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The Transatlantic Economy in 2020:

A Partnership for the Future?

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Policy Paper

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Foreword

The transatlantic economic relationship is at a crossroads. The economies of Europe and the United States form the strongest, most interdependent economic partnership in the world, based not only on a significant trading relationship, but also on a strong presence in each other's domestic economy through mutual investment and foreign affiliate sales. Yet key trends in growth and productivity, as well as aging populations, may pose significant challenges to that economic partnership by the time we reach the year 2020. Will the governments of the United States and Europe, including the institutions of the European Union, rise to meet those challenges? Or will current trends become future reality, perhaps even reinforcing or exacerbating existing structural differences between the United States and the EU.

Whichever path the transatlantic economy takes, it will be a key factor in determining the health of the overall relationship over the years to come. The strong interdependence of the two economies has served as a stabilizing factor in transatlantic relations, reminding both the United States and Europe of their joint interest in the growth and stability of the global economy. If the structural differences become more acute and the strength of the two economies less balanced, some larger questions may arise not only about the role of the United States and the European Union in the global economy, but also about the political strength and commitment behind the transatlantic relationship as well.

To examine these questions, the Atlantic Council convened a small working group of policy leaders and experts to consider likely developments in the U.S. and European economies between now and 2020 and consider the impact of those changes on the transatlantic relationship and the international economic system. This report contains group's assessment of the likelihood of several different "scenarios" for the future of the transatlantic economic relationship, and its conclusions and recommendations for dealing with the impact of those alternative futures. The conclusions of this report reflect a consensus of the individual views of the working group members, and do not necessarily represent those of any organization. While not every participant may agree with every recommendation made, all have agreed that the report captures the key points that were discussed. Individual dissenting viewpoints are included in the annex to this report. In addition, the report benefited from the participation of government and media representatives who, for professional reasons, cannot be formally associated with a report of this kind. These individuals are listed as "observers," but bear no responsibility for the final form of the report or its recommendations.

The Atlantic Council would like to thank all those who made this report possible. Particular thanks are due to the working group's co-chairs, W. Bowman Cutter and Paula Stern, for ably guiding the discussions and shaping the direction of the group's work. Our rapporteur, Peter Rashish, did a masterful job of summarizing discussions and showed great imagination in developing plausible alternative scenarios. The working group also benefited from presentations on particular topics by Martin Baily, Randall Henning, and Adam S. Posen of

the Institute for International Economics, and Michael Teitelbaum of the Alfred Sloan Foundation. Posen also made a major contribution to the working group's efforts by producing the analyses that appear in Annex B. Several European participants contributed their views, which were of great value in the preparation of this report, at a special working group session: Guy de Jonquières of the *The Financial Times*, Carola Kaps of the *Frankfurter Allgemeine Zeitung*, Bernhard May of the German Council on Foreign Relations, Patrick A. Messerlin of the Institut d'Etudes Politiques de Paris, Stefano Micossi of Assonime, and Jens van Scherpenberg of the Stiftung Wissenschaft und Politik. Although they are not responsible for the contents of this report, their comments made a great contribution to the discussions. The Council also thanks the Council on Foreign Relations and Warburg Pincus for the use of their meeting facilities. Finally, we are grateful to our sponsors, the German Marshall Fund of the United States and the European Commission. While they bear no responsibility for its recommendations, their support was essential to the production of this report.

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The Transatlantic Economy in 2020:

A Partnership for the Future?

Executive Summary

The United States and the European Union maintain the world's largest and most significant economic relationship, which in turn is a foundation supporting the transatlantic political partnership. By some estimates, the transatlantic economy — including two-way trade and foreign affiliate sales — totals $2.5 trillion and is responsible for 14 million jobs in the United States and Europe. It is not just the scale of the transactions, however; the transatlantic economy is deeply interconnected through impressive levels of foreign direct investment in both directions. Together, the United States and the EU have been key players in managing the global economy through the World Trade Organization, World Bank, and International Monetary Fund. They have been responsible for the major accomplishments in international trade liberalization of the last 40 years, and have spurred the adoption of global standards in a wide range of sectors.

Despite the fact that the transatlantic economy seems to grow ever larger and more closely knit, problems of a serious order may lie ahead. The United States and the European Union confront serious macroeconomic issues and a looming demographic crunch, which will place a strain on pension, unemployment, and health insurance schemes. If current trends in growth, productivity, and demographics continue uninterrupted — particularly in Europe — the strong economic foundation for the transatlantic partnership may become seriously eroded. The United States faces great challenges in terms of reducing deficits and absorbing new security costs. But in Europe, where the demographic crunch is likely to be much more severe, prosperity can only be maintained by reducing government expenditures, stimulating faster economic growth, and increasing labor utilization. Despite the impressive achievements of the single market and the euro — and the promise of the new, reform-oriented European Commission under José Manuel Barroso — there is reason to question whether the European Union will once again be able to accomplish what is necessary to renew its economy. At the same time that the United States and the EU find that their economies are moving in different directions, China, India, and others are likely to experience strong economic growth and to lay claim to a bigger role in economic decision making, challenging the traditional joint stewardship of the United States and Europe. In sum, the conditions that allowed transatlantic political relations to flourish over the past fifty years and fostered U.S. and European joint leadership of the world economy may no longer exist by the year 2020.

As a tool to understanding the likely evolution of the transatlantic economy in the years to 2020, the Atlantic Council's working group developed four basic scenarios, two each for the United States and Europe: *U.S. Prosperity*, *Stalemated United States*, *Reformed Europe*, and *European Stagnation*. For a range of reasons, the working group determined that the likeliest combination of scenarios is *U.S. Prosperity and European Stagnation*. While scenarios are a valuable tool to project different futures for the transatlantic economy, more important are their implications for both global economic governance and transatlantic political relations. The performance of both the U.S. and European economies will be a key determinant of how the future leadership of the international trade and financial system is shaped, and will also impact the political and economic relationship between the two regions.

Implications for Global Governance

The principal implication to be drawn from the scenarios in this report is that only under the most favorable economic conditions could one expect the joint global leadership provided by the transatlantic relationship since the end of World War II to survive in its current form through 2020. More likely, some combination of domestic pressures and transatlantic disputes will create an atmosphere that is no longer conducive to joint transatlantic leadership of the global economy. If institutions such as the WTO are not to be threatened with marginalization, the United States and European Union will need jointly to reaffirm their intention to provide active leadership in the governance of the global economy. Reaching out to new actors — including, but not limited to, the G-20 developing countries — to help ensure that they have a significant stake in the smooth and just functioning of the international economy will be crucial. Part of this effort will include the consideration of some reform of the WTO, particularly to ensure that its management of the multilateral trading system is adequate for running negotiations that are greatly expanded, both in terms of issues and participants.

Implications for Transatlantic Relations

The future of the transatlantic economy has implications not only for global economic governance, but also for the close political and economic linkages between the two sides of the Atlantic that have been fundamental to international stability for the last fifty years. Those links are expressed through cooperation in institutions like NATO and the UN, in continuing U.S.-EU undertakings in the framework of the New Transatlantic Agenda, and via bilateral U.S. relations with individual European states. If the European economy continues to lose ground, not only will Europe become more inward looking, but the EU will not have the resources or inclination to play a larger international role and to join the United States as a partner in dealing with some of the strategic challenges around the world. The United States may well try to turn elsewhere, and with the likely rise of new global players such as China and India, the United States will have alternatives. These potential partners are unlikely to share fully the democratic values that have been at the core of transatlantic cooperation, but that will be less important if these partnership arrangements are temporary and aimed at specific issues. Over time, the U.S. reflex of turning first to Europe when seeking cooperation may fade.

Recommendations

The following recommendations suggest short- to medium-term strategies that the United States and Europe can pursue to increase the likelihood that the most favorable scenario options define the transatlantic economy and overall relationship to the year 2020:

- **Both the United States and Europe should recognize that domestic economic policy is a legitimate subject of discussion for the transatlantic dialogue.** Europe should accept the validity of U.S. concern about the need for economic reform in Europe, while the United States should be ready to listen to legitimate European critiques of its fiscal and monetary policies. However, neither should try to impose a specific economic or social model on the other — partnerships and productivity can exist with diversity.

- **The United States and the European Union should reaffirm their commitment to the multilateral trading system**, making it a priority to ensure that the Doha Round is concluded at a quickened pace, actively seeking to rebuild a consensus in favor of trade on both sides of the Atlantic, and positively managing the energized G-20. As part of their re-commitment to the multilateral trading system, the United States and the EU should jointly lead an effort to examine ways to reform the WTO in order to make it a more effective vehicle for trade liberalization.

- Even with modest reforms on the EU's part, a growing discrepancy in the economic performance of the United States and Europe could lead to a deterioration in their bilateral and global cooperation. In order to reduce the political impact of their divergent economic paths, **the United States and the EU should pursue a two-track strategy involving greater coordination of policies, especially in all the major international economic institutions (WTO, World Bank, IMF, G-8), and more encouragement of "transgovernmental cooperation" among informal networks across the Atlantic.**

- **The United States and the European Union should especially focus on cooperation in encouraging a constructive Chinese role in global economic management and on reform in the broader Middle East and North Africa.** China should be encouraged to adhere to WTO disciplines, and perhaps be asked to join a core group to pursue further trade liberalization within the WTO comprised of the 15-25 countries that account for the lion's share of world trade. The United States and the EU should also forge a more coordinated approach toward economic and political reform in the Middle East and North Africa, taking into account the EU's long-standing effort to build regional cooperation with its Mediterranean neighbors and with the goal of stimulating more extensive trade among the states in this region and between them and the United States and the EU.

- **The advent of a new U.S. administration is an opportunity to reestablish transatlantic relations on a more stable footing.** The president should offer a commitment to address the U.S. budget deficit, while encouraging reform-minded European leaders. The president should indicate his intention to engage Europe as a partner on a number of key projects, and Europe must be ready to respond with greater engagement.

The Transatlantic Economy in 2020:

A Partnership for the Future?

The Transatlantic Economy Today

The United States and the European Union maintain the world's largest and most significant economic relationship. It is a key element in the foundation supporting the transatlantic political partnership. The U.S.-European economy grows ever larger and more closely knit, despite policy and commercial battles that can be contentious and often persistent. But problems of a more serious order may lie ahead: if current trends in growth, productivity, and demographics continue uninterrupted, that strong economic foundation may become dangerously eroded. As a result, the transatlantic partners may find that their economies are moving in different directions and have different priorities. The logic of such an economic erosion is that the United States and the EU are also likely to see their overall political partnership drifting apart. The conditions that allowed transatlantic political relations to flourish over the past fifty years, and that fostered U.S. and European joint leadership of the world economy, may no longer exist by the year 2020.

Today, the most obvious characteristic of the transatlantic economy is its sheer size. When two-way trade and foreign affiliate sales by each other's corporations are tallied together, the transatlantic economy comes to $2.5 trillion, dwarfing U.S. economic ties with either Japan or China, as well as the EU's bilateral economic link with any other single partner.[1] The U.S. and Europe are home to the lion's share of the globe's largest corporations; they have traditionally dominated international economic and financial organizations like the World Trade Organization, World Bank, and International Monetary Fund; and together they provide 70 percent of all official financial assistance to developing countries. Up to fourteen million jobs in the U.S. and Europe (including indirect, trade-related employment) depend on the transatlantic commercial link. Without joint U.S.-EU economic — and political — leadership, neither the Doha Round nor previous rounds of trade talks would have started, the effort to choke off sources of Al-Qaeda terrorist funding would not have scored so many early successes, and the adoption of global standards in a multitude of industries ranging from

[1] Quinlan, Joseph. *Drifting Together or Growing Together? The Primacy of the Transatlantic Economy*, The Transatlantic Center, Johns Hopkins University. Washington DC: 2003.

telecommunications to banking to accounting would not have happened so fast. In short, we would not have the open global economy that exists today.

Perhaps the most distinctive feature of the U.S.-European economic relationship is the high degree of interconnectedness. This is not just a matter of imports and exports, although transatlantic trade in goods and services is strong. Where the transatlantic economy distinguishes itself from any other bilateral economic relationship is in the links created by foreign direct investment (FDI), which, unlike trade, brings economies and societies into immediate contact, through job creation and direct participation in each other's domestic economies. Europe accounted for 65 percent of U.S. FDI in 2003, while nearly 75 percent of FDI in the United States is from Europe. In 2001, 60 percent of the $5.8 trillion in U.S. corporate assets were in Europe, and European firms held $3.7 trillion in 2001 in the United States, nearly 70 percent of the total. One indicator of this interconnectedness is the level of foreign affiliate sales; for example, the sale in the United States of goods produced there by a subsidiary of a European firm. In 2001, Europe accounted for 51 percent of foreign affiliate sales of goods by U.S. firms, and in the same year 54 percent of U.S. foreign affiliate sales of services were in Europe, compared to 20 percent in Asia. Clearly, the United States and Europe are each other's partner of choice, and the result has been deep, bilateral economic integration.[2]

This picture of the health and influence of the transatlantic economy may be deceiving, however. While a snapshot of the present is likely to reveal one set of conditions, peering through a pair of binoculars into the horizon that lies ahead may present quite another view. There are already signs that the transatlantic economy in the next five, ten, or fifteen years may play a less important role than it does today, because of both internal economic challenges and the rise of new global players. The United States and the European Union must confront serious macroeconomic issues, including growing U.S. deficits and perennially sluggish European growth rates. They also must contend with a looming demographic crunch, as fertility rates decline and the proportion of older people in the population increases, placing a strain on pension, unemployment, and health insurance schemes. During the same period, China and India, and to a lesser extent countries like Brazil and Russia, are likely to experience strong economic growth and to lay claim — for economic, political, and justice reasons — to a bigger role in economic decision making, challenging the traditional joint stewardship of the United States and Europe.

Despite their strong economic ties, the United States and the European Union are likely to respond rather differently to these challenges, with potentially significant implications for their partnership. Over the last few decades, Europeans and Americans appear to have developed divergent definitions of economic welfare, with the United States stressing longer working hours for higher pay and Europe preferring somewhat lower wealth in favor of greater leisure and assured social welfare benefits. At a certain level of prosperity, both

[2] Hamilton, Daniel, and Joseph Quinlan. *Partners in Prosperity: the Changing Geography of the Transatlantic Economy*, The Transatlantic Center, Johns Hopkins University. Washington DC: 2004.

choices can be viewed as rational. But because Europe's demographic crunch is likely to be much more severe than that of the United States (which, if the past is any guide, will bring in more younger immigrants to carry the costs of older workers), Europe will only be able to maintain that prosperity if it is able to reduce government expenditures, stimulate faster economic growth, increase labor utilization, or all three. Some countries have already made significant strides down this path, while others are still at the starting gate. Although Europe is often criticized for its slowness in addressing the need for economic reform, it should be remembered that in the 1980s and 1990s, through the creation of the single market and the euro, the European Union could rightly claim to have been at the forefront of positive economic change — and could well become so again. But it is also true that without needed reforms, European economies may, to differing degrees, experience decreased standards of living, along with social and political dislocations. The European Union as a whole may find itself with fewer resources, and thus with a bigger challenge as it seeks to assume a global leadership role.

Although the United States has a long track record in economic reform and deregulation, it is likely to face lesser, but still notable economic challenges of its own. In particular, persistent and growing budget deficits, contributing to higher interest rates, may add constraints to the U.S. economy. The United States has succeeded in eliminating high deficits in the past, and may well do so again. A new and largely unknown factor, however, is the impact of both terrorist attacks and enhanced security measures on the country's growth potential. While future attacks may cause serious, but probably temporary disruptions, increased security measures for ports, transportation, industrial facilities, etc., may add significantly to the costs of business. Increased visa restrictions may make it more difficult for the United States to accept the immigrants who have always played a major role in the economy and who will be key to mitigating future demographic pressures. Finally, developments in Europe and the United States will not happen in isolation from each other: if Europe lacks the resources to play a global role, a United States facing its own constraints may find itself even less inclined to use the transatlantic relationship to pursue policies of joint interest.

By examining the course of the transatlantic economy to 2020, this report is intended to illuminate some of the larger political implications of these potential economic developments, both for the general transatlantic relationship and the joint role of the United States and Europe in global economic governance. Are current trends in GDP and productivity growth, demographics, trade and investment, financial and monetary flows, and other economic elements likely to encourage transatlantic political unity or division and conflict? Will they contribute to a more orderly or fragmented global economy? During the Cold War, observers of the transatlantic partnership often expressed concern that persistent economic conflicts might erode allied political unity. More recently, the strength and integration of the transatlantic economy has been identified as a major factor keeping that partnership intact, despite political tensions. But can it be expected that the transatlantic economy will continue to play that positive role in the future? Or, if current trends persist, are the economies of the United States and the European Union likely to become a source of tension and division?

This report employs scenario building to examine the potential economic futures of the United States and Europe and their consequences. The scenarios suggest broad alternatives for the transatlantic economy as it evolves up to 2020 — they are not intended to replace economic forecasting, or to serve as definite predictions of the future. Rather, the scenarios provide illustrations of future possibilities that seem to have a serious chance of becoming reality. The scenarios allow us to develop a more confident assessment of the future state of transatlantic economic relations and to consider how that relationship will respond to both internal challenges and external responsibilities. That assessment serves as the basis for a set of policy recommendations for the United States and Europe designed to encourage positive trends in the transatlantic economy, while also responding to those troubling trends that may threaten the future economic and political partnership.

Looking into the Future

Any exercise in presenting scenarios about the future needs to be grounded in a sense of the present, and in particular of the current economic performance of the United States and Europe. This is, after all, the baseline which the scenarios will take as their starting point. It will also be necessary to consider the global context for the evolving transatlantic economic relationship.

The Starting Point

The U.S. economy in 2004 is expected to grow by 4.7 percent, more than double the likely EU 2004 growth rate of up to 2 percent. The average growth rates over the last ten years for the United States and the 12 euro zone countries (the EU minus Sweden, Denmark, and the United Kingdom) also shows a gap, although a more modest one — 3.0 percent vs. 2.1 percent.[3] On the other hand, in the past decade the difference in gross domestic product (GDP) growth per person is much smaller — 1.8 percent in the United States vs. 1.7 percent in the euro zone.[4] Faster population growth accounts for the United States' superior performance in its overall, as opposed to per person, economic growth rate. Employment figures also show relatively similar results during the period: 1.3 percent growth in the U.S. vs. 1.0 percent growth in the euro zone.[5]

In terms of economic productivity (worker output per hour), the two sides are currently nearly equal. The EU's productivity growth in the last 30 years helped it catch up with U.S. levels, although since 1996 U.S. productivity growth has outpaced Europe's. There are at least two possible explanations for this recent trend. On the one hand, the United States may have

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[3] Daly, Kevin. *Global Economics Paper No: 102, Euroland's Secret Success Story,* Goldman Sachs: January 16, 2004.

[4] *Op. cit.*

[5] *The Economist,* "Mirror, mirror on the wall": June 17, 2004.

been more effective at integrating high technology into its production processes. On the other hand, thanks to incipient labor market reforms in some EU countries, it has become cheaper to hire new workers in Europe, reducing the incentive to wrest more output from the existing workforce.

Where the greatest difference can be found between the two economies, however, is in GDP per capita. Europeans spend more than 25 percent fewer hours at work, 700 annual hours per capita in Europe versus 950 in the United States,[6] and fewer Europeans are employed, with U.S. unemployment in the past decade averaging 4.6 percent compared to 9.2 percent in the EU. In addition, the number of people counted as part of the labor force in Europe is lower than in the United States. The result is that output per person in Europe is only 77 percent of the U.S. level, even if output per hour is a nearly identical 93 percent.[7] Because of this discrepancy in output per person, by one measure, the average European today is 30 percent poorer than his or her U.S. counterpart — exactly where they both stood 30 years ago.[8]

There is one key question surrounding this wealth gap: does it reflect a voluntary European preference for leisure over greater wealth, and thus represents a choice that is likely to persist in the future and even be supported by government policies? Or is excess leisure and reduced wealth imposed upon Europeans against their will by rigid labor, tax, and retirement policies that are a disincentive to working more? One study suggests roughly a third of the difference reflects Europeans' preference for more leisure and the other two thirds is a result of laws and rules that make labor too expensive in Europe.[9]

An additional angle to this debate is the question of whether to measure economic success through GDP or the broader concept of "welfare," or overall well-being. For example, the United States must spend more of its (higher) GDP on heating, air conditioning, security, and prisons compared to Europe, which gets these benefits (physical comfort, for instance) at a lower cost or has less need of them (as in the case of prisons).

Even assuming that Europeans are making a rational choice for greater leisure at the expense of higher income levels, and that their overall welfare is roughly equivalent to that in the United States, there is still one key reason to be concerned about the likely economic future in Europe, and that is demography. Because of Europe's lower fertility rates and immigration levels compared to the United States, its population is slated to grow at a much slower rate, and a number of European countries will actually experience a reduction in absolute population starting between 2012 and 2030.[10] The problem: without maintaining a robust

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[6] de Grauwe, Paul. *Financial Times*, "The fallacy that stifles growth in Europe." August 5, 2004.

[7] Organization for Economic Cooperation and Development, *OECD Employment Outlook No. 75:* 2004.

[8] Blanchard, Olivier. *The Economic Future of Europe,* National Bureau of Economic Research: February 2004.

[9] Gordon, Robert J. *Two Centuries of Economic Growth: Europe Chasing the American Frontier,* Northwestern University and CEPR: March 30, 2004, p.11.

[10] UN Population Division, *World Population Prospects: The 2002 Revision.*

working age population and keeping them employed, Europe will not create the resources necessary to support its increasing ranks of old age pensioners. Other aspects of Europe's generous welfare state provisions may also become harder to finance without enough young workers contributing to the tax base. In fact, it is already too late for European families to produce enough children who will be of working age by 2020, and the levels of immigration needed to achieve replacement population growth are politically unacceptable.[11] Dealing with the demographic challenge, especially in Europe, will require a combination of serious responses aimed not only at population growth, but also at keeping more people in the workforce longer and reducing the costs of supporting them after they retire. But from the context of the current economic situation in the United States and Europe, this demographic crunch seems distant and thus far removed from the policy agenda.

The Global Context

The economic challenges to the transatlantic relationship must be met within a wider international context that will be driven by a number of variables: security, demography, technology, globalization, energy/environment, and the distribution of global political power. Although there is certainly the possibility of a massive discontinuity in the existing world order or global economy — along the lines of the end of the Cold War, for example — it is not at all clear what impact such a disruption would have on the transatlantic economy and overall relationship (for a discussion of this point, see Annex A on "Wildcards"). Thus, for the most part, this report anticipates that the future will be well-rooted in the present, with incremental and gradual change remaining the norm.

In terms of global security, this report anticipates that no major conflict — on the order of World War II — is likely to disrupt the world economy, although there will undoubtedly continue to be regional conflicts, some of which will involve the United States and/or Europe in efforts ranging from the current conflict in Iraq to more limited peacekeeping and crisis management operations. Terrorism will continue to be a disruptive force around the world. A number of developing countries are likely to face the challenge of indigenous terrorist movements, while the United States and Europe will more often find themselves the target of certain global terrorist networks. Between now and 2020, it seems reasonable to expect that the United States and Europe will experience several significant attacks on civilians similar to the Madrid March 2004 train bombings and perhaps also an event on the magnitude of September 2001.

Apart from these outbursts of conflict and violence, the world between now and 2020 is likely to be dominated by three major developments: the continuing deepening of globalization; the

[11] In order to maintain the size of the working population, the European Union must take in approximately 4,200 immigrants per 1 million inhabitants annually between 2000 and 2050, while the United States must take in approximately 1,400 immigrants per 1 million inhabitants. See *Replacement Migration: Is It a Solution to Declining and Aging Populations?* Population Division, United Nations, 2001.

increasing isolation of those (both individuals and states) who do not participate in the world economy; and the rising importance of new international powers, especially China and India. The general impetus toward economic interconnectedness and interdependence — globalization — will continue, despite some occasional backtracking and reluctance on the part of individual states. This trend will remain strong in the transatlantic arena, although there will undoubtedly be some temporary slowdowns when concerns about exports of jobs spill into the political arena. Nevertheless, the United States and the European Union are both likely to be leaders in the globalized world economy in 2020, just as they are in 2004, and their own economic partnership will continue to be one of the richest examples of globalization.

Apart from the impact on the transatlantic relationship, the worldwide effect of globalization is likely to be somewhat mixed. For those who are able to participate in the global technology and communications revolutions, the continuing economic trend of globalization will be primarily beneficial, and contribute to the development of a transnational business and policy elite. But even in the richest countries, those without adequate access to technology or without the skills to participate in the new economy are likely to be increasingly isolated. Thus, while increasing globalization during this period brings economic benefits to many, it also reinforces a bifurcation of many economies between those who can participate in the global economy and those who are increasingly left behind.

This tendency will be reinforced by the continuing advances in technology, with the most significant developments occurring in biotechnology and nanotechnology. Innovations are also likely to continue to emerge in the information and communications fields. The focus will increasingly be on the adaptation of technology to industry, a process that will further exacerbate the division between "haves" and "have-nots" as some countries prove much more able to adapt technologies than others. The United States will continue to dominate the funding, research, adaptation, and commercialization of most new technologies, but will be joined by some new powerhouses in specific fields. Europe will continue to innovate in some key technologies — telecommunications, for example — but will continue to struggle with adapting new technologies to commercial use.

Similarly, this division will also be reinforced by demographic trends. U.S. and EU populations are largely expected to evolve along their current trend lines, with some variation depending on migration patterns, security concerns, and career patterns. Fertility in the United States will continue at replacement rate or just above, while the EU, even after Romania and Bulgaria join, will be well below replacement rate. In fact, the new members of the EU all have fertility rates well below replacement and in some cases will actually decline in population. The exception is Turkey, which currently has a much younger population than EU-25, and a fertility rate of 2.7. However, by 2020, Turkish fertility is expected to drop just below replacement rate. [12] Throughout the rest of the world, populations are also

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[12] Average number of children per woman, medium variant for 1995-2000. United Nations Population Division, *World Population Prospects: The 2002 Revision*.

aging as fertility levels decline. However, higher initial fertility levels mean that most countries will remain well above the replacement birth rate and absolute population numbers will increase, albeit more slowly than in the past. In general, the least developed countries will see the greatest increases in population growth. Some key countries outside the EU and the United States will experience a range of demographic developments. In China, the "one child" policy has lead to a decline in fertility to below replacement rate, although the total population will continue to grow throughout this period. In India, the fertility rate is well above replacement, and will remain so until midway through the current century. Russia, in contrast, is already experiencing a decline in population, with no indications of a reversal in sight.[13]

Throughout this period, the world's demand for energy continues to grow. Although there is some increase in both nuclear power and in alternative energy supplies, for the most part, the growing demand must be met by the traditional sources of oil and gas. Natural gas becomes an increasingly important part of the energy equation as transport systems are developed via ship and pipeline. Increasing pressure for energy to be provided in clean forms adds to the cost of energy, but also leads to the creation of new technologies that in turn benefit the energy industry.

What is structurally new is the increased use of energy by China and India, an indication of their rise to a new level of economic development and power. Indeed, they are the only countries likely to be capable of attaining global economic power status outside Europe and the United States during the period to 2020. China could become the heart of a booming northeast Asian region, with the Japanese, Korean, and other regional economies increasingly connected to each other and to China through extensive trade and investment ties. Although India may remain more isolated among its neighbors in south Asia, it is perceived by many as a dominant player in the G-20 set of developing countries, which is increasingly active and influential in international economic matters. By 2020, these two emerging powers are likely to boast large export and international service sectors, with technology a key part of their development. In both countries, however, it is likely that that the increasing wealth will not be distributed evenly across the population, leading to societies with elites and a growing middle class that participate in globalization and a far larger majority still living in developing country conditions and far removed from the global economy.

Other areas of the world will probably see more erratic signs of progress, if any at all. African economic development will remain hindered by instability, conflict, and the impact of HIV/AIDS in many areas south of the Sahara. The continuing degradation of arable land by over-farming, coupled with recurrent drought is likely to further hinder economic progress. In North Africa, there will be some progress in achieving political and economic reforms, but the persistent struggle with Islamic fundamentalism will continue to pose challenges for moderate governments in that area and impede full reforms. In Latin America, there is likely to be an increasing division into separate regions, one based on Mercosur and another on the

[13] United Nations Population Division, *World Population Prospects: The 2002 Revision.*

Caribbean, with other individual countries, especially Brazil, seeking to play a much more independent role. Throughout this time, Russia's geopolitical and economic influence is likely to remain in question. Although it will clearly still be a major supplier of natural resources, its declining population and continuing questions about the direction of its political development mean that investment by non-Russian firms is likely to be limited and that much of the Russian economy will remain under the control of the government or the remaining oligarchs.

Alternatives on the Road to 2020

As a tool to understand the likely evolution of the transatlantic economy in the years to 2020, the Atlantic Council's working group developed four basic scenarios, two each for the United States and Europe. These scenarios emerged after extensive discussions of the past, present, and likely future economic performance of the both the United States and Europe, as well as the main political, social, and cultural factors determining these economic outcomes. Each of the four scenarios described below was deemed possible, but, for a range of reasons, some were considered to be more likely than others. In developing these scenarios, the working group was careful to take into account the recent past of the U.S. and European economies, especially as a guide to the willingness of governments and societies to select particular policies and meet specific challenges.

The United States has enjoyed more than ten years of impressive economic growth with low inflation and interest rates, small numbers of jobless, and until recently a healthy fiscal balance sheet. Because of its flexible labor, product, and capital markets, culture of innovation, capacity to attract foreign capital, and success in integrating immigrants into its workforce, the United States looks likely either to continue along this positive trend or at least to perform adequately enough to maintain its current weight and role in the global economy. There are, however, some issues that could adversely affect that positive future, primarily budget deficits and costly security measures. Europe presents a different, more internally contradictory picture. Europe has caught up with the United States in many ways over the past 30 years, and both the EU single market plan of the 1980s and the introduction of the euro in the 1990s reflect Europe's capacity for economic reinvention. Despite these intervals of policy dynamism, however, Europe has also experienced a certain amount of market rigidity, overregulation, and government health and pension commitments challenged by an "aging" society. The failure to make progress on the Lisbon agenda — the commitment to make Europe the most productive, knowledge-based economy in the world by 2010 — is illustrative of the recent lack of dynamism. As a result, Europe's future until 2020 suggests either quite modest economic growth and continued difficulty coping with demographic changes, or another period where the political will is exerted to enact major economic reforms.

Although other scenarios are imaginable, the following four capture the considerations of the working group discussions. **U.S. Prosperity** implies that the budget deficit is under control and there is recovery with innovation and jobs growth, while in **Stalemated United States,** the deficit is still large, and security considerations arising mainly from terrorist threats keep growth modest. In **Reformed Europe**, the EU achieves labor market reform, improvements in growth and productivity, and all 25 member states adopt the euro. Under **European Stagnation,** very few of these reforms can be enacted, and the European economy becomes more insular.

U.S. Prosperity

Prior to 2010, the U.S. economy will face some challenging years. But in this scenario, government deficits are gradually brought under control and enhanced government spending on defense is reversed following the end of U.S. involvement in Iraq. Employment numbers slowly begin to rise, particularly as innovations in biotech and elsewhere lead to new industries. Overwhelmingly, however, new jobs are for educated, skilled workers; some programs for retraining workers are set up, but they are only moderately successful in identifying the skills needed for the fast moving economy. U.S. productivity rates and growth rates continue to increase, although slowly compared to the 1990s.

As the U.S. economy improves, both portfolio and direct investment increase significantly. With its flexible, educated workforce, the United States is viewed as an excellent location for high-technology manufacturing. Although high interest rates and underdeveloped EU capital markets slow the rate of growth of European investment across the Atlantic, many French and German high tech companies and entrepreneurs build plants in the United States. The strength of the economy also leads to a reverse in the downward movement of the dollar, so that by 2012, the dollar is the unquestioned primary global reserve currency.

U.S. economic growth is slightly hampered by a few factors. First, there is a gradual but steady rise in the cost of energy and increasing pressures to produce cleaner, but more expensive fuels. Developments in the Middle East also contribute to tightening of the oil market, as does increased consumption by India and China, but there are no major disruptions in supply. Second, the continuing campaign against terrorism, especially after a second massive terrorist attack in 2009, adds increased security costs across the entire business world. In both areas, however, business also identifies new, profitable markets that partially compensate for the increased costs.

Throughout this period, the number of Americans no longer working is supported by a shrinking pool of workers, making it more difficult for social security and other support systems to remain sound and viable. As a result, Americans gradually increase the length of their careers, as the *de facto* retirement age rises. Migrants also continue to enter the United States in large numbers, so that by 2020, the U.S. population is almost 40 percent minorities. U.S. population growth is slightly less than replacement level, but this has little economic impact.

The political landscape is characterized by a rough balance between Republicans and Democrats during this period, with the Democrats managing to capture one of the two houses of Congress, and the White House alternating between political parties. The divisiveness between the two parties that characterized the Clinton and Bush administrations eases, and voters choose their president less on ideological grounds and more according to their views on the health of their local economy or the personality of the candidate.

Stalemated United States

Throughout the period 2005-2010, the U.S. budget deficits and debt levels continue to increase in this scenario. Deficit financing is dependent on investment from Japan, Korea, and especially China, whose financial leverage over the United States has increased somewhat since joining the G-8 in 2008. Efforts to restrain the deficits run afoul of political support for strong defense budgets, especially after a 2009 terrorist attack. That attack also leads to a significant increase in security measures throughout the United States. As a result, new restrictions are imposed throughout the U.S. economy that lead to burdensome costs, especially in areas of transportation and communication, as well as in the chemicals, energy, and high-technology industries.

The economy grows modestly through this period, and U.S. industry continues to be a leader in the development and adoption of technology. But the 2004 phenomenon of a "jobless recovery" proves persistent, and income levels within the United States increasingly diverge. Critics begin to speak of a two-tier society of haves and have-nots, and by 2009 the best-seller list is topped by a book titled *America Joins the Third World*, written by a prominent political pundit. With this strengthening of anti-globalization sentiment among significant sectors of the public, some politicians of both parties begin to gain electoral success on the back of populist and xenophobic rhetoric. Congress refuses to grant the administration trade negotiating authority unless the resulting pact includes labor and environmental provisions that restrict trade. While investment into the United States remains welcome, Congress begins to impose penalties on U.S. companies that invest overseas. As the United States seems more insular and deficits continue to mount, the dollar weakens in value.

As mentioned above, security and anti-terrorism measures become an increasingly onerous part of the American scene. The image of U.S. society abroad continues to suffer, and immigration, even for highly skilled workers, is severely restricted due to concerns about terrorism. As a result, many such workers seek careers in Europe. U.S. measures aimed at restricting the financing available for terrorists lead to a reluctance by some investors to hold cash in U.S. banks. U.S. reluctance to remain dependent on foreign energy sources, particularly those from the Middle East, leads to a debate about domestic resource exploitation, expensive new programs for alternative energies, and increased energy prices throughout the economy.

In this economic environment, U.S. politics remain divisive, as strong geographical splits emerge in the country between a Republican south and center and the Democratic-dominated coasts. Economic policy battles worsen between the Republicans, who become the party of agriculture, extractive industries, and manufacturing, and the Democrats, who represent high technology, telecommunications, and the growing entertainment industry. Both Democrats and Republicans finance their preferred industries and constituencies through subsidies and tax cuts. With the economy growing more slowly, the United States begins to have trouble integrating immigrants from Latin America, Asia, and Africa.

Reformed Europe

By 2006, the EU's two most central economies, France and Germany, are engaged in a significant reform of their labor laws, especially affecting hiring practices, working hours and unemployment benefits. These legislative successes grow out of earlier changes enacted by management and employees at several large companies as a way to avoid moving plants to lower cost countries in Europe and Asia. In addition, the Barroso Commission proves successful in pushing EU member states to take the Lisbon agenda reforms seriously. Despite an initial rise in unemployment, by 2010 the increased flexibility in the labor market has contributed not only to a rise in productivity, but also to the start up of more small- and medium-sized enterprises (SMEs). Government efforts to provide education and retraining for displaced workers prove fairly successful, allowing a significant portion of workers to reenter the workforce. Also by 2010, a gradual rise in the retirement age has led to more people remaining in the workforce longer, while pension reform has reduced the state's financial obligations.

As a result of these reforms, European industry begins to see greater gains in productivity, and more effort is put into the development and adoption of technological innovations and new business practices. Although some European economies remain unreformed, the booming Central and Eastern European countries, with their more flexible economies, become an example to the rest of the EU. Pundits in both the United States and the EU laud this new "Danube Model," which begins to spread to such regions as southern Germany, Austria, and northeast Italy. These countries build on the successes already achieved by countries like the Netherlands, Denmark, and Sweden. Financial services and capital markets become more integrated not only across Europe, but also with global markets and firms, as bank consolidation continues and equity financing expands. Although the Lisbon agenda is not achieved by the target date of 2010, by 2015 significant progress has been made and the Single Market is genuinely close to completion, even in the services sector. Moreover, Europe's long experience with energy conservation and emphasis on renewables leaves it well equipped to deal with the general tightening in energy supplies.

With a healthier European economy, the euro remains strong and becomes a serious global reserve currency. All of the accession countries join the eurozone by 2009. In a referendum held the same year, the UK public decides by a razor-thin majority to join the euro after strong campaigning by the UK's Labor Prime Minister and his pro-European Chancellor of the Exchequer. As a result of these developments, Europe enjoys higher levels of foreign capital investment. There is also an increase in direct foreign investment, although that is located mostly in the member states of Central and Eastern Europe, and in the newest member, Turkey, which joins the EU in 2015. The continual enlargement of the EU, and the need to cope with an increasing diversity of local circumstances, proves a strong incentive toward deregulation and reduction in subsidies.

With its improving economy, Europe remains an attractive destination for immigrants, which helps to ease the demographic pressures resulting from lower birth rates and the growing ranks of the aging. This initially causes some social unrest, especially as Europe struggles to integrate some immigrant communities, including those from North Africa and the Middle East. But by 2012, revised benefits laws and the obvious need for younger workers to support old-age pensioners have begun to make Europe a more welcoming place. The accession of Turkey, with its relatively high working age population, also helps to reduce labor market imbalances. The fact that educated migrants increasingly see Europe as an alternative to the United States, also increases the receptivity of Europe to these new workers. Populist and xenophobic politicians begin to lose popularity as their views are seen as contrary to Europe's efforts toward greater economic prosperity.

European Stagnation

In this scenario, Europe continues to experience slow economic growth, principally because governments are stymied in their ability to introduce reforms to unemployment and retirement programs. The 35-hour week, long vacations, and generous pension programs remain a feature of the European social model, keeping the labor utilization rate low in most countries. The inability to rein in government spending on welfare provisions, coupled with decreasing levels of tax revenues, leads to chronic budget deficits and high interest rates in both the old and new members.

After the modified constitution is finally ratified in 2008, no new major reforms in EU governance are launched. EU budget negotiations become increasingly difficult and there is little determination to reform either the CAP or the regional support funds. By 2018, the EU budget looks unsustainable, but no reforms seem politically acceptable. Little progress is made on the Lisbon reform agenda, with the exception of some new spending programs at EU-level to encourage research and development in new technologies. These measures are insufficient to stimulate many news jobs, so unemployment remains a problem. The intractable employment problem is reinforced by sluggish economic growth, which averages between 1 and 2 percent in most years and only slowly growing productivity rates. Although Europe does well in certain segments of the information, computer, and telecommunications industries, most new patents in biotechnology and nanotechnology are filed in the United States and Asia. Eventually, in the interest of harmonization within the Single Market, the

European Union begins to adopt Europe-wide labor rules, but they have the impact of actually reducing flexibility in some countries and enhancing it slightly in a few others.

As European industries and workers struggle to hold on to their existing markets and benefits, the sentiment against globalization and liberalization increases, limiting the political prospects for deregulation in the financial and other sectors. The EU continues to trade mostly with itself, with some modest growth in commercial links with Russia due mostly to energy imports. Overall, the rise in energy prices adds to the European economic woes. The euro falls from its high of 2006 of 1.35 to the dollar, and it is not until 2015 that the rest of the new member states join Slovenia and Cyprus in adopting the single currency.

Europe's economic stagnation is reflected in a political stalemate in major EU member states. The UK experiences a rise in budget deficits and government debt that violates even the more flexible terms of the newly revamped EU Stability and Growth Pact. After a referendum on joining the euro is postponed, a new Conservative government is voted into office in 2009, keeping the UK out of the eurozone through the end of the period, along with Sweden and Denmark. In Germany, there are tensions within both major parties that limit reform options. In France, an uncomfortable cohabitation between a president and prime minister of opposing parties creates legislative deadlock. Difficulties also become apparent in integrating new members from Central and Eastern Europe, some of whom are led by anti-EU governments. The uncertain political situation in many countries causes foreign investors to cut back on new projects and divert some resources to East and South Asia. In at least a few of the new EU members, a combination of farmers, pensioners, and the unemployed succeed in voting in a protectionist and xenophobic party.

Although Turkey is invited to engage in membership negotiations, increasingly suspicious attitudes towards Muslim countries effectively blocks any progress on the talks. Anti-foreigner sentiment causes immigration from both Arab and sub-Saharan African countries to slow, aggravating the EU's employment problems and the sustainability of its overly generous pension systems. Tougher asylum laws gradually restrict those entering the EU legally, and a growing illegal population exists without benefits in a black market economy.

Combining Transatlantic Futures

To understand the implications of these scenarios — and develop recommendations to address the challenges they present — some judgments must be made about the likelihood of each alternative future. Overall, it seems more likely that the United States will prosper rather than fall into a political and economic stalemate. This is in part a reflection of the recent U.S. experience in stepping up productivity, lowering unemployment without serious inflation, and overcoming serious deficits during the 1990s. It also reflects a consensus among the Atlantic Council working group that the United States will overcome the longer-term challenges posed by greater domestic and international security costs. These will include not only the actual expenses incurred by government and business for enhanced security measures, but also non-monetary costs such as reduced flows of skilled immigrants. As a result of this new, less secure internal and external environment, the United States may not prosper as it did in the exceptional period between 1995 and 2000, but it is expected nonetheless to maintain a strong, growing economy that is the source of the most significant business and financial innovations through 2020. For these reasons, the most likely U.S. scenario is that of *U.S. Prosperity*, although *Stalemated United States* is certainly possible.

The future course of the European economy is much more difficult to judge. Europe has been on a steady, positive growth path for over a decade, its fiscal and monetary policies are providing stability to the business environment, and important reforms have been introduced in many countries that should help raise their long-term growth potential. The recent appointment of a reform-minded European Commission is also a positive sign, although the actual impact will be unclear for some years to come. At the same time, the demographic challenges that confront Europe, and in particular its relatively expensive social-welfare systems, are a cause for genuine concern. The possibility exists, of course, that meaningful reforms to increase labor utilization — for example through increased working hours, higher levels of working-age immigrants, and reduced pension benefits — will be enacted in large European countries such as France, Germany, Spain, and Italy. But the seriousness of this demographic challenge and the political constraints to reform are such that Europe is more likely to stagnate than to grow vigorously during the period to 2020. Finally, the European preference for leisure over greater wealth, along with a commitment to a robust social welfare system, further reduces the incentives for reforms designed to create a workforce that more closely resembles the U.S. model. All these factors seem to make the scenario of *European Stagnation* more likely than that of *Reformed Europe*.

One of the key characteristics of these scenarios is that they do not occur in a vacuum. The high level of economic integration across the Atlantic and increasing globalization mean that whatever happens in the United States and Europe will have consequences for each other, for the transatlantic relationship, and for the world at large. Whether the United States prospers or languishes will undoubtedly have an impact on the European economy. An under-performing European economy means that the U.S. economy will not be able to reach its full potential, while a Europe energized by reforms would offer more opportunities for U.S. firms and thus raise the level of U.S. economic performance. Thus, to recognize the full range of implications for these alternative futures, it is necessary to identify the consequences from each combination of scenarios and consider how they will affect the United States, Europe, the overall transatlantic relationship, and the broader global arena.

Scenario Combination 1: U.S. Prosperity and European Stagnation

- **Consequences for the United States.** Europe's internal difficulties mean some opportunities for U.S. trade and investment with the EU are lost, and there is a marginally negative impact on the U.S. economic growth rate. U.S. investors are cautious about the more highly regulated economies of countries like France and

Germany, but continue to look for opportunities in the emerging new member states of Central and Eastern Europe. Some Western Balkan countries with more stable democracies and market economies also attract limited U.S. investment. The dollar regains its role as the unquestioned world reserve currency and returns to the valuation levels experienced in the 1990s.

- **Consequences for Europe.** Europe's inability to push through significant labor market and pension reforms is contrasted with the strong performance of the U.S. economy. As a result of Europe's increasing dependence on the U.S. export market, there are calls for the European Central Bank to keep interest rates low. The ECB prefers to keep rates high to rein in government deficits and there is discussion of lessening the bank's independence. The older members of the EU have difficulty attracting workers in several key sectors of the economy, and mobile workers from the new member states of Central and Eastern Europe either stay at home or choose to go to the United States.

- **Transatlantic Impact.** European firms continue to invest in the U.S. market, while U.S. consumers, spurred by the strong dollar, spend record amounts on European imports across a range of industries, helping to prevent most European economies from falling into recession. There is a wave of mergers in the European financial industry, and some banks are acquired by U.S. financial institutions, although takeover defenses remain strong. There is little progress toward harmonizing transatlantic financial regulation.

- **Global Impact.** Faced with a weak economy in Europe, the United States increasingly looks to other regions of the world for its commercial relationships, principally China, India and other countries in Asia, although the passage of the FTAA in 2008 leads to somewhat stronger economies in certain Latin American countries. Global trade negotiations become harder to conclude, although stronger leadership from emerging economies helps to keep them on track. Upwardly mobile immigrants from developing countries opt to go to the United States if they can overcome moderately burdensome security-related procedures for obtaining a visa.

Scenario Combination 2: U.S. Prosperity and Reformed Europe

- **Consequences for the United States.** The high dollar tends to make U.S. exports less competitive in the EU, but strong domestic demand continues to drive the U.S. economy. European investors become much more aggressive in the U.S. market, creating jobs there but, in some sectors, spurring a mild backlash against foreign ownership of U.S. companies. After several years of negotiation, the United States adopts international accounting standards, and allows firms listed on the NYSE to employ European disclosure terms.

- **Consequences for Europe.** European productivity and economic growth rates are boosted by high levels of U.S. direct and capital investment, and unemployment begins to fall without a concomitant rise in inflation. Central and Eastern Europe experiences growth one to two points above the EU average, easing budget deficits and helping to reduce the attractiveness of populist politicians. Higher EU growth rates make it easier to integrate a growing number of working-age immigrants, and also encourage a slightly higher fertility rate in the EU — a development which offers some long-term relief for the pension crisis. Finally, as more countries join the euro, it becomes a true international reserve currency, and the euro zone countries become more influential in global fora. There is increased discussion of a single EU representative in the G-8 and the International Monetary Fund.

- **Transatlantic Impact.** Stronger transatlantic investment leads business groups to push successfully for greater regulatory harmonization in transatlantic financial markets, which in turn leads to more mergers and acquisitions. In order both to manage the political repercussions of closer transatlantic economic relations and to facilitate their further growth, the United States and the EU create a Transatlantic Free Trade Area in 2012, focused mostly on regulatory issues, after the successful conclusion of the WTO Doha Round.

- **Global Impact.** Workers with high tech qualifications from India, China, and other advanced developing countries increasingly choose to migrate to Europe, making it a bit harder for the United States to fill all the new jobs in technology industries. Some globally traded commodities are valued in euros rather than dollars, although oil remains dollar denominated. Global trade negotiations are facilitated by a more prosperous and outward-looking EU and closer U.S.-EU cooperation.

Scenario Combination 3: Stalemated United States and European Stagnation

- **Consequences for the United States.** Ostensibly for security reasons, the United States adopts new laws that make it difficult for European and other foreign companies to acquire U.S. firms, and places onerous requirements on those already in the U.S. market. In retaliation, the EU sets up strong new anti-takeover defenses, which particularly impact large U.S. financial firms, who find they cannot acquire undercapitalized European banks. There is increasing debate in the United States about the inability of the Europeans to contribute to joint multilateral efforts in the World Bank, UN, and NATO, contributing to growing public concerns about free trade and globalization generally. On balance, skilled and mobile global workers worldwide prefer to come to the United States rather than the EU, but securing visas is difficult.

- **Consequences for Europe.** EU growth rates are a point or two lower than those in the United States, and in many years during this period the European economy falls into recession. As U.S. export markets weaken, there is more pressure for European consumer spending to generate growth, leading to "stop-and-go" fiscal policies that create unsettled macroeconomic conditions and a decline in domestic investment. By 2015 the EU's generous pension policies begin to be unaffordable, leading to increased government borrowing on financial markets and further macroeconomic deterioration. The Stability and Growth Pact is dismantled, diminishing the role of the European Commission in overseeing member state economies and leading to further divergence in macro policies. There is increasing acrimony among the European governments about the policies of the European Central Bank and whether it should consider exchange rates and unemployment, in addition to inflation, when setting interest rates.

- **Transatlantic Impact.** Transatlantic trade and investment decreases from its high early in the period, and the United States and the EU launch several cases claiming unfair trade practices against the other under the WTO's dispute settlement procedures. The dollar and euro fluctuate in value fairly widely over the period, leading to calls for transatlantic management of exchange rates, which are unheeded as both the United States and the European Union focus on domestic economic policy tools.

- **Global Impact.** Protectionist pressures exist in both the United States and the EU, and the two sides have great difficulty agreeing on a common position in the WTO Doha Round, postponing its completion for several years. High technology firms from China and India begin to be real world leaders, and take increasing stakes in U.S. and European markets, where they bring new and often contested ways of doing business. As more mid-ranked countries, such as those from the G-20, become active internationally, there is little effort by either the United States or the EU to convince these countries that they have a stake in established international institutions.

Scenario Combination 4: Stalemated United States and Reformed Europe

- **Consequences for the United States.** Economic growth is weak as a result of protectionist policies and onerous security controls that are imposed on business. The United States expands NAFTA to include Chile, but the FTAA is not concluded owing to demands from several large countries that go unmet. The dollar is no longer the world's leading reserve currency by 2020, when all natural gas contracts are denominated in euros, although most oil contracts are still valued in dollars. Several struggling U.S. middle-sized banks are acquired by European financial firms, which grow strong on the back of the EU's broader and deeper financial markets.

- **Consequences for Europe.** The EU makes a push to open export markets in several countries through bilateral free trade agreements. The most important of these is the EU-Mediterranean Free Trade Area covering the Mediterranean rim from Morocco to Syria, which is facilitated by Turkey's accession to the EU in 2015. The EU-ASEAN investment agreement also helps Europe to secure new outlets for its firms. A new Stability and Growth Pact that accounts for variations in the business cycle governs the 25-member Eurogroup, as the UK, Denmark, Sweden and all the new member countries adopt the single currency by 2010. France and Germany rebound economically, while the Baltic countries and Scandinavia post particularly strong growth, in part owing to the newly dynamic Russian market.

- **Transatlantic Impact**. Although trade and investment across the Atlantic remain fairly healthy, a weaker U.S. partner in tandem with a still politically fragmented EU means that new institutional and political initiatives are few. Although the two business communities continue to push for further transatlantic economic integration, U.S. and European political leaders struggle to counter increasing resentment from the media, labor unions, and NGOs over European takeovers of U.S. firms, which provoke some factory closings. European governments also focus their efforts on accession talks with the Balkan candidate countries, rather than on building a stronger institutional framework for transatlantic relations.

- **Global Impact.** Trade and investment opportunities in many parts of Latin America decline because of the weakness of the U.S. economy. The lion's share of skilled migrants worldwide opts to enter the EU, providing a major boost to its high tech industries. The world looks increasingly to the EU and its new variant of multiculturalism as a model for 21st century social organization. Multilateral organizations such as the UN, World Bank, and the WTO are strengthened owing to new European leadership exercised on their behalf, while the United States is increasingly accused of using these institutions to address domestic political and economic concerns.

The Future of Global Economic Governance

The point of these scenarios is not simply to project different futures for the transatlantic economy, but more importantly to identify their implications for both global economic governance and transatlantic political relations. The future performance of both the U.S. and European economies will be a key determinant of how the future leadership of the international trade and financial system is shaped, and will also impact the political and economic relationship between the two regions.

For nearly sixty years, the United States and Europe have together been the driving force behind the creation and management of the institutions that provide governance to the global economy. The WTO is the *primus inter pares* of these international institutions, and the sole entity with real powers to enforce nearly universally accepted rules. Unlike other institutions on the world stage, the WTO, through its Dispute Settlement Understanding process, can render binding decisions that eliminate protectionist policies and promote free trade that (it is widely assumed) in turn contribute to global prosperity. The WTO is not alone, though, as a vehicle for global economic governance. The United States and its European partners have also played the leading role in sustaining two other Bretton Woods institutions, the World Bank and International Monetary Fund, as well as the Organization for Economic Cooperation and Development, and the G-7/G-8 leading industrial countries. Politicians in the United States and Europe, on both the right and the left, have often committed themselves to these institutions even in the face of strong domestic lobbies pursuing narrower — but politically compelling — domestic interests.

The principal implication to be drawn from the scenarios described above is that only under the most favorable economic conditions could one expect the joint global leadership provided by the transatlantic relationship since the end of World War II to survive in its current form through 2020. Continued U.S. prosperity, significant reform in Europe, and an absence of serious external shocks — a constellation of events that this report deems unlikely — would be necessary to preserve the resources and leadership that can prolong transatlantic stewardship of the global system over the next 15 years. With vibrant economies at home and a fairly predictable external environment, government leaders in the United States and Europe should still have the political strength and self-confidence to win over warring domestic constituencies to the greater good of global governance.

But the world this report expects to be more likely is one characterized by a relatively stable and growing United States, a somewhat weaker Europe, and occasional but serious external shocks that are deleterious to both sides — in other words, a clear worsening from the 2004 baseline. Under these circumstances, some combination of domestic pressures and transatlantic disputes could create an atmosphere that is no longer conducive to joint transatlantic leadership of the global economy. In such a setting, a resolute and parallel assertion of political will on both sides of the Atlantic would be required to ensure a continued U.S.-European leadership role and prevent erosion of the institutions as well.

It may be asked, why should the United States and Europe be concerned if the nearly 60 years of joint governance of the global economic system is coming to an end? What are the implications if they do not take steps to reinvigorate their shared leadership of the international economy? First, the commitment to further multilateral trade negotiations — or even to the completion of the current Doha Round — could weaken beyond repair. The current trend toward regional or bilateral free trade agreements (FTAs) is likely to continue for some time. It is also possible, however, that ultimately FTAs will fail to deliver any serious economic benefits, and in particular that corporations will come to regret the costs that such separate and diverse arrangements entail for their global operations.

But disillusionment with FTAs does not necessarily mean that the world will return to the WTO; the result could equally well be stasis in the pursuit of free trade, whether bilateral or multilateral. A stalemated United States in particular might gradually disengage from active international commitments — a possibility that would be made more likely if the U.S. Congress continues to show skepticism toward new trade liberalization initiatives. The European Union, especially if confronted with stagnation in its domestic economy, could deepen its tendency to focus on its own internal economic management. Under these circumstances, it would take a widely spread and deeply felt fear of systemic collapse in the multilateral trade system for more progress to be made, as the concern about losing existing benefits is likely to be a sharper spur to action than the desire for additional ones. This will particularly be the case as long as the United States continues to prosper enough to keep world trade volumes growing and protectionism muted. This attitude of benign neglect toward global trade could change if a stalemated United States combined with a stagnant European Union find that liberalizing trade offers one of the few ways out of the economic doldrums. The risk, however, is that this combination could also lead to much more insularity, driven by a determination to get the domestic house in order before taking on an international leadership role.

Second, this withdrawal of the United States and Europe from their leadership roles may well happen just as there is more need for a global approach to certain economic issues. A key question is how either strength or weakness in the U.S. and the EU economies could affect the capacity of the IMF, World Bank, and the G-7 to manage the financial imbalances in the world economy that could grow more acute. At least in the remaining years of this decade, the dollar-euro relationship and the financing of the U.S. current account and budget deficits will remain a key concern of policymakers within these international fora. A prosperous United States may be able to continue to live with its current level of deficits without a major devaluation of the dollar, but if the U.S. economy were to weaken significantly, any downward move in the dollar could become severe and beyond the ability of the IMF and the central banks of the G-8 to control. A strengthened European economy, on the other hand, would most likely reduce its export dependence and increase its demand for imports from the United States, thus easing the deficit threat to the U.S. economy and the dollar.

Third, as the leadership of the WTO-based system of multilateral trade becomes more contested — and if the commitment to trade rounds weakens — there is likely to be a profusion of different actors, both state and non-state, attempting to pursue their own interests in various ways, and to some degree this is both inevitable and just. Global corporations can be expected to press governments to take cases to the WTO in order to create favorable conditions for their operations in various markets, reinforcing the current tendency to rely on the WTO to resolve disputes. Even today, the United States and the EU sometimes find themselves struggling to find agreement among different domestic interests and use the threat of WTO sanctions to push the parties toward a solution — witness the recent reform of U.S. corporate taxes. In a stalemated United States or stagnant EU, such disputes are even more likely to end up at the WTO. Although a more dominant role for the dispute settlement understanding within the WTO may attract the ire of a growing number of governments, few alternatives exist unless a re-energized United States and EU address the need to find less legalistic ways of resolving differences.

But it is not only corporations — whose market capitalization is often larger than the GDP of small countries — but also non-governmental organizations, which are likely to be an increasingly important element in the global economy. Some will seek merely to change consumer and producer behavior by highlighting objectionable labor or environmental standards in a given country, but others are likely to continue attempting to prevent the passage of free trade agreements that do not serve their goals or constituencies' interests. Of course, many NGOs make valuable contributions to the management of the global economy, for example, those that advocate on behalf of greater domestic transparency, which in turn serves the goal of increased international trade and investment. But as the role of non-state actors — both corporate and non-profit — increases and so does their pursuit of their own particular interest, the need for leadership in the international economy will become even greater.

It is the proliferation of important state actors that is the most important development in global economic governance and that may pose the greatest challenge to continued U.S. and European shared leadership. As amply demonstrated during the recent Doha Round sessions, the Group of 20 is a collection of emerging economies from the Latin America., Asia, and Africa whose aim is to widen the stakeholders in the system of global governance. Notwithstanding the fact that the G-20 is in its infancy, under the most likely scenario outlined above, the G-20 could be called upon to try to replace or at least engage in co-leadership with the United States and the EU or the G-8. The July 2004 agreement on agricultural issues in the WTO Doha Round demonstrates that the G-20 can play a positive role in furthering a liberal international economic order, having flexed its muscles by disrupting the Cancun negotiations in September 2003. In the future, there could be battles over the differing trade, investment, and financial policy priorities between the United States and the EU on one side and a number of the emerging countries on the other. As for the G-8, which has already added Russia to its ranks, it may also come under pressure to add China soon, by reason of its economic weight and level of development. This would be another indication that the traditional U.S.-EU dominance of global governance is evolving towards a more complex state of affairs.

Given the likely unevenness of U.S. and European economic power in the future, what should be done, if anything, to restore and maintain their shared leadership in the governance of the global economy? Some in the United States in particular may consider that it has sufficient power to go it alone. More likely, the United States or Europe may consider choosing among several new, potential partners in the joint exercise of leadership — China, Japan, Russia, Brazil, NAFTA for the United States, Mediterranean and African countries for the EU, or some combination of them all. While the United States or Europe could attempt to look elsewhere for partnership, no other combination of powers is likely to be able to replace what even a more challenged transatlantic relationship can offer to global stability. The accumulated experience of the United States and Europe working together in the post-World War II era could take perhaps decades to replicate with any other single country or group of countries, implying a long and undesirable period of global instability. It is also true that no two countries or regions perceive orderly international economic relations organized along current lines to be in their mutual interest as much as the United States and Europe.

Moreover, it should be recalled that economic conditions alone do not determine the response. Low growth and unemployment, rather than fueling inwardness, led the Reagan administration to launch the Uruguay Round in the mid-1980s. Meanwhile, during the prosperous 1990s, Congress repeatedly denied President Clinton fast-track authority. On the European side, it was during a period of relative economic weakness that the European Union decided to pursue the single market plan — which in turn provided the confidence for the EU to become a key partner to the United States in bringing the Uruguay Round to fruition.

Nevertheless, the likeliest scenario for the transatlantic economy in the years to 2020 — which would constitute a measurable worsening from the 2004 baseline — leads the Atlantic Council's working group to conclude that global economic governance will become more complex and disorderly, and the cause of greater contention between the United States and Europe. Institutions such as the WTO may be threatened with marginalization, to the detriment of an orderly international economy. If this is to be avoided, the United States and European Union must jointly reaffirm their intention to provide active leadership in the governance of the global economy. But they must also do so by reaching out to include the new actors — including, but not limited to, the G-20 — who will have increasing influence in this arena. They should work to ensure that these new partners have a significant stake in the smooth and just functioning of the international economy. As part of this effort, it will probably be necessary to consider some reform of the WTO, particularly to ensure that its management of multilateral trade negotiations is adequate for running negotiations that are greatly expanded, both in terms of issues and participants. None of this will be easy; indeed, given the expected course of the U.S. and European economies, the temptation will be to simply let these governance issues drift, to the detriment of all concerned.

The Future of Transatlantic Economic and Political Relations

If the institutions of global governance have been one leg of the world order established after World War II, the other leg has been the close political and economic linkages between the two sides of the Atlantic. These ties are expressed through bilateral trade and investment, cooperation in institutions like NATO and the UN, in U.S.-EU undertakings in the framework of the New Transatlantic Agenda, and via bilateral U.S. relations with individual European states. Since the end of the Cold War and the disappearance of the common threat of the Soviet Union, the close transatlantic relationship has been principally maintained by the unparalleled economic and business ties between the two sides, cooperation within multilateral fora, including NATO, and similar cultural, social, and political convictions and attitudes.

If, as the scenarios suggest, the European economic engine will lose some of its steam, the intensity of transatlantic trade and investment ties could lessen from its high in the early part of the period as both U.S. and European firms begin to shift resources away from parts or all of Europe. Under these conditions, will commercial ties across the Atlantic remain strong enough to continue serving as the "glue" that keeps the United States and Europe together? In the absence of the Cold War, shared security concerns may no longer be sufficient to keep the United States and Europe joined in close partnership — indeed, as was seen during the Iraq war, security issues can actually drive the two sides further apart — and economic ties may have to bear more of the burden of keeping the relationship strong.

Even with the European Union accounting for a declining portion of global economic product in the years to 2020, the level of trade and investment will probably still be sufficient to generate ongoing political support for the transatlantic relationship from governments, the business community, and civil society. But unless Europe moves strongly toward the reform scenario, generating considerable new trade and investment possibilities, the U.S. political and business leadership is unlikely to be enthusiastic enough to support a Transatlantic Free Trade Area that might indicate a renewed political and economic commitment to the relationship. More likely, any new agreements would be focused on clearly limited domains like regulatory harmonization that have little, if any, larger political significance.

Under these somewhat limited circumstances, Washington and Brussels will still find themselves cooperating occasionally on specific issues, including: trade, capital market regulation, health, and terrorist financing, and others. Corporations in the United States and Europe will continue to find it easiest to work together to pursue trade or regulatory policies of joint commercial interest. And when a U.S. organization is looking for a counterpart for an international initiative, it is still likely to look first to Europe and vice versa.

But this will be an uneasy status quo. It is unlikely that the activism that characterized U.S.-EU political relations in the second half of the 1990s will be repeated. The New Transatlantic Agenda, signed in 1995, was both the product of, and an incentive to, a stronger role for the EU on the world economic and political stage, in particular as a partner for the United States. The realization of the single market, the evolving European Security and Defense Identity, and the creation of the euro were part of this trend of growing EU self-assertion. If the European economy continues to lose ground, especially in relation to the United States, Europe is likely to become more inward looking as governments are forced to focus on their continuing economic troubles. As a consequence, the EU will not have the resources or inclination to play a larger international role, either politically or economically. It will undoubtedly be forced to deal with the countries and regions on its periphery, including Russia, and the Balkans will gradually move toward EU membership during this period. But its influence and activity will decrease in many strategic areas that no longer see Europe as an economic partner comparable to the United States. Nor will Europe have the ability or willingness to join the United States as a partner in dealing with some of the strategic challenges around the world.

If the EU economy stagnates and if this leads to less harmony among its members, the United States may find itself seeking cooperation with particular EU members on an ad hoc basis rather than directing its energies at enlisting the EU itself as a partner. Assuming that some countries in the EU do proceed with at least moderate economic reform, there could be a shift in both U.S. trade and investment in their direction. In other cases, the decision might not be based so much on economics, but rather on the political willingness of some EU members to work with the United States and go beyond a "least common denominator" policy established by the EU. This tendency to disaggregate the EU might be reinforced if U.S. business or ethnic lobbies establish dialogues, "action commissions," or bilateral institutions and relationships with European countries that maintain particularly warm economic or political relations with the United States This in turn could push Europe toward further disunity, perhaps contributing to more infighting within Europe over the appropriate economic model to pursue and to greater tensions about the place of transatlanticism in European foreign policy.

Also, the United States might increasingly seek new partners elsewhere, outside of Europe. This will be especially tempting as new powers emerge, including China and India, and perhaps Russia. These are unlikely to be formalized partnerships of the type that the United States and Europe have enjoyed in the past through NATO and the NTA, but much more temporary and focused on addressing a specific issue or concern. But if Europe becomes less willing or able to take on an active role on issues outside its immediate neighborhood, the United States will turn elsewhere. Since the period to 2020 is likely to see the rise of some new global players — or at least strong regional powers with global ambitions — the United States will have some attractive alternatives. The new partners are unlikely to share fully the democratic values that have been at the core of transatlantic cooperation, but that will be less important for such ad hoc arrangements. Nevertheless, these new arrangements will have an important consequence: in time, the U.S. reflex of turning first to Europe when seeking cooperation will fade.

The integration of these new international powers into the established global institutions and order is one of the biggest challenges facing the United States and Europe between now and 2020. The admission of China into the WTO is a significant step forward, but compliance with WTO norms will remain an issue for some time to come, and the admission of Russia will become ever more important. But beyond economics, these emerging powers will be increasingly influential — for good or ill — on a range of regional and global matters. If they are to be constructively involved, it may at times require the encouragement and/or pressure of established international leaders. Europe can play a key role in this, as it has recently with Iran and North Korea. But an inward-facing Europe is unlikely to be either interested or influential.

Without a consistent European partner with the resources and inclination to be active on a global scale, the United States may come to see itself as the "sole superpower" not only militarily, but also economically and politically as well. This will be particularly likely if the EU's share of the global economy declines, while that of the United States holds steady or even increases, as predicted in the analysis of the scenarios included in Annex B. With Europe (or anyone else) no longer able to claim the role of economic superpower, some within the U.S. political leadership may believe that the need for international cooperation is reduced. Just as military supremacy following the end of the Cold War led some to believe in a "unipolar moment" that justified U.S. unilateralism in the security and defense sphere, so economic supremacy may be seen as reason for pursuing U.S. economic interests in a less cooperative framework. The consequences, both for the transatlantic relationship and for the management of the global economy, could be severe.

Of course, this is a worst case scenario. There are some elements in the transatlantic relationship that will work to counter this chain of events. Foremost among these, it will be argued, is the transatlantic business community, which has a sizeable stake in the continuing partnership between the United States and the European Union. But the business community is also a creature of the bottom-line, and, over the long term, its partnerships will reflect profitability. This can already be seen in the uneven transatlantic investment relationship, with much more invested by Europeans in the United States than vice versa. The growing economies of China, India, and others will increasingly challenge the business community's commitment to the transatlantic relationship, especially if investment opportunities in Europe are limited by regulation or profitability.

It is also sometimes imagined that EU enlargement will provide a spur to the European economy. In the case of the most recent enlargement — or even anticipated enlargements involving Romania, Bulgaria, or eventually the Western Balkan states — this is extremely unlikely. Despite the higher growth rates in some cases, the GDP of these new and future members is too small to be of consequence. Even more than EU 15, these countries suffer from very low birth rates and will thus contribute nothing to overcoming the looming demographic crunch in Europe. If they do contribute to a stronger, more dynamic European economy, it will be through their determination to maintain their more flexible economies and to introduce greater acceptance of market forces throughout the EU. But this in turn depends on whether the publics will continue to choose moderate political leadership that pursues economic reform and a liberal, democratic political orientation. And this, over the long term, will be very much affected by the overall health of the European economy.

In the end, there are two factors that are most likely to ameliorate the political and diplomatic implications of these scenarios. First, a more dynamic and productive European economy, in keeping with the Reformed Europe scenario would do much to convince the U.S. policy leadership that Europe will be a capable partner for decades to come. Although this scenario is not the most likely, it is certainly the most desirable. There are signs that the new European Commission will make reenergizing the European economy its top priority; such efforts should be supported, although they are only getting ready to take the first steps on a long journey. Second, the United States should reaffirm its commitment to a form of international leadership aimed at managing and strengthening the global order. As the United States amply demonstrated in the immediate postwar era, economic dominance does not necessarily lead to marginalization of key institutions or neglect of partnerships — quite the contrary. Partnerships are much easier to construct and maintain when both parties need such an arrangement, but the lack of need does not mean that such partnerships are irrelevant. If the United States becomes as dominant — militarily, politically, and economically — as this study suggests may happen by 2020, it will still find the transatlantic partnership valuable and beneficial, even if not strictly necessary.

A Partnership for the Future?

Ensuring that a strong U.S.-European partnership persists into the next few decades will not be an easy task, especially if current trends in the U.S. and European economies continue. However, the United States and European Union can work together to enhance the possibility that the most optimistic scenarios come to pass, and that the negative implications of the other scenarios are ameliorated. The following recommendations suggest short- to medium-term strategies that the United States and Europe can undertake to increase the likelihood that the most favorable scenario options define the transatlantic economy and overall relationship to the year 2020:

- **Both the United States and Europe should recognize that domestic economic policy is a legitimate subject for transatlantic dialogue.** One price of such an interconnected transatlantic economy is that neither will be insulated from the economic policy of the other. Europe should not consider it an infringement of sovereignty if the United States expresses concern about the need for economic reform in Europe to mitigate the effects of a declining working age population. The United States, for its part, should be ready to accept legitimate European critiques of its fiscal and monetary policies, which have an impact on the dollar-euro relationship and Europe's export markets, for example. At the same time, however, both sides should recognize that the other is not required to adopt any specific economic or social model — partnerships and productivity can exist with diversity. As Sweden and other countries in northern Europe have shown, even in a high tax, high government spending environment, it is possible to reduce unemployment and increase growth through active labor market policies, trade openness, and a reduction in the regulations governing new business creation. Pushing Europeans to give up a significant portion of their leisure will be no more effective than urging Americans to support a more extensive social-welfare system.

- **The United States and the European Union should reaffirm their commitment to the multilateral trading system.** Although the July agreement in Geneva on agriculture was a sign that the Doha Development Round is still moving forward, in recent years there has been a proliferation of bilateral and inter-regional trade negotiations launched by both the United States and the EU. These narrower trade deals are often easier to accomplish than global negotiations and can be politically attractive, but their benefits are not the same as what can be accomplished through the WTO. After the U.S. election and the arrival of the new European Commission in November, both the United States and the EU should make it a priority to ensure that Doha is concluded within a reasonable time frame. As part of this effort, they must actively seek to rebuild a public and political consensus in favor of trade on both sides of the Atlantic. As part of their re-commitment to the multilateral trading system, the United States and the EU should jointly lead an effort to examine ways to reform the WTO in order to make it a more effective vehicle for trade liberalization in the future.

The role of trade rounds, the scope for applying Most Favored Nation (MFN) status, and the governance structures of the WTO could all be subjects for review.[14]

- Even with modest reforms on the EU's part, there could be a growing discrepancy in the economic performance of the United States and Europe that would likely lead to a deterioration in the ability of the two sides to cooperate bilaterally and globally. In order to reduce the political impact of a slower-growth Europe combined with a paramount United States, **the United States and the EU should consciously pursue a two-track strategy involving greater coordination of policies, especially in all the major international economic institutions (WTO, World Bank, IMF, G-8), and more encouragement of "transgovernmental cooperation" among informal networks.** The goal should be to reduce the U.S. inclination, as the lone superpower, to act unilaterally and the EU temptation to focus inwards as it struggles with governance and other internal issues among 25-plus members.

- **The United States and the European Union should especially focus on building cooperation on two specific issues: China's role in the global economy and reform of the broader Middle East and North Africa region.** China's adherence to WTO disciplines, respect for intellectual property rights and labor standards, health and environmental policies, and macroeconomic policies should be a common transatlantic concern, and indeed the United States and EU cooperated extensively during China's WTO accession negotiations. In addition, the United States and the EU should ask China to join a core group to pursue further trade liberalization within the WTO comprising the 15-25 countries that account for the lion's share of world trade. Such an effort would also facilitate a positive role for the G-20 developing countries as a forum for global growth. Any trade liberalization accomplished in this way should be extended on an MFN basis to other members of the WTO. On the broader Middle East, cooperation will sometimes be extremely difficult given the deterioration in the Israeli-Palestinian situation and the continuing transatlantic differences over Iraq[15]. Nevertheless, the United States and the EU should also forge a more coordinated approach toward reform in this region, taking into account existing efforts such as the EU's efforts to build regional cooperation among the Mediterranean countries under the "Barcelona Process." Stimulating more extensive trade among the states in this region as well as with the United States and the EU should be the immediate focus of joint policies. In sum, by working together to anchor China and the broader Middle East within the international trading system, the United States and the EU can both

[14] Paula Stern suggests that efforts to reform the WTO might usefully focus on the Trade Policy Review Mechanism and consider the lessons of the IMF's review process. In particular, the TPRM should be given an enhanced mandate aimed at promoting trade liberalization and an expanded secretariat staff able to conduct credible reviews of member's trade policies.

[15] See *Partners in Frustration: Europe, the United States, and the Broader Middle East.* Atlantic Council, September 2004.

bolster the trading system of which they have been leaders, and also reinforce their partnership more broadly.

- **The advent of a new presidential administration in the United States is an opportunity to reestablish transatlantic relations on a more stable footing.** Although policy differences between the United States and Europe are likely to remain, the president should be in a position to reengage with Europe soon after inauguration. The president should quickly address the underlying economic fundamentals of the relationship, and offer a commitment to address the U.S. budget deficit. At the same time, he should indicate that the United States welcomes a more competitive, dynamic European economy and should look for opportunities to provide encouragement to reform-oriented European leaders. Beyond the economic aspects of re-energizing the transatlantic relationship, the president should indicate his intention to engage Europe as a partner on a number of key projects, with priority given to those mentioned above. It will take two to tango, however — if approached in this way, Europe must be ready to respond with greater engagement no matter the outcome of the election.

Annex A: Anticipating the Unexpected

For the most part, the scenarios described in this report have been derived from existing and predictable trends. But it is also important to take into account the possibility of a significant and unexpected disruption to the transatlantic economies and indeed to the global political and economic order. What would be the impact of a systemic change comparable to the end of the Cold War, or of a catastrophic event similar to September 11, 2001? It is, of course, notoriously difficult to predict such occurrences, let alone their impact. In fact, the effect of even these major events on the transatlantic economy is not clear. It can be argued that the end of the Cold War has not had much effect on the transatlantic or global economies, and that the primary economic consequence has been the stagnation of the German economy following unification. And even though September 11 caused significant disruption to a major financial center, the economic impact has so far been temporary, unless security measures genuinely become onerous.

The wildcards presented here are intended to be illustrations of the type of event that might be expected to disrupt the U.S. or European economy, and perhaps also affect the broader global economy. The likelihood that events will transpire exactly as posed here is extremely slight. These examples do offer an opportunity, however, to identify the types of events that are likely to impact these economies and to consider whether the impact is likely to be temporary, or significant and long-lasting. And, while it is unlikely that events will happen as described here, each of these wildcards is certainly within the realm of the possible in the years to 2020.

- **Wildcard #1 — Energy:** By 2015, Europe receives 50 percent of its natural gas needs through a pipeline from Russia. In the middle of winter, terrorists destroy the pipeline, and the resulting fires make it difficult to repair the rupture. A combination of indecision in Moscow and a shortage of spare parts leads European analysts to warn that Europe could be without an assured supply of natural gas for two months.

- **Wildcard #2 — Disease:** In 2012, a lethal, altered descendant of the SARS virus emerges in London. Within a week 10,000 people in London are symptomatic, fifty have already died, and individuals with apparent signs of the infection turn up in Paris, New York, Cairo, and Frankfurt. To slow the spread of the virus, the United States and the European Union ban travelers from entering or leaving their countries. Later, after the International Civil Aviation Organization refuses to grant clearance to any flight from a country with a known infection, estimates are that no international travel will be possible for six months.

- **Wildcard #3 — Finance:** Early in 2011, the United States and Europe both enter a period of moderately severe recession, leading many major corporations to try to withdraw as much capital as possible from unstable foreign markets, especially China, where the banking system is becoming weighed down by bad loans. As the rhetoric becomes increasingly hostile between Chinese officials and U.S. and European businesses that cannot repatriate their capital, China begins to sell its dollar and euro denominated holdings. The dollar, already under scrutiny for the level of the U.S. budget deficit, comes under sustained pressure in foreign exchange markets and drops to historic lows. The Federal Reserve is forced to raise interest rates from 4 percent to above 10 percent to attract capital, pushing the United States into a depression.

In assessing the likely impact of these wildcards, the first question to be asked is whether other developments will mitigate the immediate damage caused by each of these events. For example, will other suppliers of natural gas step into the breach opened by the destruction of the Russian-European pipeline? Will European governments have reserves that will soften the blow? Can other energy sources — oil, nuclear, etc. — be used as even a temporary substitute to meet part of Europe's energy needs? In the case of a deadly disease, it will clearly strain health systems to the limit and disrupt the lucrative tourist industry. But in the case of a ban on international travel, will modern telecommunications provide a viable alternative that will at least ameliorate the cost to business? On the other hand, will current safeguards designed to stop the spread of disease through shipping be adequate to keep vital maritime transport moving? The final wildcard, concerning capital movement, may happen slowly enough that adjustments are possible and the impact can be spread out over a longer period. Or, given the speed of today's capital markets (not to mention capital markets in 2020), it could happen unexpectedly and without time for any of the parties to recognize the magnitude of the transactions before it is too late.

Securing reasonable answers to these questions would require significant research and investigation, far beyond the scope of this project. Moreover, the questions give an indication of only a small part of many elements that must be evaluated in assessing the potential damage from these wildcards. But the wildcards and the related questions do give rise to some tentative observations:

- there are numerous events that could potentially disrupt the course of the transatlantic economies and it is almost inevitable that some will arise between now and 2020;

- events that start more gradually (such as a capital crisis) may be more disruptive over the longer-term than an abrupt shock, such as a temporary disruption in some energy supplies;

- many variables may intercede to change the impact of an event, making the outcome significantly different from that initially anticipated; and

- given the wide range of potentially compensating factors, the possible resilience of the global economy should not be dismissed, especially if the goal is to assess disruption over the longer term.

Annex B: Growth Projections

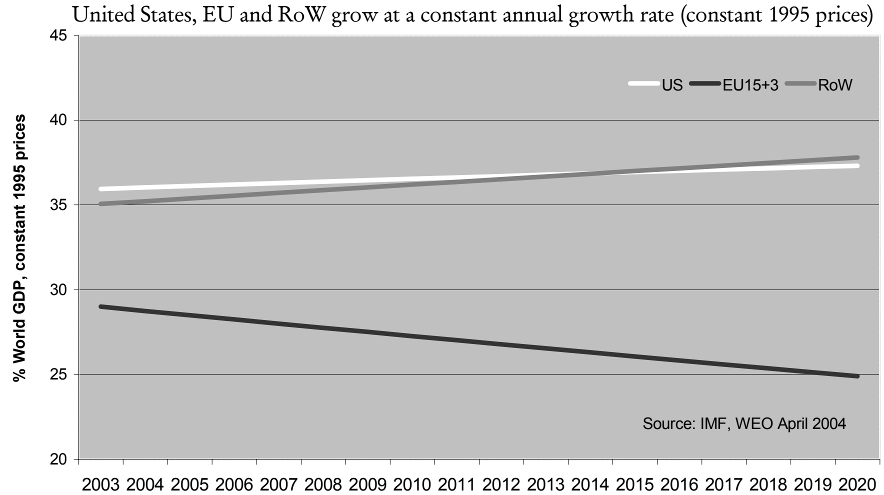
Prepared by Adam Posen, Senior Fellow, Institute of International Economics[16]

The following charts project the relative sizes of the United States', the expanded European Union's, and the rest of the world's (RoW) economies out to 2020 under three scenarios. At present, the post-enlargement European Union and U.S. economies are roughly the same size. This parity, however, is not going to last. Absent change in current trends, the U.S. economy will be nearly 20 percent bigger than the enlarged European economy in 2020. Even under the scenario considered that is most favorable to Europe, parity will not be regained. While size is not all that matters as an economic determinant of international influence, and certainly is not a sufficient statistic for well-being, there is some link between relative economic size and both military capabilities and broader influence. Moreover, in the current transatlantic context, relative economic performance is a source in itself of dispute.

Three scenarios are considered, with two sets of simulations shown (see accompanying figures). The first set of simulations projects the percentage of real global GDP on an annual basis (at average market exchange rates 2001-2003) represented by the United States, the enlarged EU, and the rest of the world (including China and India).[17] The second set projects the actual size of the U.S. and the enlarged EU economies on an annual basis in billions of (1995) U.S. dollars.

Share of Global GDP - Base Scenario

United States, EU and RoW grow at a constant annual growth rate (constant 1995 prices)



1994-2003 average used as base growth rate. Real GDP calculated using 3y average exchange rate to convert WEO constant price, national currency time-series.

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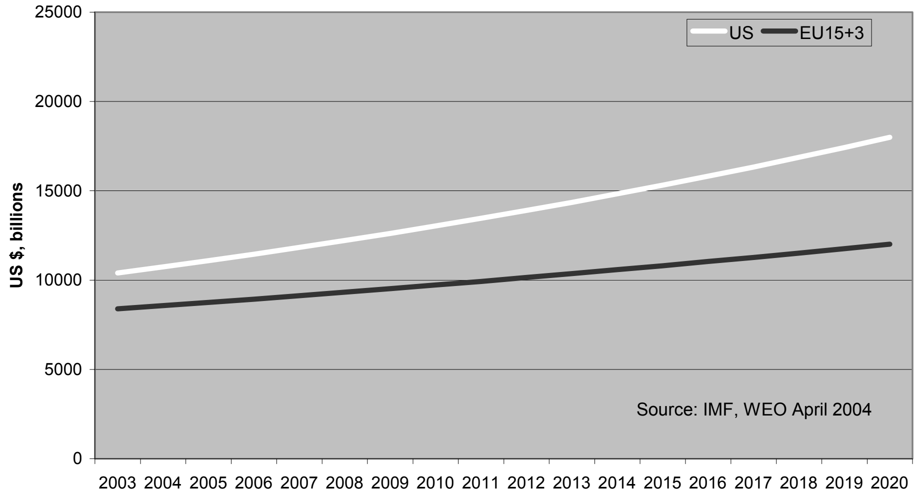
[16] Prepared for discussions of the Atlantic Council Working Group on the Transatlantic Economy in 2020. Any opinions or errors remaining within are the author' and not necessarily those of the Working Group or its members. Daniel Gould ably assisted in the running of the simulations. © 2004, Institute for International Economics.

[17] To ease computation and avoid data problems, for the enlarged EU we used the GDP of the current EU-15 plus the combined GDP of the Czech Republic, Hungary, and Poland. These three combined account for 80% of the accession countries' total GDP, and the remaining seven accession countries total roughly 1% (or less) of total EU GDP. This has little effect on the results presented.

Baseline

Relative Sizes of EU and US Economies - Base Scenario
United States, EU and RoW grow at a constant annual growth rate
(constant 1995 prices)

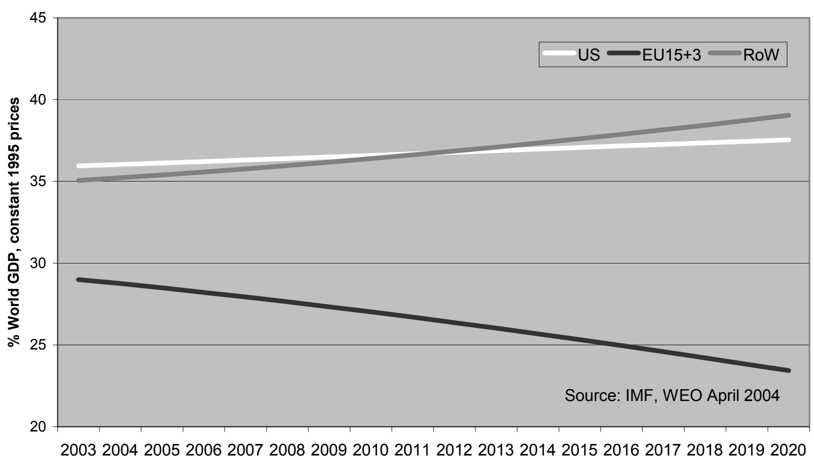


1994-2003 average used as base growth rate. Real GDP calculated using 3y average exchange rate to convert WEO constant price, national currency time-series.

The United States, enlarged EU, and RoW, are all assumed to grow at their annual average real growth rates of 1993-2003. In this case, the U.S. share of global GDP is essentially unchanged by 2020, the EU share declines by over 3 percent, and the RoW adds 4 percent. The U.S. economy more than doubles in size to $24.6 trillion, while the EU economy goes from parity with the United States in 2003 to $20.9 trillion (15 percent smaller than the United States) by 2020.

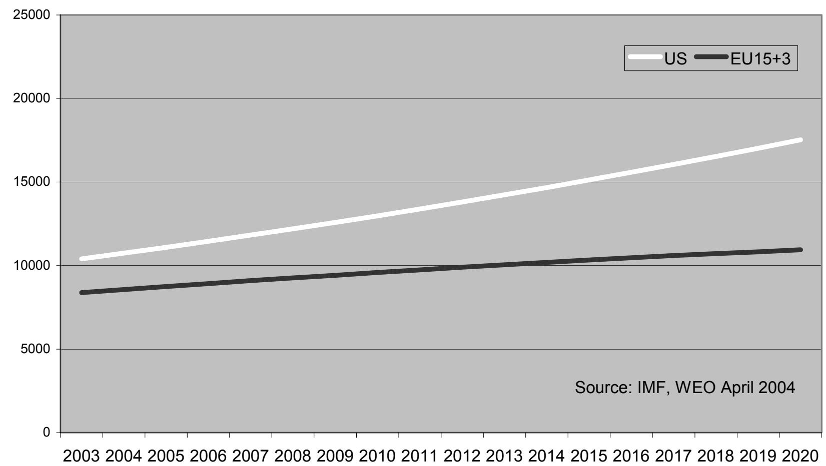
Demographic Determinism

Share of Global GDP - Demographics Scenario
U.S. growth rate slows down 0.02 percentage points, EU growth slows down by 0.07 percentage points each year. RoW grows at constant rate. (constant 1995 prices)



1994-2003 average used as base growth rate. Real GDP calculated using 3y average exchange rate to convert WEO constant price, national currency time-series.

The U.S. growth rate is assumed to slow down by 0.02 percent each year due to declining birth rates, in part due to improved income of Hispanic- and African-Americans. The EU growth rate slows down by 0.07 percent each year due to rapid aging of the population, which is if anything exacerbated by the accession countries. Part of the growth decline comes from the effect of aging on government budgets, and on productivity growth

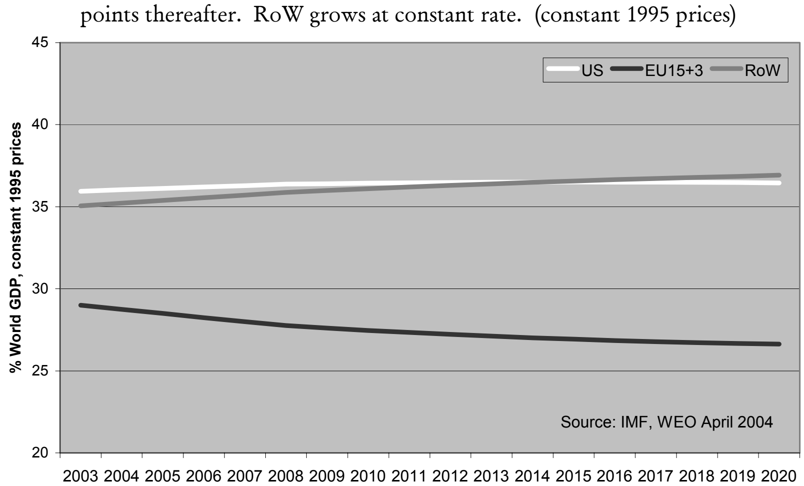


Relative Sizes of EU and US Economies - Demographic Scenario
U.S. growth rate slows down 0.02 perentage points, EU growth slows down by 0.07 percentage points each year. RoW grows at constant rate. (constant 1995 prices)

1994-2003 average used as base growth rate. Real GDP calculated using 3y average exchange rate to convert WEO constant price, national currency time-series.

of meeting those budgets through increases in interest rates and distortionary taxes, with the rest coming directly through shrinkage of the labor force. The U.S. share of world GDP declines slightly by 2020, remaining just above 20 percent; the enlarged EU share of world GDP declines by 5 percent (overall global GDP grows noticeably but not disastrously more slowly than in the baseline scenario). The relative gap between the US and the EU economies in 2020 is wider than in the baseline scenario, with the U.S. national income worth $24.0 trillion, and the EU economy $19.1 trillion (a 20 percent difference).

European Reform

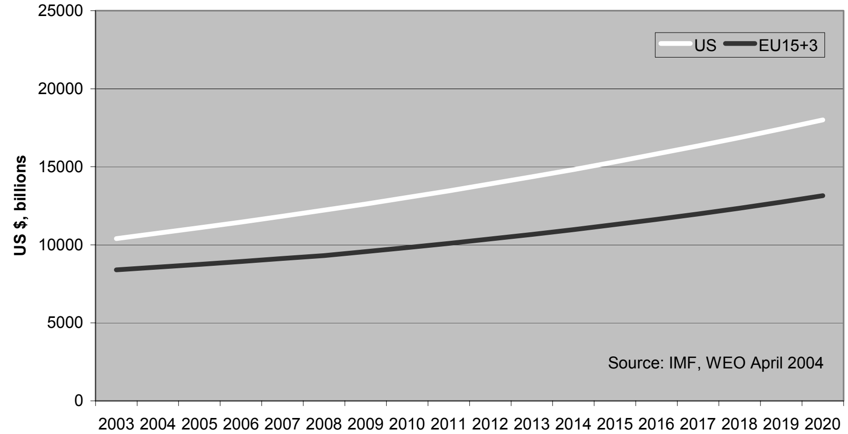


Share of Global GDP - European Reform Scenario
U.S. grows at constant annual rate, EU growth jumps 0.5% in 2008 and gains 0.05 points thereafter. RoW grows at constant rate. (constant 1995 prices)

1994-2003 average used as base growth rate. Real GDP calculated using 3y average exchange rate to convert WEO constant price, national currency time-series.

The United States is assumed to continue to grow at its average rate of 1993-2003, but the EU's growth rate is assumed to jump by 0.5 percent in 2008, stay that amount higher, and gain a further 0.05 percent a year through 2020. Under this scenario, in 2020, the EU growth rate would catch up with that of the United States. The rationale for such a scenario is that productivity is boosted from integration of the

Relative Sizes of EU and US Economies - EU Reform Scenario
U.S. grows at constant annual rate EU grwth jumps 0.5% in 2008 an dgains 0.05 points thereafter. RoW grows at constant rate. (constant 1995 prices)



1994-2003 average used as base growth rate. Real GDP calculated using 3y average exchange rate to convert WEO constant price, national currency time-series.

accession countries' low-wage labor forces and/or the results of a number of domestic reform efforts in core European economies following the upcoming election cycles. It is assumed that these benefits take a few years to be felt (thus by 2008), with ongoing beneficial effects. In this scenario, the U.S. and EU shares of world output decline at a slower but still noticeable pace by 2020 (the EU from 21.3 percent to 18.6 percent; the US from 21.1 percent to 20.0 percent). The relative size of the EU to the U.S. economy goes up versus the baseline scenario, reaching 93 percent of the U.S.' size in 2020.

These scenarios all likely underestimate the relative size of the RoW to some degree, especially that of China and India. Were economies' incomes measured in Purchasing Power Parity (PPP) terms, rather than in traded goods terms at multi-year average exchange rates, the size of developing countries' output relative to that of developed economies would increase because their non-traded activities would be more highly valued. Assuming that international influence is at least in part linked to the ability to purchase the highest-end traded (if not military) technologies, and to issue debt to foreign investors in one's own currency, however, PPP estimates would exaggerate the meaningful size of China and India.[18]

More importantly, these scenarios all likely underestimate the relative performance of the U.S. economy versus the EU going forward (barring significant structural change) as well. Not only does the 1993-2003 average perhaps include some years (1993-1995) which do not reflect the recent sustained increase in the U.S. productivity growth rate, it assumes no change in current net immigration (legal or illegal) to the United States. Assuming that all aging rich societies will have to increasingly import labor, but that the United States is more likely than most European societies to allow in foreign workers (as immigrants or illegals) on a large

[18] It is worth noting that the importance of China and India to the calculation of the RoW economy is significant but not dominant. China and India combined account for roughly 19 percent of the global economy in PPP terms, a third of the non-US/EU economies' total size and less than either the United States or the EU taken on their own. This also underlines the significance of PPP calculations which put these on a par with the United States and EU; calculating on the basis of market exchange rates cuts their size by two-thirds.

scale, a scenario taking demographics realistically into account is likely to be worse for Europe on relative terms than the second scenario here.

Even the third (hopeful reform) scenario for Europe is probably biased upwards for Europe's prospects. While there have been some ambitious economic reform efforts undertaken in Western Europe in recent years, and a few even implemented, any hopes that the accession countries will provide a growth spark to the rest of Europe are likely exaggerated. The ten accession countries are so small in economic terms relative to the EU-15 that even growth rates a few percentage point higher on average in those countries translates into little added demand or capacity for the earlier EU members. In any event, much of their catch-up growth has already taken place following the introduction of market mechanisms and the initial agreement that they would become EU members.

Despite these longer-run trends in the United States' favor, a multi-year fall in the value of the dollar and a sharp contraction in U.S. consumption and investment cannot be ruled out and may even be likely to begin over the next 1-3 years. At some point, the United States will have to close its trade deficits to pay back at least part of what it has borrowed from abroad over the last decade, and that will involve an exchange rate depreciation and a repatriation of some European capital invested in the United States. In the immediate aftermath, the EU economy would shoot up in size relative to the United States, at least when measured by contemporary exchange rates.

But such an event is likely to also harm EU growth significantly (with a lag), given the share of European GDP exported to the United States. In fact, it is the very unattractiveness of European production and investment relative to the United States that underpins the consistent net surplus position of the EU versus the United States in the balance of payments. If Europe's own trend growth rate were to converge upon that of the United States, domestic demand in Europe would increase, and then these imbalances would be reduced. The need for the United States to 'adjust' (i.e., start exporting and saving more, importing and spending less) would be less drastic. In short, a balance of payments problem or dollar crash for the United States in the near-term would do little to change the relative size or growth differential of the United States and the EU, though it would in all likelihood drive down the average growth rate for both economies and the world, given their extensive interdependence.

Annex C: Comments by Working Group Members

Beth C. Brooke

I agree in principle with the report. However, in my opinion, the report does not sufficiently address the potential economic impact on the United States and/or Europe from a potential imbalance in regulation. Most corporations are finding value in the new regulatory requirements imposed as a result of the corporate scandals of the past few years. As Europe considers similar reforms, both the United States and Europe must be sensitive to the impact on global capital flows in their own capital markets. Should global capital start to avoid either jurisdiction, the impact of that could dramatically change the scenario analysis contained in the report.

Paula Stern

The pro-competition changes that occurred in the United States in the 1970s and 1980s were the foundation of the economic boom of the 1990s. Oligopolistic and state-regulated industries in manufacturing, the utilities, transportation, energy, communications, finance, and retailing were opened up to new competitors. Trade policies and openness to foreign investment, antitrust, and competition between states and localities for new businesses all made domestic competition more intense. This competition killed inflation, weakened once powerful unions, and encouraged innovation — the key to the economic success in the 1990s. (See Paul A. London's forthcoming book, *The Competitive Solution: The Bipartisan Secret Behind American Prosperity*, AEI Press, February 2005).

These lessons may well be applied to the health industry in the next few years. Healthcare is one of the few areas in the U.S. economy where costs are still rising and where productivity has lagged. The computerization of records could reduce medical errors and create the kind of competition in healthcare that exists in other areas of the U.S. economy, where costs were cut by 30 to 40 percent. These cost reductions will occur over time, but the investment required and the improved efficiency in the health industry that is 15 percent of America's GDP could ultimately boost the U.S economy significantly.