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AICGS POLICY REPORT

THE STRESSES OF DEEP INTEGRATION: THE TRANSATLANTIC RELATIONSHIP'S NEW ECONOMIC AND POLITICAL CHALLENGES

Bruce Stokes

AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES THE JOHNS HOPKINS UNIVERSITY

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FOREWORD

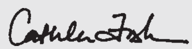
As a consequence of deepening transatlantic economic integration, trade and financial ties between the United States and Germany today are a vital part of the bilateral relationship and of relations between the United States and Europe. Economic interdependence has brought mutual benefit. As Bruce Stokes' essay aptly catalogues, however, integration has also created new potential for transatlantic conflict—over trade liberalization in the WTO, financial imbalances, or relations with the rising power of China. Even matters that were once considered purely domestic affairs, such as taxation and regulatory regimes, have come to have transatlantic implications in a globally-connected economy.

Whether the United States and Europe in the coming years will navigate these challenges in a cooperative way remains uncertain. The outcome depends on a complex set of factors, including the politics of trade, financial, and economic regulation in Washington and Brussels as well as the national capitals of the European Union's member states, which retain significant power despite the migration of economic competence to the EU. Germany's economic weight in the European economy, in particular, ensures that it will continue to play an influential role in shaping the EU's position on critical economic issues.

For the United States, puzzling through the intra-EU dynamics that shape EU approaches and regulations is increasingly necessary but often difficult. How much impact do national governments exert, particularly as the EU works to complete the single European market? Germany remains a strong player in the EU, and it arguably can be a major partner for the United States in this process. But where is Germany's weight in the issues that define the U.S.-EU economic agenda? Will transatlantic cooperation on economic issues be negatively affected by transatlantic political disputes and negative trends in German and European public opinion as it pertains to the United States and U.S. policy?

These are among the issues explored in Bruce Stokes' essay on *The Stresses of Deep Integration* and a forthcoming companion analysis of lobbying and policymaking processes in the EU within the "Berlin-Brussels-Washington" triangle. Both reports are part of a series of analyses, undertaken with the generous support of the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft, examining the historical/cultural, institutional, political, and economic context of transatlantic economic and regulatory disputes and the way that these factors shape our respective responses to the challenges of remaining competitive in a global market.

We are grateful to Bruce Stokes for his comprehensive overview of the U.S.-EU economic-political agenda and the part that Germany might play in shaping cooperative transatlantic solutions. We are particularly thankful for the sustained support of the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft for this project and the Institute's work. I would also like to express my gratitude to Dr. John Starrels, Senior Fellow-in-Residence, who has helped immeasurably to shape and guide this series of reports, and to Ilonka Oszvald for her expert assistance in the editing and preparation of the manuscript.



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ABOUT THE AUTHOR

BRUCE STOKES is the international economics columnist for the *National Journal*, a Washington-based public policy magazine. He is also one of the authors of the Global Attitudes Project and is co-author of the forthcoming book *America Against the World* with Andrew Kohut on American exceptionalism and anti-Americanism, to be published by Times Books in May 2006. A former senior fellow at the Council on Foreign Relations, Stokes was recently chosen by *International Economy* magazine as one of the most influential China watchers in the American press. In 1995, he was picked by *Washingtonian Magazine* as one of the "Best on Business" reporters in Washington. In 1989, Stokes won the coveted John Hancock award for excellence in business and economics reporting for his series on the impact of the rising yen on the Japanese economy.

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THE STRESSES OF DEEP INTEGRATION: THE TRANSATLANTIC RELATIONSHIP'S NEW ECONOMIC AND POLITICAL CHALLENGES

The transatlantic relationship—and U.S.-German ties—have never been closer economically nor more troubled politically. The bonds between Europe and the United States—and by extension America and Germany—are deep and strong. Yet the relationship faces unprecedented new stresses: public alienation, dangerous global economic imbalances, differing perspectives on the competitive challenge posed by China, and niggling confrontations over taxes or domestic regulation that were unheard of in the past but are directly attributable to the ongoing economic integration that has characterized the transatlantic marketplace in the last generation. A new government in Berlin affords a unique opportunity to reestablish a closer political and economic partnership, not only between Germany and the United States but also, with German leadership, between the United States and Europe. The challenge ahead is to mitigate current political frictions in the relationship to ensure that they do not impair the process of further deepening mutually beneficial economic integration. This process will require accommodation of values differences, bold new economic initiatives, and patience.

A Deep Economic Relationship

"Transatlantic commercial ties have never been stronger," conclude Daniel S. Hamilton and Joseph P. Quinlan in their recent book *Deep Integration: How Transatlantic Markets are Leading Globalization*. The transatlantic economy accounts for 42 percent of the world economy, 24 percent of world exports, 31 percent of world imports, and 62 percent of the stock of foreign direct investment.

In terms of trade, a third of British exports outside the European Union went to the United States in 2004, as did a quarter of German exports and a fifth of French and Italian exports. And a fifth of U.S. exports went to the European Union. And this commerce is thriving compared with the past. In 2004, transatlantic trade in goods rose 12.5 percent over 2003, and it was up another 8.9 percent in 2005. In 2004, the United States had record exports ($31 billion) to and imports ($77 billion) from Germany and was on a path to certainly break those records in 2005. The same was the case with France, Spain, and other European economies.

On the investment side, American firms and their affiliates held roughly $4 trillion in assets in Europe in 2002, while European companies owned $3.4 trillion in assets in the United States. U.S. corporate assets in Germany alone—$351 billion—exceeded total American-held corporate assets in all of Latin America. U.S. firms employed 4.1 million workers in

Europe—including 385,000 in Germany—while majority-owned European companies in the United States gave work to 3.8 million Americans in 2002, including 676,000 by German firms such as DaimlerChrysler. Deeply embedded in each other's markets, it is no surprise that 52 percent of U.S.-foreign affiliate income earned abroad came in 2004 from Europe.

As Hamilton and Quinlan conclude: "the transatlantic economy is where the markets are, where the jobs are and where the profits are." And history suggests it is a remarkably resilient marketplace. Nevertheless, it faces economic and political challenges that threaten both its stability and its current trajectory.

Economic Challenges Ahead

COMPLETING THE DOHA ROUND

The most immediate economic test for both Europe and the United States is a successful completion of the Doha Round of multilateral trade negotiations. In the past, it has taken American and European cooperation to finalize such talks. Today, their collaboration is still a necessary, if not sufficient, condition for a successful outcome.

With the Doha Round slated to end in 2006 so that the U.S. Congress can vote on the outcome in mid-2007, before the American president's trade negotiating authority expires, time is short and the task is formidable. The European Union and the United States have agreed to end all forms of export subsidization by 2013. But how this will apply to controversial issues, such as food aid, remains to be determined. Exactly how much and with what formula farm subsidies and agricultural and industrial tariffs will be cut also have yet to be resolved. And there has been almost no progress in liberalizing trade in services.

Domestic politics on both sides of the Atlantic complicate the end game. France, backed by Poland and Italy, has blocked European Union negotiating flexibility, refusing to consider further reform of the Common Agricultural Policy as part of market liberalization in the Doha Round. European public opinion supports that obstructionist stance. Three-fifths of the Italians and half the French and Poles are committed to subsidizing farmers, according to the 2005 *Transatlantic Trends* poll undertaken by The German Marshall Fund of the United States (GMF). Boxed in this way, it is little wonder that EU trade commissioner Peter Mandelson, in a speech 23 January 2006 in Berlin, stated that: "It is out of the question that we consider another move in agriculture without a much clearer picture of the final result of the negotiation—and a real commitment by others to open their markets further."

What are the implications of Europe's stance for prospects to complete the Doha negotiations in 2006? "First," concluded Simon Evenett, a professor at the University of St. Gallen in Switzerland, "the large group of EU member states who sought to constrain the European Commission's negotiating tactics in 2005 are likely to persist in doing so in 2006, especially if the agricultural trade negotiations broaden in scope to include market access matters. Second, the willingness of Austria (which holds the EU presidency in the first half of 2006) to broker (a compromise) must surely be in doubt. Time and again in 2005, Austria sided with those member states concerned with the (European Commission) exceeding its negotiating mandate."

For its part, the Bush administration has made bold proposals to radically restructure U.S. farm programs, which now provide greater subsidies than ever before. But Congress will not rewrite the U.S. farm bill until 2007. And influential members of Congress are already balking at significantly curbing outlays to farmers, in part because there is no evidence of public support for such an effort. Half the Americans surveyed by GMF support subsidizing farmers, even if such payments disadvantage developing country farmers unable to compete with the U.S. Treasury's deep pockets. Moreover, in a sign that such sentiments are here to stay, young Americans—those under the age of twenty-five—are much more likely than people sixty-five and older to see nothing wrong with taxpayer benefits for farmers.

The political task ahead is even further complicated by new evidence that the hoped for benefits from the Doha Round may be far less than anticipated. The World Bank's estimate of the benefit of a "likely" Doha

outcome is $96 billion, according to *Putting Development Back into the Doha Agenda: Poverty Impacts of a WTO Agreement*. The benefits are even less if countries are permitted some exemptions, as is highly likely. Overall, an economic model developed by Sandra Polaski of the Carnegie Endowment for International Peace, finds that a "likely" Doha outcome would actually cost world market share for the EU-15—those nations that were members of the EU before 2004—primarily because of losses in agricultural exports. Such results will make it all the harder for both Brussels and Washington to mobilize business community support for completing the Round.

Thus a timely and successful result will once again require U.S. and EU leadership and close cooperation.

To convince Third World nations to go along with a Doha deal, developing economies must see something in it for them. The Bush administration needs to give the forty-nine poorest countries unfettered access to the American market for all their goods and commodities, just as the European Union has already done. The current U.S. offer is generous but excludes 3 percent of poor country products, such as Bangladeshi textiles and Cambodian-made shoes. While needing to be cognizant of political sensitivities in Congress, the White House needs to reduce these exemptions to no more than 1 percent of products. Moreover, by making this preference immediate and not contingent on a successful conclusion of the Round, as it now is, development issues can stop being roadblocks to finishing the Doha negotiations. Moreover, such a move would demonstrate American commitment to addressing the needs of developing economies in the Doha Round, a dedication that has not always been self-evident. At the same time, the United States also needs to finally put an ambitious offer on the negotiating table in Geneva to ease the temporary movement of service workers, an Indian goal for the Round that cannot be ignored. The European Union has such an offer, and the White House needs to overcome domestic opposition to such an initiative if it expects to see reciprocal services offers from developing countries.

For its part, the European Union needs to reinterpret the budget deal it made in December 2005, not to cut agricultural spending but to redirect it to non-trade distorting activities, such as conservation. This would effectively allow EU trade minister Peter Mandelson to offer more cuts in trade distorting subsidies, showing the EU flexibility needed to jump start the negotiations.

Germany, under the new leadership of Chancellor Angela Merkel, could play a pivotal role in such a European effort. But she will face key constraints.

There is historical precedent for such a German initiative in multilateral trade negotiations. At the end of the Uruguay Round in the early 1990s, then-chancellor Helmut Kohl pressured then French president Francois Mitterrand to agree to farm support concessions, breaking the existing deadlock and resulting in the successful conclusion of the talks. Merkel could choose to play a similar role in the Doha Round.

Only Berlin has the trade and investment ties and the diplomatic leverage to convince Paris, Warsaw, and Budapest that further agricultural reform is in Europe's long term interest, whatever the short term costs. And Merkel has done it before.

In December 2005, Merkel broke the deadlock over the new EU budget by striking a deal that had eluded British Prime Minister Tony Blair (who at the time held the EU presidency). In return for a larger German budgetary contribution, a smaller budgetary rebate for the United Kingdom, and more input from France and Italy, the ten new and poorer EU member states were able to preserve more of their EU structural aid.

Only Germany has the standing to broker a similar deal within the European Union to alter its negotiating stance in the Doha Round. Berlin could propose that the agreed amount of money for the EU agricultural budget should remain unchanged, but suggest that money be used differently, with savings in the elimination of export subsidies to be plowed into non-trade distorting forms of agricultural support, such as land conservation. Such an initiative has already drawn the support of non-governmental organizations such as Oxfam.

The French, among others, may object, arguing that the 2005 budget deal locks in spending decisions until 2013. But, as Adam Posen, a senior fellow at the Institute for International Economics, points out, "all intergovernmental agreements (such as the EU Takeover Code, the EU Services Directive, and the Stability and Growth Pact) are subject to renegotiation in the guise of reinterpretation if the major states decide to do so. There is certainly no reason the French and Poles should get away with keeping the CAP deal more sacrosanct than all the other deals."

But Merkel's room for maneuver may be limited. Her coalition government is dependent upon the support of the Christian Social Union, whose Bavarian farmer voters are some of the greatest beneficiaries of EU farm subsidies. Merkel is not Kohl and French President Jacques Chirac is not Mitterrand. And Merkel has far more pressing domestic priorities. "(All) this must call into question how far German support for further agricultural concessions by the (European Commission) will go," concluded Evenett.

But even successful German-led farm reform initiatives will not ensure the Round's success. So Washington and Brussels should prepare fallback positions.

If a maximalist Doha agreement is beyond reach, then Europe and the United States need take the lead in crafting an adequate minimalist deal. The outlines of such a conclusion will be defined by what can be accomplished in negotiation over the next few months. But some elements of such an agreement are already clear.

An end to trade distorting export subsidies is certainly within reach. In addition, limited cuts in European and American farm spending are doable given current proposals on the table. Most nations now apply tariff rates that are actually lower than those they are permitted to impose under international rules. Bringing these bound rates down to or even slightly below the applied rates is achievable.

At the same time, a critical mass of trading nations, led by Europe and the United States, may be willing to agree to the elimination of all tariffs in individual sectors of the economy, such as chemicals or electronic products. If only the top dozen nations exporting such goods could be convinced to participate, more than 90 percent of world trade in these sectors would be duty free.

Similarly, WTO members have agreed to permit sector-specific services negotiations among like-minded countries, with the aim of freeing up trade in key service sectors such as air express, insurance, software, and the like. Such initiatives, even in a half dozen sectors, would be real progress.

But even a minimalist agreement will require close cooperation between Washington and Brussels. After being on the same wave length for some time during the negotiations, European-American cooperation showed signs of strain at the Hong Kong trade ministerial in December 2005 and immediately thereafter. While the European Union pressed for greater progress on trade in goods and services, to enable it to revisit agricultural reform, the United States continued to hammer Brussels to further sweeten its offer on cutting farm support. Moreover, Americans were enamored with a sectoral approach to advancing both the non-agricultural market access talks and the services negotiations. Europeans held out for broader progress. And while Americans expressed more and more interest in a minimalist deal, Europeans remained committed to a maximalist agreement.

Washington and Brussels—with a boost from Berlin—will need to get back on the same page if a Doha agreement is to be reached this year, or ever.

RIGHTING GLOBAL IMBALANCES

Whatever the outcome of the Doha Round, the deepening transatlantic marketplace faces a potentially destabilizing macroeconomic challenge in the years ahead: the inevitable rebalancing of the unprecedented U.S.-European current account imbalance. The weakening of the dollar and strengthening of the Euro attendant with any such adjustment threatens economic slowdown in Europe and the renewal of U.S.-European trade tensions.

Until recently, the seemingly self-correcting trade balance between Europe and the United States was considered a model for America's more troubled bilateral economic relationships with Japan and China.

From 1960 through the early 1990s, the transatlantic balance sheet fluctuated between surplus and deficit: seven years in surplus for the United States followed by six years of surplus for Europe, then ten years of American surplus followed by seven years of European surplus, and then another four years of U.S. surplus.

To economists, who argue that bilateral trade imbalances do not matter, the U.S.-European current account experience was exhibit number one of a well functioning economic relationship, demonstrating that, over time, bilateral surpluses and deficits tend to smooth themselves out. Thus, while a snapshot at any moment might suggest problems, a moving picture demonstrated long-term transatlantic macroeconomic equilibrium. That was then. It is not now.

Recently, the transatlantic trade balance suggests another, more troubling picture. Since 1994, the imbalance has worsened and shows no sign of correcting itself. The United States is likely to run close to a $150 billion current account deficit with Europe in 2005, up by a third from 2004. This will mark the thirteenth year in a row of a U.S. current account deficit with Europe, the longest such run in post-World War II history. And the imbalance has been getting steadily worse almost every year, with no sign of rebounding into positive territory any time soon. To put this imbalance in perspective, the U.S. transatlantic deficit is 18 percent higher than the U.S. deficit with Japan and totals two-thirds that of the much higher profile U.S. imbalance with China.

These imbalances contribute to a global U.S. current account deficit that equals 6 percent of the U.S. GDP. Since that imbalance is growing at the rate of about 1 percentage point of GDP per year, it is on a trajectory to reach a current account deficit of nearly 10 percent of the American GDP by the end of the decade.

There has been much finger pointing in recent years over what is to blame for this imbalance: American fiscal profligacy, the overvaluation of the Chinese yuan, or disparate levels of economic growth between Europe, Japan, and the United States. All are to blame. What is more important going forward is that this imbalance, whatever its cause, is unsustainable. No industrial country has borne an international deficit of this magnitude for very long without a currency crisis. And while the United States has many things going for it—the dollar is the reserve currency and the United States remains a very attractive place for international investors to park their money—to bet against an adjustment of the U.S. current account deficit is to bet against history. And no one has ever made money for long betting against history. The danger is, when and if the U.S. current account deficit corrects in a disorderly manner, through an abrupt decline in the dollar and a rise U.S. interest rates, that growth and prosperity all over the world will be threatened.

So both for Europe and the United States, the only questions are: How will the adjustment occur? And who will pay the price?

Because of the enormity of the U.S.-China imbalance and the fractious history surrounding the U.S.-Japan imbalance, the U.S.-European imbalance has received relatively little attention in recent years. But with the U.S.-European imbalance accounting for nearly a fifth of the total U.S. trade deficit, the overall U.S. imbalance cannot easily shrink unless Europe's surplus with America shrinks. And such contraction will generate transatlantic economic pain and political tension.

Most economists believe the United States can sustain a current account deficit of roughly 3 percent of GDP, half its current total. If the adjustment to that lower indebtedness is to be equally shared, the annual European current account surplus with the United States would have to be cut in half, to about $60-70 billion.

The best way for this adjustment to take place is through a strengthening of the Euro and a concomitant weakening of the dollar. In late January 2006, the Euro was worth about $1.22, a 9.6 percent appreciation of the Euro since 1 January 2005. To shrink European exports to the United States and grow European imports of American goods and services, the Euro will have to appreciate further.

How much appreciation is needed and whether the burden of currency realignment is entirely borne by Europe or shared with Asian nations will determine the economic impact on the transatlantic marketplace. In the late 1980s, a three percentage point swing in

the U.S. current account balance came with a real depreciation of the dollar of 30 percent. The longer any current depreciation is delayed, the larger the deficit that will need to be corrected, and the further the dollar will have to fall.

Ted Truman, a senior fellow at the Institute for International Economics, has estimated that a 20 percent depreciation of the dollar to rein in the U.S. current account deficit, would require a 68 percent appreciation of the Euro if Europe bears the brunt of the realignment, but only a 1 percent appreciation if China, Japan, and other Asian nations share the adjustment.

The margin for error in spreading the pain is not great. The European Central Bank estimates that a 5 percent appreciation of the Euro leads to a 0.7 percent slowing of economic growth in the Euro area in the subsequent year. Since the Euro area is only expected to grow by 1.8 percent in 2006, even a 15 percent appreciation of the Euro, to $1.40, would tumble Europe into recession.

Economists Alan Ahearne and Jürgen von Hagen, in a policy brief for Bruegel, a Brussels-based European think tank, have an even more disturbing take on the adjustment. If the U.S. goal is more ambitious, i.e. to totally eliminate its current account deficit, then the European trade balance will have to be reduced by $233 billion, the equivalent to about 2 percent of the EU-15 GDP, costing the EU about 3 million jobs. If those displaced persons were unable to find other work, the EU-15 unemployment rate would jump to 9 percent from 7.5 percent.

Moreover, any depreciation of the dollar would also adversely affect Europeans' holdings of their roughly $3 billion in dollar assets—stocks, bonds, plant and equipment. A 20 percent to 30 percent decline in the value of the dollar would wipe out an equivalent amount of European investment. Europeans and European firms holding such assets would be that much poorer, undermining their capacity to spend and invest at the very time the European economy may need such boosting. (Of course, the value of U.S. assets in Europe would appreciate a similar amount, providing a boon to Americans and American firms invested overseas.)

Such economic contraction and the adverse effect it would have on European manufacturing and agriculture could generate new transatlantic trade tensions. Overt protectionism against U.S. exports is unlikely, although there might be a creative use of standards and testing to slow imports. The friction would manifest itself indirectly. Europe would likely become even more reticent to liberalize its markets in the context of the Doha Round, demanding more exemptions, more safeguards against import surges, and shallower cuts in subsidies.

Most important, European protectionism is likely to most fully manifest itself against imports from China, in the form of more anti-dumping actions and other import management schemes. With China already experiencing a production overcapacity in steel, autos, white goods, fiber optics, paper, and paper products, new European import restrictions will simply divert Chinese products toward the U.S. market, posing new challenges for U.S. producers and new resentment toward Brussels.

Much of the pain of this adjustment is unavoidable. Europe has benefited from export-led growth in recent years and all good things come to an end. The challenge for the transatlantic community is managing this transition to a new, more sustainable transatlantic current account equilibrium, to mitigate the problems it creates.

Fortunately, Ahearne and von Hagen contend, "it may be some time before things turn sour. It is important to use this time effectively to prepare for a smooth adjustment."

At the macroeconomic level, the U.S. Federal Reserve, the European Central Bank (ECB), and American and European budgetary officials will need to reassure their publics that they will respond quickly to swings in growth and not drag their feet, as the ECB and European officials have done in the past. For Germans, this will mean overcoming their historic aversion to a loose monetary policy. Such decisiveness will limit overshooting of exchange rate adjustments and help insure a soft landing. As Adam Posen of the Institute for International Economics has suggested, for both the Federal Reserve and the ECB, this may require adopting inflation targets that

would oblige monetary policy to offset excessive movements in prices up or down. For the European Union, this may also mean making the Stability and Growth Pact more flexible. For the United States, it may mean granting higher unemployment benefits to minimize the political cost of adjustment. And for both governments, it means saving for a rainy day, curbing fiscal deficits so that they can spend money to stimulate their economies if the need arises.

Greater and easier transatlantic foreign direct investment and capital flows can also help ease the burden of adjustment. Washington and Brussels could facilitate cross-border mergers by narrowing the definition of what constitutes a "national security" reason to block an acquisition, by developing compatible accounting standards to remove uncertainty for prospective investors and by educating their publics on the job-creating and job-preserving benefits of transatlantic foreign investment, Posen suggests. Such efforts would help keep capital flowing in both directions across the Atlantic even as the Euro appreciates, the dollar weakens, and Europe slows.

Finally, financial fragility is the primary means by which limited economic shocks could escalate into crises. A transatlantic current account adjustment could lead to sharp declines in asset values, undermining financial institutions. Posen argues that American and European bank supervisors "should be tightening their scrutiny and encouraging increased provisioning by banks. Financial regulators should be warning households of the risks presented by investments that have appeared stable in recent years." And serious effort should be made to rationalize the decentralized nature of the European banking system to strengthen it in advance of an adjustment shock. Germany, with its fractured banking system, should take the lead in this consolidation or it will surely suffer dearly for its failure to take preventive action. This is a domestic economic reform that should be at the top of the Merkel government's agenda.

On the trade front, the protectionist backlash that can be expected in the wake of the economic turmoil attendant with a transatlantic current account rebalancing argues for a quick end to the Doha Round of multilateral trade negotiations. The European Union is only likely to become less forthcoming in an economic slowdown. Better to lock in minimalist market liberalization in 2006, rather than be disappointed by striving for maximalist liberalization through extending the Round.

It is Europe's and the world's self-interest to pursue these reforms. "Restoring confidence and revitalizing growth in Europe through structural reforms that address supply-side constraints and raise domestic demand would help raise global growth and offset the potential contractionary effect of fiscal adjustment in the United States," concluded Rodrigo de Rato y Figaredo, managing director and chairman of the executive board of the International Monetary Fund in the fall issue of *European Affairs* magazine.

There is still time for Europe, in partnership with America and possibly behind German leadership, to begin these reforms in order to head off the worst consequences of a U.S. current account rebalancing. But time is not Europe or America's friend. "Prudent people buy insurance," wrote Ahearne. "Given the magnitude of the imbalances, policymakers in Europe need to act quickly."

THE CHINA CHALLENGE

China will play a pivotal role in the unwinding of global imbalances. How Europe and the United States handle China's growing surplus with each of them will largely determine just how painful that unwinding is and what damage it does to transatlantic relations.

The integration of China into the global marketplace—with its hundreds of millions of low paid, but often highly skilled workers—is one of the principal economic and political challenges of the twenty-first century. The benefits to European and American consumers and investors of better relations with the fourth largest economy in the world are self-evident. But, Europe and the United States have also borne much of the brunt of that integration by amassing large and growing trade imbalances with China. This path is neither economically or politically sustainable.

In 2004, the United States ran a $162 billion trade deficit with China, and the European Union amassed a €79 billion deficit with China, €11.9 billion of that deficit amassed by Germany. While America's imbal-

ance is greater than that of Europe, both imbalances have more than doubled since 1999 and show no signs of reversing themselves.

Moreover, Europe's imbalance is only likely to grow, as more and more European companies seek to cut costs by producing more goods and services off shore, increasingly in China. In the services sector alone, 56 percent of companies in German speaking countries—Germany, Austria, and Switzerland—expect a much higher degree of off-shoring over the next five years, according to a survey by Deutsche Bank. While much of this work will go to Eastern Europe (46 percent expect to offshore to the new eastern European members of the EU in the next five years), more and more will go to India (21 percent expect to offshore services there in the next five years) and China (16 percent in the next five years). Notably, suppliers of services, those who often do the outsourcing for their clients, are twice as likely to cite China as India as the site they will outsource client work to over the next five years.

Two-thirds of those surveyed who supply services thought off-shoring would lead to job cuts of up to 10 percent, and nearly a third of those who demand services expect similar cuts. Somewhat compensating for those employment reductions, 20 percent of those who demand offshore services and 16 percent of those who supply them expect off-shoring to increase their hiring more than 5 percent.

Contrary to popular belief that a lack of German language skills in India and China will limit outsourcing to those locations, German companies thinking of outsourcing give relatively little importance to such constraints. They say they will make their off-shoring decision based on access to skilled labor, wage costs, and, notably, the English language skills of the overseas provider of services. Culture does not seem to be a major constraint for further off-shoring in Germany.

These trends and the trade imbalances they create have led to growing trade friction between China and both Europe and the United States and some resultant transatlantic tension. Between 1995 and mid-2005 the United States initiated nineteen antidumping cases against China, while the European Union initiated five. Europeans complain that U.S. actions to bar imports from China have displaced trade, leading Chinese manufacturers to ship more products to the European market. In the same vein, in 2005 the Brussels convinced Beijing to voluntarily restrain its exports of textiles and apparel to Europe under threat of more draconian measures imposed by the EU. This led Washington to negotiate its own voluntary clothing and fabric export restraint with China.

At the same time, both Europe and the United States have growing concerns about Chinese foot dragging in enforcing intellectual property laws. Washington has long complained that Brussels is, in the words of former U.S. trade representative Mickey Kantor, "more than happy to hold America's coat while we do the fighting." There was subsequently greater transatlantic cooperation in negotiating the parameters of China's entry into the World Trade Organization. But, more recently, U.S. officials have complained bitterly about a lack of European cooperation on getting the Chinese to crack down on piracy of movies and music.

To address these issues, Washington and Brussels need to strengthen their strategic dialogue over how they collectively and individually cope with the integration of China into global markets. This may include joint actions at the WTO to strengthen Beijing's backbone in going after the piracy of intellectual property. It may involve coordinated antidumping efforts. Or it may involve a joint WTO case on some mutual manufacturing concern, such as a challenge of China's high duties on imported auto parts when the use of imported parts in China's auto sector exceeds certain thresholds.

Washington and Brussels are not without their leverage. The United States buys 27 percent of Chinese exports, while the EU buys 20 percent. And the European share is growing faster than the American share. Access to these markets means something to China, and U.S. and EU negotiators should, in a coordinated fashion, make it clear to the Chinese that continued unfettered access will necessitate Chinese reforms. Moreover, China has been lobbying hard for both America and Europe to recognize it as a market economy, which would significantly

boost China's ability to fight anti-dumping charges. Washington and Brussels could make it clear that they will jointly determine when Beijing meets this test, increasing their leverage.

Such cooperation may prove particularly difficult for the Merkel government. Despite Germany's trade deficit with China, German exporters have done quite well in China. And past chancellors have periodically used trips to China to promote German products and, possibly more important, to stand tall on the international stage. A more hard-nosed approach to Beijing by the Merkel government might ruin those much sought after photo opportunities.

A good place to start is for Merkel to play good cop to Washington's bad cop in dealing with China. Given China's expressed interest in greater influence in the World Bank and International Monetary Fund, Posen suggests that Merkel lead a European effort to give up some of the European votes in the management of those institutions in return for Chinese revaluation of the yuan.

Without such closer collaboration, on currency and other issues, Europe and the United States are likely to take actions that will harm the other, will have less leverage over China to further open its market, and will be played off against each other by Beijing.

TAX COMPETITION

Until recently, taxation, whether it be in Europe or America, has been purely a domestic concern. Import duties that directly affected others, were, of course, subject to international negotiation and, since World War II, have been reduced dramatically. As a result, they account for an insignificant portion of total government revenues on both sides of the Atlantic. And while tariff reduction has, from time to time, spawned fierce political controversy, these have been trade debates, not taxation debates.

But in the future, as deep transatlantic (and intra-European) market integration proceeds, taxation issues will increasingly become the stuff of transnational economic concern. Whether levels or methods of taxation are a barrier to commerce or an "unfair" investment incentive raise concerns about national sovereignty and underscore the growing political nature of taxation issues. This friction is evident in the ongoing European debate over national corporate taxation rates and the value added tax. And taxation has emerged as a transatlantic issue both with regard to how the United States taxes the overseas earnings of its multinational corporations and how U.S. tax law treats the interest payments made by foreign subsidiaries in the United States.

The stakes in these tax disputes are enormous. The tax benefits accorded U.S. businesses in the tussle about overseas earnings were somewhere between \$2 billion and \$7 billion a year, depending on the methodology used to determine the degree of the alleged subsidy. By comparison, the high profile U.S.-European Union banana dispute in the 1990s revolved around supposed injuries to U.S. companies of less than \$200 million.

The earnings tax imbroglio had been simmering for some time. It arose from the fact that Washington taxed corporate income directly, while Brussels taxed it indirectly through a value-added tax. The EU then rebated these duties to European companies when they sold European-produced goods abroad. In effect, the United States taxed corporate income globally, while Europe had, and still has, a territorial limit on its taxation.

Washington set up entities called foreign sales corporations (FSC) to level this taxation playing field. They enabled U.S. companies to exempt some of their export earnings from federal corporate taxation by diverting revenue through an overseas affiliate set up solely for tax purposes. Such a tax dodge was clearly in violation of international trade rules that prohibited export subsidies, such as the rebate of direct taxes. But in 1981, when the foreign sales corporations were first conceived, Brussels agreed not to challenge them.

Then, in the late 1990s, in a pique over losing U.S.-initiated WTO cases involving bananas and beef-hormones, the EU filed a WTO case against the FSC. Washington countered that the 1981 pact was implicitly grandfathered in to the 1994 Uruguay Round international trade agreement and thus immune to challenge.

A WTO dispute panel sided with the Europeans, invalidating the FSC. Moreover, the WTO went on to say that Washington could not have one form of taxation of production for the domestic market and another form of taxation for exports. U.S. officials appealed and lost. They then attempted to rewrite U.S. tax law to meet the WTO's objections. The EU challenged the rewritten U.S. law and won both its case and the U.S. appeal of its second loss. Washington changed its law again, but Brussels objected that the two year phase-in Washington allowed for the law effectively continued illegal subsidies to American companies. Brussels filed yet another WTO case and was victorious for the third time in February, 2006, But the U.S. Congress is unlikely to amend the U.S. tax law yet again. Washington is more likely simply to pay up to $560 million in EU sanctions through the end of 2006, when the now illegal phase-in of the new U.S. tax law will end. This seemingly never-ending saga of WTO cases suggests just how complicated transatlantic tax disputes will be in the years ahead.

For example, while the FSC saga was playing itself out in 2004, another U.S.-EU tax disagreement arose. Under U.S. tax law, the American subsidiary of any foreign company could lower its taxable U.S. income by borrowing money from its foreign parent and then deducting interest payments on that debt as a legitimate business expense (referred to as "earnings stripping"). U.S.-owned companies could not play the same game, because they file consolidated returns and interest payments within a corporate family, whether at home or abroad, count as earnings for the corporation.

Clamping down on this tax dodge by foreign subsidiaries operating within the United States would generate about $2 billion a year in new revenue. At a time of rising U.S. budget deficits, it was an attractive target for Congress. The Bush administration backed this tax revision in a nationalistic bid for votes in an election year. "A narrow policy response may inadvertently result in a tax code favoring the acquisition of U.S. operations by foreign corporations and the expansion of foreign controlled operations in the United States at the expense of domestically managed corporations," Pamela F. Olson, acting assistant secretary of the Treasury for tax policy, told the U.S. House of Representatives' Ways and Means Committee on 6 June 2002.

The effort to halt asset stripping penalized foreign investors at a time when the U.S. economy needed them. Foreign subsidiaries, especially European-owned ones, employ 6 million Americans, about 13.5 percent of the U.S. manufacturing workforce, and account for 22 percent of all U.S. exports. But with foreign direct investment in the United States waning, Congress eventually decided that it was not time to make such investment more costly. As Gary Clyde Hufbauer, a senior fellow at the Institute for International Economics, warned at the time: "You can squeeze the foreigner, but they will just think of some way to squeeze back."

In recent years, there have not been comparable U.S. objections to European taxation initiatives. Nevertheless, tax tension runs both ways across the Atlantic. In the first Bush administration, the White House strongly objected to a proposed study on corporate taxation by the Organization for Economic Cooperation and Development (OECD) in Paris, an inquiry backed by the OECD's European members, because American conservatives believed it was a back door effort by social democratic European governments to raise U.S. taxes.

Similarly, American conservatives have been encouraging the new, eastern European members of the European Union to have or maintain low tax rates, a position that contradicts the German government position on this issue. Conservative American economists argue that lower tax rates will stimulate moribund European growth. They also believe it is a back door method of defunding the social democratic "welfare" states maintained by Germany, France, and others in Europe.

These confrontations hold lessons for future tax-related friction within the transatlantic community. There is no question that taxes shape competitive environments. And as the single transatlantic market emerges, methods and rates of taxation will increasingly become topics of debate and possible friction. Lesson number one to be learned is that clear philo-

sophical differences exist between European social democrats, who believe in tax harmonization (at least within Europe) to keep tax incentives from "distorting" competition, and American conservatives, who champion "tax competition" in pursuit of their broader goal of lowering taxes. Given the philosophical differences between Americans and Europeans about the role of the state in the economy, the tension over taxation now seen between France and Germany and the new eastern European members of European Union may one day play out in transatlantic relations.

A second lesson is that taxation issues provide fertile ground for nationalistic and protectionist schemes. The EU's FSC offensive was a tactical response to U.S. trade actions. And the U.S. effort to curtail "asset stripping" was in response to concerns about growing foreign competition in the U.S. market voiced by small and medium-sized businesses, a Republican party constituency.

But a more encouraging lesson is that both the FSC and the "asset stripping" issues were politically contained. Despite the fact that taxation is so intimately linked to sovereignty, especially in the minds of many Americans, and thus subject to demagoguery, these disputes never became issues of broad public debate. Trade officials, tax experts and a small number of politicians were able to resolve these disputes, albeit with many starts and stops, in a manner that should serve as a model for future transatlantic impasses.

Nevertheless, the growing number of tax-related transatlantic disagreements is a harbinger of things to come. There is no economic reason why the transatlantic marketplace needs a single tax regime. EU member states and U.S. states peacefully coexist despite differences in income, corporate, and sales and value added taxes. And American conservatives may be right that some form of modest tax competition is a healthy discipline on tax writers. But there is also a long history in both Europe and the United States of using the tax code to unfairly subsidize industry. So, while a leveling of the tax playing field is neither necessary nor necessarily healthy economically, some degree of tax harmonization—at least similar forms of taxation, such as a value added tax in the United States, which would have the advantage of raising the revenues needed to balance the federal budget deficit and would encourage savings, thereby easing the adjustment of the American current account imbalance—may be useful as the transatlantic marketplace deepens. At the very least, U.S. and European officials should begin an informal dialogue on such topics, comparable to the staff level interactions that now regularly take place between anti-trust officials in Brussels and Washington.

REGULATORY CONVERGENCE

Regulatory convergence or divergence is an even more immediate challenge to transatlantic comity. The political and policy coordination problems inherent in creating a single transatlantic regulatory environment may test the limits of transatlantic economic integration and globalization in general. The exercise exposes differing values—tolerance for risk, trust in government versus the marketplace, attitudes toward transparency, and public participation in decision making. And it raises questions about how to accommodate more than one regulatory regime in the same economic space.

How to regulate biotechnology, for example, has been the most visible and complex regulatory challenge faced to date. It is particularly difficult because it is both a commercial and a political problem. And it raises potentially imponderable questions about transatlantic culture differences over public tolerance for risk.

In the mid-to-late 1990s, the advent of genetically-modified commodities—such as corn and soybeans that had been altered to make crops more resistant to insects and disease—led to a transatlantic regulatory collision. Beginning in 1999, the European Union refused to certify new varieties of bio-engineered products for sale and wanted to require labeling of foods containing genetically altered ingredients. Absent scientific evidence that any of those ingredients were harmful, Washington contended that such restrictions were illegal trade barriers.

Europe's action was a particular concern for the United States because genetically engineered crops

lay at the intersection of two of America's strongest comparative advantages in the international marketplace: agriculture and biotechnology. U.S. farmers accounted for two-thirds of global production of GMO soybeans, corn, cotton, and other such crops in 2001. Thus any attempt to regulate the sale of GMO products threatened U.S. economic interests. EU constraints on imports of genetically-modified U.S. corn cost American farmers an estimated $200 million a year. Moreover, Washington feared that European restrictions would serve as templates for similar actions by Japan, China, and South Korea in thinly-veiled efforts to protect their farmers from U.S. competition.

It has long been the U.S. position that any regulation concerning GMOs should be based on "sound science" and it has argued that there is no scientific evidence that GMO products are harmful to the environment or to human health. A late 2001 European Union poll of 16,000 people found that 56.5 percent of Europeans rejected such "scientific" claims.

The EU approach to GMOs reflected European use of the "precautionary principle," a way of managing risk that can best be summed up as "better safe than sorry." On a range of issues, from the use of antibiotics in livestock to the assessment of the impact of chemicals in everyday products on human and environmental welfare, Europeans have responded to the uncertainty of modern technology and globalization by being more risk averse than Americans.

Yet even within Europe, attitudes toward risk vary widely. Swedes are concerned about dangerous chemicals, contends Ragnar Lofstedt of the King's Centre for Risk Management in London, and Danes worry a lot about Sweden's nuclear power stations. Italians, although addicted to their mobile phones, are bothered about radiation.

And as a useful reminder that attitudes can change, European risk aversion and American risk tolerance are relatively recent developments. From the 1960s through the mid-1980s, U.S. regulation of health, safety, and environmental risks was generally stricter than in Europe. In fact, the precautionary principle was the basis of the regulation of food safety and many U.S. environmental statutes developed just a few decades ago. For its part, Europe has only recently created an equivalent to the U.S. Food and Drug Administration, and this new body lacks any real power, despite the clamor among Europeans for tighter protections.

The GMO issue also exposed an ongoing struggle that pits American and European business against American and European consumers over labeling and how much information is too much. U.S. regulators have led the way in these efforts, requiring far more labeling than their European counterparts. But that balance is now shifting, as European consumers demand more information, not only about the contents of a product but also about how and by whom it was made and whether it contains GMOs.

The food industry on both sides of the Atlantic has been wary of more testing and labeling. Retailers know from bitter experience that labels can influence consumer behavior. Given the industry's razor-thin profit margins, even a small shift in buying patterns caused by scary or confusing labels could jeopardize millions of dollars invested in developing new genetically altered products and the prospects for future sales.

The United States eventually challenged European Union GMO regulations at the WTO. In early February, 2006, the WTO provisionally ruled that the EU's de facto moratorium on approvals of biotech products between June 1999 and August 2003 had been illegal. But the more than 30 biotech products Brussels has approved since 2004 makes the WTO ruling moot.

More important, however, the WTO ruled that individual national bans on the marketing and import of EU-approved biotech products in France, Germany, Austria, Italy, Luxembourg, and Greece violated WTO rules. Moreover, the WTO concluded that these nations had not undertaken risk assessments in line with international rules requiring that they be based on sound science, vindicating the U.S. objections. Whether this WTO ruling finally resolves the GMO issue remains to be seen. But the GMO episode demonstrated that leaving the regulation of genetically altered foods solely to agricultural officials on either side of the Atlantic is a prescription for prob-

lems. Such officials lack the essential trust of the consumers. A far better option in the United States would be for such products to be tested for safety by the U.S. Food and Drug Administration and for their environmental impact by the Environmental Protection Agency, a course endorsed by American Consumers Union, for example. To ease industry's concerns that labeling could deceive but not inform consumers, the Federal Trade Commission could monitor labels for truthfulness and relevancy.

But for labeling to work there would have to be reciprocal testing by equally credible regulatory agencies in Europe. Unfortunately, the failure of the European Union to create an independent, credible food safety agency with its own enforcement powers has complicated transatlantic efforts to resolve differences over issues such as GMOs. Without credible European regulatory competence, labeling may not prove effective in defusing the smoldering transatlantic confrontation over biotechnology or over animal rights.

The GMO issue had the potential to inflame transatlantic sentiments, with Europeans perceiving Americans as force feeding them adulterated food. To date, officials on both sides of the Atlantic have successfully contained the issue and its political ramifications. A European Union effort to create a single European regulatory regime for all chemicals and their derivatives, including their application to intermediate and final goods, had similarly explosive potential. And it too has, so far, been managed in a manner that has avoided a confrontation.

The EU goal was to streamline the more than forty EU directives and regulations regarding chemicals, to better understand the hazards chemicals pose to human health and the environment and to reduce the costs of regulatory implementation in one of Europe's leading industries. The proposed Registration, Evaluation and Authorization of Chemicals (REACH) directive would test 30,000 existing chemicals and all new chemical compounds. Moreover, it would shift the burden of proof for risk assessment from the government to the industry.

European industry, especially German chemical makers, immediately cried foul, forecasting plant closings, job losses, and declining investment. Subsequent independent analysis found many of these scare stories to be exaggerated. The direct costs of testing and registration may be no more than € 3 billion.

U.S. industry also had a huge stake in REACH. American chemical exports to Europe total about $20 billion a year, while imports from Europe average about $40 billion. Moreover, Jacques Pelkmans, of the College of Europe in Bruges, estimates that over $400 billion in downstream products made by U.S. firms and sold in the EU might be subject to testing and possibly risk assessment by the REACH directive.

European and American industry concerns and forceful intervention by the U.S. government led to several compromises. The principal of "one substance, one registration" was introduced to minimize costs; some tests will be waived for substances produced or imported in quantities under 100 tons ; and new substances receive greater scrutiny than existing substances. While REACH is not yet law, a contentious issue has been defused for the moment.

The history of this episode highlights the challenges that lie ahead for transatlantic regulatory cooperation and the benefits that are possible once public officials and the business community are engaged. Like all EU directives, REACH was developed by the European Commission without much input from either the business community or elected officials. As a result, provisions often failed to reflect practical, real world concerns and eventually had to be revised. Conversely, many initial fears about the directive's cost proved wildly exaggerated, in part based on lack of understanding of how the directive would operate. Many of these issues were ultimately resolved, but only after much *Sturm und Drang* that only reinforced prejudices against the bureaucratic and opaque operating style of the European Commission.

It did not have to be this way. A similar proposed U.S. regulation would have been subject to earlier and more extensive public input thanks to the U.S. Administrative Procedures Act, the Freedom of Information Act, and the Government in the Sunshine

Act, which permit public scrutiny of regulatory deliberations. As a result, food, drug, and other government health and safety regulators are held in relatively high regard in the United States. A similar openness of regulatory proceedings in Europe would help overcome much public skepticism of Brussels' decision-making and avoid future REACH-like controversies.

U.S. and EU officials are well aware of the need for regulatory cooperation, and they have engaged in a range of transatlantic discussions aimed at reducing regulatory barriers to trade and investment since 1995. Unfortunately, it has proven to be a lost decade. Almost nothing substantive has been accomplished. After years of deliberation, regulators and the industry could not even agree on common automobile headlight standards.

Currently, the Bush administration and the European Commission are pursuing a U.S.-EU Regulatory Cooperation Roadmap. But this exercise—involving a broad range of issues, including pharmaceuticals, information and communications technology, chemicals, nutritional labeling, and eco-design of electrical products—largely aims at exchanging information and encouraging dialogue between regulators. While these are necessary initiatives, they are woefully insufficient to achieve even a modicum of regulatory convergence in the short run.

The difficulties to date underscore just how complicated deepening integration of the transatlantic economic space can be. Whole new approaches may be needed to break the current logjam. The European Commission and the U.S. government might pursue a course of mutual recognition of standards and testing—accepting each other's certification rather than attempting to harmonize rules and regulations. This is the approach currently used within the European Union. The U.S. Chamber of Commerce has suggested a Transatlantic Conformity Mark in which products that meet mutually recognized standards could be distributed and sold in Europe and the United States without further testing.

But bitter experience to date suggests any such initiatives first require political will. The Transatlantic Business Dialogue, comprised of thirty-two major European and American firms, with operations on both sides of the Atlantic, has called for establishing the goal of creating a barrier free transatlantic market. The Transatlantic Policy Network, comprising some of those same firms plus members of the U.S. Congress and the EU Parliament, has gone one step further, calling for completion of that marketplace by 2015. Such goals, timetables, and public commitment would provide useful leverage in getting the European Commission and the U.S. bureaucracy to finally deliver results in their regulatory convergence efforts.

These ideas are not new. Creating a U.S.-EU single market has been bandied about for a decade. But the time may now be ripe to act. The Doha Round will end in 2007. It has long been feared that an explicit U.S.-EU commitment to create a barrier free transatlantic market would impede progress in the Doha negotiations. But with these talks ending, that obstacle will no longer exist. Nothing could do more to breathe new life into transatlantic regulatory convergence than a political commitment at the highest level to deepen the U.S.-EU market.

The benefits could prove rewarding. Cuts in tariffs, a reduction in competition-restraining regulations, and a lifting of foreign investment constraints could boost GDP per capita in Europe and the United States by at least 3 percent, according to a 2005 OECD study. This would require EU deregulation of electricity and gas generation and distribution, telecommunications, and domestic air, rail, and road transport. The United States would need to liberalize constraints on foreign investment in air transport and broadcasting. And the European agricultural market would have to be more open. If Brussels and Washington could agree to reform their labor and agricultural markets, even greater benefits would accrue.

A Deteriorating Public Relationship

The deepening transatlantic economic relationship is occurring against a backdrop of deeply troubled European-American political and diplomatic relations. This deterioration in alliance amity complicates management of economic ties. While some of this friction is a product of the times and should pass as

conditions and leadership changes, other tensions are the natural byproduct of a united Europe and fundamental differences in transatlantic attitudes that cannot be expected to change.

Anti-Americanism in Europe is at an unprecedented high. This antipathy has been mirrored by a less dramatic rise in anti-Europeanism in the United States. And there has been a growing divergence in American and European attitudes toward a range of issues that have been central to the post-World War II relationship.

Strong majorities of the British (83 percent), Germans (78 percent), and French (62 percent) held a favorable view of the United States at the beginning of the twenty-first century, according to the Pew Global Attitudes survey. That support began to slide in the wake of the 2000 U.S. presidential election. After an upwelling of sympathy for the United States in the immediate aftermath of the 9/11 terrorist attacks on New York and Washington, erosion of pro-American sentiment accelerated. By 2004, backing for the United States had fallen to 37 percent in France, 38 percent in Germany and 58 percent in Britain. In 2005, support rebounded somewhat and in some places, standing at 41 percent in Germany and 43 percent in France. But it continued to fall in Britain, to 55 percent.

No longer does the United States hold an iconic spot in the European consciousness. Japan, France, and Germany are all more highly regarded than the United States among the populations of Europe. Strikingly, China now has a better image than the United States in most European nations.

There has been a similar collapse in American support for its long-time European allies. In 2002, 83 percent of Americans had a favorable view of Germany, 82 percent had a favorable attitude toward Britain, and 79 percent saw France in a favorable light. By May, 2003, only a third (33 percent) of Americans were favorably disposed toward France and barely two-fifths (44 percent) felt positively toward Germany. Such sentiments can be attributed to lack of French and German support for the invasion of Iraq. This hostility was reflected in the fact that 52 percent of Americans said they had little or no confidence in French president Jacques Chirac. The result was petty, symbolic gestures of antipathy, such as Congress' renaming French fries as "Freedom Fries" in the House of Representatives' cafeterias. But Americans' support for Europe rebounded in 2005: to 60 percent for Germany and 46 percent for France. Backing for Britain continued to fall, however, to 72 percent.

Anti-Americanism, if not anti-Europeanism, is not new to the transatlantic relationship. Ill will toward the United States spiked during the Vietnam War and then again in the early 1980s during the allied debate over the Reagan administration's desire to station Pershing intermediate range missiles in western Europe. And while in depth public opinion analysis is not available for those periods, anti-Americanism, at least in continental Europe, is worse today than in previous times of allied tension.

Moreover, in those earlier periods, while Europeans were critical of the policies of the American government, they still exhibited great affection for the American people. That too may now be changing. While 83 percent of the British had a favorable view of Americans in 2002, only 70 percent held such positive sentiments in 2005. French and German affection for Americans similarly ebbed. Strong majorities of Europeans still hold Americans in high regard. But only a few years ago it was overwhelming majorities who held such views.

Transatlantic antipathy has grown thanks to the Iraq war, the war on terrorism, the perceived unilateral conduct of American foreign policy, the presidency of George W. Bush, and the perceived lack of European support for American global leadership.

Nothing has divided the Atlantic community more than the war in Iraq. A plurality of Americans believe the war made the world a safer place. A majority of the French and the Germans and a plurality of the British think it made it a more dangerous place.

Barely half of the British, French, and Germans favor the war on terrorism, with support down 18 to 24 percentage points since 2002 depending on the country. By comparison, three-quarters of Americans still support the struggle against terrorists.

A majority of the British and nearly two-thirds of the French and the Germans attribute their unfavorable view of the United States to their sentiments about President George W. Bush, rather than a general problem with the United States. And three-quarters of the French and Germans and three-fifths of the British think less favorably of the United States since the 2004 Bush reelection. Since the Bush presidency is term limited, such attitudes suggest European support for the United States could possibly rebound once there is a change in the White House.

One of the most striking differences in public attitudes to emerge in recent years is the divergence between American and European views of the transatlantic relationship itself. Two-thirds of Americans believe the partnership between the United States and western Europe should remain as close as it has been, according to a 2005 poll by The German Marshall Fund. Half the British, three-fifths of the Germans and three-quarters of the French think western Europe should take a more independent approach to security and diplomatic affairs.

Similar differences emerge over who should lead and who should follow in the relationship. A plurality of Americans (44 percent) think it is very desirable that the United States exert strong leadership in world affairs, according to the Pew Global Attitudes survey. Only 8 percent of Europeans agree, including only 4 percent of the French and 5 percent of the Germans.

There is greater transatlantic comity on the European Union's role on the world stage. A quarter (25 percent) of Americans and 29 percent of Europeans think that it is very desirable that the European Union exert strong leadership in world affairs.

Three times as many Americans as Europeans—36 percent to 11 percent—think the United States should remain the only world superpower. And Europeans are much more likely than Americans—by 70 percent to 44 percent—to think that the European Union should become a superpower like the United States. But these differences mask changing public sentiments. Americans' desire to be the sole super power has declined sharply since 2002, possibly a reflection of Iraq war weariness. And U.S. acceptance of European superpower status had grown from 33 percent in 2002 to 47 percent in 2005.

Moreover, Europeans and Americans are divided over whether a stronger European Union would be a competitor or a helpmate for the United States. Americans are evenly divided on this issue while Europeans overwhelming believe a more powerful European Union should cooperate with the United States.

Most significant for the future of transatlantic relations are differences in American and European attitudes toward unilateralism and multilateralism. Europeans complain that Washington conducts a unilateral foreign policy. Americans disagree. In 2005, more than eight-out-of-ten French said U.S. leaders do not take their interests into account in making policy, and substantial majorities in Britain, Germany, Spain, and Russia felt similarly that the United States ignores their concerns. In Europe, only the Dutch did not view the United States as unilateralist. Two-thirds of Americans, on the other hand, believed their government did take into account the concerns of other nations, at least a fair amount.

These differences complicate relations on a range of issues, most notably with regard to international cooperation within various forums. For example, while strong majorities of both Americans (72 percent) and Europeans (80 percent) share support for the United Nations, a small minority of Americans (16 percent) are three times as likely as Europeans (5 percent) to hold *very unfavorable* views of the UN. And 37 percent of Americans hold unfavorable views toward the WTO, compared with only 28 percent in Europe.

The intensity of this minority American opposition to multilateral institutions has long complicated efforts by the Bush administration and its predecessors to work with Europe. In the mid-1990s, for example, President Bill Clinton had a difficult time building public support for U.S. intervention in the Balkans alongside the Europeans.

American wariness of multilateralism does not, however, preclude international cooperation. Americans are best categorized neither as multilater-

alists nor unilateralists. They are pragmatists, whose views about whether to go it alone or cooperate with others on the world stage depend very much on the issue and the context. Despite the Bush administration's opposition to the International Criminal Court and the Kyoto Protocol, Americans support international efforts to prosecute crimes against humanity and to help slow global warming. U.S. reluctance to engage internationally has had more to do with the unilateralist proclivities of those in power in the White House and the fact that such international agenda items are not high on most Americans' priority list. Only 36 percent believed in mid-2004 that global warming should be a major U.S. foreign priority, down greatly from 56 percent who felt that way in 1993. And fewer than half of Americans said that protecting groups threatened with genocide should be a top priority of the United States. Different leadership in Washington that might focus public attention on different priorities could reasonably be expected to lead to a more multilateralist U.S. approach to problem solving, one that would naturally include greater cooperation with Europe.

Building a Twenty-first Century Transatlantic Relationship

Nevertheless, the rise of anti-Americanism and anti-Europeanism at a time of unprecedented transatlantic economic integration is cause for alarm. Anything that upsets the relatively well-functioning transatlantic marketplace—potentially deterring investment or inhibiting trade cooperation—would prove costly for consumers on both sides of the Atlantic.

Fortunately, to date, there is no evidence of meaningful and lasting economic costs associated with tension over the Iraq war, unilateral American foreign policy, or resentment due to a lack of European support. For a time, surveys showed Americans less inclined to buy French products, but such sentiments appear to have been transitory and have had no significant impact on trade.

These transatlantic differences in attitudes are both a reflection of the inevitable evolution of the relationship and a product of their times. The former sentiments are a complication that must be accommodated, the latter are likely to change with circumstance.

History demonstrates that anti-Americanism in Europe waxes and wanes. And the recent rebound of pro-European sentiment in the United States suggests such views may follow a similar pattern. The fact that much transatlantic friction is driven by European opposition to the Iraq war and the war on terrorism or American resentment at lack of European support for such efforts, suggests time can heal many of these wounds because the wars will one day end. Moreover, U.S. unilateralism—another sore point for Europeans—is a product of the unique circumstances after the 9/11 terrorist attacks on the United States and the assertive proclivities of the Bush administration. History suggests that in less dire straits and with different leadership, the United States may take a more multilateralist approach to foreign policy and thus do less to alienate Europeans.

At the same time, European desire to be more independent of the United States is an inevitable consequence of the creation of the single European market and the Euro. A bigger, more unified Europe empowers public sentiment. And an end to destructive nationalism and the development of a public sense of being European, not just German or French, has long been an implicit goal of American foreign policy. So it is unreasonable for Americans to want Europe to be economically stronger and yet continue to defer to the United States at every turn. Moreover, it is also likely that European desire to chart a separate course from the United States at this point in history is exacerbated by European antipathy toward recent U.S. foreign policy. That alienation is likely to ebb with changes in U.S. policy and leadership.

However, surveys show Europeans want distance from the United States without a willingness to foot the bill. Half of Europeans are unwilling to have the European Union become a superpower if this implies greater military expenditures. Some Europeans—particularly the Germans, the Dutch, and the Scandinavians—would argue that Europe can exercise autonomous influence through the "soft power" of foreign aid and culture. This may be true, but Americans would argue that Europe's experiment in

being a soft super power is only possible in a dangerous world because the United States foots the bill as the world's policeman.

The first imperative in mitigating these differences is to recognize that recent transatlantic friction is a product of differences over policy, not fundamental values. Americans and Europeans do have some differences in values. Religion is much more important to Americans than it is to most Europeans. Americans are also far more individualistic than most Europeans. But, for the most part, these differences do not directly and adversely affect transatlantic relations. Moreover, Europeans and Americans share similar beliefs in free markets, in trade and globalization, and in democracy. Thus, reconciling the United States and Europe is not about either side changing their fundamental values—a task that would be well nigh impossible—and any effort to do so would risk further inflaming the relationship.

However, events over the last few years have surfaced differences in attitudes toward multilateralism. These differences call into question the future viability of deeper transatlantic cooperative action, not only on political and military issues but also within the U.S.-EU marketplace on issues of trade and regulatory and tax harmonization. Since these differences are deeply rooted in both Europe and America in contrasting historical experiences, it will take bold political leadership to begin a new history of beneficial collaboration. That joint action will need to build on Europeans' positive experience with deep integration within the single European market and Americans' pragmatism, whatever their suspicion of multilateralism.

The Bush administration and European leadership need to redouble the spirit of transatlantic collaboration begun in January 2005 with President Bush's trip to Brussels and the reciprocal efforts to collaborate with the United States begun by European leaders. The improvement in European attitudes toward the United States by mid-2005, however slight, suggests such efforts can pay dividends.

To date, this effort has entailed more European burden sharing in Afghanistan, U.S. deference to European leadership in negotiations over Iran's nuclear capability, and more transatlantic consultation on diplomatic and security issues. The Bush administration also now seems genuinely committed to the U.S.-EU high-level Regulatory Cooperation Forum. Such initiatives are long overdue. Nevertheless, the European public's backlash in late 2005 to reports of secret European prisons maintained by the U.S. Central Intelligence Agency is a reminder of how vulnerable the relationship still is to events.

It is in this context that the Merkel government may be able to play a pivotal role in reestablishing transatlantic trust and cooperation. Merkel began this rebuilding effort during her January 2006 visit to Washington. Her clear commitment to common transatlantic values—freedom and security—struck a cord in the White House and laid the groundwork for closer cooperation on foreign policy matters, from Afghanistan and Iran to the future of NATO. On the economic front, Merkel's greatest contribution to the relationship will be to successfully pursue reform at home. A more vibrant, competitive, and growing German economy would help ease the current and anticipated economic strains on the transatlantic relationship.

It is likely to take a concerted, cooperative effort to overcome the bad blood that has polluted the transatlantic political relationship over the last few years. The inherent economic frictions attendant with deep Euro-American economic integration—the clash of heretofore domestic regulatory regimes—will pose new challenges even while they afford vast new economic opportunities. This is unchartered territory for both Europe and the United States. But the stakes are high. And the stakeholders—the governments, the corporations, and consumers on both sides of the Atlantic—have an abiding self-interest in resolving these political and economic tensions. Corporate and elected leaders are determined that these problems shall not impede the deepening of the transatlantic marketplace, which is still the most important bilateral relationship in the world. For the sake of that marketplace and its potential, that rebuilding cannot come any too soon.

Anti-Americanism among European Youth

Even more troubling for the future of the transatlantic relationship is the emergence of an anti-American younger generation in Europe and sharp differences between young Americans and young Europeans on a range of issues.

In 2002, prior to the war in Iraq, when the war on terrorism was still on the drawing boards, 38 percent of French men and women aged 18-29 had an unfavorable opinion of the United States. In 2005, 64 percent disliked the United States. There was a similar rise in animosity among the young in Germany. Even in Great Britain, long a U.S. ally, anti-Americanism had doubled from one-in-six to one-in-three young men and women.

And younger Europeans now hold some of the strongest anti-American sentiments. This is only recently the case. In 2002 in Germany, for example, the strongest anti-American sentiments were held by those over age sixty-five. Now it's Germans under thirty who dislike the United States in overwhelming numbers. Similarly, in France in 2002, everyone under fifty had about the same view of Washington. A little over a third disliked America. Now younger Frenchmen are the most turned off by the United States, with two-thirds considering themselves anti-American.

George Bush is the focal point of much of this youthful anti-Americanism. Among the British, French, and Germans, those under the age of thirty are the most likely to have the least confidence in the American president, with anti-Bush sentiment held by two-thirds of British young people, four-fifths of young Germans, and nine-tenths of young French men and women.

Even more striking is the emergence of generational animosity toward Americans, as distinct from dislike of the United States. Even during the Vietnam war and again in the early 1980s, when European frustration with America was highest, that negative sentiment was generally directed toward U.S. policy and not American citizens, who foreigners have always held in relatively high regard. Today, while majorities in Europe still like Americans, that support has slipped badly, especially among the young. In Britain, four-in-ten people under the age of thirty now have an unfavorable view of Americans, up from one-in-ten in 2002. Dislike of Americans is also on the rise in France, Russia, and Poland, but not in Germany or Spain.

Opposition to the U.S.-led war on terrorism is a driving force behind youthful anti-Americanism. The young are the most critical of the war on terrorism in Britain, France, Germany, and Spain, and this opposition is rising rapidly. In 2005 in Britain, half of those under thirty opposed the war on terrorism, up from a third in 2004. In France opposition was at 68 percent, up from 60 percent. In Germany it was 66 percent, up from 51 percent.

Europe's future leaders want a more independent Europe. Across the continent, those under thirty are the most likely to support another country becoming as powerful as the United States, and they want western Europe to take a more independent approach to security and diplomatic affairs.

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