up its education system if it does not want to grow increasingly dependent on foreign talent. A second Plaza Agreement might prevent its partners from currency manipulation and thus from engaging in unfair competition. Global engagement is necessary to ensure that the US's massive ties to the rest of the world's economy will not be disrupted by threats to global supply chains. For the sake of its own security, America should be aware of the growing discontent of those 2 billion people in the world who survive on less than $2 a day. In turn, if the public is to support a continued global role for the US, policy makers need to respond to the frustration and worries about wage pressures and growing inequalities at home.

Still, the US economy remains resilient: The country so far has gained tremendously from globalization. And today it enjoys huge competitive advantages from its role as the world's most efficient capital hub.

Excessive public spending and large and rising defense expenditures are not of pressing concern for the European economies. In fact, American working group participants noted that defense issues do not seem to be on the radar screen of European publics at all. And the prospects for a badly needed expansion of defense budgets are dim. In Germany, for example, increasing military spending is very unpopular with the public, a tax hike to finance such an increase is unadvisable given the country's high marginal tax rates, and government deficits are constrained by the EU's Growth and Stability Pact (SGP). The country's only option to boost its external expenditures is faster economic growth; and growth should be the German government's highest priority. Some did have more optimistic views on future German defense budgets (especially under the Merkel government) and also stressed the positive spillover effects that such spending will have on the German R&D sector and the rest of the country's economy.

Participants offered different explanations for the Eurozone's lackluster growth in recent years. Many of Europe's woes have to do with bad macroeconomic management, especially bad fiscal policy. The common currency allows less disciplined countries to free-ride on other country's more prudent fiscal policies and if the European Central Bank (ECB) has to hike interest rates as a result of excessive spending in part of the Union, other Euro-members suffer equally. Hence, Europeans often find themselves in an unwanted and sub-optimal economic situation that was not consciously decided or debated by anyone. This lag of legitimacy in macroeconomic policy making is especially problematic. One might recommend that Eurozone members adopt common fiscal policy guidelines. Macroeconomic uncertainty in Europe has been at a continually high level in recent years. Consequently, gross investment growth has been far below that of the United States and even stagnant for much of the 1990s, and economic growth has suffered. It is not surprising that, in the absence of a consistent monetary and fiscal policy mix, the burden of adjustment in the Eurozone rests squarely with the real sector.

Others doubted that the macroeconomic policy mix in Euroland is the main culprit behind Europe's sluggish economic performance. They recommended that policymakers focus on factors on the supply side that have worked against competition in Europe as well as on skewed incentives and inefficiencies in labor markets. American working group participants saw especially good prospects for financial services sector liberalization in Europe.

Third Session: Macroeconomic Imbalances and their Foreign Policy Implications

Several factors determine whether current macroeconomic imbalances will remain sustainable in the medium term. The introduction of the Euro has certainly added a set of challenges to the current set-up: The United States is set to lose international seigniorage advantages (estimated at some 0.16% of GDP) if the Euro becomes a serious contender to the dollar's dominant international position. As long as America's imports are invoiced in dollars, the country faces limited exchange rate risk – this may change if major exporters switch to the Euro for billing purposes. And if investors come to prefer euro assets, risk premiums on US bonds may rise. This could have serious consequences for the sustainability of the US's rising current account deficit.

This large current account deficit leaves the United States exposed on the financial side. Foreign ownership of US treasuries is on the rise and the United States Net International Investment Position (NIIP) stood at negative $2.5 trillion in 2004. The United States has always received positive net income flows despite this negative NIIP. But with foreigners investing a relatively large share in interest-bearing assets and with a probable rise in interest rates, even these income flows might easily turn negative in the near future. This would make the question of sustainability of the US's foreign debt and worries about a precipitous fall in the dollar loom larger.

Growing official holdings of US dollars might make for interesting developments going forward: Will foreign policy makers suddenly become interested in what has been the purview of central banks? What will happen if the Chinese decide to alter their portfolio? Would market disruption ensue or could such a decision be implemented in a negotiated way? Could there arise a situation in which Chinese reserve holdings were seen as a security problem? Reserve holdings only constitute a small share in international financial flows and Chinese dollar assets are actually much smaller than is often believed. But foreign central banks' decisions to diversify their portfolios and move away from dollar holdings might act as a trigger or tipping point in global financial markets. Private investors seem to have been fairly myopic throughout the build-up of current imbalances, as they continue to hold large amounts of US debt at record low rates of interest. A central bank decision to diversify might be a more forceful trigger than interest rates have been.

Still: American demographic and growth prospects look better than those of other industrialized countries in the long run. And foreign central banks would only be able to exert serious leverage on US policy if there was a realistic alternative to the US dollar. As of now, there does not seem to be one. The United States still enjoys the advantages that come with its role as monopoly provider of international security and liquidity.

In addition, the risks lie not only on the US side. The rest of the world depends on the United States for its exports. A drop in the value of the dollar would seriously hurt Asian Central banks' holdings. The United States, Europe and Asia find themselves in a co-dependency relationship, which no side has an incentive to abandon.

Conclusion – When Macroeconomic Policy Coordination Fails: Does Macroeconomic Burden Shifting Work?

Throughout post World War II history, international economic imbalances or looming currency crises in industrialized countries have been countered successfully by transatlantic macro-economic policy coordination and other transatlantic burden sharing mechanisms. Unfortunately, the constellation of countries' economic and foreign policy objectives today seems quite impervious to globally coordinated responses. Ways out of the current dilemma are thus less clear: Should there be a G-20 to steer the global macro-economy and is William R. Cline's suggestion for a new Plaza agreement a practicable solution? Such an agreement would require that all members accept the global security role of the United States or that the United States concede to play the role of a "normal" country within a multipolar or multilateral international regime. International summits focusing on broad policy consensus might be a more realistic way forward, the more so since a process of policy convergence might well be underway.

Barring any change in the current international consensus, the United States for now is indeed providing three public goods: security, a vibrant market and a stable reserve currency. If Europeans (and other players in the global economy) do not consider these public goods acceptable ones, they must present viable alternatives.