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THE CHANGING GLOBAL ECONOMY: ROLES OF THE UNITED STATES AND THE EUROPEAN UNION IN THE EVOLVING CONTEXT[1]

The United States and the countries comprising the European Union have dominated the global economy during the past seventy years. However, momentous change is underway. China will soon be the largest economy in the world, and other countries of the developing world are rapidly increasing in economic importance. Meanwhile, the European Union is experiencing slow growth and the United States is struggling with serious economic problems. This paper considers how the transatlantic economic relationship is likely to be affected by these circumstances, and how the US and the EU can best work together to facilitate smooth transitions in the global economy.

Keywords: globalization, China, Asia, United States, European Union, international trade, international investment, international institutions

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Introduction

In the seventy-plus years since the Second World War, the global economy has been dominated by the United States and the countries comprising the European Union. The international economic and financial institutions that have been the centerpiece of the global economy were crafted by these countries. The US dollar has been the world's primary reserve currency and its medium of exchange, a role shared recently by the euro. Even today, the United States and the European Union account for approximately forty-five percent of total world output in value terms,[1] for about thirty percent of world merchandise trade, and forty-five percent of world services trade. Their dominance is even more apparent with regard to capital flows. Together they account for about sixty percent of outward flows of foreign direct investment, and for about seventy percent of the stock of world foreign direct investment. They also are responsible for about seventy percent of world expenditures on research and development. The degree of transatlantic economic integration is truly remarkable, and the importance of the European Union and the United States in the world economy is indisputable. However, momentous changes are underway that recently have reduced transatlantic dominance in the global economy, with prospects for further relative decline in the future.

The Changing Nature of the Global Economy

As Michael Spence has recently pointed out, during the first 250 years after the Industrial Revolution living standards among the world's economies diverged as the new production processes were applied in some countries but not in others. During this period, only about fifteen percent of the world's population reached high income status. However, during the past sixty years living standards have been converging as economic development has spread to countries containing sixty percent of the world's population. The process of convergence has accelerated during the past twenty-five years as thirteen countries have grown at historically unprecedented rates of seven percent or more, doubling their national incomes in ten years or less. (29) Economies throughout the world have become increasingly integrated as communication technologies have made possible the fragmentation of production so that components for many products are sourced from several different countries, and international trade in some services that previously was impossible has become commonplace. Knowledge transferred from technologically advanced countries to lesser-developed countries has made "catch-up growth" possible.

A combination of demographics and rapid economic growth among developing countries virtually assures their greater role in the global economy. World population is projected to increase from about seven billion in 2010 to over 8.5 billion in 2030, with almost all of the increase occurring in developing countries. Because of the rapid economic progress in many of these countries, domestic saving of developing countries as a percentage of GDP has increased from 21 percent in 1970 to 34 percent in 2012, and investment over the same period has increased from 22 percent of GDP to 33 percent. Consequently, developing countries now account for 46 percent of global savings, almost twice their share during the 1960s. Assuming an average annual GDP growth rate of 5.5 percent in developing countries, by 2030 they will account for an estimated 97 percent of world economic growth, and for two-thirds of global savings. Even under conservative assumptions concerning their economic growth, China and India are projected to account for 38 percent of global gross investment by 2030, almost as much as all high-income countries combined. Developing countries as a group are projected to account for between 47 percent and 60 percent of gross capital inflows in 2030, as compared to 23 percent in 2010. (36) While economic progress is occurring in every region of the world, the region of most dynamic growth is Asia.

The Increasing Importance of Asian Economies

According to projections, transpacific economic relations will in the not too distant future outweigh transatlantic economic relations as more rapid economic growth in Asia increases the weight of the region in the global economy. This rapid growth can be expected to eventually slow as per capita income levels converge, but will likely continue for decades.[2] Latecomers to economic development benefit from the transfer of technology and capital from more developed areas, and also from eliminating causes of chronic inefficiency. Transitional growth factors include reallocation of labor from low productivity agriculture to higher productivity industry, realloca-

[1] The US and the EU account for 45 % of world nominal GDP; 38 % of GDP measured in purchasing power parity terms. (Calculated by author from IMF statistics)

[2] Asian countries that have achieved high or middle income status saw their growth slow considerably when per capita income levels reached the equivalent of about $13,000. (7)

tion from non-agricultural self-employed workers and involuntary part-time employees into more productive jobs in the industrial sector, realization of economies of scale as incomes grow and as industries are integrated into the global economy through reduction of trade barriers, and improvements in human capital through increased education and training. (5)

China's Dramatic Rise in the World Economy

By far the most dramatic change in the world economy in recent decades has been the rise of China. Throughout much of its long history China was among the world's more advanced civilizations and its more sophisticated economies. As recently as 1820, China is estimated to have accounted for almost one-third of total world output. (18) However, because of inner turmoil China was largely bypassed by the Industrial Revolution that so greatly increased living standards in Western Europe and the United States. During the post-World War II era until 1978, China largely isolated itself from the world economy. Economic progress in China was stifled by this isolation, by the inefficiencies of the Chinese Communist planned economic system, and by dramatic disruptions such as the Cultural Revolution.

Beginning in 1978, under the influence of communist party head Deng Xiaoping, China embarked on a process of economic reforms and opening to the world that were to have a most dramatic effect. In the thirty-year period between 1980 and 2010, the Chinese economy grew in real terms at almost ten percent per annum, doubling in size approximately every seven years. Because of China's very large population, this rapid growth has had an unprecedented impact upon the world economy. In current United States dollars the Chinese economy is now the second largest in the world, having surpassed Germany in 2007 and Japan in 2010.[1] Goldman Sachs projects that the size of the Chinese economy will surpass that of the United States by 2027, but the Economist research group predicts that this could occur as early as 2019. (27) In nominal terms, China now accounts for about 11.5 % of world Gross Domestic Product.[2]The size and dynamism of the Chinese economy attracted more than 8.1 % of total inflows of foreign direct investment in 2011 (13.1 % if Hong Kong is included).(31) This foreign investment, combined with an exceptionally high level of domestic investment, has propelled economic growth at a furious pace.

China's growth has also been export-led. During 1980–2010, exports expanded at an annual rate of about 12.0 % per year, even faster than income was increasing. For several of those years the growth was closer to a 20 percent annual rate, and as a result export production has come to account for about 35 percent of Gross Domestic Product, a most unusual ratio for a country as large and diverse as China. (3) China has displaced exports of some relatively labor-intensive countries, such as Mexico and Bangladesh, causing considerable dislocation in these economies. China has also become a voracious consumer of primary products such as petroleum and various metal ores, causing the prices of such products to increase sharply.

China's economic impact on the EU and the US has already been profound. In 2011, China was the EU's second largest trading partner, accounting for 12.5 % of total EU trade, as compared to the 14.3 % share of the United States, and the EU was the largest trading partner of China. China has run large trade surpluses with the EU in recent years. In 2012, China accounted for 16.2 % of EU imports, almost doubling its 8.3 % share of the EU import market since 2000. China is now the second largest export market of the EU behind the US, accounting for 8.5 % of EU exports in 2012. China's share of EU exports has more than doubled during the past decade, rising from 3.4 % in 2001, to 4.9 % in 2005, to 8.5 % in 2012. During this same period, the US share of the EU import market was cut in half, from 20.6 % to 10.9 %. (11)

China was in 2011 the largest source of imports for the United States with an 18.1 % share, and was the fourth largest destination of US exports, making China the third largest trading partner of the United States behind Canada and the European Union. Its 13.6 % share of US trade, while increasing, followed at some distance behind the EU's 17.2 %, and the 16.6 % share of Canada. The United States was China's second largest trading partner and second largest export market in 2011, behind the European Union. The EU's trade with the United States has been affected to only a small extent by China. The EU has seen its share of US

[1] Looked at in purchasing power parity terms, the Chinese economy probably surpassed Japan as the second largest economy in 2001. Arvind Subramanian of the Peterson Institute for International Economics contends that the Chinese economy may already be as large in purchasing power parity terms as the United States economy, although the International Monetary Fund projects that it will not happen before 2016. (6) Purchasing power parity gives a better indication of a country's total economic size, but the current dollar measure is probably a better measure of a country's impact on other countries because it is determined by traded goods, services and assets. See discussion in (35).

[2] China's share is 15 % in purchasing-power-parity terms. (Calculated by the author from IMF data)

imports decline slightly to 17 % in 2011 compared to 18.5 % in 2009, while EU share of US exports in 2011 was 18.1 %, down from 21.4 % in 2009.[1] While for the most part goods traded between the US by the EU are currently not competing directly with products from China, Chinese production is gradually moving up the value chain so that more direct competition can be expected in the future.

While China's impact on the world economy has already been profound, projections into the future herald even more significant change, as indicated in Table 1.

As seen in the table, the International Monetary Fund projects that China's share of world GDP will increase steadily, more than tripling between 2007 and 2030, from 6.1 % to 20.1 %. The US share declines gradually from 25.5 % to 21.4 %. The share of the EU declines by almost one-third, from 30.6 % to 21.3 %.

Even more dramatic projections have been made by Nobel-laureate economic historian Robert Fogel. According to Fogel's projections, by 2040 the output of the Chinese economy will be nearly three times as great as total world output was in the year 2000. Fogel estimates that by 2040 the United States will account for 14 % of total world output, the EU-15 will account for a mere 5 %, and that China will account for 40 %, slightly more than twice as much as the United States and the EU-15 combined. He projects that per capita income will be about twice as great in China as in the EU-15, although still not as great as in the US.[2] (13)

Fogel's very optimistic outlook for Chinese economic growth is based upon a presumed continued shift from relatively low-productivity agriculture to industry and services, benefits realized through improved labor quality due to the heavy investments that China has been making in secondary and tertiary education, and a very favorable business climate. Fogel is well aware of the concerns that social unrest and political instability arising from corruption or inter-regional, urban/rural, or inter-ethnic inequalities could derail Chinese economic progress. He argues that the Chinese governmental authorities are keenly aware of these dangers and are taking effective steps to avoid a crisis. (12)

Table 1

Projected Gross Domestic Product Trends of Major Countries & Regions (billions of US dollars, and percentages of world GDP)

	2007	2014	2030
US	14,078 (25.5)	17,419 (23.0)	49,267 (21.4)
EU	16,938 (30.6)	19,055 (25.5)	48,992 (21.3)
Japan	4380 (7.9)	5792 (7.8)	17,503 (7.6)
China	3,382 (6.1)	8,283 (11.1)	46,366 (20.1)
India	1,101 (2.0)	1,908 (2.6)	7,560 (3.3)
Indonesia	433 (0.7)	704 (0.9)	2,878 (1.2)
Malaysia	181 (0.3)	306 (0.9)	1,376 (0.5)
Philippines	161 (0.2)	278 (0.4)	1,296 (0.5)
South Korea	970 (1.8)	1,517 (2.0)	5,881 (2.3)
Thailand	246 (0.4)	405 (0.5)	1,705 (0.7)
Vietnam	71 (0.1)	127 (0.2)	641 (0.3)
World	55,270	74,660	230,523

Source: For the US, EU, Japan China and India, World Economic Outlook Database, International Monetary Fund, October 2009; projections for the remaining countries made by the author using methodology similar to that of the IMF projections.

India's Rising Economy

Another significant reason for the increasing economic importance of Asia is rapid growth in India. As in the case of China, the Industrial Revolution did not take hold in India and therefore economic progress there was limited until recently. After India gained independence in 1947, much hope and optimism prevailed concerning India's economic development prospects. Initially, there was significant progress. Between 1951 and 1965, India's economy grew at a respectable 4.2 % rate, quite an improvement from the rate of less than one percent that characterized India during the first half of the twentieth century. (25)

[1] Percentages in this paragraph calculated by the author from data in (32).

[2] Fogel's projections assume an 8.3 % annual growth rate in China's Gross Domestic product from 2000 to 2040 and a 4.0 % annual rate for the United States and 1.2 % for the EU-15. (12) Horst Siebert posited a 6.0 % per annum growth rate for China between 2005 and 2030, and a 2.5 % annual growth rate for the United States. At these rates, by 2030 China would account for only 9.1 % of world output and the United States for 22 %. (28) However, according to recent figures, China has already significantly surpassed Siebert's projection for 2030! Writing in 2011, Arvind Subramanian posited a conservative 5.5 % annual growth rate for China and 1.8 % for the United States. Under these assumptions he projects that by 2030 China's GDP will be slightly less than that of the United States in nominal terms, but more than twice as large in terms of purchasing power parity. (30)

However, during the next fifteen years the state intruded pervasively into Indian economic life. Many industries were nationalized, the activities of foreign firms tightly restricted, trade and foreign exchange controls tightened, and labor markets made inflexible. Predictably, India's growth rate fell to 2.6 % for the 1965–75 decade, barely above the rate of population increase. Consequently, the poverty population of India increased. (25)

As a gradual process of economic liberalization began in the late 1970s and gained impetus in the 1980s, India's growth rate increased to 4.8 % for most of the 1980s, with a jump to 7.6 % at the end of the decade. A balance of payments crisis in 1991 provided the opportunity for implementation of broader and more systematic reforms that have yielded positive economic results, with the growth rate of real Gross Domestic Product approaching ten percent before the 2008 global financial crisis. (25) The Indian economy rebounded quickly from the financial crisis, but economic growth has slowed recently to around 5 %, partly as a result of problems in the global economy, and partly because of policy failures in India. But expectations have been raised in India, and competition for influence with China is so strong in India that further reforms to keep the growth process growing there would seem to be inevitable.

Other Rapidly Growing Economies

While China and India by virtue of their economic sizeare having the greatest impact on the changing global economy, remarkable economic progress is by no means confined to Asia. In the latest year for which data are available (2012 in most cases) twenty-seven countries had real GDP growth rates of 7 percent or better. Fifty-eight countries had real growth rates of 5 percent or more. (4) Economic progress of this rate and scope is historically unprecedented. The former dominance of the United States and the European Union on the global stage is being eroded. Changes in thinking and in policy actions will be required on both sides of the Atlantic to adapt to these changing circumstances.

United States and European Policy Responses to a Changing Global Economy

As lesser-developed countries, particularly in Asia, increase their weight in the world economy, it is unrealistic to think that they will not expect and demand to play a more significant role in world affairs. How the transition to a more multipolar global economy is handled will depend primarily on the United States and the European Union as the dominant players currently in the international economic and political system. Neither the interests nor the perceptions of the United States and the European Union will always coincide concerning how the global economic system will evolve, but in the realm of international economic policy their objectives are generally consistent. If they work together to help shape the changing world economic system this will improve the chances that the evolution will be in the long-run interests of each.

The Global Trading System

The global trade regime that was established and has been guided primarily by the United States and the countries of the European Union has generally served the world well. Under the General Agreement on Tariffs and Trade, merchandise trade was considerably liberalized. Under the agreements reached in the Uruguay Round, some significant steps were taken to liberalize regulatory and administrative barriers to trade and to provide a reasonably well-functioning dispute settlement mechanism. During the GATT era, not much was expected in negotiations of developing countries, and under the most favored nation principle tariff reductions were automatically extended to them. These countries were more involved in the Uruguay Round negotiations, but even then the United States and the countries of Western Europe were primarily dictating the terms of agreement. However, in the current Doha Round of negotiations developing countries have played a much more active role with the result that reaching agreement has thus far eluded the negotiators.[1]

Partly in response to the agonies of the Doha Round, and partly in response to the rise of China, the United States has entered into an ambitious round of negotiations for a Trans-Pacific Partnership (TPP) agreement. With the recent inclusion of Canada, Mexico, and Japan, these negotiations now involve eleven Asia-Pacific countries.[2] The negotiations are significant in their own right, but are possibly even more important as a template for eventual trade agreements with other countries in the region.

Removal of trade and investment restrictions is sometimes facilitated by competi-

[1] WTO member countries did agree in Bali in December 2013 on trade facilitation measures and a few other noncontroversial issues. (22) But India has since blocked even their implementation.

[2] Participating countries are the United States, Canada, Mexico, Japan, Brunei, Chile, New Zealand, Singapore, Australia, Malaysia, Peru, and Vietnam.

tive liberalization, and that seems to be occurring in the Asia-Pacific. The TPP negotiations appear to have been a catalyst for the Regional Comprehensive Economic Partnership (RCEP) between the ASEAN+6 countries that were launched in 2012.[1]Petri and Plummer have termed the RCEP negotiations an "Asian track" in competition with the TPP. They see the competition between an Asian track and TPP as a "… 'contest of templates' for organizing future cooperation…" rather than economic warfare, with large potential gains for all involved. (26, pg. 2) They suggest that the TPP and the Asian track could be merged by 2020 into a Free Trade Area of the Asia-Pacific (FTAAP). According to their simulations an FTAAP has the potential to increase world trade by 20 %, with resulting welfare gains several times as large as those resulting from successful completion of the Doha Round. Of course, none of these anticipated agreements can be taken for granted. The United States is pushing an ambitious agenda for the TPP negotiations, and is reportedly getting pushback from the other negotiating partners concerning its demands for more stringent copyright and patent protections. (16) And agricultural trade liberalization is going to be a major political challenge for several of the countries involved.

At the same time, initiatives are being put forward to further liberalize transatlantic trade. Mexico already has a free trade agreement with the European Union, and Canada after four years of negotiations has agreed on aComprehensive Economic and Trade Agreement with the European Union.[2] The combination of the United States' 'pivot to Asia' and the current economic doldrums of the Eurozone have increased the interest of the European Union in a free trade agreement with the United States. In November 2012 the US and the EU agreed to establish a joint working group to examine the possibility of a transatlantic free trade area. Since that time important trade facilitation measures have been put in place, namely, agreements to recognize each other's certificates of origin for organic agricultural products (20) and to recognize each other's safe traders. (21) Even though a Transatlantic Economic Council had been in existence since 2007, trade facilitation measures such as these had been unattainable until recently. Furthermore, in February 2013 the EU-US High Level Working Group on Jobs and Growth released a report concluding that "…a comprehensive agreement that addresses a broad range of trade and investment issues, including regulatory issues, and contributes to the development of global rules, would provide the most significant mutual benefit of the various options that we considered." (10, pg. 1)In June 2013 negotiations for a Transatlantic Trade and Investment Partnership (TTIP) were formally opened, with the first round of negotiations held during July 2013 in Washington, D.C.

The most sophisticated and complete projections of the effects of a TTIP have been made by Joseph Francois, et al., on behalf of the European Commission. (15) and (16). Some of these results are shown in the following three tables. As can be seen in Table 2, the estimated macroeconomic effects of a TTIP agreement will depend heavily on both how comprehensive the agreement is and how ambitious it is.[3] Although import tariffs are on average quite low for both the US and the EU, they are quite significant for certain products, particularly agricultural products. Therefore, assuming that 98 percent of import tariffs were removed (less ambitious scenario), or 100 percent (more ambitious scenario), there would be significant benefits for both the US and the EU as compared to a projected 2027 global economy in the absence of such reductions. The fact that the gains for the EU are more than twice as large as for the US reflects the fact that import tariffs of the EU are considerably higher on average than for the US. If only trade in services were liberalized, the benefits would be much less for the EU than for tariff removal, but only slightly less beneficial for the US. Likewise, the EU would have almost four times as much to gain as the US from a 25 % reduction in nontariff barriers related to government procurement, although there would be significant gains for each. As can be seen in the last two columns of Table 2, a more ambitious agreement that attained complete import tariff removal, elimination of 25 percent (as opposed to 10 percent) of the nontariff trade barrier costs, and reduction by 50 percent (as opposed to 25 %) of the cost of procurement-related nontariff barriers yields significantly greater benefits for both the EU and the US.

[1] Negotiations were formally begun in March 2013. Countries involved are the ten countries of ASEAN plus Australia, China, Japan, Korea, India and New Zealand. An ancillary benefit of the negotiations is that through their involvement in them the countries may be more reluctant to let territorial disputes of South Korea and Japan with China get out of hand.

[2] The European Union has concluded free trade negotiations with the Andean Community and Central America, and has relaunched negotiations with Mercosur.

[3] The estimates in Tables 2–4 are taken from (15) and (16), and were generated by CGE modelling using the GTAP model (19) with features added from the Francois, van Meijl, and van Tongeren model (14) and using the ECORYS (8) survey of nontariff barriers to trade.

Table 2

Macroeconomic Effects of TTIP Agreement

	Limited agreement: tariffs only	Limited agreement: services only	Limited agreement: procurement only	Compre-hensive agreement: less ambitious	Compre-hensive agreement: ambitious
Change in GDP					
EU, million euros	23,753	5,298	6,367	68,274	119,212
US, million euros	9,447	7,356	1,875	49,543	94,904
Bilateral exports f.o.b.					
EU to US, million euros	43,840	4,591	6,997	107,811	186,965
US to EU, million euros	53,777	2,859	3,411	100,909	159,098
Total exports f.o.b.					
extra-EU, million euros	43,740	5,777	7,136	125,232	219,970
US, million euros	57,330	5,488	5,942	142,071	239,543

(from (15, pg. 2)
Note: estimates to be interpreted as changes relative to a projected 2027 global economy.
Source: Summary of Macroeconomic Effect (15, pg. 2)

Table 3

Simulated TTIP Agreement Effects on Changes in GDP (in percent), 2027 benchmark, ambitious experiment, 20 per cent direct spill-overs [Table A5.1 from (16)]

	A = B + C + D + E + F	B	C	D	E	F	G
	Total	tariffs	Total NTMs goods	Total NTMs services	direct spill-overs	indirect spill-overs	procure-ment
European Union	0.48	0.11	0.26	0.03	0.07	0.02	0.05
United States	0.39	0.04	0.23	0.06	0.06	0.00	0.03
Other	0.14	–0.01	–0.04	–0.01	0.05	0.15	0.00
Other OECD, high income	0.19	–0.03	–0.06	0.00	0.07	0.20	0.00
East Europe	0.33	–0.04	–0.02	0.00	0.00	0.39	0.00
Mediterranean	0.08	–0.05	0.02	0.00	–0.04	0.15	0.00
China	0.03	0.02	–0.08	–0.02	0.14	–0.02	–0.02
India	0.04	–0.01	0.02	0.00	–0.02	0.06	0.00
ASEAN	0.89	–0.02	–0.09	–0.01	–0.01	1.01	–0.02
MERCOSUR	0.03	–0.01	0.00	0.00	0.00	0.05	0.00
Low Income	0.20	–0.02	0.01	0.00	0.00	0.21	0.01
Rest of World	0.12	–0.02	0.00	0.00	–0.01	0.16	0.00

Source: CGE calculations [as reported in Table A5.1 of (16)].
* Quantity-based GDP change does not correspond to real welfare gains, which are linked to real consumption!

Given the current level of global economic integration, a TTIP agreement between the EU and the US will naturally have an impact on other countries as well. As can be seen from Table 3, while a limited agreement would have adverse effects on certain other countries, a comprehensive agreement would, because of growth stimulation, have positive effects across the board. Direct spill-overs in the table indicate the beneficial effects on third countries of having greater regulatory harmonization between the US and the EU that would reduce the cost of third countries trading with them. The direct spillover effect is assumed to be 20 percent as large for the third countries as the effects on the US and the EU of regulatory harmonization. The indirect spillover effect assumes that certain third countries will follow the lead of the US and the EU and will adopt similar standards. This indirect spillover effect is assumed to be 10 percent as large for third countries as the effects of the US and the EU of regulatory harmonization.

As can be seen in Table 4, the estimated benefits of a less ambitious TTIP agreement are considerably less than for a more ambitious agreement, reducing by almost one-half the estimated change in GDP for both the EU and the US. The effects on third countries are correspondingly reduced as well, but are positive in every case for a

Table 4

Simulated TTIP Agreement Effects on Changes in GDP (in percent), 2027 benchmark, less ambitious experiment, 20 per cent direct spill-overs [Table A5.2 of (16)]

	A = B + C + D + E + F	B	C	D	E	F	G
	total	tariffs	total NTMs goods	total NTMs services	direct Spill-overs	indirect Spill-overs	procure-ment
European Union	0.27	0.10	0.12	0.01	0.03	0.01	0.02
United States	0.21	0.04	0.11	0.03	0.03	0.00	0.01
Other	0.07	–0.01	–0.02	0.00	0.02	0.08	0.00
Other OECD, high income	0.08	–0.03	–0.03	0.00	0.04	0.10	0.00
East Europe	0.14	–0.04	–0.01	0.00	0.00	0.20	0.00
Mediterranean	0.02	–0.05	0.01	0.00	–0.02	0.07	0.00
China	0.02	0.01	–0.03	–0.01	0.07	–0.02	–0.01
India	0.02	–0.01	0.01	0.00	–0.01	0.03	0.00
ASEAN	0.45	–0.02	–0.04	–0.01	0.00	0.52	–0.01
MERCOSUR	0.01	–0.01	0.00	0.00	0.00	0.02	0.00
Low Income	0.09	–0.02	0.01	0.00	0.00	0.11	0.00
Rest of World	0.05	–0.02	0.00	0.00	–0.01	0.08	0.00

Source: CGE calculations [as reported in Table A5.2 of (16)].

* Quantity based GDP change does not correspond to real welfare gains, which are linked to real consumption!

comprehensive agreement. The adverse effect on third countries from tariff elimination between the US and the EU indicates trade diversion. But the higher incomes in the EU and the US are more than enough to offset the negative effects, so that the projected net effects are positive across the board for all countries and regions. The less ambitious scenario is much more likely to be agreed than the more ambitious one.

While a transatlantic free trade agreement has been proposed several times in the past, both the US and the EU have been reluctant to proceed because of feared adverse effects on the multilateral trading system. Given the dominance of the US and the EU in world trade, it was thought that an agreement between them could reduce the multilateral trade regime to irrelevance, while possibly harming those excluded from it. But the rise of Asia is reducing the dominance of the US and the EU in the global economy. And the failure of the Doha Round is causing the multilateral trading system to be regarded as dysfunctional, with bilateral and regional trade agreements being viewed as the only alternatives available for trade liberalization.

Should the "pivot to Asia" by the United States result in both a Free Trade Area for the Asia-Pacific and a US-EU free trade agreement, by then so much of world trade would be included in these agreements that it would make sense to integrate the various bilateral and regional trade agreements into a new multilateral agreement. It may be that future multilateral trade liberalization will be accomplished in this piecemeal fashion instead of through the comprehensive multilateral rounds of the past.

Successful conclusion of the Transatlantic Trade and Investment Partnership could be an important building block toward a larger agreement. Given the importance of the US and the EU in the global economy, if they can agree on regulatory standards and administrative practices these could set the standard for the global economy. At no time will the influence of the US and the EU on the future course of the world trade regime be greater than it is currently. The issues over which they will be negotiating, such as food safety, data privacy, geographical indications, product standards, agricultural product access and the sanctity of cultural industries will be extremely challenging. Transatlantic differences concerning these issues are often deeply rooted in culture, making compromise exceedingly difficult. Unless both sides enter into the talks willing to make major concessions the negotiations have almost no chance for success. But it is in the strong interest of both the US and the EU to be able to affect the evolution of the world trade regime in positive ways so that the global public good of unrestricted trade is preserved and strengthened.

The US and the EU can no longer expect to dictate terms with regard to the world trading system, however. The interests of the rapidly growing developing countries will have to be taken into account and concessions made to them. Greater market access for agricultural products will be es-

sential. A sore point for formerly planned economies such as China and Vietnam is the refusal of the EU and the US to recognize them as market economies for the purposes of antidumping and countervailing duty cases. Failure to do so increases the range of actions that can be taken against these countries with regard to administered protection measures. Australia and several other countries have deemed these countries worthy of designation as market economies. A constructive step would be for the EU and the US to agree on exactly what criteria these countries must meet for them to be extended this designation, and then communicate these clearly to them. Doing so could encourage further reforms in these countries. A strong multilateral system, with the larger emerging economies firmly embedded in it, is certainly in the interest of both the EU and the US as the world becomes more multipolar.

The Global Monetary System

A source of much friction between the US-EU and certain of the emerging economies is exchange rate policy. China has been running large trade surpluses with both the US and the EU, and this is widely perceived to be the result of undervaluation of the Chinese currency. The US Congress has threatened repeatedly to impose a border tax to offset the effects of China's undervalued currency, while China and Brazil have objected vociferously to the Federal Reserve's quantitative easing of the money supply because it has required them to accumulate even more dollar reserves in their efforts to keep their currencies from appreciating.

China has accumulated an estimated $3.7 trillion in foreign exchange reserves, with perhaps two-thirds of these denominated in US dollars.[1] As a result of the Asian financial crisis of 1997–98, a number of Asian countries decided to self-insure against future crises by accumulating sizeable reserves of foreign exchange. China, however, because of its capital market restrictions, was little affected by the Asian financial crisis. Its reserve accumulations have been the result of currency market intervention rather than accumulation for precautionary purposes. Nevertheless, the accumulation of reserves in China and other Asian countries, and their investment in the West, provided excess liquidity that contributed to the recent global financial crisis.

China is widely perceived as intent on keeping its currency value low in order to maintain the competitiveness of its export industries. It is true that Chinese leaders consider strong economic expansion as necessary for maintaining employment and social stability, and that export production is an important component of Chinese growth. However, the situation is a bit more complicated. China's large current account surpluses are the result of an imbalance between saving and investment in the Chinese economy. China has a high household saving rate because of its minimal social safety net and insufficient pensions. In addition, corporate and government savings rates are high. China's current account surplus ballooned between 2004 and 2008, from 3.55 % of GDP to 9.88 %, without any increase in the personal saving rate. During this period, corporate profits surged as state-owned enterprises in China exited low-profit industries but increased their presence in high-profit sectors. The Chinese government lacked the channels to redistribute these profits for household consumption, so the savings-investment imbalance intensified. (34)

Because China is an immature creditor country, this imbalance cannot be corrected through exchange rate policy alone. China's financial markets are underdeveloped, with restrictions on both international capital flows and interest rates. Also, because the world is still largely on a dollar standard, even as the world's largest creditor country China cannot use its own currency to finance foreign investments. To do so would require that private financial institutions be willing to acquire liquid foreign assets. But with their liabilities denominated in renminbi, the currency mismatch makes them unwilling to assume the foreign exchange risk necessary to be international financial intermediaries. Consequently, the central government must assume the financial intermediation role, through its Chinese Investment Corporation sovereign wealth fund investing dollars abroad, by investing in aid programs in less developed countries which provide a flow of raw materials, and by accumulating huge dollar-denominated foreign exchange reserves. (24)[2]

China is gradually taking steps to become a more mature creditor country and to move toward renminbi convertibility. It is allowing export firms to keep some foreign exchange balances abroad, and a sizeable number of import and export firms are now conducting transactions in renminbi. The Bank of China has recently been allowed, on a very

[1] China's foreign exchange reserves increased by 23 percent in 2009 alone. (37) China does not reveal the composition of its reserve assets.

[2] McKinnon contends that, under the described circumstances, renminbi appreciation could, by lowering the profitability of investments in China, cause investment to decrease more than saving, thereby exacerbating the savings-investment imbalance and actually increasing the size of current account surpluses.

limited scale, to open renminbi-denominated accounts in New York, thereby providing foreign exchange trading services to Americans. And a number of foreign firms have been permitted to issue renminbi-denominated bonds in China. (9) China is moving slowly and deliberately in this matter, for a move to full convertibility will require the removal of capital controls and loosening control of the banking system which is one of the Chinese government's primary levers of control.

China is also taking some steps to address its macroeconomic imbalances. It has liberalized its capital account and is encouraging Chinese firms to invest overseas. China increased spending on healthcare beginning in 2009, providing coverage to 200 million of its citizens, and is aiming toward universal coverage by 2020. It also set aside $400 million toward rural worker pensions. These measures are at least a small step toward reducing precautionary saving by the Chinese public. Increased access to credit for private firms so that they do not have to generate capital for expansion through retained earnings would also be helpful. (37) Chinese leaders have an interest in changing the situation, for the accumulations of large foreign currency balances "…are a serious political problem for the Chinese leadership both internationally, where they are seen as evidence China is manipulating its currency, and domestically, where they are seen as the nation's wealth and so any capital loss on the portfolio is politically unacceptable." (1)

While the steps taken by China will help to rebalance the global economy, policy responses on the part of the EU and the US are also needed. If the euro's standing as a reserve currency is to be enhanced, which would provide beneficial diversification possibilities for reserve holdings, the eurozone countries must work together to stabilize the financial situation of the weaker countries, agree upon stabilization measures to be employed in the case of crises, and perhaps eventually establish a system of fiscal transfers. The United States, in order to prevent an eventual dollar crisis, must address the underfunding of healthcare and social security programs in the face of a rapidly aging population. Projected levels of US public debt are unsustainable over the longer term. The dependence that the US has developed on foreign funding of its public debt places policy restraints on the US, and increases the likelihood of financial crisis in the future.

The US and the EU should realize that it will take time for China to make the changes needed for correcting its imbalances and for attaining full currency convertibility. Cooperation and encouragement are likely to be more effective in moving China in the right direction than confrontation, given China's historical sensitivities to outside pressure. An important step toward macroeconomic coordination was taken at the G-20 meeting in Paris in February 2011. The countries of the G20 agreed on economic indicators that should be used to evaluate whether policies proposed by national governments will lead to:

— adjustment with balance in the global economy along with economic growth

— lack of adjustment and inadequate economic growth, or

— lack of adjustment that results in growth but is still characterized by imbalances. Technical analysis for the G20 Mutual Assessment Process (G20-MAP) will be provided by the International Monetary Fund.[1] The parties, including China, agreed that trade balances and investment flows will be monitored, "taking due consideration of exchange rate, fiscal, monetary and other policies." (33) China finally gained recognition that exchange rate policy should not be considered alone, but only in a wider policy context. The G20-MAP may provide an institutional framework for macroeconomic coordination that has long been lacking, although its effectiveness will depend entirely on the commitment of the countries involved to take corrective actions when indicated.

With regard to the international financial system, a way in which emerging economies could be incorporated more completely into the multilateral system would be through increasing their quotas and voting rights at the International Monetary Fund commensurate with their economic size. The EU is over-represented at the IMF, but the member countries involved have been reluctant to relinquish their privileged position. A move toward rebalancing was made on October 23, 2010 when the G20 finance ministers agreed to shift an additional 6 % of voting shares from developed to developing countries.[2] Even after the 2010 reforms, however, the EU still has more than two times the voting rights of the combined BRICS countries,[3] although in terms of combined GDPs they are approximately equal in size. (2) Just as the United States will eventually have to for-

[1] G20-MAP was first agreed at the Pittsburgh G20 meeting in October 2010. (23). The Paris meeting of February 2011 reached agreement on what indicators would be used. (33)

[2] This limited reform was agreed only under the threat of the US to use its veto power to cause the 24 places on the IMF executive board to revert to the 20 members originally stipulated in by IMF rules. (2)

[3] The BRICS countries include Brazil, Russia, India, China and South Africa.

feit the "exorbitant privilege" of being the world's dominant reserve currency, so will the EU countries have to forfeit their "exorbitant privilege" of over-weighted influence in international institutions such as the IMF and the World Bank. A greater role for China is already justified based on its economic size, and further increases will be expected as the renminbi becomes convertible and used as a reserve currency.[1] Giving China and other emerging economies increased standing in such institutions will shift some of the responsibility for the provision of global public goods such as a stable and open financial and trading system to them. As Wendy Dobson has pointed out, China has long benefited from the provision of these goods by other countries, and as an ascendant power should shoulder some of the responsibility of providing them. (7)

Conclusion

The global economy is evolving rapidly in ways that imply a relative decline in the influence of the US and the EU in the future. The United States and member countries of the EU crafted the international economic and financial institutions that provide the framework for provision of global public goods such as unrestricted trade and financial stability. Together these countries continue to play a dominant role in the global economy. However, it is unrealistic to think that as developing countries, particularly large ones such as China and India, increase their footprint in the global system that they will not demand a larger role in its character and functioning. The US and the EU can together play a key role in shaping the institutional framework of the evolving global economy in ways that will benefit themselves and the world as a whole, and their influence will never be greater than it is currently. This makes it extremely important that the US and the EU work together to see that the global economy evolves in positive ways. The current negotiations for a Transatlantic Trade and Investment Partnership provide the opportunity for establishing norms and standards for the world at large. However, the complicated issues involved will make consummation of the agreement extremely difficult. Both sides will have to be willing to compromise as never before if the negotiations are to succeed. Beyond these negotiations, the US and the EU must face up to the fact that countries such as China, India and Brazil must be given increased voice and responsibilities in the global economic system, which will require forfeiting of some of the privileges currently enjoyed by the transatlantic countries.

[1] In addition to GDP, the current formula for IMF quotas takes into account variability of capital flows, openness of the economy, and holdings of the currency as international reserves.

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