Summary – Transatlantic Colloquium

Sharing the growing economic burden of world order: How to strengthen the economic base of foreign and security policy in the Atlantic Alliance

Stiftung Wissenschaft und Politik, Berlin, May 11-12, 2006

This working group was established to bring together communities of experts who rarely interact with each other, economists and political scientists, to discuss transatlantic approaches to security and foreign policy as well as accompanying economic problems.
Main focus of the first meeting were questions of international macroeconomic burden sharing: Are burdens already shared? Do Europeans and Asians "pay" the US for an international good (security)? Will the American public continue to support the US's global role? Does the US see Europe as doing its fair share?
Two related issues were discussed: First, the challenge governments face in choosing between providing external security and domestic welfare. And second, the challenge of defining international "burden sharing" in a wider sense. Finally, the central theme of discussions was the accepted set-up in today's world: the US provide global physical security, whereas Europe and Asia finance its debt.
While all participants agreed that the current status quo seems stable at least for now, there was some disagreement on whether this status quo was truly stable in the long run and who would shoulder the burden should it unravel. Not surprisingly, the presentations and discussions during the second meeting were mainly concerned with the policies that might be adopted 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 was to diminish.

Foreign & Security Policy Resource Requirements – How do the US and Europe cope?

One might think that the US's increased dependence of foreign capital could constrain its foreign policy options. However, despite the US's increased need for foreign capital it has pursued a decidedly unilateralist foreign policy. Furthermore, Russia, China and the EU lack the political will and have too much at stake economically to act as counterbalancing forces.
Economically, the US's technological advantage, its efficient and flexible financial market and its powerful consumers will kept the US the world's most attractive destination for foreign capital.

The status-quo is challenged however. Katrina may lead the US to conclude that their country has not spent enough on butter in recent years, leading to decreased public support for global engagement especially if another natural disaster or terrorist attack were to occur. If trade-offs were framed differently (e.g. guns vs. medicine) the public might also question US global engagement. Main concern is the emergence of protectionist sentiments in Congress ("Schumer amendment").
Other challenges include inflexible markets, lagging economies in Europe and Japan, inefficient capital investments in China, or a possible resurgence of Great Power rivalries (i.e. with Russia or China). Any of these threats could lead to an economic crisis that could turn in to a political crisis or a geo-political crisis leading to global economic instability.
European working group members disputed the use of the term "consensus" to describe the current global status quo. While Asia, and especially China, might be more interested in accumulating reserves to insure against recurrence of a financial crisis in the region than in paying the US for physical protection, European publics probably do not perceive the US as providing *security* but rather as spreading *insecurity*. Most Europeans probably don't think they are "free-riding" but rather that they are confronted with US empire building.

Threat perceptions in the US and the EU have converged in recent years: economic challenges result from economic integration and globalization; security threats from an increasing "globalization of insecurity" (especially terrorism and nuclear proliferation). However, while there's consensus on the nature of threats the means to be employed to counter these threats differ. While America prefers "hard" security tools and conflict resolution, Europeans tend towards "soft" tools and emphasize assistance for and stabilization of "failed states".

As this leads to differences in the public resources spent on the military, Europeans are often accused of "free-riding" on US defense expenditures and force projection. Some participants insisted that current spending levels were simply not enough, while others maintained that the European vision and approach to security might be better suited to the new security environment, especially in a heightened ability to engage in humanitarian interventions.

All participants agreed that the current global security set-up implied heavy costs on both sides: while the US has to live with the risk of macroeconomic imbalances that could lead to a steep drop in the value of the dollar, the Europeans are sacrificing domestic consumption for their heavy dependence on exports.

Public Goods, Public Finance and Structural Reform

Under Bush military spending increased by 45 percent, but non-defense discretionary spending grew by 28 percent as well. Working group members deemed it vital that the US reduce its budget deficit to reduce global imbalances. US policy makers might consider broadening the tax base to avoid income tax hikes as the US will not be able to outgrow fiscal challenges with increased productivity growth in the long run. Main problems are lagging education system, outdated infrastructure and health care costs. Participants worried that Bush will have to raise taxes eventually, hurting the flexible and efficient character of the American economy.

Competition from abroad is likely to increase, meaning the US has to shore up its education system to keep its lead in innovation and R&D. A second Plaza agreement might prevent its partners from currency manipulation. While global engagement is necessary to protect against disruption of global supply chain, global as well as domestic public discontent in economic matters should be taken seriously.

Still, the US economy remains resilient: it has gained tremendously from globalization and is the world's most efficient capital hub.

Excessive public spending and defense expenditures are not of pressing concern for the European economies. American participants noted a lack of enthusiasm for defense spendings, a situation that is unlikely to change in the foreseeable future. Taking Germany as an example, while some participants where optimistic that the new government would raise the defense budget the country's only option to boost its external expenditures is faster economic growth.

Participants offered different explanation for the Eurozones's lackluster growth in recent years, but a major reason was identified in bad macroeconomic management, especially bad fiscal policy. Due to a lack of coordination and clear macroeconomic strategies Europeans find themselves in a sub-optimal economic situation that was not consciously decided on by anyone. It is recommend that Eurozone members adopt common fiscal policy guidelines to attain more macroeconomic stability, as at the moment the burden of adjustment rests squarely with the real sector.

Others recommended that policymakers focus on factors on the supply side as well as on skewed incentives and inefficiencies in labor markets. American working group members saw especially good prospects for financial services sector liberalization in Europe.

Macroeconomic Imbalances and their Foreign Policy Implications

Several factors determine whether the current macroeconomic imbalances will remain sustainable in the medium term. If the Euro becomes a serious contender to the dollar's dominant international

position the US could face exchange rate risks and rising premiums on US bonds. The large current account deficit leaves the US exposed on the financial side, as foreign ownership of US treasuries is on the rise. A large share of foreign investments goes into interest-bearing assets and if the interest rates rise, income flows might turn negative in the near future. This could lead to a fall in the dollar and could endanger the sustainability of the US's foreign debt.
Foreign policy implications are also an issue here: Will foreign policy makers decide to use their official holdings of US dollars as leverage? If the Chinese were to alter their portfolio, would market disruption ensue or could such a decision be implemented in a negotiated way? While Chinese dollar assets are actually much smaller than is often believed Chinese reserve holdings might become to be seen as a security problem. However, the real danger lies somewhere else. Foreign central banks' decisions to diversify and move away from the dollar might act as a tipping point in global financial markets and become a more forceful trigger than interest rates have been.

Still: American demographic and growth prospects look better than those of other countries and without an alternative to the dollar foreign central banks can't exert serious leverage. The US still enjoys the advantages that come with its role as monopoly provider of international security and liquidity.
Finally, the US, Europe and Asia find themselves in a co-dependency relationship, which no side has an incentive to abandon.

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

In the past international economic imbalances or looming currency crises have been countered by transatlantic macroeconomic policy coordination and other transatlantic burden sharing mechanisms. Unfortunately, the constellation of countries' economic and foreign policy objectives today hinder such coordination. Ways out of this dilemma could be a G-20 or a new Plaza agreement. Such solutions are difficult to implement however, as they would either require all members to accept the US's global security role or that the US 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 US for now is indeed providing three public goods: security, a vibrant market and a stable reserve currency. Any contender would have to present viable alternatives.

While all participants agreed that current global economic conditions make for a seemingly stable status quo, they did not agree on whether this status quo was truly desired by the transatlantic partners, 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 US current account deficit eventually proved unsustainable.

Prospects for the Future of the Status Quo

On the question, whether the status quo was actually in danger of unraveling and what could trigger such a development two virtually opposite opinions emerged.
US participants were largely convinced that only big jolts could seriously destabilize the current global geopolitical and economic consensus. In matters of global security the US is unquestioned in its dominance, while the EU seems unwilling to play a greater security role beyond its boundaries. European experts, however, insisted that the EU's security contributions around the globe have been growing, making the EU an important actor in ensuring the West's security interests.
The US economy on the other hand is flexible, vibrant and dynamic and not one of the US's partners is seriously interested in challenging its economic predominance. Thus the status quo is in everyone's interest – both from a security and an economic standpoint.

Most European participants, however, argued that current global economic imbalances are unsustainable. According to this view, the US's current account deficit implies an unsustainable and growing external debt that will lead to inevitable adjustment by depreciation of the US dollar. This 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. Europe would be the hardest hit by such a correction as its economic institutions would not allow for the swift and significant policy reactions necessary under such circumstances.

The US economy – Macro- and Microeconomic Conditions

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. The macro- and microeconomic conditions in the United States were therefore analyzed. A look at the disaggregated external debt of the country shows 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. Recent data, however, may well indicate a coming shift in foreign investors' preferences – away from dollar-denominated assets.

Another focus was the market for American private mortgages. After decentralization and regionalization of the American mortgage market, 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, American mortgages represent stable and quite profitable investments. And in spite of recent interest rates hikes, a significant slowing of the American housing sector seems unlikely.

Discussing the microeconomic conditions behind the American productivity surge of the mid- to late-nineties, participants saw 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. American policy makers have 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 disagreed on the extent of global challenges to US 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 continued to place high confidence in the dynamism of U.S. product and capital markets.

Europe

Participants agreed that Europe cannot and does not want to spend more resources on a greater security role in the world. One reason could be a faulty macroeconomic policy mix that has slowed investment rates and potential growth, inhibiting Europe's ability to play a greater geopolitical role. The European Central Bank's monetary policy in conjunction with badly coordinated national fiscal policies make for unstable and unpredictable investment environments.
The European defense sector also suffers from a lack of coordination: Nationalist tendencies lead to duplication and inefficiencies that aggravate the effect of much smaller European defense budgets when compared to the US. There was some agreement that only the establishment of a true "European government" could improve the situation.
However, looking at European public opinion, many Europeans may favor greater EU-wide defense cooperation, but they certainly do not favor greater spending on defense. This is closely linked to the fact that many Europeans are wary of the US's defense spending and think that the US has

contributed to making the world less safe in recent years. While the differences in European and American preferences for military engagement have deep historical roots European distrust of American foreign policy has risen in the years of Bush's presidency.
All conference members agreed however, that the transatlantic relationship is still strong enough to weather such differences as the transatlantic partners do share the same goal of ensuring growing global economic prosperity and worldwide physical stability.

Conclusions

Most participants agreed that none of the states that are part of the current geo-political and economic status quo would intentionally endanger the state of affairs, at least not in the short- to medium-term. If an adjustment occurs it will most likely be a result of imbalances in the global economic set-up. How likely such an adjustment actually is and who would pay the price if it comes was seen differently by American and European participants however. American participants insisted that only a major disruption of the global markets could seriously endanger the status quo, while the US is unquestioned in its dominance in matters of global security. Most European participants, however, argued that current global economic imbalances are unsustainable and will lead to an adjustment.
The American economy is still at the center of the world's financial markets. However, the role of education in maintaining the US's lead in matters of innovation and the development of cutting edge technologies was stressed repeatedly. Also, some participants were of the opinion that the current trade off between "guns and butter" would have to be addressed to prevent public discontent with the US's global engagement.
Concerning Europe, there was general agreement that the EU is prevented from taking on a greater security role in the world by a lack of coordination in fiscal policies as well as insufficient cooperation in the defense sector.