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# Partners in Crisis: EU Strategic Partnerships and the Global Economic Downturn

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Partners in Crisis:  
EU Strategic Partnerships and  
the Global Economic Downturn

GIOVANNI GREVI AND THOMAS RENARD EDS.



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# Introduction

**Giovanni Grevi and Thomas Renard**

» Many people anticipated that economic and political power would shift from the West to the East and the South in the coming decades. Likewise, deepening interdependence has been widely commented on as a core enabler and by-product of ever more pervasive globalisation. Few, however, expected the power transition to accelerate so dramatically, nor did many predict that interdependence would rapidly turn from a source of prosperity to a vehicle of contagion, threatening the resilience of globalisation. The global financial and economic crisis that began in 2008 was a turning point.

The crisis triggered new initiatives aimed at containing the immediate risk of financial meltdown, notably, the G20 meeting at leaders' level. However, more fundamentally, the crisis has durably affected the mutual perceptions of major economic actors, the terms of the debate on sound economic and development models, and the prospects for multilateral cooperation. In a world of growing economic divides, whether over rising protectionism and mercantilism or the so-called currency wars, bilateral partnerships can become a key tool for sustaining dialogue, improving mutual understanding and fostering a degree of convergence as a condition for multilateral cooperation. But if that is their purpose, this report suggests that much remains to be done.

## The impact of the crisis

The key message of this ESPO Report is that the global economic crisis has proved to be a game changer in the European Union's relations with its strategic partners. The 2008 financial crisis has affected all major economies, but it has hit Europe especially hard, with lasting consequences for growth. Since 2011, the eurozone crisis has been aggravated by the combined impact of weak public finances, speculation and political tensions among member states. Austerity and recession within the EU are draining Europe's key partners' confidence in the European project and turning the EU from an engine of growth to a source of concern all the way from Washington to Delhi.

The impact of the crisis on separate partnerships varies greatly, given the partnerships' very different breadth, depth and level of ambition. Overall, however, the crisis has exposed some features that are common to the partnerships addressed in this report. For one, the EU's strategic partnerships do not seem to have made a tangible contribution to narrowing the gaps in times of crisis between the EU and its partners, whether on fiscal, monetary or trade issues. Moreover, if the crisis has undermined Europe's profile, neither the United States nor the emerging powers have delivered the sort of leadership needed to broaden the ambition of bilateral partnerships and raise the multilateral game to deal with pressing challenges. The economic crisis has uncovered a world of increasingly introverted powers, each bent on restarting or sustaining growth at home, but reluctant to compromise on domestic priorities and vested interests for the sake of bilateral or multilateral agreement.

The crisis has brought about what Boillot calls a 'role reversal' in mutual perceptions between the EU and emerging powers such as India and Brazil. The gap in growth rates between these rising economies and the EU is not expected to decrease in the years ahead. Divergent economic fortunes put into question the ability of the EU (and of its partners) to recalibrate traditionally asymmetric relationships, centred on development cooperation, in order to build partnerships of equals, focused on trade, innovation and sustainable growth.

## Bilateral partnerships and multilateral brinkmanship: the missing link?

Successfully managing the economic crisis requires global engineering at the multilateral level, which could be facilitated by deepening bilateral dialogues. However, there is little evidence that the strategic partnerships have increased the influence of the EU on the multilateral stage, and what evidence exists largely concerns relations with the United States. The transatlantic partners joined forces in 2008/2009 to react to the crisis and convene the G20 at leaders' level. When the EU and its largest member states act together with the U.S., they can make a difference. But the experience of the G20 itself demonstrates the inadequacy of the transmission belt between bilateral partnerships and multilateral negotiations. Zandonini argues that differences between the transatlantic partners on financial regulation and fiscal policies have contributed to stalling progress in the new forum. The EU, Brazil and India do not seem to see each other as heavyweights within the G20. Meanwhile, China is growing more disengaged, despite high-level bilateral macroeconomic dialogues with the U.S. and the EU.

Strategic partnerships have not brought about much convergence on the reform of international financial institutions. On this key issue, the EU has no autonomous voice,

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since it is not a member of the International Monetary Fund (IMF) or the World Bank (WB). Its member states are resisting change, emerging powers are growing more frustrated and the U.S. has managed to corner its European partners since the push for reform in 2010. Otero notes that the slow pace of reform of the international financial institutions may lead emerging economies to attempt to deal with global financial instability through cooperation in alternative frameworks, such as the recently proposed BRICS development bank and reserve pool.

The lack of progress at the multilateral level reflects the diverse positions and perceptions of actors such as the EU, the U.S., China and India and Brazil. The U.S. and Europe are no longer in a position to dictate good economic practice to the rest of the world. The BRICS are questioning the current global monetary order and the role of the U.S. dollar within it. As the balance of global economic power shifts, different diagnoses of the roots of the crisis work against the realisation of a shared prescription for action. Strategic partnerships are, in principle, a critical tool for bridging this kind of ‘cognitive dissonance’ among major actors, as Otero puts it. In practice, achieving this objective will take time, political space to adjust positions and, arguably, a more targeted focus. This report suggests that more political investment needs to be put into the (too) many formats for bilateral dialogue with EU strategic partners. The bureaucratic approach should be downgraded in favour of setting up ad hoc task forces with more precise mandates for striking deals on controversial issues such as capital controls and competitive currency devaluations. Likewise, bilateral consultation should be intensified ahead of major international events such as G20 summits.

## Strategic partners to Europe’s rescue?

The crisis has shown that the global economy is not a zero-sum game – but if inertia prevails, it could become one, to the detriment of all. The assumption that a decoupling could exist between stagnation in the West and growth in the rest has been proven false, at least over the short term. Growth rates in Brazil, India and China have slowed due to the downturn in Europe and modest recovery in the U.S. The upside is that all EU partners, especially the U.S. and China, have a strong interest in Europe’s recovery from the eurozone crisis. This report notes that China has been making a significant contribution to keeping the euro afloat by boosting its purchase of eurozone bonds in the last two years, albeit shifting from buying those of peripheral countries to acquiring those of so-called core countries such as Germany. Moreover, China, India and Brazil have recently contributed to the IMF fund that could be mobilised to contain crisis in Europe: China has provided \$43 billion and India and Brazil have contributed \$10 billion apiece. But support to the eurozone comes with controversial

implications related to each country's self-interest, whether in keeping the value of the euro up, which benefits exports to Europe, or in linking multilateral action to a new round of redistribution of votes and seats in the IMF.

Some powers appear to be making more strategic use of the crisis than others. In this regard, the fragmented governance system and external representation of the EU and of the eurozone are seen as seriously hampering Europe's position at a time when its partners call for clarity and determination. Increasingly, strategic partners are keen to engage at multiple levels at once, with EU bodies and with countries that are seen as pivotal to Europe's politics and economics, particularly Germany, but also France and, more recently, Italy. The inherent asymmetry of strategic partnerships between major state actors and a collective body like the EU can only be corrected by making the EU's external action and representation much more coherent and linear. Casarini notes an ambivalent trend in relations with China, where a new 'eurozone monetary diplomacy' led by EU bodies and key national leaders runs parallel to other levels and areas of engagement, such as the ongoing and problematic trade negotiations.

## Tapping into strategic partners' growth

As the EU seeks to tap into sustained growth beyond the Union, ambitious trade and investment deals are central to strategic partnerships with a number of partners, including India and Brazil. The launch of negotiations on a EU-U.S. free trade agreement is the subject of intense debate within the bilateral High-Level Group on Jobs and Growth. While there seems to be considerable momentum behind this action, EU-MERCOSUR negotiations have reached a dead end, not least due to the difficult politics within the South American bloc. And the conclusion of a bilateral investment and trade agreement with India still faces a number of obstacles on both sides. This report shows that there is little willingness to make trade concessions that could affect sensitive domestic sectors and interests.

Along with these negotiation difficulties, the EU is losing ground in terms of trade. While remaining the top trade partner of all the four countries addressed in the report, the EU's share of India's and Brazil's external trade is eroding fast. This trend fits in with a broader reorientation of trade routes. A recent report by Standard Chartered envisaged that South-South trade would increase as a share of global trade from 7 per cent in 1990 to 18 per cent in 2010 to 40 per cent by 2030. Boillot notes that the EU's share of Indian trade has dropped from 45 per cent in 1960 to 28 per cent 20 years ago to 15 per cent today. Increasingly, India looks at East Asia and the Middle East as its key future trading partners.

Trade, however, is not the whole story. The slow progress in setting up a better framework of rules for trade and investment contrasts with considerable forward motion in direct investment between the EU and its partners. In particular, according to various estimates, Chinese investment in Europe has been skyrocketing in recent years, although it started from a very low base. It tripled between 2006 and 2009 and then again between 2009 and 2011 to reach \$10 billion. Similarly, Indian companies have carried out high-profile acquisitions in Europe, and have expanded in particular in Central and Eastern Europe. Brazil and Europe have witnessed high volumes of mutual investment flows and stocks. EU foreign direct investment (FDI) stocks in Brazil are by far the largest relative to other BRICS countries. Otero points out that Spain and Belgium together have a larger FDI stock in Brazil than that held by the U.S. Conversely, Brazil's FDI stock in the EU in 2010 was greater than that of all the other BRICS combined.

## Conclusion

The global economic crisis has exposed both the shortcomings and the importance of EU strategic partnerships with Brazil, China, India and the U.S. Under serious economic strains and uncertainty, all partners have turned inwards, and the very survival of the eurozone has come into question. Creating more targeted partnerships, infused with the right dose of political will, is critical in order to prevent mutual estrangement and the breakdown of multilateral efforts. All partners need to step up their commitment to problem-solving at the bilateral level in order to bridge gaps at the multilateral one, or else the G20 will continue to lose traction. If it wants to regain the credibility and clout that the crisis has dented, the EU needs to shape up and present its strategic partners with a consistent stance across various policy areas.



# The EU and Brazil: What crisis? What partner? What strategy?<sup>1</sup>

Miguel Otero-Iglesias

## Introduction

After decades of failed negotiations to reach an inter-regional agreement with Mercosur, in the mid-2000s and especially after the collapse in 2004 of talks on a free trade agreement (FTA), the European Union decided to change track and focus on the bloc's largest economy: Brazil (Malamud 2012). In July 2007, during the Portuguese presidency of the EU, Brazil and the EU signed a strategic partnership agreement. This signalled that the EU had started to recognise Brazil as 'an increasingly significant global player' and 'a strategic partner as well as a major Latin American economic actor and regional leader' (EC 2007). Brazil has now the same status as other emerging powers that are also strategic partners of the EU, including Russia, India, China and South Africa – the other members of the BRICS group.

This paper intends to identify the achievements of the EU-Brazil strategic partnership in the aftermath of the greatest global financial and economic crisis since the 1930s Great Depression and amidst a lingering sovereign debt crisis in the Eurozone. The key questions tackled here are whether the global and euro crises have strengthened or weakened the partnership, whether the association provides the right tools to overcome both crises and, if not, how the partnership can be improved to increase its effectiveness. Overall, this paper argues that the partnership's success in terms of macroeconomic policy coordination has been limited. The EU-Brazil strategic partnership is a good framework to enhance dialogue and exchange information and best practices between both sides, but it lacks a coherent direction and concrete objectives in order to yield tangible results in the policy areas addressed here.

The EU-Brazil strategic partnership is vague and ambiguous. This is reflected in how both players interpret the crisis, each other's policies and the macroeconomic framework that

<sup>1</sup> I would like to thank Giovanni Grevi and Thomas Renard for their editorial suggestions on the paper, and the participants at the workshop 'The Global Economic Crisis and EU Strategic Partnerships', ESPO, Brussels, 2 July 2012, for their comments and insights. The paper has greatly benefited from this feedback.

needs to be developed in the future. From a Brazilian point of view, the crisis originated in advanced economies and thus they are the ones who need to take responsibility for their mistakes. The crisis has raised doubts about the European economic model. Perhaps the main questions being asked in Brasilia right now are: what does the EU stand for? Is it a community with a shared destiny or just a group of sovereign and independent states entrenched in national self-interests? Conversely, in Brussels the question is what does Brazil really want? Brazil and the other BRICS are seen as very eager to demand more voice in international fora, but rather weak when it comes to supplying solutions. Brazil often likes to present itself as the leader of South America. However, to be a leader you need followers. So far, Brazil has underperformed on this front.

## What crisis?

One of the key aspects of every systemic crisis is the interpretation of its causes and consequences (Blyth 2002). In this regard, for a strategic partnership to work, it is important to agree on a common diagnosis. Are policymakers in Brazil and Europe on the same page? Not quite. For Europeans, the global financial crisis (2008-2009) originated in the United States and spread globally through globalised finance and trade. From 2010 onwards, it has been affecting above all Europe because of the European Monetary Union's (EMU) structural flaws. However, for Brasilia, in the words of former President Lula da Silva, the global financial crisis was 'caused and encouraged by the irrational behaviour of white people with blue eyes who before the crisis appeared to know everything but are now showing that they know nothing' (BBC 2009). This opinion reflects the widespread feeling among Brazilian policymakers and business elites towards the EU. For many years, Europeans have lectured Brazilians on how to run their economy and banking system, arguing that Brazil needed more openness, more market and less red tape. European bankers boasted about the solidity of their business models and European financial regulators gave lessons to their Brazilian counterparts on best practices. But Spain's (among other European states) current banking crisis proves that the European model was not so resilient after all. Thus, to a certain extent the crisis has rebalanced the positions of both partners. Brazilian policymakers recognise that corruption and excessive bureaucratic rigidities – the so-called 'Custo Brasil' – need to be addressed. At the same time, Europeans, especially those from the Eurozone's periphery, acknowledge that their economies need far-reaching reforms.

Nonetheless, the basic source of tension between the EU and Brazil resides in different views regarding macroeconomic policy. For a long time, the Commission and the European Central

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Bank (ECB) followed a mixed approach, combining elements from the UK's liberal model and Germany's 'ordoliberal' approach. Thus, politics – in other words, the state – should interfere as little as possible in economic activity (McCann 2010). Consequently, capital controls and foreign exchange intervention should be avoided (McNamara 1998; Henning 2007), and the financial sector should be able to regulate itself. However, this has been proved wrong, with dire consequences. In Brazil, following the developmentalist tradition to which the new Brazilian President Dilma Rousseff is greatly attached (Gomes Saraiva 2012), the balance is tilted towards the role of the state rather than the market (which is coincidentally closer to the French model). This was recently confirmed when Brazil imposed capital controls to hamper the appreciation of its currency. This type of interventions contrasts sharply with the behaviour in the Eurozone during the first decade of the twenty-first century when the euro experienced considerable appreciation. From 2002 to 2008, the euro appreciated almost 100 per cent, going from \$0.86 to \$1.60. The obsession with not intervening in the foreign exchange market was one of the causes of the euro debt crisis, as it heavily affected the export sectors of peripheral Eurozone countries.

Before the global financial crisis, the mainstream view in Western macroeconomic thinking was that a floating foreign exchange regime was best. Even Brazil adopted it in 1999. After the outbreak of the crisis, however, this approach has been increasingly questioned by the emerging powers (Otero-Iglesias & Zhang 2012). Foreign exchange intervention is now commonplace not only in South East Asia and China, but also in developed nations such as Japan and Switzerland. We are now living in what Brazilian Finance Minister Guido Mantega has labelled 'currency wars' (FT 2010). This has placed the EU and the Eurozone in particular in a difficult situation. While the US and the UK have openly tried to devalue their currencies through 'quantitative easing', the rest has been struggling to stop this 'monetary tsunami' (Dilma Rousseff, FT 2012a) through capital controls and foreign exchange intervention. The Eurozone is the only key player that has followed the rules, thus absorbing most of the adjustment process (De Grauwe 2010). This precarious situation has forced the less orthodox new ECB President Mario Draghi to adopt a laxer monetary policy, which in itself confirms the trend towards increased competitive devaluations.

The global financial crisis has shown that the US is not the economic leader that it once was. The United States is in relative decline, politically and economically. The BRICS increasingly question the dollar (Otero-Iglesias & Steinberg 2012). The post-World War II international regime of liberal institutions, rules, norms and values (Hasenclever et al. 1997) established by the US, and shaped to a large extent by the EU, is under considerable duress. In financial and monetary matters, this means that coordination and cooperation are missing. Hence, traditionally rule-shapers, EU policymakers are now complaining about

the unilateral actions taken by the likes of Brazil or China, and even the US, whose extreme loose monetary policy has been labelled ‘clueless’ and a ‘manipulation of the exchange rate’ (Wolfgang Schäuble, German Finance Minister, FT 2012b). The consequences are clear: when the main guarantor of the regime breaks the rules, the rule-takers have greater incentives to free ride (Valladão 2012).

## What partner?

In principle, the EU-Brazil strategic partnership framework, which includes an annual high-level dialogue to coordinate efforts to reform the ‘world’s financial architecture so as to prevent financial crises in the future’ (EU-Brazil Summit 2011), should be an ideal setting to find common positions and take them to international fora such as the International Monetary Fund (IMF) and the G-20. Brazil and the EU share similar goals. Both are in favour of strengthening the multilateral framework, enhancing financial regulation, avoiding disruptive exchange rate movements and ameliorating volatile commodity prices. Nonetheless, so far the partnership has not achieved concrete results. Coordination at the bilateral level in the G-20 has been limited (Gomes Saraiva 2012; EUBrasil 2011). There are several reasons for this. On the one hand, it is very difficult to identify what the Brazilian government really wants beyond more voice in global governance. Brazil’s goals seem more domestic. It is keen to preserve its sovereignty and autonomy and favours a managed exchange rate regime, combining floating elements with occasional intervention and capital controls.<sup>2</sup> Brazil also values national autonomy when regulating its financial and banking systems. Other than this, Brasilia has no blueprint for the reform of the international monetary and financial system. What is clear is that it does not favour a rigid, rules-based international regime, which would be more of the EU’s liking. Mirroring the behaviour of the US, Brazil, like China, prefers a ‘multilateralism à la carte’ or ‘lucrative multilateralism’ based on pure national economic interests (Holslag 2006, Valladão 2012), a distant cry from the normative and legalistic framework advocated by the EU.

Notwithstanding Brazil’s vagueness, Europeans do not have a common position either. Neither the EU nor the Eurozone have a common Treasury or Ministry of Finance that could speak with one voice before the Ministry of Finance of Brazil. The Eurozone, for instance, has no common position regarding exchange rate coordination, a feature that weakens it both internally and externally. Germany has traditionally favoured a single mandate for the

<sup>2</sup> The new interventionist measures taken by Brazil have been met with stark criticism from European officials, who have voiced their concern to their Brazilian counterparts. Interview with a European Commission official, DG Economic and Financial Affairs, Brussels, March 2012.

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ECB focused on price stability and non-intervention in exchange rate markets, while France has always advocated more intervention and the creation of an international exchange rate regime based on fluctuation bands among the leading international currencies (Henning 2007, Otero-Iglesias & Zhang 2012). As long as the EU, or at least the Eurozone, has no common position on these important matters, the EU-Brazil strategic partnership will not yield concrete results in macroeconomic coordination. The partnership's Joint Action Plan (EU-Brazil Summit 2011) includes a Macroeconomic and Financial Dialogue. The dialogue has held three annual meetings since 2009, but these have served mostly to exchange views and information (which is an advance per se). So far, no substantial accords have emerged beyond easing the agreement to enhance the IMF's financial resources.<sup>3</sup> Besides, even here Brazil's contribution is conditional to acquiring more voting power.

The sui generis status of the EU as a supranational institution, which lacks the capabilities of a nation state, hinders the smooth development of the partnership. Brazilian policymakers often point out that the EU always arrives at bilateral negotiations with a draft document that is the result of internal consensus-building and which is thus very difficult to amend. This happened, for instance, in FTA talks with Mercosur. Brazil finds this quite frustrating as it narrows the room for negotiation. According to Brazilian policymakers, the EU needs to listen more.<sup>4</sup> For instance, the EU firmly opposes capital controls (mainly because it does not want to see capital controls in its internal market), but in a globalised world of extremely volatile capital flows, external capital controls might be a useful macroeconomic tool to avoid future crises (Rodrik 2011).

Another consequence of the EU's internal structure is that to change or shape the EU's position, strategic partners like Brazil need to lobby hard at the national level. This is why Brazilian diplomacy has turned to the big member states and Portugal, rather than the EU as a whole (Gratius 2011). The crisis might have reinforced this trend due to the perceived weakness of the European Commission vis-à-vis member states. In general, the EU is seen as an influential actor in lower politics like democracy promotion, human rights, climate change, and regional integration, which are included in the Joint Action Plan. But when it comes to hard politics and economics, the EU lacks a common voice. It has no economic and monetary statecraft (Andrews 2006). It is unable to project itself as a strategic power.

<sup>3</sup> Interview with a European Commission official, DG Economic and Financial Affairs, Brussels, September 2012.

<sup>4</sup> This information has been collected from a number of conversations with experts on EU-Brazil relations, especially regarding Brazil's point of view. The author would like to thank Carolina B. Pavese, Miriam Gomes Saraiva, Andrea Ribeiro Hoffmann, Lia Valls Pereira, Alfredo G.A. Valladão and Andrés Malamud for their insights.

## What strategy?

Despite its flaws, the EU is a major trade and investment bloc for Brazil. The numbers show that the partnership is still asymmetric (EC 2012a). The EU is Brazil's main trading partner, representing 21.7 per cent of Brazilian trade. It exports mostly chemicals and machinery and transport equipment to the Brazilian market. Brazil, on the other hand, is the EU's ninth trading partner and represents only 2.3 per cent of the EU's overall external trade. Most of its exports to the EU are agricultural products and commodities. In foreign direct investment (FDI), the balance is also tilted towards the EU. In 2010, EU FDI outflows toward Brazil reached €21.5 billion, while those from Brazil toward the EU stood at €7.1 billion. When it comes to FDI stocks with Brazil, in 2010 the EU recorded €187.7 billion of outward stocks and €67.3 billion of inward stocks, with a net surplus of €120.4 billion. In the 2011 census of inward FDI stocks published by the Brazilian Central Bank (which interestingly differentiates between intermediate and ultimate investor countries; see tables 1 and 2), the EU countries that invested the most in the lucrative Brazilian market were Spain, Belgium, the UK, France, Germany and Italy (BCB 2012). It is significant that Spain and Belgium together have a larger combined FDI stock than the US (see table 2). This shows how important the Brazilian market is for European (and especially Spanish) companies. The volume of European FDI in Brazil might have fallen in the past two years due to the sovereign debt crisis, but European investment in Brazil, and vice versa, is likely to remain significant, especially if current investment barriers are reduced (EUBrasil 2011).

**Table 1: Top 20 investor countries in Brazil (intermediate origin) in 2010 (in bn US\$) /**

Source: Banco Central do Brasil

Investment origin (intermediate country)	Share in capital	Company loans	Total
<b>Total</b>	<b>579,627</b>	<b>80,881</b>	<b>660,507</b>
Netherlands	162,740	6,765	169,505
United States	110,356	15,056	125,412
Spain	70,577	8,917	79,494
Luxemburg	29,530	3,580	33,110
France	28,682	1,797	30,479
Japan	25,632	1,829	27,461
United Kingdom	16,058	3,522	19,581
Mexico	15,895	3,363	19,258
Germany	13,636	2,494	16,130
Switzerland	10,167	4,740	14,906
Cayman Islands	11,114	3,714	14,828

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Canada	12,340	1,556	13,896
Belgium	3,745	4,415	8,160
Bermudas	6,123	2,020	8,143
Chile	6,130	1,424	7,554
Portugal	6,281	1,147	7,428
Austria	4,424	2,544	6,968
Italia	5,518	1,136	6,654
British Virgin Islands	4,392	1,991	6,383
Australia	5,263	768	6,030
Other countries	31,023	8,103	39,126

**Table 2: Top 20 investor countries in Brazil (ultimate origin) in 2010 (in bn US\$) /**

Source: Banco Central do Brasil

Investment origin (ultimate country)	Total
<b>Total</b>	<b>579,627</b>
United States	104,698
Spain	85,295
Belgium	50,374
Brazil	47,841
United Kingdom	41,667
France	30,767
Germany	30,308
Japan	26,586
Italy	17,872
Mexico	15,683
Netherlands	14,385
Canada	13,849
Luxemburg	13,733
Switzerland	13,060
Bermudas	9,064
China	7,889
Portugal	7,233
Australia	6,541
Cayman Islands	4,812
British Virgin Islands	3,943
Other countries	34,027

Given this interdependence in trade and investment, hopes were high regarding the establishment of a free trade agreement between the EU and Mercosur through the strategic partnership.<sup>5</sup> Indeed, talks were resumed in 2010 during the Spanish presidency of the EU. But progress has been very limited. The positions of both blocs are still very far apart. While Brazil wants the EU to fully open its agricultural market, the EU is eager to open the Brazilian market for industrial goods and services (Gomes Saraiva 2012). Both want to open up their sectors of competitive advantage, but are reluctant to reduce tariffs on weaker sectors. Prospects to reach an agreement have darkened in recent times. European officials claim that they have made concessions and presented new proposals, but that Brasilia has been unable or unwilling to engage or bring its neighbouring countries on board, especially Argentina.<sup>6</sup> There is the sense that Brazil is a self-portrayed leader without followers. It is acting as a mere 'fire-fighter' to solve emergency situations in South America (Malamud 2010), but it does not have a consistent plan for the region, which is increasingly divided between a Pacific and an Atlantic basin. Thus, some in Europe find it ironic that Brazil asks Europe to listen more when it has actually little to say.

Overall, it is doubtful that the EU-Brazil strategic partnership has increased Brazil's leadership role within Mercosur and South America. On the contrary, its neighbours see the partnership with increased suspicion. Furthermore, Argentina's decision to nationalise the oil company YPF owned by Spain's Repsol, and the Plano Brasil Maior, which establishes a series of measures to protect the Brazilian industry hurt by the appreciation of the real, are both trends that will hamper further negotiations (EC 2012b). Like the World Trade Organisation's (WTO) Doha Round, an FTA with Mercosur is very unlikely in the near future.

On the financial side, one important topic on the agenda is the reform of international institutions such as the IMF and the World Bank. Here Brazil is disappointed with Europe. Brazil supported Christine Lagarde's campaign for IMF Managing Director in exchange for promises of reform. But so far reforms have been minor. With the excuse that the US has not yet ratified the quota shift from developed to developing countries agreed in 2010, Europeans have dragged their feet to decide which EU countries will have to reduce their voting power in the institution's executive board. As with their dealings with the euro sovereign crisis, Europeans are divided and incoherent. Unofficially, European Commission officials agree that the Eurozone should have only one seat at the IMF, a position favoured by Brazil. But countries like France and Germany, which have permanent

<sup>5</sup> Brazil is part of the Mercosur trade bloc. Hence, any attempt to establish a free trade agreement between the EU and Brazil needs to be done on an inter-regional level.

<sup>6</sup> Exchanges with EU officials at the workshop 'The Global Economic Crisis and EU Strategic Partnerships' organised by the European Strategic Partnership Observatory (ESPO), Brussels, 2 July 2012.

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executives on the institution's board, reject this proposal. After negotiations conducted through the Macroeconomic and Financial Dialogue, Brazil has reluctantly agreed to inject \$10 billion into the IMF (a relatively small amount when compared with Japan's contribution of \$60 billion and that of China of \$43 billion) in order to provide a financial buffer in case the Eurozone crisis escalates. Brazil, like the other BRICS, does not want the Eurozone to collapse because that would damage its economy, but it has clearly stated that financial help is conditioned to more voting power.

For Brazil, the EU's representation in the IMF is disproportionately high. Even with the 2010 agreement, Brazil, the sixth largest economy in the world, will have a smaller voting share than Belgium and the Netherlands combined. By contrast, the UK, the world's seventh largest economy, will have almost double voting power. The EU and the US need to realise that the time has come to accommodate the new emerging powers in the existing institutions. Otherwise, there is the danger that the BRICS might be tempted to establish their own institutions. Proposals to establish a BRICS development bank and a reserve pool to palliate the negative effects of global financial instability are already on the table (FT 2012c), although it is unclear whether these will materialise given the existing differences among the BRICS.

If the strategic partnership framework wants to be more effective in financial matters, the EU and Brazil need to set more concrete objectives and provide the tools to achieve them. Once these goals are established, it would also be important to enhance transparency and monitoring (EUBrasil 2011). For example, the three meetings of the Macroeconomic and Financial Dialogue have produced only one public document, a short and vague joint statement from the first meeting. Policymakers on both sides give great value to the promotion of dialogue and the sharing of best practices behind closed doors, but without concrete results the dialogue risks becoming nothing more than a talking shop.

For example, Brazil has proposed to solve the pressing issue of competitive currency devaluations within the WTO framework. Despite certain reluctance from the other partners, in March 2012 it organised a symposium in Geneva on this highly sensitive subject under the auspices of the WTO (ICTSD 2012). Given that the positions of China and the US are the furthest apart on how much exchange rate intervention and capital controls there should be, Brazil and the EU could establish a taskforce within the strategic partnership framework to look at different options to solve this tension. A concrete working plan could be established and a joint report could be produced as the basis for a common approach at the global level. A similar taskforce could be set up with regard to financial regulation and tax regimes, areas where collaboration is certainly possible.

## Conclusion

This paper has tried to shed some light on the effectiveness of the EU-Brazil strategic partnership in the context of the global financial and the European sovereign debt crises. So far, the results of the partnership are disappointing. For Brazil, it is seen as a good forum to raise the country's profile, exchange views and foster dialogue. It is also a useful platform to establish exchange and cooperation programmes in areas such as peace promotion, climate change, international cooperation, tax regimes, education, social policy, research and cultural exchanges. The second three-year Joint Action Plan for 2011-2014 is full of such general commitments and cooperation agreements. However, for Brazilian policymakers the partnership has limited importance. It has under-delivered on hard economics. The section on financial and economic affairs is conspicuously vague. When it comes to strengthening macroeconomic cooperation and coordination at the bilateral level, necessary to achieve results at the regional and multilateral levels, the partnership has been unable to find solutions to the current crisis or to prevent future ones. This is in part because Brazil and the EU are in the midst of a transitional phase in the balance of power between established and more liberal powers on the one hand and emerging and more statist ones on the other hand.

While the EU still sees the relationship as asymmetric – the trade and investment balance shows this –, Brazil increasingly sees itself as an upcoming power in the new emerging economic world order. It does not need to be lectured by the EU. This mutual cognitive dissonance is obstructing the development of the partnership. Europe needs to realise that the US is no longer the leading nation that sets the rules and Europe is no longer the one who shapes them. If Europe wants to maintain a multilateral framework, it needs first to listen to the other players (if they have something to say) and then try to come up with a strategy of its own to preserve its interests and the common good. Of course, in order to be more assertive externally, Europe will need to unite further internally. The protracted euro crisis is precisely a consequence of the lack of political unity.

Brazil, on the other hand, needs to realise that multilateralism can only be achieved by pooling a certain degree of sovereignty. Brazilian policymakers believe that the preservation of full autonomy and sovereignty is compatible with multilateralism. This is an oxymoron. 'Lucrative multilateralism' is a dangerous development that will most likely lead to neo-mercantilist strategies. To avoid this, a sensible way forward would be to narrow the strategic partnership's goals. It is important to identify common areas and then set up concrete task forces, with precise objectives and stricter timelines to achieve strategic results. In order to be successful, Europe will have to adjust its mindset on global economic

governance, pragmatically accepting the co-existence of different national development models and being open minded regarding the formation of a new international regime on macroeconomic policies.

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# The EU and China: Investing in a troubled partnership

**Nicola Casarini**

## Introduction

This paper looks at the key features of the EU-China strategic partnership and examines whether – and how – the current economic crisis has made the working relationship weaker or stronger. The establishment of the EU-China partnership in 2003 came at a time of converging priorities between the two partners. The EU and China could build on a similar understanding of the post-Cold War international system and of both partners' place within it. They were brought closer together by cooperation in high-tech and strategic industrial sectors and by closer economic and monetary ties, including China's support for the euro. But in the years following, EU-China relations would gradually deteriorate due to growing misperceptions and differences on issues such as trade, technology and human rights. By the time the economic crisis broke out in autumn 2008, the EU-China strategic partnership had reached one of its lowest points.

Since 2010, with the worsening of the eurozone sovereign debt crisis, some degree of strategic convergence seems to have resurfaced amid a number of irritants and frictions. This new coming together is largely due to China's continued euro-optimism at a time of increasing speculation against the euro and of broader euro-scepticism.

China has diversified its foreign reserves away from the dollar and into the euro in earnest since 2010, a dynamic that intensified after the U.S. was downgraded by Standard & Poor's in August 2011. China's intervention in financial markets has kept the value of the euro up, in the process lending political support to the euro-area at a time when there was a real risk of break-up. However, Chinese activism has come with a price for the EU, since keeping the value of the euro high has benefited the competitiveness of Chinese products. Moreover, China's contribution to address the eurozone debt crisis through the IMF comes alongside renewed discussion on IMF reform, including redistributing voting rights away from European countries to emerging economies.

## The EU-China strategic partnership before the crisis

The EU-China strategic partnership was established in autumn 2003. Buoyant economic and trade relations between the two sides provided the backbone for it. But strategic considerations were also involved. The strategic partnership between Brussels and Beijing was launched during one of the most serious transatlantic rifts since the end of World War II, brought about by different views on the Iraq War and the unilateral policies of the Bush administration. As a result, some of the initiatives undertaken by the EU and China gave the partnership a distinct 'strategic' flavour, attracting the attention – and concern – of U.S. policymakers. There was some surprise in Washington at the EU's attempts to engage China on global power relations. While strategic thinking was not a novelty for Chinese leaders, it was the first time that the EU had attempted to act strategically with regard to China and tried to go beyond its traditional role as a junior partner of the U.S.

The upgrading of EU-China relations was based on three cornerstones that were supposed to give meaning and content to the strategic partnership. First, a shared understanding of the post-Cold War international system and the place of China and the EU within it. The EU and China used multilateralism and multipolarity as two key concepts of their strategic partnership. The white paper, 'China's EU Policy Paper', released by the Chinese Ministry of Foreign Affairs in October 2003, pointed out that 'the trend towards world multipolarity and economic globalisation is developing [...] and is an irreversible trend of history.' For China, a strategic partnership with the EU would serve to promote global multilateralism, the democratisation of international relations and what is being referred to as global multipolarisation (Ministry of Foreign Affairs of the People's Republic of China 2003, p.2).

The idea of creating a more balanced world order was shared by many EU policymakers. In its policy paper on China published in September 2003, the European Commission stated that 'China's geopolitical vision of a multipolar world, and the Chinese perception of the EU as a partner of growing importance, provide a favourable context [...] the EU as a global player on the international scene shares China's concerns for a more balanced international order.' (European Commission 2003, p. 23).

Second, cooperation in high-tech and strategic industrial sectors. On 30 October 2003, the same day on which the strategic partnership was declared, the EU and China signed a political agreement on the joint development of Galileo, the EU-led global navigation satellite system alternative to the dominant U.S. Global Positioning System (GPS). China would be the most important non-EU partner in the Galileo project. Because of the dual-use nature of space technology and its different interpretations by EU member states, the existence of an

arms embargo was felt to be a serious hindrance to the further development of EU-China space cooperation. This was one of the main reasons why some member states supported lifting the embargo.

Third, closer economic and monetary ties, including support for the euro. As part of the newly established EU-China strategic partnership, the People's Bank of China (PBOC) made an informal commitment in autumn 2003 to further diversify its holdings of foreign reserves away from the dollar and into the euro. This process had begun back in 1999, when the euro was created. At the time, China had hailed the event as a landmark step towards the creation of a multipolar currency system. After the euro started circulating on 1 January 2002, Beijing became one of the first buyers of the new currency. The informal pledge by the PBOC to increase diversification of its foreign reserves, made in the context of the establishment of the EU-China strategic partnership, can thus be seen as part of China's traditional strategy of supporting European integration in order to drive a wedge between the Western allies.

## Changing perceptions and priorities

Beijing's perceptions of the EU were changed by the official postponement of the decision to lift the arms embargo made by the Council of the EU in summer 2005. Chinese leaders stopped looking at the EU as a strategic actor and possible partner for countering American dominance. To move relations forward after the arms embargo impasse, the two sides established a Strategic Dialogue in 2005. One year later, the EU-China High Level Economic and Trade Dialogue was initiated, following on the heels of the U.S.-China Strategic and Economic Dialogue. In the meantime, perceptions were changing in Europe too. Negative attitudes towards China began to emerge, in particular in relation to trade, human rights and the Tibetan question.

In July 2008, another blow to EU-China relations came with the European Commission's decision to exclude Chinese contractors from the second phase of Galileo, which involved the procurement of the remaining 26 satellites of the constellation. This put a halt to what was possibly the most visible aspect of the EU-China strategic partnership established in 2003. The decision followed the European Commission's assessment citing unfair competition, lack of Intellectual Property Rights (IPR) enforcement and reciprocity in public procurements.

When the global economic crisis broke out in autumn 2008, EU-China relations were at one of their lowest points and no longer retained the strategic elements that had informed the launch of the partnership in 2003. However, the eurozone crisis focused minds around new strategic priorities for the bilateral partnership.

## China's response to the eurozone crisis

From the beginning of the subprime mortgage crisis in 2007 and through the collapse of Lehman Brothers in September 2008, Beijing closely monitored the state of the U.S. economy, since China was the largest foreign investor in U.S. treasury bills and other U.S. securities. In autumn 2010, China's Dagong Global Credit Rating Company downgraded the U.S. to A+ (four levels lower than AAA) when the U.S. Federal Reserve decided to continue its policy of quantitative easing. Similar concerns were raised again after the announcement of the third round of quantitative easing, the so-called QE3, on 13 September 2012.

To China, quantitative easing seems essentially to be a way for the U.S. to print money, which comes with the associated risks of debasing the currency and setting off inflation in emerging markets. This forces foreign investors like China to keep rolling over debt to avoid realising currency losses on their investments. The situation limits China's financial flexibility at a time when it is most needed if China is to succeed in rebalancing the domestic economy and growth model. The damage could also lead to political instability. Low interest rates and the falling U.S. dollar encourage investors to increase investments in emerging markets, which offer better returns and higher growth prospects as compared to the developed economies. These flows have pushed up asset prices and currency values, distorting economic activity and leading to inflation in China, which has traditionally been a trigger of social instability. As a result, the People's Bank of China (PBOC) has had to intervene several times in recent years to increase interest rates and restrict bank lending.

Since March 2009, when the PBOC governor explicitly called for the creation of a new international reserve currency, Chinese policymakers have reiterated their desire for an alternative to the U.S.'s 'exorbitant privilege' (Eichengreen 2011). For China, the euro represents the strongest alternative to the dollar. As the economic crisis reached Europe, Chinese leaders voiced their concerns about the economic area that has become China's most important trading partner.

EU-China trade amounted to €428 billion in 2011 and it is expected to grow further by the end of 2012. Wen Jiabao said in front of the Greek parliament that 'the two sides have become indispensable partners in each other's development endeavour.' (Ministry of Foreign Affairs 2010) But the growth in China-Europe ties has led to significant trade imbalances. The EU's trade deficit with China is Europe's biggest bilateral trade deficit with any country; it has increased from €89.6 billion in 2002 to a projected €170 billion in 2012.

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This has contributed to the perception of China's economic expansion as a threat in some EU member states, based on the argument that China has been invading European markets with cheap products and taking away jobs in the manufacturing sectors. This viewpoint is only strengthened by Beijing's active industrial policy, which is turning the country into a low-cost competitor in high-skill industries. The rapid growth of skill-intensive imports from China represents a serious challenge for certain sensitive European industrial sectors (Holslag 2012, p.221-238). Given the importance of the European market, China has a strategic interest in continuing to bolster the value of the euro. By doing so, Beijing keeps the value of the renminbi down, thus helping its products to remain competitive.

Chinese officials have intervened on a number of occasions since the beginning of the eurozone's debt crisis to reassure markets and Europeans that they will continue to buy eurozone bonds. Moreover, Chinese investors have continued to make up a large proportion of the buyers of Portuguese and Irish bailout bonds auctioned by the eurozone's €440 billion rescue fund since 2010. And Beijing has also showed an interest in investing in fully guaranteed and safe (i.e. AAA-rated) Eurobonds once they become reality.

In contrast to widespread euro-scepticism coming mainly from Anglo-American banks and hedge funds, China has consistently been more euro-optimistic (Otero Iglesias 2012). For China, the U.S. is no longer a safe bet, since Washington's debt has continued to increase in the last years, raising doubts about the U.S.'s capacity to service it in the future. These concerns were highlighted on 5 August 2011 when Standard & Poor's downgraded the U.S. sovereign credit rating by one notch, from AAA to AA+. Subsequently, the Chinese Dagong rating agency further lowered the U.S. to a single A, indicating heightened doubts over Washington's long-term ability to repay its debts. After the U.S. downgrade, the Xinhua news agency called explicitly for an end to American hegemony over world markets and for the international supervision of U.S. printing of new dollars.

Since summer 2011, China has accelerated the diversification of its holdings of foreign reserves, adopting a contrarian strategy compared to other major central banks. In 2010, China's currency reserves-mix was pretty similar to the global average: 65 per cent in dollars, 26 per cent in euros, 5 per cent in pounds sterling and 3 per cent in yen (Otero Iglesias 2012). But by the end of 2011, according to data from the U.S. treasury, the percentage of dollar holdings in China's foreign reserves had fallen to the lowest point in a decade, amounting to 54 per cent in 2011. This trend has continued in 2012 and is expected to go on in 2013, especially after the announcement of QE3. According to estimates, China's holdings of euro-denominated assets are at present between 30 and 33 per cent of total foreign reserves, which at around \$3.3 trillion are the world's largest

(Casarini 2012, p.43-47). This means that Beijing has bought around €1 trillion so far – which would confirm Premier Wen Jiabao's declaration that the euro is currently the prime target of China's acquisitions.

## Chinese investment in Europe

Beyond purchasing eurozone bonds, China is increasing its investments in industrial assets and infrastructure projects across Europe (Hanemann and Rosen 2011). Analysts at Grisons Peak Merchant Bank found that Chinese FDI in the EU had soared by 297 per cent in 2010 compared to 2009, to reach \$2.13 billion. Europe was proving more fertile ground for Chinese investments than the U.S.: according to the Chinese Ministry of Commerce, China's total investments in Europe were 53 per cent greater than the \$1.39 billion that went to the U.S. in 2010. But the amounts invested in Europe come to less than 5 per cent of China's global overseas foreign direct investment (Brown 2012, p,74-86).

Thilo Hanemann and Daniel Rosen of the Rhodium Group argued in a report published in June 2012 that Europe is experiencing the start of a structural surge in outbound direct investment by Chinese firms. The authors found that annual inflows tripled between 2006 and 2009 and tripled again by 2011 to total \$10 billion (€7.4 billion) for the year. The number of deals with a value of more than \$1 million doubled from less than 50 in 2010 to almost 100 in 2011 (Hanemann and Rosen, 2011). This trend is likely to accelerate in the future, as the debt crisis in some eurozone members provides investors with lucrative opportunities. In March 2012, the Chinese government injected \$30 billion into the China Investment Corporation (the Chinese sovereign wealth fund) to be used specifically for acquiring industrial and strategic assets in Europe.

## Implications for the EU-China strategic partnership

China's continued interest in euro-denominated assets should not be interpreted as an endorsement of how Europe has been handling the debt crisis in some of the eurozone countries. China's primary motivations lie in finding new, safe investments into which to put its growing reserves, diversifying risk away from the U.S. dollar, and sustaining its most important export market.

To help it achieve these aims, Beijing has agreed to participate in international efforts aimed at solving the eurozone's debt crisis. Chinese leaders have reiterated their promise to help

several times, but they have attached some conditions to their 'friendly behaviour' towards the eurozone. China has demanded that the EU 'puts its house in order'. In September 2011, Wen Jiabao also indicated that granting China Market Economy Status (MES) and lifting the EU arms embargo would be regarded favourably both by Chinese leaders and by citizens, thus helping China find public support for bailing out rich Europe.

China has also reallocated its purchases of eurozone bonds, away from peripheral countries such as Portugal, Ireland, Italy, Greece and Spain and into the more secure core members of Germany, France, Finland, Austria and the Netherlands. This is in line with the statement issued by Zhou Xiaochuan, governor of PBOC, on 12 March 2012, which spoke of the need for Beijing to make continued efforts to manage the country's reserve assets with 'new ideas' and in a more 'effective' manner. In other words, China will continue to diversify its investments in foreign bonds away from the U.S. dollar and into the more secure (i.e. AAA-rated) eurozone's core members, while keeping risk control a top priority. However, this contributes to the North-South divide within the eurozone, that is, between the core eurozone members and the southern periphery, in particular Greece, Portugal, Spain and Italy.

The peripheral countries have stepped up efforts to attract Chinese investments to offset the reallocation of bond purchases within the eurozone, allowing Beijing to encourage further divides between EU member states in order to obtain economic and political concessions. At the same time, China continues to prop up the euro by acquiring euro-denominated assets. In sum, China continues to view the eurozone as a counterbalance to the U.S., seeing the euro as the only alternative to the dominant position of the dollar. And China has not been alone in playing this game. The eurozone itself has set in motion an active 'monetary diplomacy'.

## The new eurozone monetary diplomacy

Since the establishment of the European Financial Stability Facility (EFSF) in May 2010, EFSF CEO Klaus Regling has been engaged in a sort of shuttle diplomacy to Beijing to seek support for the eurozone and obtain concrete pledges for the purchase of Portuguese and Irish bailout bonds auctioned by the EFSF's €440 billion rescue fund. The EFSF is a special purpose vehicle set up by the EU-27, but financed only by members of the eurozone, to address the European sovereign debt crisis. Its objective is to preserve financial stability in Europe by providing financial assistance to eurozone states in economic difficulty.

The EFSF's active monetary diplomacy has gone hand-in-hand with several missions by eurozone governments, including various visits by Angela Merkel and Mario Monti to China. These efforts have been aimed at testing the ground for a more robust intervention of Beijing in financial markets to help the eurozone ward off international speculation against the peripheral members. Concurrent with bilateral exchanges between Chinese leaders and eurozone representatives, both from the EFSF and member states, there have also been discussions between the EU and China in multilateral forums such as the G-20 on finding a solution to the European sovereign debt crisis.

In November 2011, at the G-20 in Cannes, France's President Nicolas Sarkozy attempted to reach a deal with China on the euro crisis and the reform of the global economic system, but to little effect. The only notable outcome of the French initiative was the organisation of a high level seminar in Nanjing on the reform of the international monetary system. The seminar served to highlight the two sides' different positions. The EU agrees with the U.S. on the promotion of flexible exchange rates and free capital flows, which is resisted by China. And Europe is reluctant to give up its voting rights within the IMF. The issue of voting rights has become a pressing issue among Chinese leaders, who side with other emerging countries – the BRICS – in demanding a meaningful reform of the international monetary system that would take into consideration the shift in the global balance of economic power.

The question of the reform of the IMF is a delicate one for the EU, because there seems to be no prospect of achieving a common position among EU member states. European countries today have 8 seats out of 24 on the IMF executive board. Germany, the United Kingdom and France each have a larger voting share than China, as do the Netherlands and Belgium combined. With a voting share (or quota) of 16.75, the U.S. retains veto power over IMF decisions, which require 85 per cent support. Europe, with its 32 per cent combined voting share, is the IMF's biggest stakeholder. Today, the U.S. is the world's largest debtor, Europe has been hit by the most severe economic crisis since its inception, and China is the holder of the world's largest reserves. The reform of the IMF is pressing.

But reforming the international monetary system, although it was tackled during the French Presidency of the G-20, has met with strong resistance from the U.S. and from some European leaders. This was the background of the G-20 summit in Mexico in June 2012, where China committed to make \$43 billion available for the eurozone's rescue fund through the IMF. Given that this is not a huge sum compared to Japan's pledge of \$80 billion, it appears to reflect Chinese frustration about the slow pace of reform of the international monetary system.

## Conclusion

The current economic crisis has conferred a renewed strategic dimension to the EU-China partnership. Chinese leaders have approached the eurozone's sovereign debt crisis through the lens of their longstanding support for a stronger and more united EU – in this case the eurozone – that could work alongside Beijing to balance American hegemony, helping to challenge the dollar's 'exorbitant privilege'. In the face of mounting speculation, some eurozone governments and EU institutions have courted and welcomed China's engagement. China's intervention in financial markets has helped keep the eurozone afloat. But its involvement has been selective, engendering collateral political effects for the EU and introducing divisions between its member states.

On the multilateral level, important differences between the two sides persist, most notably on the reform of the international monetary system and the redistribution of voting rights within the IMF away from some EU member states towards China and other emerging economies.

Overall, however, China's support for the eurozone and the corresponding process of diversification of Chinese foreign reserves away from the dollar and into the euro represent important elements of support for the EU. Notwithstanding a number of sources of friction, particularly those related to trade, China's actions are making the EU-China strategic partnership stronger by foregrounding a core common interest: the survival of the eurozone and its common currency. The crisis has also seen the emergence since 2010 of a parallel 'monetary diplomacy' by the European Financial Stability Facility and some eurozone governments with regard to Beijing. This trend raises the question of the overall coherence of EU foreign policy and external action towards China.

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# The EU and India: Reinvigorating a tired partnership

Jean-Joseph Boillot

## Introduction

The revamping of the EU-India partnership in the early 1990s was marked by the neoliberal globalisation paradigm. Trade and investment liberalisation were the core principles of such paradigm, permeating economic decision-making in both Europe and India and influencing the latter to open up its economy. In the wake of fast rising growth rates in India and sustained growth in Europe, the two parties set the ambitious goal of concluding a free trade agreement (FTA) at their sixth bilateral summit in 2005.

The financial and economic crisis that broke out in 2008 was a game changer that affected the credibility of the globalisation paradigm underlying the bilateral partnership, the FTA negotiations and the prospects for broader EU-India relations. The crisis exposed the limited capacity of the free market to generate equitable global welfare, while public opinion in both Europe and India began to express strong reservations against further liberalisation, whether commercial or financial. This was one of the main factors that hampered progress on the bilateral economic agenda at the last two bilateral summits, which were held in Brussels in 2010 and in New Delhi in 2012. While the partners are growing more introverted, the trade deal is still on the table and there is considerable dynamism at the micro-level, especially in terms of mutual private direct investment. The EU and India need to refocus their partnership on global issues and improve its architecture, further enhancing the parliamentary dimension and involving non-state actors.

## A role reversal

Following the 1974 Commercial Cooperation Agreement, the EU and India expanded their partnership through the signing in 1993 of a wider Partnership and Development Cooperation Agreement. In the early 1990s, the partnership connected a wealthy continent with a country

then seen as one of the poorest in the world. The relationship essentially focussed on development issues, with little discussion about trade and investment. While India registered strong growth rates following the economic reforms carried out in 1991, the partnership remained largely asymmetric throughout the 1990s. In the 2004 proposal for a strategic partnership (European Commission 2004), reaching India's Millennium Development Goals by 2015 was still the EU's priority.

During the second half of the 2000s, diverging growth patterns between rising India and stagnating Europe started to rebalance the relationship, to the extent that the 2007 New Delhi summit saw the launch of free trade agreement negotiations. But despite 14 rounds of talks, an agreement is yet to materialise. New Delhi is reluctant to compromise on issues it considers vital to its national sovereignty and pride (and to vested interests). At the same time, the EU is resisting to make concessions on a key point – the liberalisation of labour (Mode 4) – which would favour the Indian IT sector.

It can be said that the 2008 crisis was a tilt factor in the balance of power and perceptions between the EU and India. The severe financial crisis in the European Union during the winter of 2011 has been a source of major concern for the Indian authorities as India's economy suffered due to large bank capital withdrawals. The impact will be felt even harder in the coming months, with India's GDP sharply slowing down in early 2012. India's growth rate could fall to 5-6 per cent in 2012, compared with the expected 10 per cent target of the 12th Five Year Plan. That said, the gap in growth rates between the EU and India this year remains in the range of 5-6 per cent and is unlikely to shrink in the near future.

The EU is experiencing another recession in 2012. Europe's growth potential could be stuck at an annual 1 per cent, while India grew by nearly 7 per cent in 2011 alone and could experience a return to its trend of 7-8 per cent growth rates for 2013-2025 (IMF 2012). So despite the huge GDP gap between the two partners – even in terms of purchasing power parity –, India believes it could sustain high growth rates like China did and catch up with the EU's global GDP over time. Even if the Chinese outstanding performance was largely due to an export-led growth strategy, some Indian experts believe that their country has the internal engines to follow a more domestic-oriented growth model, particularly given its strong corporate sector, which China lacked (Chaudhuri 2012a).

Moreover, India has gone from receiving financial support due to frequent crises since Independence (the last one in 1991) to being asked to help crisis-torn Europe. European countries tried to involve India and other emerging economies in the European mechanisms set up to rescue the most indebted EU member states. India contributed \$10 billion to the

## EU Strategic Partnerships and the Global Economic Downturn

IMF - a limited amount compared to China (\$43 billion) but a politically significant one. As Indian Prime Minister Singh indicated in the June 2012 G-20 summit, which endorsed the decision to double the IMF lending capacity: 'Instead of strengthening our own economy – also hit by recent flights of foreign capital – we've chosen to aid those far richer than us'.

The structural impact of the crisis may create a durable and possibly widening growth gap between Europe and successful emerging countries such as India, despite the latter's many handicaps. India's new diplomacy, driven by the 'look East' and 'look West' mantra, stresses how China and Asia at large, but also the Middle East, are considered real strategic economic partners. A simple look at the geographical orientation of Indian trade shows that the EU could soon lose its comfortable position as India's first trading partner. The EU's market share is declining fast (from 45 per cent in 1960 to 28 per cent in the early 1990s to 15 per cent today) and nowadays represents less than one-sixth of total Indian trade. Conversely, in the past few years China has become the largest trading partner of India if one includes the indirect trade through Hong Kong and the Middle East.

This reversal of perceptions and fortunes is also visible in European public opinion. Europeans increasingly fear the competition from emerging countries at a time when mass unemployment is affecting a growing number of member states. The future of Europe is the subject of intense discussion in New Delhi. Arvind Virmani, former IMF representative for India, published an influential paper in 2005 with a provocative title, 'A tripolar century: USA, China and India'. The EU did not feature in the top league. With the Eurozone crisis far from over, most Indian experts today agree with Virmani's argument.

**Figure 1: India's total trade in 2010-11 (in million US\$)**

Source: Economic Survey 2012, Government of India

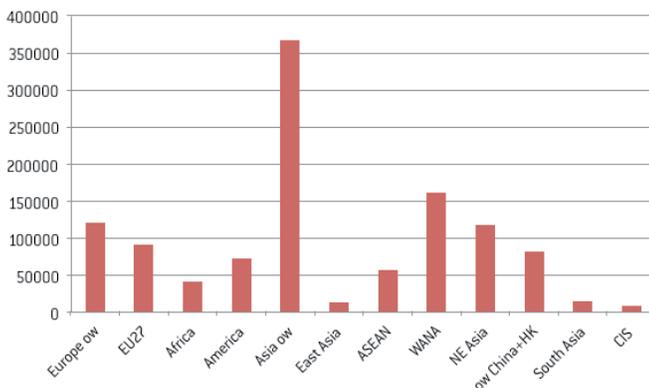


Figure 2: GDP growth rates 1980-2012 (in %)

Source: World Economic Outlook, IMF, 2012.

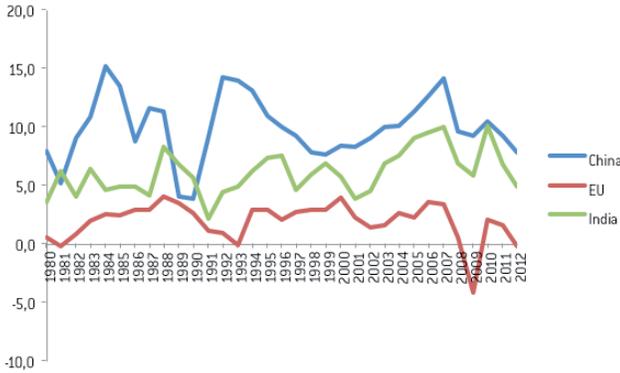
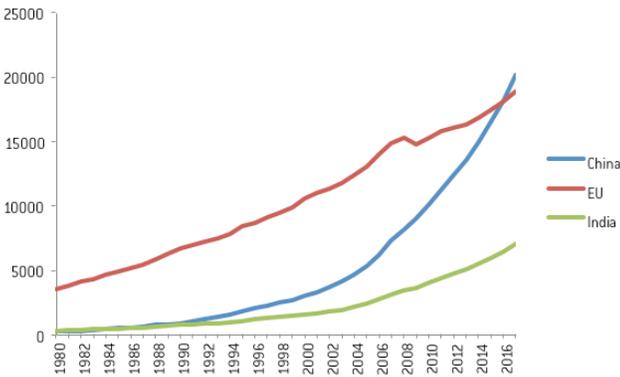


Figure 3: Evolution of GDP at Purchasing Power Parity 1980-2017 (in bn US\$)

Source: World Economic Outlook, IMF, 2012.



## The bilateral trade and investment agreement

At a time when multilateral negotiations within the World Trade Organisation (WTO) are at a halt, the conclusion of the FTA or Bilateral Trade and Investment Agreement (BTIA) is a priority for the EU. To some observers – like the Euro-India Chamber of Commerce (EICC 2012) – the differences between the EU and India appear to be quite small, with core issues being Indian custom duties on EU cars and alcohol on the one hand and the liberalisation of the EU visa for Mode 4 services on the other. But disagreement goes much further, covering regulatory

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issues such as public tenders in key sectors like roads and public utilities. Five years of negotiations on a major trade deal do not represent an exceptional delay. However, India still considers concessions on sensitive areas like cars or services and market access as too heavy a political price for the expected benefits. This is the case, for example, of European demands for India to liberalise its financial system. The current crisis has affected many Indian banks and these are too small and fragmented to compete with European giants, as the Deputy Governor of India's Central Bank, the Reserve Bank of India (RBI), recently stated (Gokarn 2012).

The problem is that the EU-India economic partnership seems to hang in the balance pending negotiations on the trade agreement. Concluding the BTIA presents both parties with difficult trade-offs that they may not be ready to accept. For social, economic and political reasons, Europe needs to protect its interests more than ever amidst protracted economic stagnation (as shown by the car industry crisis with new Hyundai cars exported to the European market from India at a very cheap price). Similarly, the European pharmaceutical sector is facing a double challenge with the demand for generics rising and the globalisation of R&D, where India has become a successful global player.

A rapid conclusion of the trade deal does not seem to be in the interest of India either, since the agreement is not necessarily backed by a sufficient consensus on the reform package that New Delhi must implement to lift its growth potential. Political controversies over the wave of liberalisation measures in September 2012 concerning retail trade, aviation and finance seem to confirm this point. Largely triggered by some sectoral lobbies, the move has revived a strong political and social debate on the net impact of trade and investment liberalisation on employment. This also explains why the provisions attached to the formal liberalisation package are so stringent, as Trade Minister Anand Sharma recognised<sup>1</sup>. A more comprehensive approach would be required to make decisive progress in the negotiations and conclude the agreement, including a better balance between trade issues (less emphasis on tariff concessions) and investment issues (more attention paid to symmetric concessions). In particular, European firms have expressed strong interest in a much more open Indian market for tenders in infrastructure and, more generally, in improving India's business environment, which is still ranked as poor by the World Bank annual survey (2011).

<sup>1</sup> According to the Overseas Indian Facilitation Centre: 'Investment for MBRT activities has been permitted subject to compliance with specific conditions such as minimum capital investment of US\$ 100 million, mandatory 30 per cent sourcing of products (manufactured or processed) from small industries having a total investment in plant & machinery not exceeding US\$ 1 million and minimum utilization of 50 per cent investment in back-end infrastructure within three years from the first tranche of FDI'. (OIFC 2012)

## Growing direct investment

A paradoxical effect of the crisis has been rising direct investment between the EU and India to foster economic relations. Indian companies initiated this trend with high-profile operations such as the 2006 acquisition of Arcelor steel by the Mittal group, followed by that of Corus, the EU's number two steel company; and the acquisition of Jaguar-Rover, the UK automobile flagship brand, by the largest Indian conglomerate Tata. The friendly take-over of RE Power, Europe's number two wind energy manufacturer, by the previously unknown Indian group Suzlon, over the French giant Areva, is another example.

These major deals hide a bigger shift of often medium-sized Indian businesses being established in Europe. Acquiring technologies and brands is a higher priority than accessing the Western European market, as the latter is considered saturated and rather unreceptive to the 'Made in India' label. This is not the case, however, in the new member states (and Turkey) such as Romania (Mahindra tractors), Hungary or Poland (Videocon, Escorts, Strides Arcolab, Reliance Industries, Ranbaxy, Essel Propack, Zensar Technologies Ltd., Tata Consultancy Services, HCL Technologies, Infosys etc.), where Indian acquisitions targeted local markets for a low-cost base at the heart of emerging Europe.

European companies are not lagging behind and have played a strong part in the rising tide of FDI in India, aggressively buying the shares of a growing market. The anticipated sheer size of the Indian market 10 to 20 years down the line and the real costs of exporting to India due to poor logistics and administration, including corruption, make it necessary for strategic investments to have a direct presence in the country and not rely just on export relations. European automobile manufacturers, for instance, have done this since the early 2000s. The crisis has reinforced European companies' interest in investing in India directly, either as a new market opportunity or to cut costs in a much more competitive environment.

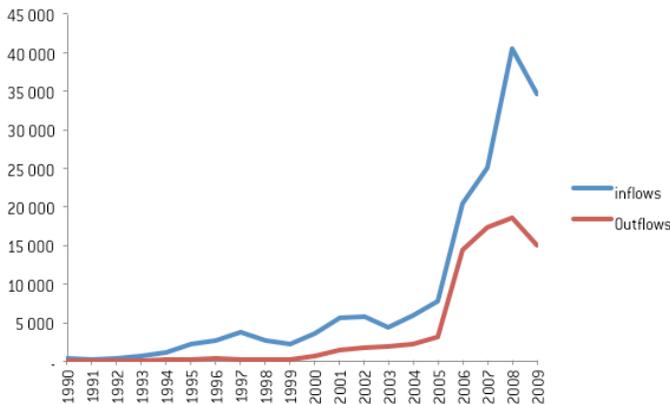
Nevertheless, difficulties abound on both sides, as illustrated by the French public's reaction to Arcelor's takeover or, conversely, Vodafone's multi-billion tax dispute with the Indian Income Tax Department over its purchase of Hutshison Essar Telecom services in April 2007. The so-called general anti-avoidance rule (GAAR) introduced during the 2012-2013 budget discussion to counter tax avoidance is another big point of contention with foreign investors, particularly Europeans. If applied, it would allow the tax authorities to ask for tax arrears on transactions dating back to more than 30 years. The postponement of the GAAR in June 2012 has not reassured European investors, who fear legal uncertainty and are asking for the cancellation of the measure.

## EU Strategic Partnerships and the Global Economic Downturn

Despite the establishment of a Business Forum alongside the official EU-India annual summits, bilateral mechanisms to facilitate crossborder direct investment between both partners remain underdeveloped as shown by recent controversies. Neither the European Business Group (EBG) in India nor the Indo-European Chamber of Commerce (IECC) in Brussels has gained enough attention and support from official authorities. The widening of the original free trade agenda to cover investment is a very positive step, but the debate on the business environment on both sides has been quite limited.

**Figure 4: India's Foreign Direct Investment 1990-2009 (in million US\$)**

Source: World Investment Report, UNCTAD, 2010.



It is possible that increasing protectionism may boost the globalisation of firms on both sides in order to escape trade barriers. Indian companies receive strong support from their government as an instrument of global economic diplomacy, since they lack China's financial power and are still struggling to become true global players. European companies are increasingly looking for new markets given the weak demand at home and India is seen as a key market in the emerging world. Hence, the 'micro' agenda of EU-India relations should receive much more attention to promote FDI and overcome trade and non-trade barriers that investors face on both sides.

## Beyond bilateral relations: on to the global agenda

The EU should widen the scope of economic cooperation with India beyond ongoing negotiations on the BITA. Despite, and arguably due to the global crisis, India and Europe have more reasons than ever to strengthen their economic cooperation on global issues.

At the outset of the crisis, the international community took the urgency of the situation as an opportunity to strengthen international cooperation by launching the G-20 process at the Washington summit in November 2008, and by expanding the role of emerging countries in international institutions like the IMF. India, like China, was naturally propelled to the forefront of the international scene. While some hoped that India and the EU would place global governance at the core of their agenda to coordinate and concentrate on the reforms needed for sustainable globalisation, their relationship was eclipsed by the 'Chinamerica' duo. The bilateral agenda of China and United States was clearly prevalent in G20 debates (under-evaluation of the Yuan and the American budget deficit) with the Eurozone crisis climbing the list of priorities since 2010.

In the current multipolar world, India and Europe are relatively weak players compared to heavyweights such as the US and China. They struggle to assert themselves in important international fora. The economic crisis has indeed weakened the cohesion and the reputation of the European Union and introspection seems to be the prevalent political mood in Europe. During major international summits like the G-20, India is also partially marginalised, whether because its economic weight just about equals that of an average European power<sup>2</sup> or due to India's rising regionalism and paralysis at the federal level, which leads it to focus more on its domestic priorities.

As globalisation is increasingly contested in Europe and also in India, it is important for the two parties to increase bilateral ties on major global issues and be proactive in major international frameworks. This applies to global economic governance and the reform of the Bretton Woods institutions, as well as to crucial topics such as new banking regulations and the liberalisation of financial markets. Interaction between India and Europe at the level of the G20 has been weak and would benefit from more structured bilateral consultations in advance of major meetings.

The last G-20 summit held this year in Mexico has clearly shown the limits of this global forum once the sense of urgency prevalent in 2008 dissipated. European countries appeared once more divided on issues such as the reform of the international monetary system or the factors underlying the global imbalances behind the crisis. Such divisions prevent the EU from asserting itself as a pivotal actor in the G-20. The consequence has been the return to the Bretton Woods institutions, in particular the IMF, as the only effective arm to regulate the world economy. But India is not very happy with the slow pace of reform and in particular with

<sup>2</sup> According to the IMF World Economic Outlook, Spanish GDP at current exchange rates was US\$ 1,536 billion, as opposed to US\$ 1,843 billion for India in 2011 (IMF 2012).

the absence of a single European chair, which would provide much more space for emerging countries. This issue remains a crucial bone of contention with India (and other rising powers) and reflects the perception gap between the two partners on the new architecture of the world economy.

In a multipolar world, other regions of the world cannot be ignored. Broadening the spectrum of dialogue and cooperation with third partners relevant for both India and the EU, as is already the case with space or research, would be quite useful. Apart from diversifying its economic links with Asia, in recent years India's economic expansion and engagement has targeted Africa too. This continent is of utmost importance for both India and the EU, offering considerable potential for enhancing triangular cooperation in areas like health (pharmaceuticals or hospitals), agriculture (rural development) and energy (solar) (Boillot 2012).

In Asia, which now represents more than half of Indian trade and investment, there will be large opportunities to work closely with India in regional institutions like the Asian Development Bank (for instance co-financing large infrastructure programmes) or in regional fora like the Asia-Europe Economic Forum (AEEF). The seventh AEEF annual meeting was held in Seoul in December 2011 and discussed intensively the Eurozone crisis and its consequences for Asia, including how Asian partners could help overcome Europe's woes (Bénassy-Quéré & alii 2012).

## Conclusion: a more connected partnership

Progress on the partnership requires redefining the architecture of EU-India bilateral relations by multiplying the levels of engagement, making the partnership less technical, more political and more connected beyond government bodies. This requires, first of all, more coordination between EU institutions and member states in their relations with India. Today, the European Commission plays a key role in EU-India economic relations, but it does so without enough support from member states, not least due to their different national priorities. The most important EU countries have parallel and strictly bilateral consultations on major global issues with New Delhi, without effective coordination at the European level. This largely owes to the fact that these states, and not the EU, are full members of multilateral institutions like the IMF, the World Bank and the United Nations. The EU is considered by the Indian elite as a politically and culturally fragmented space with an uncertain future, as recently put by an influential member of the New Delhi Planning Commission (Chaudhuri 2012b). It is up to the EU to start reversing this perception and to persuade the largest member states that it is in their interest to work together in relations with India and to support more consistently the Commission.

Furthermore, the partnership suffers from limited exchanges between parliamentarians and civil-society on both sides. It should acquire a more political and social orientation. The European Parliament's (EP) role needs to be strengthened. Given its prerogatives on trade accords, the EP has monitored trade negotiations with India and taken stance through its resolutions, for example on the contentious issue of India's generic drugs, patents and access to medicines. However, parliamentary exchanges between the two parties are quite limited and should intensify.

Exchanges between respective civil societies should receive much more attention and resources at the EU level, so as to prevent the exacerbation of mutual concerns, such as those recurrent in Europe about competition from emerging countries like India. The Chinese have devoted substantial financial resources to this level of interaction with Europe by inviting EU political, intellectual and business leaders to visit their country. India cannot match China's financial means, but the EU could probably schedule more visits to India.

Education and demographics should be seen as a resource. Student exchanges can be expanded with India, since it is a very young country and the number of Indian students in Europe is only one tenth of the number of Chinese. Given stringent budgetary constraints on both sides, it would be advisable to shift the priority from government-sponsored programmes to the promotion of large civil society platforms, as it happens alongside the annual meetings of major institutions such as the IMF, the World Bank or the WTO. The business community holds regular summits in parallel to the official ones, but the civil society from both sides does not have a suitable platform to meet on a regular basis since the suspension of the 'EU-India civil society roundtable' in 2008. A greater societal engagement between Europe and India would bring added value to the bilateral partnership.

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# The EU and the US: Partnership in search of leadership

Myriam Zandonini<sup>1</sup>

## Introduction

The global economic and financial crisis has shown that the transatlantic partners remain at the centre of the global economy and of international negotiations. But it has also highlighted the role and importance of emerging market economies within the world economy: China experienced an average GDP growth rate of 9.6 per cent a year between 2008 and 2011. The crisis has demonstrated the importance of Europe for the U.S., given the role that the on-going eurozone crisis played in the U.S. presidential campaign. Even though risks to one economy are immediately transmitted to the other, the relationship has moved far away from the 'London consensus' reached in 2009 when world leaders, thanks to a transatlantic push, agreed on coordinated efforts to solve long-term sustainability issues and adopt measures to restore market confidence and growth. While the U.S. waits for the eurozone to solve its own crisis, the European Union continues to show an inability to carry out concerted action and the euro-club still lacks a formal body that can represent it in international discussions.

The first section of this paper examines the current status of the transatlantic partnership and assesses recent developments that have resulted from the global financial crisis. The U.S. was severely hit in the initial phases of the crisis and has been showing signs of recovery since late 2010. Europe, on the other hand, has experienced multiple crises since summer 2011 (Subacchi and Pickford 2011). The next section reviews the challenges currently faced by the EU and the U.S. and the risks of spillovers and crisis transmission within the partnership. This section also touches on the proposed EU-U.S. Free Trade Agreement. The paper concludes with a discussion of the role and weight of the transatlantic relationship in global institutions, particularly within the G-20 and the IMF.

<sup>1</sup> The author would like to thank Paola Subacchi for her assistance. Richard Varghese also contributed to an earlier draft.

## Today's relationship

### A strong foundation

Cooperation between the U.S. and the EU rests on extensive historic political and economic ties, but it was only in the last two decades that this cooperation was formalised.<sup>2</sup> Now, the relationship forms part of the broader EU strategy of engaging with key world players by means of so-called strategic partnerships. Although the partnerships' specific purposes and objectives are still to be precisely defined, the U.S. has undoubtedly been a 'true' strategic ally for the European Union (Van Rompuy 2010). Already in 2003, when the European Security Strategy (ESS) first envisioned strategic partnerships as a foreign policy tool for the Union, the U.S. was defined as the 'irreplaceable partner' (Renard 2011). The Transatlantic Economic Council (TEC) was created in 2007 to move forward efforts to boost the transatlantic economy, though it initially had limited success. Discussions are under way to identify policies and measures that can increase U.S.-EU trade and investment and support mutually beneficial job creation, economic growth and international competitiveness. Specifically, a High-Level Working Group on Jobs and Growth was established in November 2011; it will report its recommendations and conclusions by the end of 2012, and it released an interim report in June 2012 (see section II).

Together, the economies of the EU and the U.S. accounted for almost half of world GDP in 2011 at market exchange rates (see figure 1).<sup>3</sup> EU-U.S. trade has almost doubled since 2000 – it was estimated at \$632 billion in 2011. Financial integration has also deepened. Transatlantic financial markets continue to play the most significant role in the global financial sector. They account for over two-thirds of global banking assets and of private and public debt securities. They make up more than three-quarters of global financial services and of all new international debt securities. And they represent almost 80 per cent of interest-rate and equity-linked derivatives (Hamilton and Quinlan 2012).

<sup>2</sup> Formal cooperation between the U.S. and the EU is based on the 1990 Transatlantic Declaration, followed by the establishment of the wide-ranging New Transatlantic Agenda (NTA) in 1995. A Transatlantic Economic Partnership (TEP) was launched in 1998.

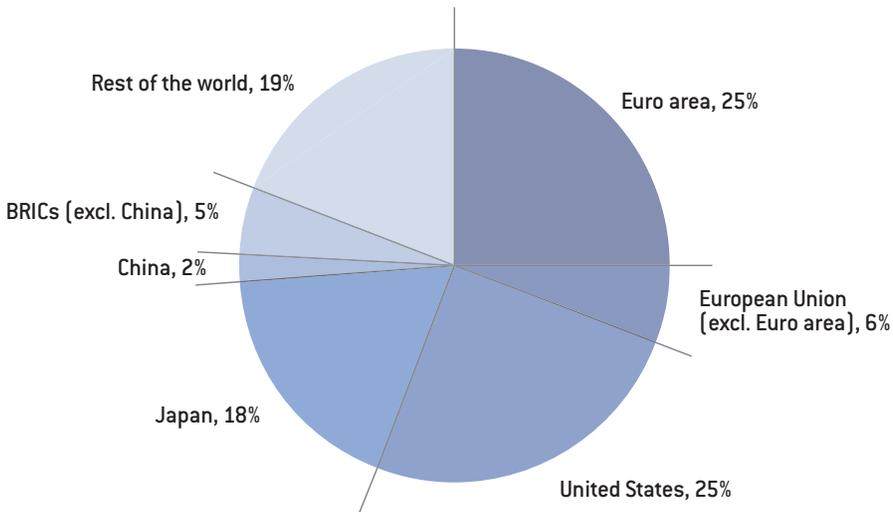
<sup>3</sup> In the long term, some estimates suggest that rising developing Asian countries will take over the dominant position of the transatlantic partners in the world economy, accounting for almost half of world real GDP in 2050. In this scenario, the share of the EU and the U.S. combined is expected to fall to just over a quarter of world GDP (Buiter and Rahbari 2011).

**Figure 1. Share of World GDP (%), 1995 and 2012 at Market Exchange Rates)**

Source: IMF World Economic Outlook, April 2012

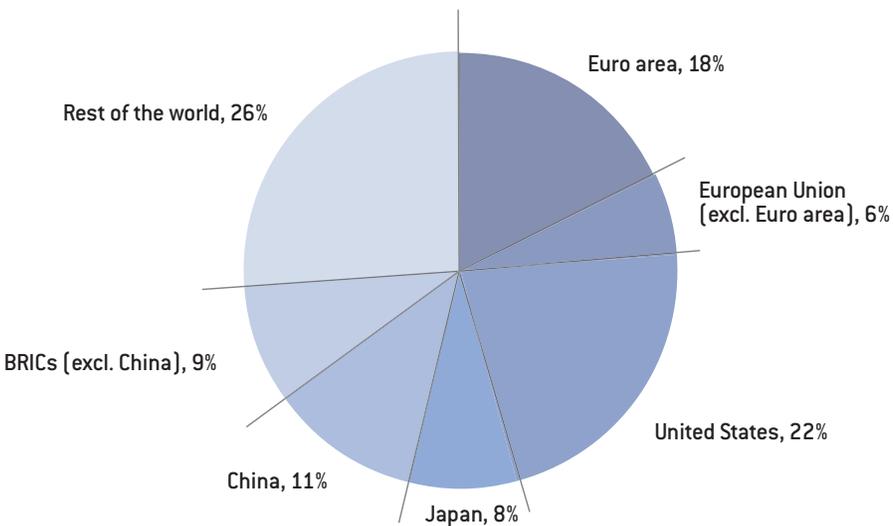
**1995**

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## **Ebbing and flowing**

Over the last five years, crisis management at a multilateral level has betrayed the ups and downs in the current state of the relationship between the U.S. and the EU. The strong cooperation that emerged in the early stages of the crisis began to weaken as both partners moved towards different paths and paces of recovery.

The risk of a global financial and economic collapse sharpened everyone's focus in the early stages of the crisis, resulting in a coordinated common response and an exceptional level of cooperation. For instance, the European Central Bank (ECB) and the U.S. Federal Reserve signed an unprecedented 50-basis-point interest rate cut in early October 2008.<sup>4</sup> Coordinated policies at the G-20 level culminated in agreements on crisis resolution through increases in liquidity, as well as on measures to prevent future crises, which included the call to reform the international financial and monetary architecture made at the London summit in April 2009. Later that year, the establishment of a Mutual Assessment Process (MAP) within a new 'Framework for Strong, Sustainable and Balanced Growth' seemed to pave the way for increased and effective concerted action.

However, the multiplication of international gatherings since the start of the crisis has made these meetings less significant in the long run, allowing them to be overwhelmed by more urgent issues. For example, at the G-20 Cannes meeting in November 2011, the European debt crisis became the priority. Together with the lack of drive from the U.S., this caused the thoroughly conceived and wide-ranging agenda of the French presidency to be put aside. So, viewing the U.S.-EU relationship through the lens of multilateral activities in the last five years might hint at a relationship that is stalling. No country is willing to take the lead and push for necessary structural reforms or immediate growth enhancement, least of all the U.S.; the presidential elections meant that the U.S. had to prioritise domestic issues. The potentially dramatic global effects of the multiple crises in the eurozone do not seem to have caused enough international concern to trigger a new round of concerted action, as illustrated by the weak recommendations of the latest meeting of G-20 leaders, held in Mexico in June 2012.

## **Diverging attitudes**

Different countries reacted to the crisis at different speeds, and traditional divergences on macroeconomic policy priorities re-emerged. For instance, the U.S. called for a gradual

<sup>4</sup> Along with the ECB and the Federal Reserve, the measure was agreed by the central banks of Canada, Sweden, Switzerland and the United Kingdom.

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exit from fiscal stimulus and for extended tax cuts.<sup>5</sup> But European countries, bolstered by the Sarkozy-Merkel axis, continued to issue fiscal consolidation packages differentiated to national circumstances (The G-20 2010).

Monetary policy measures by the European Central Bank (ECB) and the Federal Reserve System (Fed) followed a similar pattern on many occasions in the last five years, such as when they made substantial cuts in interest rates. However, actual coordinated action was limited to currency swap agreements, which were put in place after the Lehman collapse and have been retained ever since. Monetary policy measures reflected the different sources of financing of respective economies, as well as the central banks' mandates and aims, and so had different consequences at the global level. The Fed aimed at increasing internal demand and turned to quantitative easing, purchasing government bonds and asset-backed securities, to avoid the liquidity trap.<sup>6</sup> The ECB is not allowed to directly finance government debt, but it expanded its role and provided financial institutions with liquidity against collateral, in order to improve the monetary transmission mechanism and to achieve financial stability.

Monetary policy decisions help explain the significant impact of different governance structures on shaping policy choices. The distribution of responsibility for fiscal and banking policy within the eurozone is opaque: it lies partly with the ECB and partly with the eurozone group of finance ministers. The cacophony of the voices of eurozone members dissipates much of the potential for realising a key international role (Bergsten 2005). Within the ECB's governing council, members often tend to stick to a national perspective and, in more than one case, strong disagreement has even led to resignation.<sup>7</sup> In general, the EU has a more interventionist outlook on the role of market regulation and supervision by the government, seeing these issues as the domain of public authorities. The American doctrine, on the other hand, has always favoured a market-oriented regulatory environment and independent regulatory institutions, to limit political intervention. This attitude is also reflected in the case of bank failures, with the U.S. having a more tolerant view towards corporate insolvency than most European cultures, which see them as 'politically ominous disasters to be avoided at all costs' (Goldstein and Veron 2011).

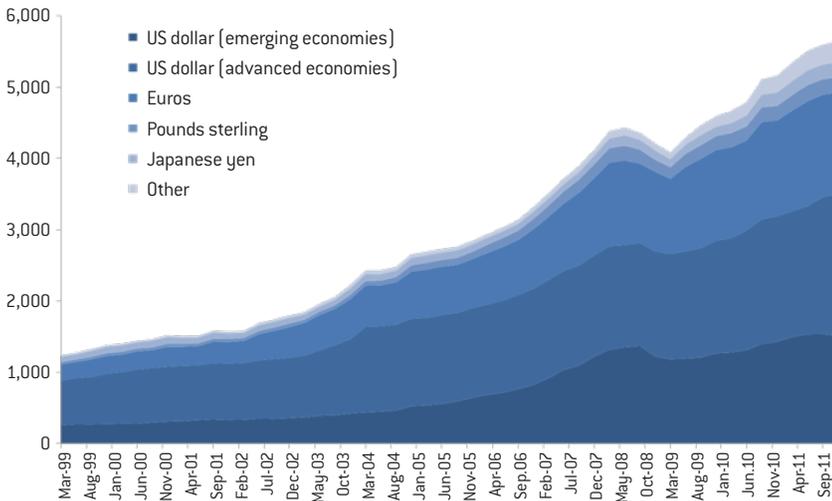
<sup>5</sup> In July 2012, the Bush administration's tax cuts were further extended by the Obama administration for one year for Americans with annual income of less than \$250,000 a year. Instead, taxes for the wealthiest 3 per cent of Americans will move up from 35 per cent to 39.6 per cent.

<sup>6</sup> Interest rates are close to the Zero Lower Bound (ZLB).

<sup>7</sup> European Central Bank Governing Council member Axel Weber quit the post in April 2011, in part because of his long-standing discomfort at the ECB's initial decision to embark on bond purchases in 2010. Jürgen Stark, an executive board member at the ECB, also resigned in September 2011, as a protest at the ECB's crisis management, again with regard to the bank's bond-buying programme.

**Figure 2. Currency Composition of Known Allocated Reserves (\$ billion)**

Source: IMF COFER database



## Today's challenges

### Growth

The changing epicentre and shifting nature of the global crisis required differentiated policy responses at different times on both sides of the Atlantic. After the crisis, the two sides were left with different underlying economic situations. Engaging with new partners to look for new sources of growth across the world poses a challenge to the extent and scope of the transatlantic strategic partnership. It also presents a challenge to the global pre-eminence of the U.S. economy, which is likely to shift towards a position of 'primus inter pares' in a multipolar economic order (Subacchi 2010).

The impact of the global financial crisis is expected to linger on, leaving transatlantic economies with low growth prospects for a prolonged period. However, the U.S. reached its pre-crisis GDP levels of 2007 in mid-2010, with an estimated tepid GDP growth of just 2 per cent in 2012 (IMF 2012). Meanwhile, Europe has suffered heavily since summer 2011, with the emergence of a sovereign debt crisis in several eurozone countries. These crises are likely to bring with them negative growth in the euro area in 2012 and lead to a feeble recovery in 2013 (IMF 2012). Nevertheless, there are clear divergences among the economies of the single currency union, which is often referred to as a 'two-speed' Europe.

## **Troubled finances**

Public finances still remain a challenge for economies on both sides of the Atlantic, which are struggling to strike a balance between austerity measures and growth-boosting stimulus. The combination of a deepening EMU crisis with a lack of action in dealing with the so-called fiscal cliff, the potential U.S. fiscal crisis set for the beginning of 2013, could cause major stress to the world economy.<sup>8</sup> Spillovers and direct transmissions from one economy to the other are also possible. The Congressional Budget Office (CBO) warned in August 2012 that if new legislation is not produced to prevent the George W. Bush-era tax rates from expiring and automatic spending cuts from being implemented, the U.S. economy will contract by 0.5 per cent in 2013 and unemployment will rise by almost 1 point to 9.1 per cent next year (Congress of the United States Congressional Budget Office 2012). At the same time, U.S. debt is expected to continue growing, after hitting an estimated 105 per cent in 2011 (IMF 2012).

## **Mutual exposure**

The eurozone crisis poses risks to the U.S. economy through different channels, which might be magnified by a weak and still recovering domestic economy that is burdened by high and increasing amounts of debt and worrying deficit levels. Given the economic interdependence between Europe and the U.S., it is not surprising that spillover effects to the U.S. economy are a relatively large concern in America. Concerns about a deepening or an easing of the eurozone crisis have a swift effect on volatile U.S. stock prices. In 2011, 6 out of the 10 biggest moves in the U.S. stock market were due to European events, according to the Bloomberg market wrap (Harris 2012). On the day of the ECB's announcement in early September 2012 that the bank was ready to begin its bond-buying programme, the move pushed the benchmark American stock index to a four-year high (Popper 2012). Given the uncertain evolution of the sovereign debt crisis in the Monetary Union, no unanimous assessment has emerged on its implications for the U.S. economy. While a modest contraction in the eurozone would adversely affect U.S. exports and the sales of U.S. companies, the impact on overall U.S. GDP growth would probably be minimal (Ahearn et al. 2012).

<sup>8</sup> The fiscal cliff is a term used to describe the conundrum that the U.S. government will face at the end of 2012, when tax breaks will expire and tax increases and spending cuts will be introduced. They include automatic spending cuts triggered by the August 2011 deal to raise the debt ceiling; the expiration of the Bush-era tax rates; a sharp cut in Medicare doctor payments; and the failure to index the Alternative Minimum Tax for inflation, which would raise taxes for many households.

Particularly worrying, however, is the potential mutual exposure of financial institutions. The U.S. remembers how the collapse of Lehman Brothers directly affected European financial institutions. American banks have been reducing exposure to stressed markets over the past year.<sup>9</sup> But direct and other potential exposure to the troubled eurozone countries of Greece, Ireland, Italy, Portugal and Spain was estimated at around 7.5 per cent of their total exposure overseas, accounting for \$765 billion at the end of 2011 (Bank for International Settlements 2012).<sup>10</sup>

### **Towards an EU-U.S. FTA?**

A comprehensive transatlantic economic initiative has long been advocated and is especially supported by the private sector, which knows the benefits that could arise from the reduction of trade barriers and the creation of a more stable and transparent trading and investment environment. In November 2011, a High-Level Working Group on Jobs and Growth was created to identify policies and measures that could increase bilateral trade and investment, with the final aim of full transatlantic market integration. The interim report released in June 2012 highlights 'the greatest potential for supporting jobs and promoting growth and competitiveness across the Atlantic' (EU-US HLWG 2012). Though no concrete recommendations have been made, talks about a Free Trade Agreement between the US and the EU are likely to start in 2013, as recently stated by the European Council (General Secretariat of the European Council 2012). A study for the European Commission in 2009 estimated that even partial successes, which would involve aligning half of relevant non-tariff barriers and regulatory differences, would push EU GDP 0.7 per cent higher in 2018, while U.S. GDP would gain 0.3 per cent per year compared to the baseline. This represents a potential annual gain of €41 billion (Berden et al. 2009).

These talks are likely to revive the transatlantic relationship. Aside from technicalities about market access, they have the geopolitical aim of maintaining the relationship's preeminent

<sup>9</sup> Since 2010, U.S. domestic banks have reduced their investments in Greece by more than two-thirds, from \$18 billion to only \$5.8 billion at the end of 2011. They have also downsized their exposure to other troubled countries, including Spain (down 21 per cent), Ireland (down 16 per cent) and Italy (down 14 per cent) (see Appelbaum 2012).

<sup>10</sup> 'Direct exposure' refers to exposure to public and private sectors. 'Other potential exposures' includes derivative contracts, guarantees extended, and credit commitments. It is generally believed that the Bank for International Settlements' 'other potential exposures' data capture gross exposures, rather than net. It is also worth noticing that BIS data capture the exposure of banking institutions, and do not include the exposures of other financial institutions, such as money market, insurance and pension funds. They also ignore secondary exposures. BIS data may suggest that U.S. banks have higher levels of 'other potential exposures' to eurozone countries facing market pressures. In particular, whereas direct exposures to Greece, Ireland, Italy, Portugal and Spain (sovereign and private sector) totalled \$135 billion in September 2011, BIS figures indicate that other potential exposures for U.S. banks to these economies (sovereign and private sector) totalled \$582 billion in September 2011. Again, this figure is not believed to reflect net exposures, and analysts disagree about whether BIS data overstate or accurately represent the exposures of U.S. banks overseas.

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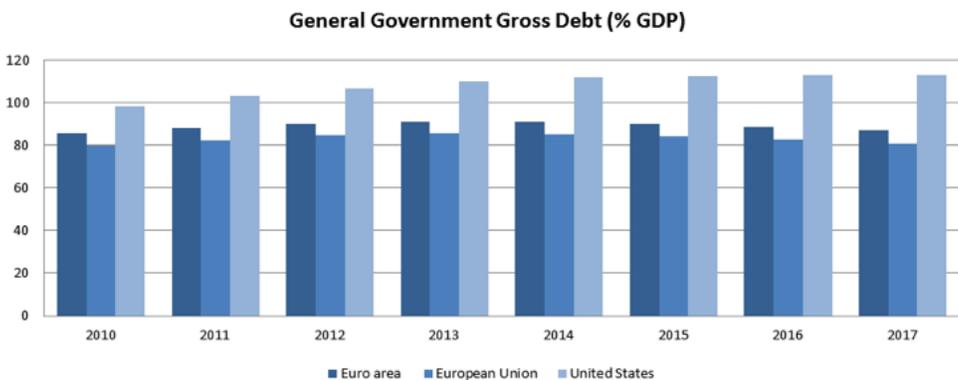
role in the world economy, by showing that the transatlantic partners can compete with rapid developing economies. Previous efforts within the Transatlantic Economic Council (TEC) and the High-Level Regulatory Cooperation Forum have proved that the process is likely to be difficult and time consuming.

Officials on both sides fear getting bogged down in endless discussions about the technical details of the agreement, which could end up damaging the overall relationship. If agreement is reached in a reasonable amount of time, however, it would represent a trade-driven boost to economic growth and give confidence both to the private sector and to struggling leaders.

However, engagement at the bilateral level runs the risk of providing the nail in the coffin of the multilateral approach, which has already faded after the initial ‘burden sharing’ policy coordination that characterised the early stages of the crisis.<sup>11</sup> Again, this would signal that both the EU and the U.S. will only engage internationally when specific domestic interests are concerned and when the issue in question is on top of either region’s domestic agenda.

### Figure 3. General Government Gross Debt (% GDP)

Source: IMF, WEO Database, April 2012



<sup>11</sup> Moreover, both parties are engaged in several bilateral and multilateral talks with other strategic partners. For instance, a Free Trade Agreement between the EU and India, which would represent the single biggest trade agreement in the world and would benefit 1.7 billion people, is in an advanced stage of negotiation. The Trans-Pacific Partnership (TPP) FTA negotiations, which aim to bring together economies across the Pacific into a single trading community, are part of the bigger realigning and shifting strategy of the U.S. towards the Asia-Pacific region.

**Figure 4. Growth Prospects**

Source: IMF, WEO Database, April 2012.



## Multilateral engagement

The bilateral relationship also plays out within the multilateral institutions in which both the EU and the U.S. are involved, most of which were founded with American impetus and are still led by either American or European nationals.<sup>12</sup> The appointment of the World Bank president and the International Monetary Fund (IMF) managing director in 2011 showed how jealously the U.S. and Europe guard their predominant position in international fora.<sup>13</sup>

### The bilateral into the multilateral: new impetus...

Much needed political drive and vigour could be injected into multilateral arrangements by a joint transatlantic effort. Multilateral initiatives can be better implemented using the leverage of the partnership, as evidenced by the call from President Bush, which was also endorsed by the European partners, to convene an emergency G-20 summit after the Lehman collapse. Favoured by circumstances that called for urgent and decisive action, the transatlantic-driven revamp of the G-20 framework, which brought with it an increased role for the IMF, proved that transatlantic leadership in a multilateral system was possible. Likewise, it was President Obama who suggested designating the G-20 as the ‘premier

<sup>12</sup> Under the terms of an unwritten agreement, the IMF is usually led by a European and the World Bank president is an American.

<sup>13</sup> The U.S. nominee for the World Bank’s chief post, Jim Yong Kim, was chosen on 16 April 2012. However, for the first time in its 66 years of history, there were other nominees, namely Nigerian Finance Minister Ngozi Okonjo-Iweala and José Antonio Ocampo (a former Colombian finance minister), signifying the increasing clout of emerging markets on a global level. According to World Bank officials, however, China and India backed the U.S. nominee (see Lowrey 2012).

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forum for international economic cooperation' in September 2009, as the Pittsburgh summit communiqué reports (The G-20 2009).

However, transatlantic-driven policy coordination efforts showed signs of short-term thinking when national economic conditions started to diverge and the initial peak of the crisis was overcome. In consequence, the comprehensive London summit agenda was not fully implemented. Specifically, at the G-20 level, the main obstacle to a coordinated approach was transatlantic differences on financial regulation, with both sides pursuing different policies with regard to liquidity rules for global banks and fiscal policies, where the U.S. differed from European countries' emphasis on austerity.

**...or detriment?**

The multilateral framework also has the potential to prove detrimental to the partnership. Firstly, the EU has yet again shown its inability to speak with one voice, and there are signs of an inward looking attitude on the part of its members that hint at a renationalisation of policymaking (Kupchan 2010). Even if Europe is indeed seen as overrepresented in many gatherings, including the G-20 – where it holds a single seat for the Union plus four EU members, and Spain as a permanent invitee – it has not taken advantage of its position. The forum has emphasised the role of the major European economies instead of the Union as a whole, perpetuating the debate on the intergovernmental versus supranational approach. This offers more evidence of the lack of political will and coordination among the EU member countries in putting forward a unified response (Giovannini et al. 2012).

Secondly, the approach of the Americans and the Europeans on the multilateral stage may differ, as in the case of the on-going reform of the IMF's quota system and governance. The reform was initially slowed by an undercurrent of European opposition, with EU members reluctant to dilute their influence in one of the world's most important financial institutions. But in August 2010, the U.S. suddenly turned its back on its traditional partner and forced the reform process to move forward by effectively vetoing the renewal of the Executive Board's seats. This pushed European countries to accept a reduction from eight to six seats on the Executive Board, with the surrendered seats going to emerging countries.<sup>14</sup> National agendas (and domestic disagreements) also prevailed when the U.S. Congress blocked

<sup>14</sup>In August 2010, the U.S. abstained from the biannual renewal of the IMF's Executive Board seats, which would have permitted European countries to retain their dominant position on the board. This meant that the U.S. effectively vetoed the decision, since the U.S. holds 16.74 per cent of the votes in the Fund, in which the majority is 85 per cent. The U.S.'s manoeuvre highlighted the division between the U.S. and emerging countries on the one hand and European countries on the other. Moreover, it brought to light subtle tensions between big European countries and smaller ones, which were more likely to be damaged by a potential reduction of seats in the Executive Board.

finance promised for an increase of the IMF fund in April 2012, which was perceived as only benefiting troubled eurozone countries.

The G-20 framework, which was heavily championed by European leaders in its early days, is now in part turning against the Union. Ahead of the G-20 summit in Los Cabos in June 2012, Europe was put under pressure by its American partner, which feared its vulnerability to a potential European downturn and was focused on its own domestic issues. Facing criticism from emerging economies as well, European Commission President Barroso felt the need to underline that the EU was not going to the summit ‘to receive lessons in terms of democracy or in terms of how to handle the economy’ (BBC 2012).

This friction reflects the fading, or at least the current lack, of effectiveness and legitimacy of the G-20. Mainly due to the lack of commitment and leadership by the transatlantic partners, and in particular the United States, it has not turned into the promised world’s ‘permanent steering committee’ (Subacchi and Jenkins 2011). It may also point to a U.S. strategy of turning to bilateral relations with ‘strategic’ European countries, such as Germany and France, to make use of the key role they can play in the unfolding of the eurozone crisis, instead of fully committing to an overall ‘strategic partnership’ with the European Union.

At the same time, improving both the governance and legitimacy of the G-20 is in the interest of all its members – first and foremost, the U.S. and the EU. An empowered G-20 would help the EU leverage its role internationally and with its transatlantic ally. The U.S. should see the group as a suitable forum to continue to exert its de facto world economic leadership. The U.S. would benefit from a forum in which it is still the premier partner and the leading decision maker, through which it could engage with pivotal emerging economies within a flexible – that is, non-binding – framework.

## Conclusion

The transatlantic powers’ role is not just an artefact of the past, but is of paramount importance in handling the global economic and financial crisis. The relationship rests on solid trade and financial linkages, which are supported by shared values and ideas. The two partners also use their link to lead international discussions and push forward the multilateral agenda. When they lack impetus or a shared vision, international institutions are easily brought to a standstill, as seen in the stalemate in broadening and deepening the G-20 agenda in the

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last few months.<sup>15</sup> Domestic issues are currently at the top of the agendas of both partners, which has contributed to differences between them. In the final months of the presidential campaign, U.S. hands were tied, especially where congressional action was required.<sup>16</sup> On their side, European countries are devoting all their attention to future scenarios in the core 17 euro area countries, consumed as they are by their own financial and economic problems. Though U.S. banks have reduced their direct exposure to troubled economies, the U.S. domestic economy remains vulnerable to disruptions in Europe. Europe is the destination of around one-quarter of exports from the U.S. and \$1.4 trillion of the securities of eurozone companies and countries are held by the U.S.

Although they are at a different stage of recovery and have dissimilar underlying economic and institutional conditions, the transatlantic powers are still at the top of the world economy and at the forefront in setting the global agenda. The importance of their relationship must surely be one of the lessons to be learnt from the global economic and financial crisis. Given the crisis that the partners are facing and the rise of other powerful actors on the world stage, it is in the mutual interest of the EU and the U.S. to ensure that they are on the right track to recovery and to promote tighter and more stringent relations between them.

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<sup>15</sup> In addition to this, even China seems to have put the reform of international institutions, and of the G-20, at the bottom of its national agenda, in view of fears of a possible economic slowdown and in the run-up to a very sensitive change of its political leadership (see Smith 2012).

<sup>16</sup> Ibid.

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