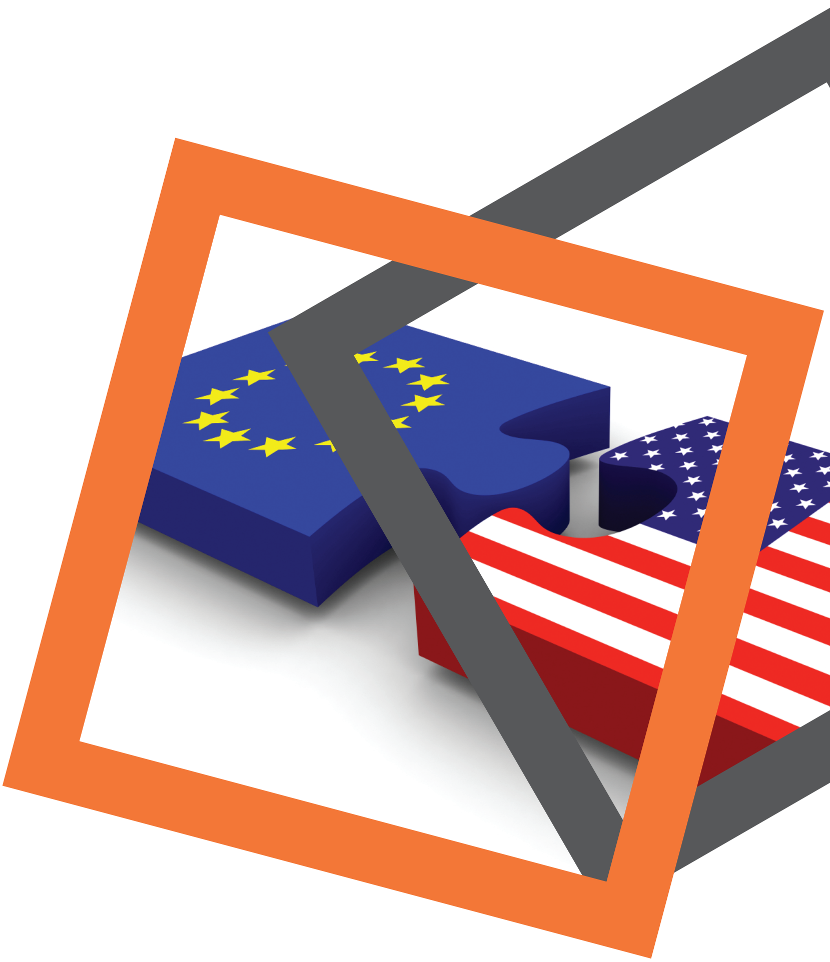
Edited by Paweł Świeboda and Bruce Stokes

The Case for Renewing Transatlantic Capitalism



NEW ATLANTIC CAPITALISM
RESHAPING THE ECONOMIC MODEL IN THE EU AND THE US

Edited by Paweł Świeboda and Bruce Stokes*

The Case for Renewing Transatlantic Capitalism

Warsaw, March 2012

Report by a High Level Group convened by demosEUROPA – Centre for European Strategy (Warsaw), the German Marshall Fund of the United States (Washington DC), Notre Europe (Paris), Stiftung Wissenschaft und Politik (Berlin) and European Policy Centre (Brussels).

Members of the High Level Group: Barry Anderson (Deputy Director of the National Governors Association, former Deputy Director of the Congressional Budget Office), Iain Begg (London School of Economics), Krzysztof Blusz (demosEUROPA – Centre for European Strategy), Stormy-Annika Mildner (Stiftung Wissenschaft und Politik), Daniela Schwarzer (Stiftung Wissenschaft und Politik), Eulalia Rubio (Notre Europe), Sherle Schwenninger (New America Foundation), Bruce Stokes (The German Marshall Fund of the United States), Paweł Świeboda (demosEUROPA – Centre for European Strategy), Fabian Zuleeg (European Policy Centre)

This paper concludes a series of meetings and policy discussions held since the end of 2010 as part of the **project on New Atlantic Capitalism**. Our objective has been to examine the pressing economic challenges facing both the EU and the US as a consequence of the financial crisis, the Great Recession and the crisis in the euro area, focusing on the transatlantic points of convergence and divergence. We conclude that the US and Europe will walk separate ways at their own peril. We suggest that only by joining forces can the transatlantic community most effectively respond to these economic challenges, protect American and European interests and help ensure the prosperity and peace that has been the post-war legacy of the transatlantic alliance.

* *Paweł Świeboda is President of demosEUROPA – Centre for European Strategy;*
Bruce Stokes is Senior Transatlantic Fellow for Economics at the German Marshall Fund of the United States.

Contents

Executive Summary 5

Part One:
The Relationship 9

1. The Failed Transatlantic Growth Model 11

2. Challenges Ahead 13

3. Transatlantic Ties that Bind 21

Part Two:
Proposals and Recommendations 25

4. Transatlantic Market Integration 27

5. Transatlantic Economic Dialogue 31

6. Financial Markets 33

7. Energy and Climate 37

8. Innovation 41

9. Social Policy 45

10. Common Neighborhoods 49

11. Maintaining a Level-Playing Field 51

12. Conclusions 55

Executive Summary

Transatlantic capitalism has long been the defining economic relationship in the world economy. Trade and investment between Europe and the United States dwarf all other commercial relationships. The democratic and market-oriented values and practices that gave rise to transatlantic capitalism are the foundation of globalization. Yet Europe and the United States now face profound challenges to their economic model. The recent financial crisis has exposed deep-seated and long-ignored structural economic shortcomings on both sides of the Atlantic. At the same time, the emerging economies of China, India and Brazil pose unprecedented philosophical and practical challenges to both the tenets and the practice of transatlantic capitalism. Only through joint effort can Europe and the United States reinvigorate economic growth and job creation, overcome the shortcomings of transatlantic capitalism and insure that their economic model prevails in the global economy. To that end, this report proposes:

- a binding timetable for the elimination of all tariffs on goods traded across the Atlantic and liberalization of services, investment and procurement markets,

- reduction in non-tariff barriers through regulatory coherence, based on the principle of mutual recognition, with all regulations in play unless specifically exempted,

- an annual strategic economic dialogue involving officials from the US Federal Reserve, the European Central Bank, the US Treasury, finance ministers from European Union member states and relevant officials from the European institutions,

- resolution of the remaining obstacles to a comprehensive new framework for financial regulation,

- negotiation of common rules for subsidies and the practices of state-owned enterprises, rules on inward investment, and government procurement to assure the maintenance of genuine global market standards.

Part One:
The Relationship

1 The Failed Transatlantic Growth Model

The post-2008 crisis has shaken people's faith in the economic system on both sides of the Atlantic. Questions are being raised about the very essence of the capitalist growth model. In several EU member states, as well as in the US, the crisis is threatening social cohesion. It has intensified a long-running debate over the role of the state in the economy. The pillars of the success of post-war transatlantic capitalism – accountability, balance between risk and reward, a balance between consumption and investment, balanced economic growth domestically and internationally, a linkage between productivity and income – have eroded.

The main problems with the transatlantic economic system predated the financial crisis. They had to do with the accumulation of macroeconomic imbalances internationally and within Europe, with some countries relying too much on domestic, debt-fuelled consumption and some on external demand. Excessive risk-taking behavior was fuelled and encouraged by some of the main public and private actors in the economy. In addition, corporate governance models were deeply flawed and assets were widely mispriced. Micro- and macro-prudential regulatory frameworks were not sufficiently linked. Regulation itself was often insufficient and procyclical.

Although allowing the advanced economies to avoid a 1930s-type of depression, the expensive government rescue programs in the wake of the 2008 crisis contributed to what has quickly turned into a sovereign debt crisis. There are several reasons why the problem became particularly grave in the euro area. A number of the governments had been able to mask the real situation of their public finances in the pre-crisis period. The growth of too-big-to-fail banking groups created massive off-balance sheet risks. Finally, there was a massive accumulation of external liabilities that resulted from negative real interest rates in the most inflationary countries of the eurozone.

Challenges Ahead

2

Excessive Indebtedness

Debt overhang is one of the most pressing problems facing transatlantic capitalism. The rapid rise in public debt since 2007 cannot be blamed entirely on the economic and financial crisis. Debt had been building up for years. The crisis augmented the problem as automatic stabilizers, rescue measures for banks and other threatened industries and fiscal stimulus measures kicked-in. The dimension of the problem has led to a new debate as to whether US Treasuries or German bunds can be considered "risk free" assets. Germany's maximum guarantees of 211 billion euro for the European Financial Stability Facility (EFSF) rescue fund, amounting to two-thirds of the German annual federal budget, as well as future commitments to the European Stability Mechanism (ESM) facility, have inevitably weighed on the position of the bunds. The idea that the United States could potentially default on its debt is no longer unthinkable given recent political volatility in Washington. This has consequences for the asset pricing models for which the US Treasuries have been a reference point. The high public debt burden that exists on both sides of the Atlantic suppresses both public and private spending since it implies the necessity of growth-slowing fiscal austerity in the medium to long-term with lower investments in infrastructure, education and health.

Total debt levels are as important to look at as public debt and they have been rising steadily since the 1950s. In many troubled European countries, it is the private debt, mostly bank-financed, that is the main problem. Spain, Ireland and the UK are among countries with the highest total debt to GDP ratios in the world. Much of the borrowing in Greece and Portugal comes from foreign creditors. Private debt should be disaggregated further and compared to the sources of income needed to service it. Hence, in Ireland, the problem is primarily household debt which stands at twice the level of after-tax incomes. The debt of the Portuguese non-financial sector is 16 times its pre-interest profit while Spain's is 12 times the size, raising the risk of a Spanish and Portuguese banking crisis.

In Europe, reducing public debt is now at the center of the new economic doctrine. The main objective of the new Fiscal Compact is is to bring down the level of public debt and introduce a balanced budget provision in the primary law of the member states. Problems in Europe differ substantially from country to country. Italy's sizeable banking sector is heavily exposed to its government debt. In Ireland, Portugal and Spain, the debt excesses are in their private sectors and they are largely bank financed, but have become public debt problems as national governments have been forced to backstop their domestic financial institutions and deal with problems of other sectors of the economy, including construction. The Fiscal Compact is meant to reorient the European growth model to ensure it does not result in excessive indebtedness. However, it will not solve the balance-of-payments crisis in Europe that shows few signs of abating. Given the lack of political will for a "transfer union", the outcomes could be either permanent monetary financing of the imbalances or internal real exchange rate realignment through deflation in the deficit countries and inflation in the surplus countries. The latter is likely to take place in the context of deeper economic integration that is increasingly seen as necessary in response to the crisis.

In the US, the redesign of fiscal policy is deadlocked. The country narrowly avoided defaulting on its national debt in August 2011. The Budget Control Act, approved at the time, stipulates major spending cuts, but many observers believe it is highly unlikely that they will be met. A **viable plan for medium and long-term fiscal consolidation is very much needed**. A window of opportunity for a bipartisan fiscal deal could be early in 2013, after the US elections. But the Obama administration's budget does not significantly reduce debt levels. And the Republican candidates for president and the Republican leadership in the Congress have promised further tax cuts. It is entirely possible that the next President and the new Congress will continue to differ fundamentally on how to reduce American public indebtedness.

Debt de-leveraging needs to be done together across the Atlantic and there has to be close coordination over the issue. Acting only to stabilize the public debt-to-GDP ratio at current levels – which remain too high to sustain for many countries – would require an effort of around 8.5 percent of GDP in consolidation of the primary balance in the US and 2.5 percent of GDP in the euro area. This would still leave debt levels of 106 percent GDP in the US and 92 percent in the euro area. Much more effort would be needed to reduce the debts to their pre-crisis levels, according to the calculations by the OECD. This does not include the ageing-related expenditure which, under current arrangements, would increase by over two percent of GDP by 2025 in countries such as the US or the UK and Germany, unless they are prepared to make necessary adjustments to their welfare systems. These costs would have to be managed on top of the debt-stabilizing consolidation efforts mentioned above. The United States needs to expand exports to readjust its growth model and substitute for decreasing domestic demand. Export-oriented countries such as Germany need to boost domestic demand. This, however, will not be possible, if the country continues to pursue strict fiscal austerity. A conflict between European and US austerity can easily ensue in such circumstances. The US and the EU have a joint responsibility to prevent global imbalances from increasing.

The design of fiscal policy measures is of great importance, both when it comes to the character of the stimulus measures and the reform of the entitlement system. High-return investment in infrastructure can lead to improved productivity in the private sector and have a multiplier effect on the economy as a whole. Pension reform or social insurance reform can be carried out in ways that can either augment or undermine confidence in the system on the part of consumers, with a long-term impact on spending and growth prospects. Similarly, tax cuts can benefit the economy by lowering the burden for companies that invest or they can add to the deficits or, perversely, benefit other actors, such as the emerging markets, by stimulating growth of consumption and imports.

Addressing the Growth Challenge

Fiscal consolidation is not sufficient to deal with the current crisis. Both Europe and the US need economic growth through enhanced competitiveness to ensure productivity rises in the face of mounting global competition. The challenge is to remove rigidities and to deploy the labor force in income and welfare-generating activities. **The depth of the structural economic problems in the US and in the EU should be fully acknowledged.**

The United States ranks 15th among high income countries in terms of educational achievement, according to the Organization for Economic Cooperation and Development. The US school system has deteriorated dramatically over decades. It will take time and new flexibility to rebuild it. America's physical infrastructure – its ports, highways and rail system – has been neglected for years and will take time and major new investment to rebuild.

European countries face similar structural problems. For all its recent success, Germany still ranks 13th among high income OECD countries in terms of the ease of doing business, according to the World Bank. France is 18th, Spain 24th and Poland 28th. This will require regulatory reform to correct. European structural problems also include poorly functioning labor markets that in some countries have accumulated rigidities leading to dismally high levels of unemployment. In addition, the European single market is not yet fully developed and integrated. Lackluster innovation and weak entrepreneurship are also a problem.

These structural impediments to growth and job creation need to be removed to create a new foundation for transatlantic capitalism based on high value-added productive activities requiring high intellectual content. This requires more education and training and more investment in information infrastructure and research and development. Specific recipes will vary from country to country, speeding up the approval process for infrastructure projects, creating incubators or centers of excellence for clean technology, allowing the immigration of more skilled labor. Rapid diffusion of knowledge in a non-proprietary manner is particularly crucial. The EU and the US cannot compete with emerging countries on labour costs. Their competitive edge will have to come from a lower cost of capital, technologically intensive production and a workforce that is well-equipped for the economic remodelling that is taking place.

Reinstating the Sense of Inclusion

One of the most obvious challenges facing transatlantic capitalism is growing inequality that has led to the Occupy protests carried out ”in the name of the 99 percent“. In some countries, the policies of the welfare state created enormous societal expectations that were gradually taken as a given, irrespective of how widely they diverged from market and fiscal realities.

The US Congressional Budget Office has reported recently that average real after-tax household income grew by 275 percent between 1979 and 2007 for the top one percent of the population. The bottom 20 percent of the population saw their average real after-tax household income rise by about 18 percent. Similar trends have been observed in other high-income countries although there are significant differences in the form that inequality has taken. There is wide divergence in the development of inequality in the EU, where the UK has seen similar trends in the rise of inequality to those of the US while in France inequality has not grown significantly in the past two decades.

Much of the recent growth in inequality in the US and the UK has been a function of the growth of the financial services sector and the economic rewards this sector has bestowed on a small group of its star performers. Furthermore, technological change has been one of the crucial drivers of rising inequalities as growing automation of production processes has exerted a downward pressure on wages as has growing competition from low income countries and the reduction of the welfare state. But policy choices, regulations and institutions have also had a strong impact in shaping how globalization and technological change affect the distribution of income.

Inequality matters because it strengthens vested interests of those who use their power both to increase their share of national income and to socialize their costs through public bailouts when markets turn sour. This not only creates a sense of injustice, but also leads to economic inefficiencies and market distortions. Inequality lowers the incentives for the poorer members of the society to invest in their own education. Furthermore, inequality incentivizes private debt accumulation as lower income people strive to preserve their standard of living or pursue the life style of the rich. Given the slowing of social mobility in the US and the growing sense among the lower echelons of the society that they will not be able to move up the social ladder, significant new disincentives to invest in education are building up.

Reinventing Globalization

The world at large played an important role in shaping Atlantic capitalism although the latter's failures are primarily of its own making. The relationship between advanced economies and emerging ones became more complex as a result of the financial crisis. It raised the question as to whether the advanced countries, mostly around the rim of the Atlantic, were still able to provide what other actors saw as international public goods, namely free trade, financial stability, diffusion of technologies and a global monetary system. There has been evidence of some attributes of globalization being reversed through rising trade, currency and financial protectionism, the phenomenon increasingly referred to as deglobalization. The next decade will clearly be about ways of managing the relationship between the advanced and the emerging economies. Whether it will lead to the opening of a new phase of globalization, in which the new actors share some of the benefits as well as the costs of international governance, or whether it will usher in an accelerating process of deglobalization, is an open question.

In either case, in the short term the emerging countries, especially China, will be more important for the future of transatlantic capitalism. This influence will be felt through a number of channels, including capital investment and growing demand.

The rise of the "rest" is a fact of life. A crisis of growth in China could be as destabilizing to international finance as the housing crisis in the US or the contagion effect of the Greek sovereign debt crisis.

Globalization has increased the number of access points to prosperity and well-being. Many countries, including the emerging powers, have made shortcuts in governance reforms, retaining large chunks of nontransparent and complex regulation. Others have experimented with a mixed economic model in which the state actively leverages market actors. **The level-playing field remains a distant goal**. The US and Europe have used different methods to fight for it but they have generally assumed that as the emerging powers gain economic weight, they will inevitably become stakeholders in the global system and embrace the principles of free trade and limited government intervention that reign in advanced economies. That assumption is now in doubt. Since its entry into the World Trade Organization the number of trade cases brought against China reflects wide-spread sentiment that Beijing has not lived up to its commitments and certainly has not played a leadership role in furthering global trade liberalization.

3

Transatlantic Ties that Bind

Transatlantic capitalism is inextricably bound together by the very nature of its integrated economies, the democratic system of liberties on which it is based and a broader US – European strategic partnership that combines shared values with common interests. Despite the financial crisis, the ensuing global recession and the crisis in the euro area, the transatlantic economy accounts for more than half the world economy, over two-thirds of global banking assets and three-quarters of global financial services. **The United States and Europe remain each other's most important trade and investment partners**, with over $600 billion in goods traded across the Atlantic each year and $1.9 trillion in American foreign direct investment in Europe and over $1.7 trillion in European investment in the United States. Three million Europeans work for American firms in Europe and three million Americans work for European firms in the United States. And most foreigners working for American companies outside the United State are Europeans, while most foreigners working for European companies outside the EU are Americans.

This deeply integrated market is held together by common economic and democratic values that are the mortar of the transatlantic relationship and give purpose to common efforts to meet common challenges. Americans and Europeans broadly share a commitment to free markets and free trade. In addition, despite the recent economic travails, Europeans and Americans retain an abiding belief in free markets. Overwhelming majorities of Europeans and two-thirds of Americans say growing trade and business ties between their country and other nations are good for their society, according to the 2011 Pew Global Attitudes survey.

They share a belief that **the state has a role to play regulating the free market, but that it should not control it**. Strong majorities of Europeans and three-in-five Americans believe it is a good idea for the government to more strictly regulate the way large financial companies, such as banks, do business, according to the 2010 Pew Global Attitudes survey. But with some exceptions there is no wide-spread support for state ownership of business in either Europe or America.

This commitment to free markets is bolstered by European and American commitment to democratic values: a shared belief in the rule of law, due process and transparency in public life. These democratic norms make it possible to realize the benefits of private property and economic competition.

It is little wonder then that both Americans and Europeans believe they share enough common values to be able to cooperate on international problems, according to the 2011 German Marshall Fund Transatlantic Trends survey.

Shared interests and beliefs have long been the basis of the transatlantic alliance. There has been a **mutual conviction that capitalism was the most productive and efficient means of organizing an economy and that in a democracy citizens had a right to a social safety net**, so that all could share in the benefits of capitalism. This, in turn, led to the evolution of the Western social welfare state that exists, to one degree or another, on both sides of the Atlantic and has served Americans and Europeans so well. It was faith in contestable markets and an open, democratic political process that united

Western Europe and the United States during the Cold War. It was such beliefs that were the underlying rationale behind the Marshall Plan. And such commitment motivated Washington's support for creation of the Common Market and, later, for the European Union in the belief that a more economically prosperous and politically united Europe was in America's self-interest.

This commonality continues to bind together transatlantic capitalism in the face of new, shared challenges: the sovereign debt and banking crises in the euro area, the American financial crises, the public and private debt overhang and the rise of Chinese state capitalism. Just as the United States and Europe rebuilt the shattered western European economy after World War II because it was in the self-interest of people on both sides of the Atlantic, **Americans and Europeans now need to work together to revive their shared economic space in the wake of the devastation wrought by the Great Recession, which is still ongoing in Europe**. They need to cooperate to craft rules of the road, especially for the transatlantic capital market, to avoid such catastrophes again. And they must jointly face the competitive challenge posed by China's growing weight in the commercial realm, ensuring that it is the norms of transatlantic capitalism – open competition, transparency, limited state involvement in the economy, the rule of law – and European and American regulatory and technological standards that prevail in the global marketplace.

The EU and the United States have gone separate ways in the aftermath of the crisis, a result of both slightly differing economic traditions and the fact that the US still functions at the centre of the dollar zone that remains central to the world economy. **The immediate post-crisis period has, however, brought both sides of the Atlantic to a common point of deleveraging and austerity.** There is now a strong rationale for a new effort to merge transatlantic growth paths to enhance future prospects and avoid future clashes.

Part Two: Proposals and Recommendations

Transatlantic Market Integration

4

The American and European economies need jobs and growth. Given budgetary constraints, public and private debt levels, a sluggish global economy and the near exhaustion of monetary policy, **economic revitalization must come from renewed investor confidence, structural reforms, increases in global economic integration and more consumer spending**. The European Union and the United States can cut taxes on imports, spur exports and consumption and encourage new investment through a **Market Integration Initiative**, for which the recently established High Level Working Group on Jobs and Growth can create a conducive framework.

This initiative should include parallel negotiations to eliminate all tariffs on goods traded across the Atlantic, to create a US – EU free trade area for services, to remove remaining barriers to investment and to reduce non-tariff trade barriers through regulatory convergence. Over time, such efforts could result in a comprehensive transatlantic free trade zone, as recently called for by German chancellor Angela Merkel or a barrier-free transatlantic market as proposed by the Transatlantic Task Force on Trade and Investment convened by the German Marshall Fund of the United States and the European Centre for International Political Economy.

While a deeply integrated transatlantic market place already exists, US and European firms still face numerous obstacles to trade and investment. Although tariffs are generally low, little more than nuisance taxes that penalize consumers, some peak tariffs remain for items such as apparel and food products. Non-tariff trade barriers in the form of differing regulations continue to limit commerce. And segments of the economy, such as the US airline industry, remain off limits to European investors. Removal of such barriers would pay significant dividends:

- A 2010 study by the European Center for International Political Economy in Brussels estimated that a reciprocal elimination of all tariffs would boost American exports to Europe by up to $53 billion (17 percent) and European exports to the US by up to $69 billion (18 percent).

- The effects on GDP, after including dynamic gains from liberalization, would range up to 0.47 percent in the EU and 1.33 percent in the US (in total, by 2015).

- A recent study by the Dutch firm Ecorys found that a 50 percent reduction of barriers to transatlantic service trade could increase EU GDP by $158 billion (0.7 percent) and US GDP by $53 billion (0.3 percent) annually.

- Ecorys also estimated that a reduction of non-tariff barriers to transatlantic trade could lead to an increase of EU exports to the US by 2.1 percent, while US exports to the EU could be boosted by 6.1 percent.

To put such prospective benefits in context: **the payoff from eliminating transatlantic trade barriers exceeds the likely economic benefit to the United States or to the European Union from completion of the Doha Round, the way it is currently defined**.

The time is ripe for such an initiative because there are no prospects of growth-generating multilateral trade liberalization in the near future. The EU already has a free trade deal with Mexico and is negotiating one with Canada. America has one with Canada and Mexico. What is missing is a US – EU trade and investment agreement. And, far from making future multilateral negotiations more complicated, a transatlantic agreement would establish a new benchmark for international market opening.

Moreover, China is a growing commercial challenge for the transatlantic economy. And **Beijing may best be dealt with by Washington and Brussels working together in a reinvigorated economic relationship**. But the window of opportunity to do something is closing as both Europe and the United States become more dependent on trade and investment with China.

A transatlantic trade and investment accord should be as comprehensive as possible. It should include heretofore troublesome issues, such as: public procurement; agriculture (where a number of products are already at zero tariff levels, where there is joint experience in phasing out peak tariffs and where real gains are possible in some commodity areas); product safety (where it is possible to demonstrate that American and European approaches deliver similar benefits for consumers); and in the motor vehicle and pharmaceutical industries (where a joint product safety framework would lead to significant savings). These efforts should be dealt under separate negotiations so that there can be an early harvest of those economic benefits that are most readily achievable. The area of 'new economy' services (ICT or ICT-based) should receive particular attention, given their importance for productivity and competitiveness and the need to develop a framework for such services trade.

Recommendations:

The European Union and the United States should:

- Establish a binding timetable for the elimination of all tariffs on goods traded across the Atlantic and on the liberalization of service, investment and procurement markets.

- Negotiate a reduction in non-tariff barriers aiming for regulatory coherence, based on the principle of mutual recognition, with all regulations in play unless specifically exempted.

- Set an explicit goal of creating a barrier-free transatlantic market by 2025.

Transatlantic Economic Dialogue

5

The transatlantic market is the largest single nexus of trade and investment in the global economy. The triple crises of the last few years – the 2008 financial one, the economic one of 2009 and the sovereign debt crisis in the euro area – have merely underscored the **structural interdependence** of this transatlantic economic space. Sovereign debt issues, banking insolvency, and current account imbalances on one side of the Atlantic have created problems that have rapidly spread to the other side. To maximize the potential of the transatlantic market, to act as an early warning system for future difficulties, to understand differing perspectives on mutual challenges and to better coordinate macroeconomic policies **the European Union and its member states and the United States should initiate a regular strategic economic dialogue**.

There is already close coordination between the US Federal Reserve and the European Central Bank and frequent interaction between the US Treasury and the finance ministries of key European countries. But the severity of current challenges and the nature of the potential challenges that lie ahead suggest it is now time to **deepen that interaction**

and give it more of a strategic agenda and purpose, especially since the European Union is likely to gain significant new powers of fiscal surveillance and control in the years ahead.

In the 1980s, the United States conducted an enlightening, but largely one-sided, Structural Impediments Dialogue with Japan. Both the European Union and the United States now have strategic dialogues with China and others. And each member of the G20 now subjects its economic policies to a Mutual Assessment Process, essentially a peer review managed by the International Monetary Fund, to judge each country's performance in the joint effort of achieving balanced global growth. A nation deemed to be pursuing policies that undermine that goal will face peer pressure to change direction. This ambition may not be achievable between nations as disparate as China and Mexico. But given their common stake in the global economy, their shared values and history of cooperation, **Europe and the United States can lead the way in establishing the norms for and expectations of how nations harmonize fiscal and monetary policies that were once purely domestic in nature, but that now are globally relevant**.

Recommendations:

The United States and the European Union should:

- **Launch an annual strategic economic dialogue** involving officials from the FED, the ECB, the US Treasury, finance ministers from European Union member states and relevant officials from the European Union.
- Conduct a regular peer review of each other's economic assumptions, structural impediments, policy goals and actions, with the results publically discussed to engage a wide public in this transatlantic dialogue.
- Aim to minimize structural and policy impediments to growth and to facilitate eventual transatlantic market integration.

6 Financial Markets

The financial sector is widely blamed for being at the root of many of the problems that have hit the global economy in the last few years. The charge sheet includes unsafe lending, forms of financial innovation that exacerbated asset bubbles and resulted in severe misalignments between risks and incentives, and distortion of income distribution.

As the influence of financial markets has grown, the financial sector itself has expanded its share of GDP. It has now grown too big, but its optimal size is unclear. Moreover, the primary 'infrastructure' function of financial services in intermediating between savers and investors to allocate capital efficiently has been increasingly over-shadowed by the 'casino' role played by Wall Street and the City in London in which highly remunerated traders subtract rather than add value from the perspective of end users of financial services. In addition, the euro area almost ran into a credit crunch that would have had very negative consequences on growth had the ECB not stepped in with new instruments and higher lending volumes to banks. Worthwhile market deepening and liquidity creation have given way to harmful and volatility-inducing speculation. And the power of financial markets is such that good governance of public policy is being undermined. This may be because regulation has been misconceived or it may be because lobbying from financial intermediaries has become so effective.

The renewal of transatlantic capitalism requires a recasting of financial regulation. The financial and economic crisis has revealed several shortcomings in both financial regulations and oversight of the financial sector in the United States and the European Union. **Regulation and supervision fell short on four major accounts:** in spotting systemic risks in the markets, in sending out early warnings, in implementing effective regulatory safeguards, and in setting disincentives for excessive risk-taking behavior. Much better macro-prudential surveillance is needed. Information deficits need to be reduced, risk assessment should be improved and regulatory arbitrage minimized. Excessive risk-taking behavior should be curtailed and new rules need to be devised to tackle the 'too big to fail' problem.

The US and the EU have initiated numerous regulatory reforms involving micro- and macroprudential regulation, bank capital and liquidity requirements, accounting standards, derivatives, alternative investment funds, credit rating agencies, and compensation schemes. But although some progress was made, **the momentum has slipped and current positions across the Atlantic (with the UK, as so often, somewhere afloat in-between) are not coherent** on basic financial regulation, including capital requirements and manager pay, or on a financial transactions tax. **The US and the EU are still the most important players in global finance.** If they do not take the lead, including at the G20, and join efforts on coherent rules for global finance, others will not follow and the transatlantic capital market and the global economy risk renewed financial crisis.

Recommendations:

The United States and the European Union should:

- Resolve the remaining obstacles to a **comprehensive new framework for financial regulation**. The Financial Markets Regulatory Dialogue, which established clear roadmaps for the resolution of divergences, needs to step up its efforts in this regard with the subsequent efforts pursued by the United States and the EU at the G20.
  - First, **a level playing field needs to be created to avoid regulatory arbitrage and a distortion of competition** between the European and the US financial markets. This requires an intense dialogue in the design of new regulations.
  - Second, stronger cooperation is necessary during the design of new rules and regulations to prevent regulatory arbitrage. More cross-country supervisory cooperation is required to spot risks on the international markets.
  - Third, the US and the EU need to advance crisis-resolution structures. This is necessary because financial market actors that are too big to fail frequently operate in several countries – and functioning solutions for crisis resolution and burden-sharing still need to be found.
- **Launch a transatlantic dialogue on the future shape of the financial services industry** and on how it can be 'normalized' to curb its excesses and return it to its appropriate role as a facilitator in a capitalist economy, not the dominant force.

7 Energy and Climate

Energy markets have recently been important sources of instability and macroeconomic imbalances. They also have a geo-political resonance because of the concentration of supply of conventional hydrocarbons in the Middle East, Russia and other economies subject to disruption.

Developing indigenous energy resources is one way for both the EU and the United States to limit their exposure to such instability. The rapid progress in the US in developing shale gas extraction is a promising development. It has led to the decoupling of the prices of gas and oil, changing the world market of gas by eliminating American dependence on imports and freeing up for the world market substantial amounts of LNG gas that was meant to be sold on the US market. Shale gas deposits exist in Europe as well and they could play a role as a transition technology in the continent's decarbonization process provided it is eventually phased out to create space for non-carbon emitting ways of generating energy. Nevertheless, the wider climate change challenge remains, so that complementary measures to lessen greenhouse gas emissions are still vital. While China has now overtaken the US to become the number one emitter of greenhouse gases, the per capita emissions of Americans are some four times those of the Chinese. And Western Europe still emits more than twice as much per capita as do emerging market countries.

Hence, for both sides of the Atlantic a major rethinking of energy markets is imperative, and several overlapping strategies can be envisaged.

- First, much more rapid progress is required to decouple **energy demand from GDP growth**. The amount of energy used per unit of GDP must be reduced through the use of alternative production technologies and by curbing increases in the consumer use of energy. The carbon-intensity of energy products must also be limited.

- Second, **pricing structures have to reflect not just production costs, but also social costs**. However, imagination is needed to find ways of achieving such a goal without engendering resistance from, on the one hand, consumers, especially those at risk of fuel poverty, and on the other, businesses that fear competition from rivals in low energy cost countries.

- Third, there must be a renewed commitment to **boost energy saving**. This will require a range of policy actions, including attention to building codes, the elaboration of suitable packages of incentives and deterrents and effective communication with citizens.

On the assumption that a progressive switch away from coal, oil and gas as primary sources of energy has to occur, **the market opportunities are immense**. The transition toward sustainable energy systems of electricity generation will inevitably require the diversification of energy mixes, with both the need for clean, sustainable and decarbonized energy sources and research into new carbon-neutral technologies. These are often stymied by high development costs, technological uncertainties and the harsh fact that oil, especially, is extremely convenient as a fuel for transport. However, 2010 saw record investment in clean technology, $243 billion globally, a 30 percent rise compared with 2009. China today (and probably other emerging economies tomorrow) is trying to wean itself off carbon-based fuels by large investments in alternative energy sources and cleaner applications through carbon capture and sequestration.

Although the ultimate outcome of the process is not certain, China is clearly looking to acquire a competitive edge in the next generation of non-carbon energy technologies, possibly for mercantilist rather than environmental reasons.

Government support for an energy transition remains crucial, especially in Europe and the United States, which often find it more difficult to bring clean energy technologies to market because of the presence of the existing energy infrastructure and vested interests in the status quo. Given their need for fiscal austerity, governments need to become more creative in supporting this emerging energy sector, creating incubators or centers of energy excellence rather than simply offering tax credits.

To the extent that American and European strategic energy futures diverge, for example with the US looking to revert to supplies from the western hemisphere, both the US and Europe need to be alert to the possible security consequences of a much reduced US energy demand and thus strategic interest in the Middle East.

Recommendations:

The United States and the European Union should:

- **Intensify research collaboration on major technologies across the energy mix, including in the framework of the extended Innovation Action Partnership.** Collaboration should focus specifically on the demonstration and early deployment phase where the most significant cost barriers exist. Efforts should be made to achieve pooling and sharing of expertise with regard to technologies such as smart grids, energy storage, nuclear fusion, hydrogen and fuel cell technologies, hydraulic fracking used in the extraction of shale gas and carbon capture and storage. Future research could be modeled on the cooperation in the field of resources, where a wide-ranging action plan was endorsed during the 2011 TEC meeting.

- **Share experience on energy subsidies and energy regulation**, with a particular focus on the benefits and limitations of support for renewable energy technologies and the use of feed-in tariffs to foster adoption of renewables.

- Collaborate to blunt China's mercantilist ambitions with regard to renewable technology, preferably with the aim of drawing the latter into cooperative solutions. This could be achieved in a framework similar to the recently launched Trilateral Critical Materials Initiative bringing together the EU, the US and Japan.

8 Innovation

The US and the EU are both faced with a significant economic challenge: to maintain a competitive edge – especially in knowledge-intensive industries – with emerging economies such as China that are investing in innovation, technology and human capital in order to shift from low-valued added to high-value added production. **Both the US and the EU face intense competition in the global knowledge economy in sectors where they have been strong in the past:** renewable energy technologies, pharmaceuticals, electronics, the production of capital goods and advanced manufacturing. In addition, the US and EU education systems, long the gold standard, face challenges from newcomers in the developing economies.

Research strategies on both sides of the Atlantic require a focus on basic research, its translation into innovation and the subsequent adoption of new technologies by businesses and society. The policy input calls for a balance between fundamental research and pre-competitive research support, raising questions about the attribution of intellectual property rights and how openly knowledge should be disseminated in areas such as biotechnology or energy.

The US and the EU – often rivals in the past in leading-edge industries – now have a common interest in intensified cooperation. By opening up the transatlantic market further (as discussed above), firms will have a larger market place to commercialize their innovations, making research and development more profitable. A joint transatlantic effort to promote the mobility of researchers and create common funding streams is needed to back joint collaborative research and move toward a genuinely integrated transatlantic space for research and innovation.

Recommendations:

The United States and the European Union should:

> Create an integrated **Transatlantic Innovation and Research Space**, where public funding is jointly invested to maximize American and European human capital and research capabilities.

> Create more opportunities for students, researchers, teachers and lecturers to spend time in each others' universities and laboratories by funding large scale exchanges and by ensuring easy access to visas and work permits.

> Enhance the work of the Transatlantic Intellectual Property Rights Working Group in order to further develop a common approach to intellectual property rights/patents, to create a single transatlantic system to protect and promote intellectual property and jointly push for enforcement of intellectual property rights around the world, while also taking the lead in shaping global open source access to intellectual property where appropriate.

- Open up public procurement in non-strategic policy areas to transatlantic competition, especially in areas where electronic/remote delivery of services is envisaged.

- **Create and fund a joint EU-US Research Council to back cutting-edge, collaborative research** aimed at solving common societal challenges, for example in the field of energy; extend the current scope of the Transatlantic Innovation Action Partnership to new sectors, such as bio-economy, in order to sustain leadership in setting global standards.

- Explore means of pooling research and innovation efforts in the development of key technologies, bringing together public and corporate interests, so that synergies can be exploited and a suitable balance can be struck between wasteful duplication and healthy competition.

- Coordinate and link fundamental/basic research programs to ensure that projects can go ahead despite current constraints on public finance.

9 Social Policy

Transatlantic capitalism has to strengthen itself internally if it wants to remain a relevant force in the global economy. This requires parallel efforts on both sides of the Atlantic not only in stabilizing public debt but also in promoting a sustainable, equitable and job-rich recovery.

Social policies are an essential component of a successful recovery strategy. The most immediate challenge is to minimize the social effects of the crisis. **In the medium term, it is essential to guarantee well-functioning labor market structures and social safety-nets in both the US and Europe**, capable of balancing security needs and work incentives while being financially sustainable on a long-term basis.

Policy responses required for a sustainable and job-rich recovery differ from country to country. There are significant differences (both transatlantic and intra-European) in welfare models and labor market structures, and countries are confronted with different short-term budgetary and social challenges. To date, there has been no coordination of social policies as there are no major spill-over effects from national decisions on labor and social reforms between advanced economies (the risk of social dumping is practically nil in the transatlantic context and the eventual benefits of such measures basically go to the country undertaking the reform). Nevertheless, **soft coordination, aimed at facilitating the exchange of experiences and mutual learning across the Atlantic** would prove beneficial.

Both the United States and Europe have much to learn from each other about the way each has dealt with the social effects of the crisis. In the US, a historically high long-term unemployment rate has exposed the flaws of a social safety-net that is too closely linked to employment and lacks strong automatic stabilizers. In Europe, the crisis has demonstrated the ill-effects of "dual" labor markets, with a core of well-protected workers and a number of unstable jobs at the margin, especially in some southern European economies. The bonus culture especially prevalent in the financial sector has contributed to rising inequality. A soft coordination procedure could help identify best practices or promising innovative approaches to deal with common challenges. **The crisis has highlighted common structural problems, such as** the need to improve the financial sustainability of age-related social programs, and it has added new common concerns such as the increasing number of long-term, low-skilled unemployed who risk being permanently excluded from the labor market.

Recommendations:

The United States and the European Union should:

> Benchmark employment and social policies, with an eye toward a balance between labor market flexibility and a social safety net, what Scandinavians call flexicurity.

- Launch a dialogue on achieving growth in aging societies with a goal of developing comparable approaches to maintaining and integrating older workers into the transatlantic labor force in order to contain the growing fiscal burden of an aging population while maximizing their contribution to growth.

Common Neighborhoods

10

The future of the transatlantic economy lies, in part, in neighboring emerging markets in Eastern Europe and North Africa. If Europe and the United States are to maximize the benefits of access to each others‘ markets and to compete effectively against low-cost producers in Asia, then they must work with these neighborhoods, which can be both production platforms and new markets for transatlantic producers.

The United States already has a free trade agreement with Canada and Mexico and the EU has one with Mexico and is negotiating one with Canada. The EU has concluded an Association Agreement with Ukraine, although it has not yet been signed. The EU will now pursue a similar approach with other eastern neighbors, including Georgia and Moldova. And both Europe and the United States have preferential trade agreements with some, but not all, of the North African states.

Countries of North Africa face pressing economic challenges and need to find niches for themselves in the world economy. The EU and the US can assist in this process through greater market access, ease in labor mobility, debt relief and credit guarantees.

Southern and Eastern Europe also pose challenges and opportunities for Europe and the United States. The EU is an important center of gravity in the region. The EU accounts for around 30 percent of the trade volume of the six eastern European states. It is also the largest investor in the region. The US is the biggest donor of development assistance to the post-Soviet states, especially in Armenia, Georgia, Kyrgyzstan, Moldova, or Tajikistan. US-originated FDI forms a significant part of the FDI stocks of Azerbaijan, Georgia, Kazakhstan, and to a lesser degree Moldova.

Recommendations:

The European Union and the United States should:

- **Align trade liberalization and funding afforded Eastern Europe and North Africa to foster growth and entrepreneurship.** This should include harmonization of existing trade deals in the region to minimize trade distortion, negotiatation of joint accords with those nations that do not already have such agreements and a requirement that countries with preferential deals with Europe and the United States also open up trade and investment with each other.

- **Jointly launch an institutional framework for stability and cooperation in North Africa aimed at** conflict prevention and resolution, confidence building measures and arrangements for crisis management.

- **Create a EU-US Entrepreneurship Forum for** countries of Eastern Europe and North Africa and covering issues of access to capital, SMEs, youth entrepreneurship, innovation and technology incubators and skill training. Such an initiative would help ensure structural change in the region.

Maintaining a Level-Playing Field

11

The challenges facing transatlantic capitalism are primarily of Europe's and America's own making, the result of their own economic excesses and policy failures. But these problems have been aggravated by other states' intervention in both product and currency markets, which tilts the balance in favor of individual companies or sectors and hence creates distortions, not only on the national level but also internationally. Outright protectionism has been replaced in the world economy by more nuanced means of looking after national interests. The World Bank has catalogued the diverse forms of protectionism that have been applied since October 2008. These include iron and steel tariffs in Russia, agricultural quotas in Latin America and "buy local" procurement rules in China.

The next decade will be about preserving a level-playing field in the global economy. Protectionism, which remained rather subdued in the immediate wake of the 2008 economic crisis, may prove increasingly difficult to contain in a protracted slow-growth environment. Growing global trade imbalances could spark currency wars, as deficit nations look to export their way to growth and surplus nations seek to hold on to their export-led growth strategies. In the second half of 2010 alone, more than a dozen countries – Brazil, China, India, Indonesia, Israel, Japan, Korea, Malaysia, the Philippines, Singapore, South Africa, Switzerland, Taiwan, and Thailand – intervened in foreign exchange markets and/or effected capital controls to curb currency appreciation.

The uncertainties created by state actions undermine global trade and investment flows, and sow antagonism in international affairs, that, in turn, complicate multilateral rebalancing efforts.

This challenge is complicated by emerging Chinese state capitalism that is unlikely to evolve into a mirror image of transatlantic capitalism rooted in openness and competition. And given its size and recent success, China will be increasingly resistant to individual US or European efforts to influence the trajectory of its economic evolution.

Both the US and Europe are tempted to gain a strategic edge vis-à-vis China. One potential point of friction involves the growing flow of Chinese investment and the mixed reactions to it on both sides of the Atlantic. The United States has a powerful investment review procedure that is applied to transactions with potential strategic implications. **Europe maintains no barriers** to inward investment, although EU member states do restrict foreign acquisition of some sectors of the economy. There is a growing need for a US–EU dialogue defining the broad parameters for foreign investment in the transatlantic economy to prevent third parties from playing America off against Europe.

Recommendations:

The European Union and the United States should:

> **Assure the maintenance of genuine global market standards by** negotiating common rules for subsidies and the practices of state-owned enterprises, rules on inward investment, and government

procurement that apply both to the transatlantic market and to others investing in or doing business with Europe and America.

- Jointly monitor risks and challenges to common rule of law standards and coordinate measures to address problems resulting from the lack of respect for them, including a common strategy for systematically challenging through the dispute settlement process in the World Trade Organization violations of multilateral trade rules, including protectionism and the theft of intellectual property.

- Pursue common high-level technological and regulatory standards that promote innovation and a level-playing field for all competitors.

12 Conclusions

If anyone had thought that the United States and Europe could decouple economically and be spared fallout from each others' problems, events since the beginning of the financial crisis have proven them wrong. There was hardly a policy development on either side of the Atlantic that did not have significant mutual repurcussions. Nevertheless, **the Atlantic community has remained the dominant force in the global economy due to the strength of its commitment to the rules of the capitalist market economy and democracy**. And both Europe and American have a stake in preserving an open and rules-based international economic regime.

But transatlantic capitalism is changing in the face of its challenges. The crisis has highighted a growing commonality of problems across the Atlantic: growing economic and financial interdependence, the need for common financial rules, the need for fiscal consolidation as well as broad-based, inclusive economic growth. US and European policy responses will continue to differ, expressing the specificity of each other's circumstances and policy traditions. But efforts to resuscitate the European and American economies need to be coordinated.

In today's international environment, crucial economic decisons have to be conducted in a synchronised fashion. Global imbalances, regulatory loopholes, indebtedness and credit culture will need to be reduced, monetary policy coordinated, a sense of social and economic inclusion revived and sources of growth multiplied. **The global dimension of the US-European relationship will shape the international economic order**, the evolution of the regulatory regime and the effectiveness of global policy instruments, even though the transatlantic relationship will be one of many competing in today's world.

This is all the more reason for the United States and Europe to be smart about their relationship, multiplying opportunities and identifying potential sources of trouble and contagion. The new transatlantic agenda is needed to a) identify risks to the system and address them without delay, b) establish policy coordination for the benefit of growth, c) jointly reinforce the global rules of the game. Transatlantic ties are **no longer a marriage of sentiment or convenience. They are a strategic economic relationship** that will shape the new global economic regime and determine the future well-being of both Europeans and Americans.

Cover design:
Studio Brandingowe BAKALIE

DTP:
Studio Brandingowe BAKALIE

The Project is supported by the European Commission.
The views expressed in this publication do not necessarily reflect the views of the European Commission.

More at: www.atlanticcapitalism.eu