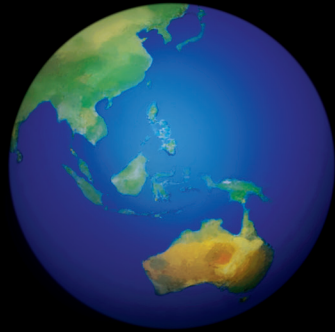
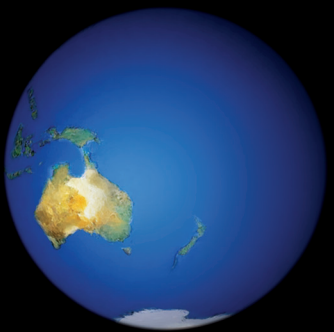
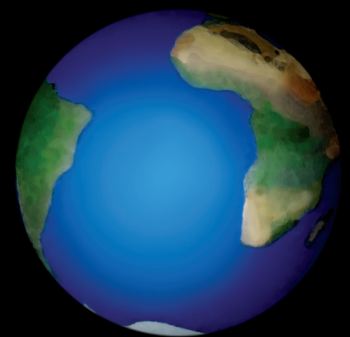


GLOBAL SHIFT

HOW THE WEST SHOULD RESPOND TO THE RISE OF CHINA






Transatlantic
Academy

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FROM THE EXECUTIVE DIRECTOR

The transatlantic community arose in the middle of the twentieth century as a response to external threats posed by authoritarian states and the crisis of capitalism produced by the Great Depression. Over time, it has successfully integrated former authoritarian powers into the international order, most notably Germany and Japan, as well as newer democracies in Southern and Eastern Europe, Asia and Latin America. Now the world is witnessing a major and rapid shift of economic and political power to non-western regions, most dramatically toward Asia and especially China. This shift will have profound implications for the nature of the global system and its ability to meet the formidable tests of this century. How should the transatlantic community meet this latest challenge?

As Executive Director of the Transatlantic Academy I am pleased to present the 2011 Report of the Transatlantic Academy Fellows: *The Global Shift – How the West Should Respond to a Rising China*. This report provides in-depth analyses of four sectors: the global economy, global security, energy and the environment, and the global commons. It also proposes a three-part strategy for responding to global shift and the rise of China. First, the transatlantic community will have to develop common approaches, which include a division of labor, especially in the security policy sector, to meet the confluence of new challenges with our limited resources. Second, the West needs to refurbish and globalize its own institutions more effectively and creatively and advance a comparable program to work with others to make these institutions more effective, accountable and representative at the global level.

Third, Europe and North America must demonstrate that its democratic systems are capable of continuing to adjust and adapt to the myriad of problems its societies face internally, regionally and globally, including fiscal constraints, demographic changes, environmental degradation, rising social and economic inequalities, and political gridlock.

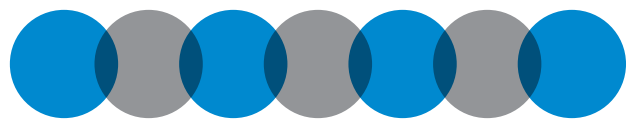
The Academy serves as a forum for a select group of scholars from both sides of the Atlantic and from different academic and policy disciplines to examine a single set of related issues each year. Working together from a transatlantic and interdisciplinary perspective, Academy Fellows use research, publications, and seminars to make policy-relevant contributions to policy debates facing the transatlantic community.

This report represents the collective efforts of the third group of Academy Fellows. It follows on the work of the first group, which focused on immigration policy, and which published a report titled *No Shortcuts: Selective Migration and Integration*, and the second group, which focused on Turkey and published the report *Getting to Zero: Turkey, Its Neighbors and the West*. This report is the product of the academic research of the full-time academic Fellows and the Helmut Schmidt Fellow, and is also informed by contributions by the Bosch Public Policy Fellows and the Compagnia di San Paolo Fellow, who were in residence at the Academy for shorter periods and provided practitioners' perspectives. The Fellows engaged in an intensive collaborative research environment in which they presented their work and critiqued the work of their colleagues. They interacted with a

wide range of experts and policy makers in the United States, Canada, Europe as well as with specialists in east Asia during a study trip to Beijing and Seoul, as they shaped the research for this report.

The Academy would like to acknowledge the support of its donors in making this study and the broader Academy possible. Thanks to their support, the Fellows were able to spend ten months in Washington working in collaboration on this theme, including study trips to China and South Korea and in numerous workshops and discussions with academics, policy analysts, business people, journalists and government officials in North America and Europe. We hope this report helps bridge the Atlantic policy and academic communities and makes a contribution to the transatlantic dialogue on the nature and implications of the global shift.

Stephen F. Szabo
Executive Director
The Transatlantic Academy



GLOBAL SHIFT

HOW THE WEST SHOULD RESPOND TO THE RISE OF CHINA



At the end of the 20th century, Western dominance of the international order appeared complete. With the collapse of the Soviet Union and communism as a systemic alternative, the United States stood in a position of unrivaled military dominance, and the perception that democracy was the only legitimate form of government and capitalism the only viable economic system was widespread. By the late 1990s, in both economic and military affairs, it seemed that America could do whatever it wanted, and others had no choice but to go along. During the 1997–98 Asian financial crisis, the United States and the International Monetary Fund, with the support of the European partners, imposed solutions on the afflicted countries based on the so-called Washington Consensus. In March 1999, as China and Russia fumed, the United States and its NATO allies went to war against Serbia without UN Security Council authorization to prevent another wave of ethnic cleansing in Kosovo.

A mere decade later, this commanding position has greatly eroded, due as much to a series of self-inflicted wounds as to the “rise of the rest.” Superficially, this was the result of the worst financial and economic crisis the world had experienced since

the 1930s. Yet the causes for this change lie deeper. Actions taken by the United States — the refusal to join international agreements like the International Criminal Court and the Kyoto Protocol, the invasion of Iraq, and the images of torture from Abu Ghraib — undermined the political credibility and standing of the United States and the West writ large. On the economic front, the housing and banking crises, as well as the accumulated burden of years of excessive public and private spending, have undermined America’s position and diminished the willingness of other nations to heed Washington’s lectures about good governance and economic policy. Meanwhile, Europe remains beset with high unemployment, uneven growth rates, disputes over migration and religious tolerance, and the debt crisis in the Eurozone, while on the international stage European institutions rarely act cohesively and effectively. In order to overcome this situation, we require a clear understanding of the challenges posed by the global shift and rising powers, a thorough assessment of our strengths and weaknesses, and an ambitious program for renewing the transatlantic community on a more realistic foundation.

THE TRANSATLANTIC COMMUNITY

Born in fire, the transatlantic community has been the most successful grouping of states and peoples in history and has furthermore significantly shaped our world for the better. It arose in the middle of the 20th century as a response to external threats posed by aggressive authoritarian states and the crisis of capitalism produced by the Great Depression. Although built on a shared cultural heritage, this community is based on the universal values of security, freedom, and prosperity. Over the second half of the 20th century, the Atlantic community successfully responded to the Soviet threat and fundamentally transformed Europe, bringing it close to a continent that is unified, free, and at peace. This community also helped to project those values on a global scale, and its members, particularly the United States, have played a pivotal role in creating and developing the panoply of existing international institutions, most notably the United Nations, the GATT/WTO, the International Monetary Fund/World Bank, and many other regimes and legal orders, which efficaciously govern the diverse domains of international life.

Since its inception, the transatlantic community has been successful because it has been able to grow, adapt, and innovate to meet challenges. It has expanded its international order to include former enemies, most notably Germany and Japan, as well as previously authoritarian states in Europe and around the world. At the same time, the transatlantic core deepened its own political, economic, and military ties and institutions. This success required recasting institutional bargains at each stage in the growth and evolution of this community to reflect changing relative power relations and capabilities. These bargains were achieved by consensus, often only after long and difficult internal debates and by accommodating competing interests and perspectives.

The many differences and great diversities within the West are a source of strength. Domestically, there are differences over the proper balance between state power and individual freedom as well as over problems of social justice, economic fairness, public deficits, and the distribution of wealth. Internationally, there are divergences in military capabilities and disagreements about when and how to use military force. The United States and Europe differ on the role of national sovereignty, the value of international law, the utility of international organizations, and the management of the global commons. The community is also marked by diverse philosophies, both within countries as well as among them, on solving global economic imbalances, managing exchange rates, and regulating international commerce. There are also different strategies regarding the rise of new actors and their position in the international system. These differences are real, but they are differences of degree within a liberal

democratic capitalist consensus. This diversity, which in any case is here to stay, enables the members of the community to debate and seek better solutions for common problems. These problems include fiscal constraints, demographic changes, environmental degradation, rising social and economic inequalities, and political gridlock.

Past successes have depended on renewals that responded to changing circumstances and problems. Economic and political renewal is again needed because, over the last several decades, the dynamism of capitalism and shifting government policies have produced dramatic increases in inequalities in wealth, income, and employment opportunity that threaten to undermine, destabilize, and ultimately delegitimize political democracy. The recent financial crisis has greatly exacerbated these trends. Failure to resolve these largely domestic economic and political problems will undermine the competitive appeal of the democratic capitalist model and limit the resources available to address public problems domestically, regionally, and globally.

The focus of this report is not, however, on these domestic problems themselves. Rather, it is on the relationship between the transatlantic community and the changing world order. Our objective is to develop a transatlantic strategy to meet the challenges posed by the global shift and rising interdependence and to lead in recasting the global bargains at the heart of problem-solving institutions. However, no outward-looking program of renewal and leadership can succeed without addressing the domestic economic and political problems facing the members of the community.

GLOBAL SHIFT AND THE DEBATE OVER CHINA

The age-old pattern of shifting power from core to peripheral states has taken on global proportions, accelerated by the spread of capitalism. Since the fall of the Soviet Union, the fastest-growing economies in the world have been outside the transatlantic core, most notably China, India, and Brazil. The rise of these states will require fundamental changes in the bargains at the heart of the international order. Unlike previous renegotiations, however, this one will not be done largely on Western terms. For the first time ever, the international order created by the West over the course of the 20th century will have to take fully into account the interests and perspectives of non-Western, even anti-Western, states and peoples.

Changes in the global distribution of capacity, as we have noted, are not new. What is new is the quality of global interdependence and its complexity. In two important ways, the world today is fundamentally different from the past. First, advances in information, transportation, and communication technologies; growth in transnational economic activity and trade; the development and spread of nuclear weapons; and the cumulative degradation of the global environment are producing historically unparalleled levels of global interdependence. Second, the rise of interdependence has produced a world of complexity and turbulence in which changes tend to be frequent, significant, and sudden. This new world, marked by surging interactions and capacities, is a world of novel and widely shared vulnerabilities that have created a cross-cutting pattern of competitive and cooperative interests. As global problems grow, the diffusion of world

power is undermining present arrangements of global governance, widening the gap between what is needed and what can be delivered. If global problems are going to be addressed, it will be necessary to reconfigure existing international regimes to take into account these new realities of diffusion, interdependence, and complexity. Within the horizon of the global shift, China is in a league of its own among rising powers. Since 1980 Chinese growth rates have averaged 10 percent per year, transforming China into the second-largest economy in the world in 2010. If these trends continue, China will overtake the United States as the world's largest economy within the next

two decades. Moreover, China is the only credible challenger to American hegemony, in Asia and beyond.

The shift in the global balance of power has triggered a debate about China and the world order. As China has grown economically, it has managed to maintain its authoritarian political system, while reaping the benefits of a capitalist economy dependent on the international system of free trade. China has also weathered the recent financial crisis better than the United States and Europe. As a result, China appears to represent a fundamental alternative to the economic and political model of democratic capitalism,

giving rise to the notion that a "Beijing Consensus" could replace the "Washington Consensus." These developments have led to a debate about whether the existing international liberal order can successfully repeat the pattern of integrating rising powers that has occurred since World War II. China's growth raises the specter of a return to great power rivalry and ideological competition that appeared to end with the Soviet collapse.

On one side of the debate is the optimistic view that convergence and integration will win out. The historical experience of countries as diverse as South Korea,

Spain, and Chile suggests that a growing and increasingly affluent middle class will demand political freedoms, that the inefficiencies of authoritarianism in governing complex industrial societies will overwhelm the Communist Party regime and lead to China's democratization. This line of thinking also expects that China will become a more responsible international stakeholder as it grows more economically interdependent within the capitalist trading system and as it grapples with the many problems of contemporary interdependence such as climate change, regulation of nuclear weapons, and energy security. This view is also skeptical of China's ability to dominate its neighbors and of authoritarian capitalism as a sustainable model given China's immense internal vulnerabilities and problems. Those subscribing to this view believe that as long as the West continues to hold the door open to Chinese integration, Beijing will come to accept the

norms and rules of the current international system. The policy prescriptions favored by this integrationist view consist in helping China realize that its interests lie in joining, rather than disrupting, the Western-led international order.

The other side in this debate holds that the Chinese authoritarian system will modernize but not democratize, thereby providing an alternative model that other developing countries will find attractive, just as postcolonial states did with the Soviet model in the 1950s. In this view, Beijing will balk at assuming the international responsibilities that its growing weight would imply and support revisionist regional actors dissatisfied with the rules of the international system created by the West. According to this school of thought, China will also seek to dominate its region and eventually form the nucleus of an alternative global order. Adherents to

this view recommend a balance-of-power strategy of proactive containment and an extension of the existing system of alliances to other states that are threatened by China.

The debate between integrationists and balancers sets the alternatives too starkly. Looking at the medium term, with a time horizon of five to fifteen years, China's course will probably fall somewhere in between these two extremes and will be some combination of selective revisionism and partial integration. Western policies toward China have reflected this duality by mixing engagement and containment and for the foreseeable future will realistically have to continue this mixed approach. What the West does may help shape but will not determine China's future course. The rise of China (and others) is but part of a larger story of growing interdependence and complexity and a resulting crisis of global governance.

China Becomes a Global Player

Ever since the beginning of the reform period in 1978, China's approach to the world has been informed by Deng Xiaoping's dictum that the country needed to concentrate single-mindedly on economic growth and the reduction of poverty, while at the same time creating the most favorable international environment for achieving this. From this outlook flowed the characteristics that have typified China's attitude to the world over the last three decades: attaching the highest priority to establishing a good working relationship with the United States, not allowing itself to get drawn into conflicts that might detract from these objectives, and as far as possible trying to keep a low profile. The Chinese have pursued this strategy with great self-discipline and to remarkable effect. And it has led to the most open period in Chinese history and its rapid integration with the rest of the world.

It would be wrong, however, to think of Deng's strategy as an end in itself: on the contrary, it was a means to a much broader end, to make China strong again after over a century of weakness and humiliation. The role of the strategy, therefore, was essentially

transitional – to create the conditions for China becoming a serious global player. That has now begun to happen, with the Western financial crisis marking a key moment in the shifting balance of power between China and the United States. Although Deng's dictum continues to inform China's international strategy, important changes in tone and approach have become evident since the crisis; in particular China is now much more outspoken on economic questions, including, most dramatically of all, its willingness to question the dollar's role as a reserve currency.

China's rise will change the international system profoundly because of its huge population and the fact that it is a product of a quite different history and civilization to the West. China sees the world in a very different and distinctive way. This will become much clearer as China's foreign policy emerges from the Deng Xiaoping era and begins to express China's interests as a global power while seeking to articulate deeper nativist Chinese traditions and concepts. The present debate taking place in Beijing on these questions is a harbinger

of the future. While there is no reason to believe that the Chinese will abandon the extraordinary patience they have displayed over recent decades, that should not be confused with a deeper intent over time to shape the world increasingly in their own image. This can most clearly be seen in East Asia – the largest economic region in the world – whose economy is once more becoming China-centric, where American influence is in rapid long-term decline, and where older patterns of Chinese political and cultural ascendancy are likely to reassert themselves. But with the dollar under growing pressure and the renminbi set to become a formidable global currency over the next decade or so, and in all probability ultimately usurp the role of the dollar, the global order will increasingly be shaped by China rather than a steadily declining America.

Martin Jacques, Bosch Fellow 2011, The Transatlantic Academy

China and the West

China is no longer a monolithic communist system. Political decision-makers in the West would be well served to take a closer look at how China's system really operates and the debates that are on the agenda in Beijing. Despite tight political control of public opinion, these debates are open and critical, and they concentrate on all major concerns of China's leadership. Topics include political reform, environment, stability and democracy, social unrest, among others. Many of these debates may not yet meet Western standards, but even in its intellectual discourse China is catching up.

China's strategic elites, and certainly China's diplomats, are as capable as their Western counterparts, sometimes even better trained than Western observers acknowledge. This is one of China's main strategic assets: hundreds of well-educated

and experienced young scholars and experts within China's political consulting apparatus are doing nothing but studying the West all day long – our debates, our politicians and our decisions both on domestic and global issues. China's top leaders never travel to the West without being intensively briefed on their interlocutors while we find it difficult to even pronounce the names of our Chinese counterparts properly.

Based on this advantage, China's overall self-confidence is growing rapidly. We should therefore prepare ourselves for increasing conflicts with China (and some of the other emerging powers) and a growing dispute about the future rules of the game in global politics.

Of course, a coordinated transatlantic policy could help enormously to defend Western values, positions and interests towards such

an ever more confident Chinese partner. But having a transatlantic dialogue on China is not equivalent to having common or even similar positions. American and European perceptions differ widely. Europe does not have a security perspective on China but an abundance of uncoordinated policies which China elegantly plays against each other for its own advantage. The US, on the other hand, faces China as its potential next global competitor and clearly also takes a military perspective while not neglecting growing financial and economic interdependence with China.

Eberhard Sandschneider, Bosch Fellow 2011, The Transatlantic Academy

Neither panic nor complacency is the appropriate response to the global shift and the rise of China. The strengths of the West remain formidable. The combined wealth of the United States, Europe, and Japan is seven times as great as China's, and even with rapid Chinese growth, the transatlantic community will remain the world's largest economy for the foreseeable future. The combined military capacity of the democratic states will continue to surpass that of all potential rivals. Furthermore, Chinese success has been based on the importation of capitalism and participation in the liberal trading system, and the appeal of freedom remains one of the most powerful forces operating throughout the world. At the same time, China also faces enormous vulnerabilities – a large and poor rural population, the demographic challenge created by the one-child policy, and a leadership that is constantly worried about its legitimacy.

A STRATEGY FOR RENEWAL

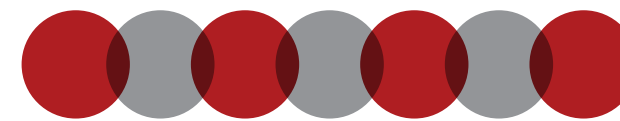
In order that the transatlantic community can deal effectively with the changes in world politics brought about by the shift in the global distribution of capacity and the rise in interdependence and complexity, we offer a three-part strategy. First, we propose a new division of labor among the members of the transatlantic community. Throughout its history, this community has pursued its shared values with different allocations of responsibility. During the Cold War, the United States led, and Europe assisted and followed in our efforts to defend ourselves against a common threat, avoid war, and eventually overcome and resolve our differences with our opponents. The new circumstances require a recasting of the previous division of labor, the use of the separate capabilities and means of the individual transatlantic community

members on problems based on a common vision and strategy. Specifically, Europe should take more responsibility for the problems in its neighborhood as the United States increasingly focuses on challenges arising in Asia.

Second, the members of the transatlantic community need to cultivate a new mindset about ourselves appropriate for a multipolar interdependent world. The United States, after years of hegemony, must recognize that it can no longer lead through domination or coercion but rather must now rely on the power of its example and its contributions to global problem-solving. Similarly, the United States will need to abandon the tendency to exempt itself from rules that it promotes in international order-building. It will need to listen better to take into account the differing interests, cultures, and historical backgrounds of other peoples and states. It will also need to be more realistic, honest, and forthright about its own failings and shortcomings, a vital prerequisite for effectively grappling with problems. Meanwhile, Europe needs to rid itself of a mindset of dependence on the United States and recognize its own capacity to solve problems in its neighborhood. Europeans will need to accept that even the largest member states will in many instances no longer be able to exert much independent international influence and thus to realize their individual interests and aspirations. Europeans will therefore have to move beyond purely national perspectives and cultivate a greater sense of European identity and political purpose, adopting a more realistic sense of what the European Union can and should do in the world. Finally, Europe must avoid the temptation to withdraw inward and erect barriers.

Third, the transatlantic community needs to lead proactively in recasting global bargains in the face of the ongoing diffusion of power and wealth. Working with rising powers will have to be a primary objective. To do this, it will be necessary to take into account the interests, histories, and situations of states that have never been fully part of the West and, in some cases, are not democracies. The transatlantic community has taken initial steps in this direction by, for example, readjusting the voting weights within the International Monetary Fund (IMF) away from Europe and toward China. But much more will need to be done, since other major global institutions still reflect the distribution of power of the postwar era. Some of the more difficult bargains, such as the reorganization of the UN Security Council, have yet to be recast. Furthermore, this agenda for global change requires the transatlantic community to develop in a proactive way innovative and inclusive solutions to global problems and to lead in their implementation through example rather than through domination.

This three-part strategy must be implemented across a range of issue areas. Subsequent sections of this report provide in-depth analyses in four areas: the global economy, global security, energy and the environment, and the global commons. These sectoral analyses identify emerging global challenges and diagnose the shortcomings of existing international arrangements. We conclude the report by offering a set of prescriptive policy proposals that advance the community's values and interests.



THE GLOBAL ECONOMY

The global shift is first and foremost an economic phenomenon. It has taken place against the backdrop of a world economy that has grown from just over USD \$1 trillion in 1960 to more than \$60 trillion today. In the first 20 years of that period, this impressive expansion was driven by the advanced industrial countries of the West. Since the 1980s, however, a number of key economies have emerged from the developing world and prospered.¹ China, as the largest and most dynamic economy in this group, has recorded nearly double-digit annual growth over the past three decades. Today, China is the second-largest economy and the third-largest exporter worldwide.

Government policies in the transatlantic community have promoted the global shift by liberalizing the flows of goods, services, and capital and by eradicating barriers between the major economies. However, while these policies undoubtedly helped to unleash the dynamics of market forces, governance has not kept pace with the dramatic changes in the global economy. Liberalization remains incomplete, and the further development of the global trading order has languished with the WTO Doha Round negotiations. Nor have the United States and Europe succeeded in renovating other aspects of global economic governance: the buildup of global imbalances has been left unaddressed. Furthermore, efforts to contain and control the risks of financial markets presaged by the Asian financial crisis in the 1990s turned out to be inadequate.

The economic and financial crisis of 2008 – 10 dramatically highlighted the dimensions of the shift and the accumulated problems of the West. The crisis, which exploded with the demise of Lehman Brothers in September 2008, was the result of

reckless borrowing and lending, both in the public and private sectors, insufficiently checked by government regulatory and supervisory bodies. To overcome the economic crisis, many governments assumed high and possibly unsustainable level of fiscal debt, and central bank balance sheets have been dramatically expanded. At the same time, the rising economies have emerged from the crisis almost unscathed.

In light of the global shift and the fallout of the financial crisis, the United States and the EU face grave challenges today and in the years to come. Their public finances are in crisis, their economies are out of balance, the international financial system needs a thorough overhaul, the reform of the WTO regime is stuck, and the global institutions designed to address many of these issues have remained unreformed and are out of sync with the new economic realities. America and Europe must play a leading role in resolving these issues and in preventing further economic crises in the future. They need to get their own houses in order, reinvigorate their joint leadership role, and put their relations with China and other emerging economies on a new basis.

TRANSATLANTIC DEBT CRISIS

The economic and financial crisis and the efforts of the United States, the EU, and other governments to stabilize their banking systems and stimulate their economies have led to an unprecedented surge in public debt. The euro area public deficit for 2010 has been estimated at 6.4 percent of GDP and overall government debt at 84 percent, just below the threshold generally considered to lead to unsustainable fiscal conditions. Even more dramatically, the U.S. deficit stood at 10.6 percent and public debt at 91 percent. While governments struggle to get deficits under control, their indebtedness is set to rise further, stabilizing below 90 percent by 2012 in the Eurozone and rising beyond 100 percent of GDP in the United States. These disquieting figures contrast with those of the emerging members of the G20, whose fiscal deficits are projected to remain below 3 percent and debt at less than 35 percent of GDP.

For the transatlantic community, this development has three serious implications. Most importantly, those high, and sometimes unsustainable, levels of debt limit the fiscal room for maneuver. While many emerging economies have embarked on ambitious investments in public infrastructure, healthcare, education, and defense – with China leading the way – the key theme for the United States and the EU for the foreseeable future will be to cut public expenditure. This will enable emerging economies to close the gap in development and competitiveness even faster than before. For the United States and the EU, the situation is aggravated by the salient and to date largely unaddressed fiscal challenges of their aging societies in the area of health care and pension policies. How quickly these challenges can translate into political incapacity was vividly illustrated by the debt crisis in Greece and other economies, which endangered the European currency and revealed the weaknesses among European governments in coordinating their economic and fiscal policies.

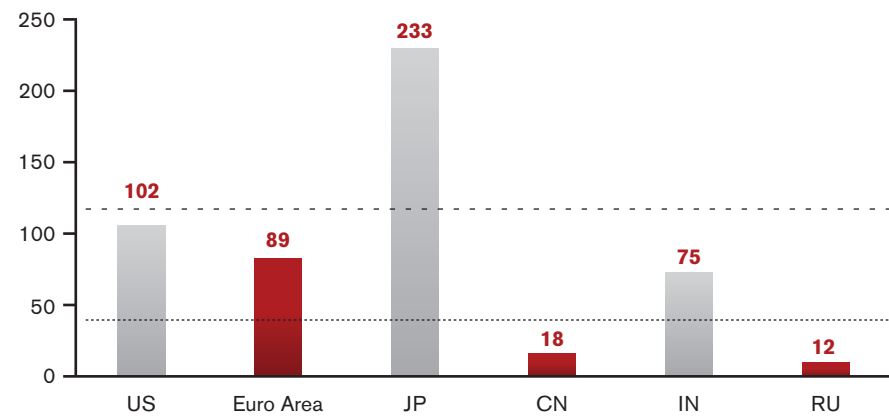
¹ As of the end of 2010, Standard and Poor's classified 19 countries as emerging markets, including Brazil, Chile, China, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. The focus of this analysis is on China.

Transatlantic Challenge – Fiscal and Debt Positions in the G20

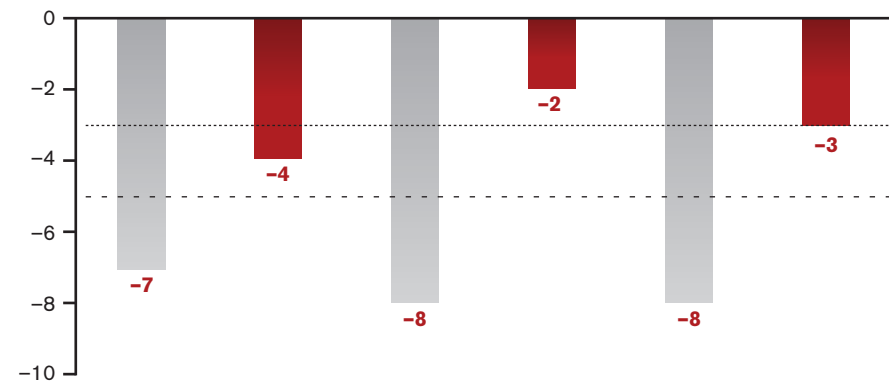
Overall fiscal balances and general government gross debt, % of GDP, estimates for 2012, major G20 economies.

--- G20 advanced economies average
 G20 emerging economies average

Debt



Fiscal Balance



Sources: IMF, own calculations

Second, as financing requirements by the United States and EU governments are expected to remain historically high, the dependence on funding, especially on foreign funding, is set to increase further. China has played an important role in this regard in past years, especially as it became the single largest foreign creditor of the United States. This creates economic and political interdependencies that can lead to a convergence of economic interests among the world's key economies but also increasingly limit the scope for sovereign decisions on fiscal and other economic policies. These interdependencies can lead to serious political disagreement, as demonstrated by the conflict between the United States and China over the valuation of their currencies.

Finally, the political discourse around economic policy and its fiscal implications during the crisis have underlined the wide rift between the United States and key EU governments in their policy objectives and approaches. The right balance between economic stimulus and

fiscal prudence remains a central bone of contention between the two sides, even if the debt crises in Europe's periphery and the threat of sovereign default have tilted the debate toward greater fiscal constraint on both sides of the Atlantic.

These political challenges emanating from the debt crisis not only constrain the options for domestic fiscal policy but also are likely to shape relations among America, Europe, and China in the years to come. The United States and the EU member states will need to reduce public indebtedness decisively in coming years if they want to regain their capacity to act across the full range of policy issues. In order to succeed, they will — given the interdependencies of their economies — need to find ways of coordinating their economic, fiscal, and monetary policies more effectively.

Rising interdependence also makes a strong case for a closer macroeconomic policy dialogue with China. Both the United States and the EU already pursue high-level bilateral deliberations with China. A dialogue will need to be established, with China's critical role as creditor and trading partner firmly in mind.

GLOBAL IMBALANCES

Global economic imbalances are another major political challenge for the transatlantic community. They reflect differences that can be observed between many advanced and emerging economies in economic performance as well as in saving, spending, and investment behaviors. The economic implications can be severe, and the United States and China are the epicenters of the challenges they pose.

The economic imbalances observed between the advanced and emerging economies are reflected in their current account balances. For the United States, current account deficits have accumulated over the past three decades, a product of the country's low savings rates and large outflows of capital to foreign economies. Peaking at more than

\$800 billion in 2006, the deficit narrowed in the course of the economic crisis but is expected by the IMF to resume an upward trend to reach \$600 billion by the middle of this decade. China, in contrast, has benefited from surging exports and incoming investments, accruing a current account surplus of more than \$430 billion in 2008. By 2015 this surplus is expected to widen to more than \$770 billion. In contrast, the EU, has maintained a much more balanced current account performance.

Whether the sizable imbalances of the United States and China are sustainable has been a longstanding issue of debate, a relevant issue in that they are expected to grow still further in the future. Remarkably, the economic crisis has not defused the situation. Despite lower growth prospects in

the United States and a sharply increased rate of public borrowing, confidence in the ability of the largest economy worldwide to satisfy existing and future foreign claims remains sufficiently strong to warrant continued foreign financing. A growing share of the latter originates from China, whose financing of U.S. debt and increasing investments by state-owned enterprises have made an important contribution to maintaining the American deficit.

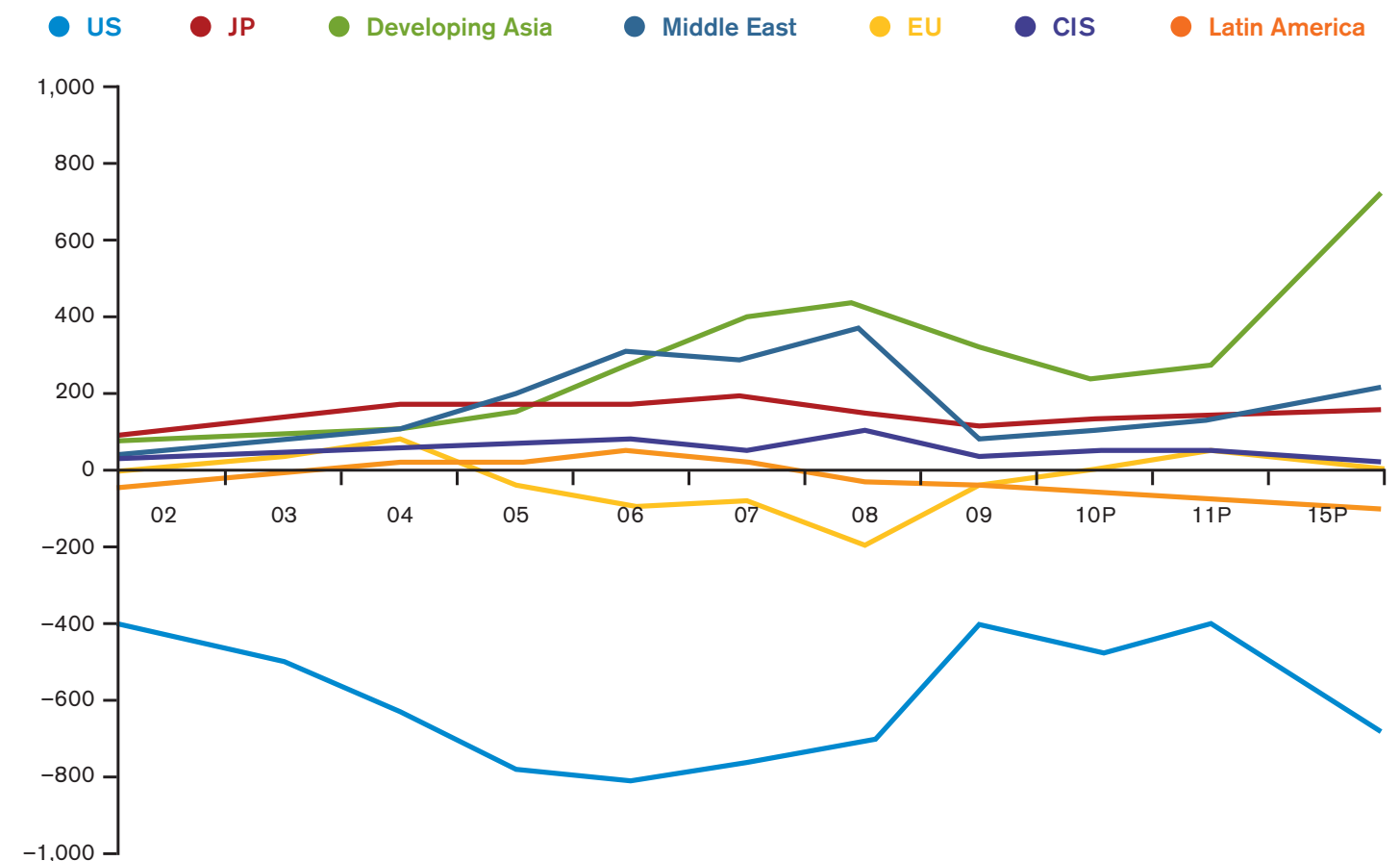
China's rising private and public investments abroad may dampen its growing current account surplus, but this effect is likely to be dwarfed by the growth of the export sector. China is a heavyweight not only in manufacturing and trade but also increasingly in the design and production of advanced technology. The country is also

witnessing a dramatic rise in its official reserves, owing to strong capital inflows. At \$2.7 trillion, China holds the largest pool of foreign currency reserves worldwide. As more than two-thirds of these assets are in dollar-denominated investments already, the scope for additional investments in U.S. assets will be limited.

Since 2010, the United States and China have had major disagreements over the appropriate valuation of the Chinese currency, the renminbi, with the United States claiming that China was keeping its currency artificially undervalued and distorting the terms of trade between the two economies. Furthermore, market forces suggest that the U.S. dollar may be on a trajectory of decline as a global reserve and trading currency. Its share in official

Global Imbalances Set to Aggravate

Balances on current account, USD bn, IMF projections for 2010, 2011, and 2015



Sources: IMF, own calculations

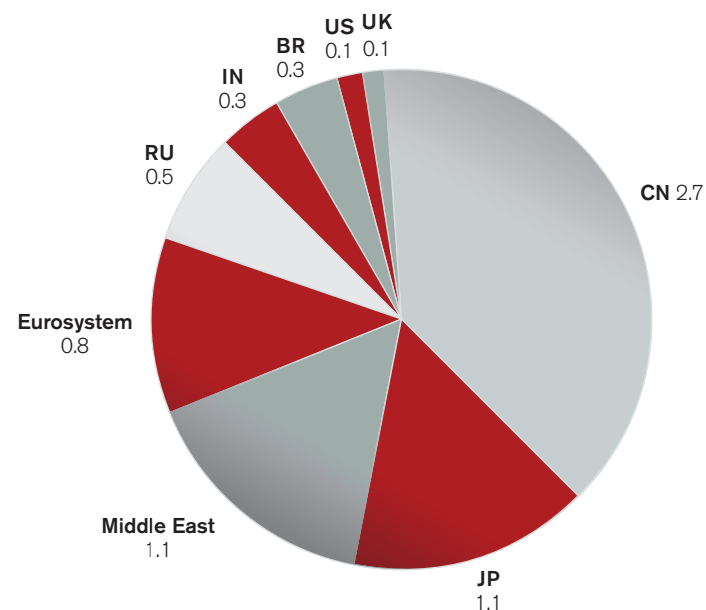
reserves worldwide stands at just over 60 percent, which marks a significant decline from more than 70 percent just ten years ago. Its share in global currency trading has fallen too, although the drop has not been as steep. While some EU member states find themselves with serious fiscal troubles, the euro has remained remarkably solid and may strengthen its position as a reserve currency should the EU succeed in helping Greece, Ireland, and Portugal out of their troubles and in establishing a viable and credible mechanism for managing such situations in the future.

In addition, the renminbi may also enter the game. As the Chinese leadership is implementing a plan to make Shanghai a leading center of international finance, it is likely that the renminbi will become fully convertible by the end of this decade. Important steps have already been taken, including the recent permission to domestic companies to conduct their cross-border settlements in their home currency. While the renminbi is a long way from full convertibility and acceptance as a reliable and trustworthy reserve currency, the potential impact of a third major currency on global markets in the next decades should not be underestimated. Against the background of the substantial fiscal liabilities in the United States and potential inflationary risks in the long term, markets as well as holders of official reserves may be quick to accept alternative and possibly more stable currencies.

In such a scenario, the U.S. dollar will need to compete with the euro and the renminbi in a tripolar global currency regime. Losing in importance as the global currency is not merely a matter of vanity. It may diminish the attractiveness of the dollar among investors and traders and make financing and transactions more difficult and costly. In other words, the benefits of having been the world's leading currency for decades are likely to erode in the coming years.

Global Reserves Holdings Large Stakes in Emerging Markets

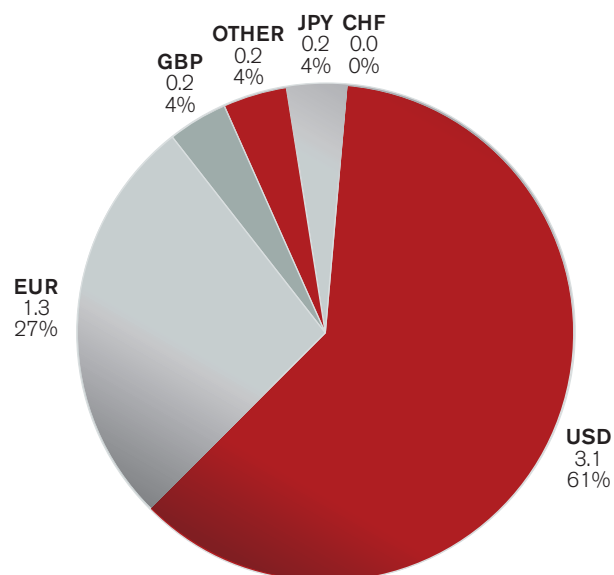
Foreign reserves excluding gold held by central banks, end 2010 USD tr



Sources: IMF, own calculations

Global Reserves Currencies USD and EUR Still Dominate

Currency composition of official foreign exchange reserves, allocated reserves only, value in USD tr, % of total, September 2010



Sources: IMF, own calculations

American and European policymakers should be prepared to face the challenges associated with global imbalances and the evolution of the global currency system and should work closely with their emerging market partners to find suitable institutional and regulatory responses at an early stage. Optimally, joint positions on how to approach these important and sensitive issues will need to be reached at the G20 level. Indeed, global imbalances have been part of the G20 agenda, but so far cooperation has ended at that point. While an accord at the G20 level should be the primary objective, agreement will first need to be reached among the most important protagonists. Most importantly, the United States and the EU must arrive at a joint long-term strategy on managing global imbalances. Equally important, this dialogue will need to be extended to China.

To that end, the United States, the EU, and China should establish a regular, at least annual, trilateral meeting on macroeconomic policy cooperation where they would inform each other about policy issues and measures of common interest in the areas of monetary, fiscal, and regulatory policy. This would be a forum for making domestic policy decisions in a coordinated way. The aim would be to prevent adverse economic developments resulting from inconsistent policy programs in the respective jurisdictions and work toward a mitigation of major balance of payments imbalances and a gradual eradication of bilateral barriers to investment and capital flows. The dialogue should be held at the ministerial level, with the relevant representatives in the area of finance and economics as well as central bank presidents

around the table on a standing basis. On an ad hoc basis, the dialogue could decide to discuss policy matters in other forums and invite representatives accordingly. The dialogue may replace existing bilateral dialogues, and it should be complementary to and supportive of the G20 process.

As part of the reforms of the international financial institutions initiated by the G20, the IMF can play a key role in enabling global macroeconomic surveillance and in finding solutions to tackle global imbalances. The G20 and the members of the IMF should ensure that the institution is adequately equipped to meet its objectives. In addition, the IMF's Special Drawing Rights may play a role in facilitating the internationalization of currencies, especially the renminbi. The options of including the latter in the SDR

The Renminbi: How Much of a Threat to the U.S. Dollar and Euro?

It is too early to think that the renminbi is poised to replace the greenback as the world's top currency — notwithstanding growing efforts by China to internationalize its currency. The status quo is one reason why the dollar's reign will continue, with the dollar accounting for about 85 percent of all foreign exchange transactions today, versus 0.1 percent attributed to renminbi transactions. This financial arrangement was created in the postwar climate and has served the world rather well over the past half-century; overturning this arrangement will take time and a sustained coordinated effort on the part of China, Russia, and the Middle East oil producers, with all parties having their own reasons to resist a dramatic overhaul of the dollar-based international monetary system.

True, with the United States bent on running large federal budget deficits in the medium term, one can certainly question the sustainability of the dollar's global supremacy. Indeed, the euro has already emerged as a legitimate alternative to the

dollar, accounting for roughly 27 percent of the total reserves of central banks at the end of last year. Today, the world has two viable reserve currencies, with the renminbi the most likely contender to make it a tripolar currency world.

For that to happen, however, China needs to overhaul its financial infrastructure significantly. A world reserve currency needs to be backed by strong and transparent financial institutions, robust financial regulations, and clear property rights; other prerequisites include a liberal and open capital account, a deep and sophisticated debt and equity market, and a convertible currency. China does not score very well on many of these metrics.

An inconvertible currency allows China to manage its exchange rate according to its overriding interests, which at this juncture pivot on maintaining China's export competitiveness. Not until the country reorients its growth model away from investment and exports and toward personal

consumption will authorities feel at ease with the foreign exchange markets setting the price of the renminbi. Full currency convertibility is needed before the renminbi can be even remotely considered a reserve currency, a path the Chinese will tread very carefully.

That said, divergent growth between the United States and China over the next decade could accelerate the pace by which the renminbi emerges as a reserve currency. With the U.S. mired in debt, foreign investors may decide to boycott the dollar in the future, opting instead to invest more in China and its currency. Such a scenario would give Beijing the confidence to push ahead with financial reform, including currency convertibility, and hasten the trend toward a tripolar currency world.

Joseph P. Quinlan, Bosch Fellow 2011, The Transatlantic Academy

basket should be reviewed once the relevant preconditions, including full convertibility, are met.

POST-CRISIS FINANCIAL MARKET REFORM

Financial market reform after the financial crisis of 2008–10 is the third important political project for the United States, the EU, and other economies worldwide. The reform efforts to date indicate the serious weaknesses in the transatlantic relationship and underline the urgent need for greater cooperation across the Atlantic. A stronger joint approach among the G20 for regulation and supervision of financial markets promises a more level playing field of regulation and a lower risk of regulatory arbitrage by market participants. Establishing robust rules across the G20 would raise the overall level of financial market oversight substantially.

Despite a promising start, the G20 process and especially transatlantic cooperation on financial market policy have reached a low point. In practice, U.S. and EU policymakers have barely moved past the minimum consensus on key agenda items and broad policy directions, and the implementation of many G20-agreed reforms in the United States and the EU has been uneven. Given the challenges of building a more stable and resilient international financial system at a time when financial globalization is likely to resume at a brisk pace, the lack of policy coordination between the United States and the EU is counterproductive. The United States and the EU should be credible promoters and forceful drivers of financial market policy coordination in the G20. This will require that they consistently implement the international standards promoted at the G20 level. Furthermore, they should attempt to reach joint policy solutions bilaterally and at the G20 level. The credibility of Americans and Europeans as promoters of free capital flows and as key innovators in the global economy will depend in the long run on their ability to be good role models and achieve a more

integrated financial market at the transatlantic level. At some point they will have to embark on the journey toward a single transatlantic financial market.

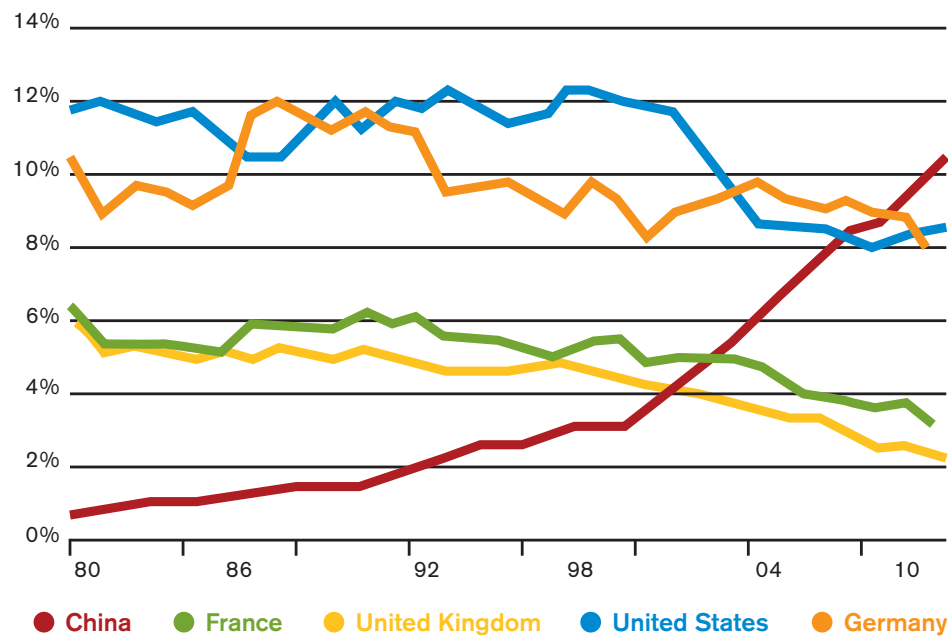
The need for greater transatlantic policy coordination becomes even more pressing when one considers the competitive challenges America and Europe are facing as their global influence is set to decline. The United States and the EU may still be the dominant financial market, providing more than three-quarters of financial services worldwide. This, however, does not change the conclusion that their historic position is increasingly being challenged by emerging competitors as the world of finance moves toward a multipolar order. China alone can be expected to raise its share in global financial markets by the end of the current decade to 13 percent in banking, 5 percent in debt securities, and 16 percent in stocks. And these may be conservative estimates, considering that China's State Council has committed to an extensive program of turning the country into a global financial center by 2020, speeding up the liberalization of its economic and regulatory policies as well as capital markets. If implemented, this program is likely to turn the country into a formidable force in global finance.

THE TRANSATLANTIC COMMUNITY IN WORLD TRADE

The open global trading order under the General Agreement on Tariffs and Trade/World Trade Organization (GATT/WTO) represents one of the great success stories of the transatlantic community and an important institutional legacy for the future. The multilateral trade regime helped to dismantle trade barriers between countries, facilitating the flow of goods and services across borders. As a result, global trade has become increasingly complex, regionalized, and multidimensional, as manufacturing shifted to emerging markets and intra-industry trade and also trade in services expanded. The multilateral trade regime has also adapted most easily and quickly to the "global shift." Owing to a bargaining protocol that provides a seat at the negotiating table for the largest traders, the WTO has provided a seamless transition for the inclusion of rising powers such as China, India, and Brazil among the major negotiators of the Doha Round.

Export Performance

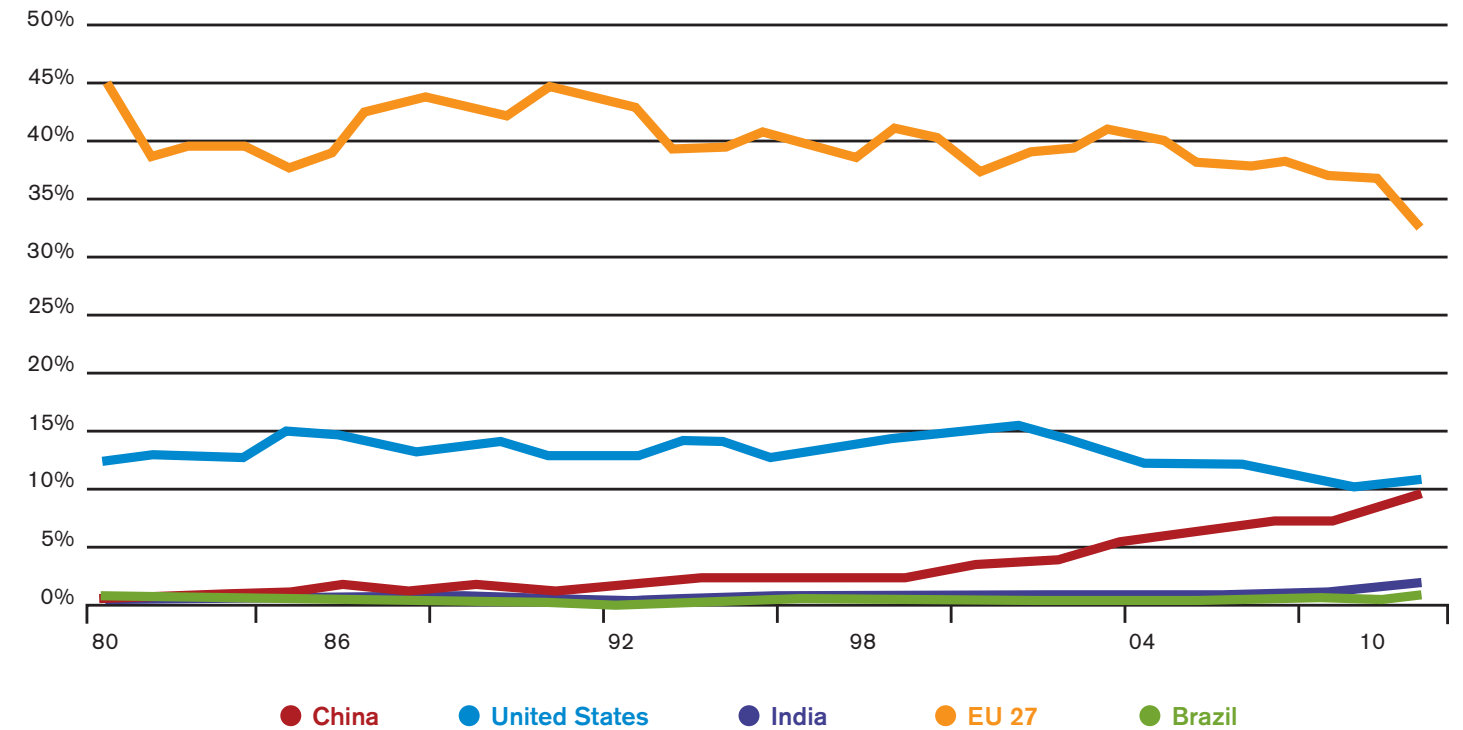
Percent of World Total



Sources: IMF

US, EU and Rising Powers in World Trade

Percent of World Total



Source: IMF

Among the rising powers, China is undoubtedly the most important economy to join the WTO since its inception. China now stands as the third-largest trader in the world and wields commensurate power in global trade governance. With its accession to the WTO in 2001, China committed itself to an open trading order and provided Beijing's reformist leadership with an external anchor for its domestic economic reform. China, India, and Brazil have gained greater voice in the Doha Round talks and will be critical actors in its successful completion. China also initiated the ASEAN-China free trade agreement, which came into effect in 2010 and codifies the largest free trade area in the world in terms of population and third in terms of nominal GDP. It has been one of the most active participants in the free trade agreements network in Asia, with 13 agreements currently in effect and another 13 in the process of formation as of January 2011, according to the Asian Development Bank. China's meteoric rise in global trade and in the international economy more

broadly over the last decades points to a future trajectory in which the Chinese economy will surpass that of the United States in the next two decades.

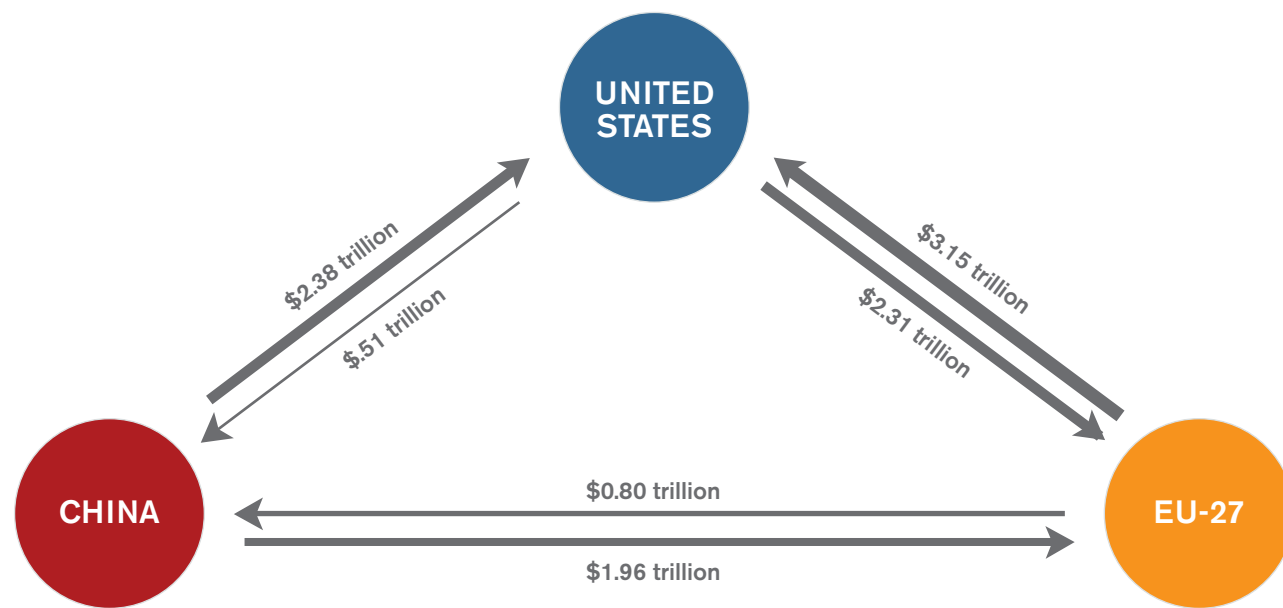
The emergence of new trading powers from the developing world, as they join the standing powers of the transatlantic community, introduces a new and critical uncertainty: who will lead the global trading order? Leadership in defining global trade governance for the 21st century is vital for fostering world economic recovery through free trade and for addressing the two most pressing challenges for global trade governance, namely the conclusion of the Doha Round and the management of free trade agreements. Stewardship of the multilateral trading system now requires agreement among a much more heterogeneous group of actors. Without the completion of an ambitious Doha Round, the multilateral trading order will likely give way to the erosion and diffusion of global trade governance into a "spaghetti bowl" of

limited free trade agreements that now exist side by side with the WTO and continue to proliferate, many of them shallow in their liberalization commitments and unlikely to expand liberal trade significantly.

While new trading powers have risen and the open multilateral trade order has become increasingly fragile, the trade policies of the transatlantic community have drifted. The United States and the EU have been rivals, pursuing their economic interests separately as they compete for opportunities presented by the dynamic markets in these emerging economies. The transatlantic community also has a long record of trade conflicts over issues such as subsidies for the civil aircraft industry, genetically modified organisms (GMOs), and bananas. Yet the transatlantic actors also share a common core interest in upholding and advancing multilateral trade liberalization. No matter how fierce competition is, nor how many trade disputes flare across the Atlantic, this is nothing more than business as usual and economic

Trilateral Merchandise Trade Flows

1999 through 2009



Source: International Monetary Fund
Data through December 31, 2009
All bilateral trade flows based on import statistics reported by the host nation

competition between longtime friends and partners. The transatlantic community is the largest integrated economy in the world, now and for the foreseeable future, with trade and investment flows that greatly exceed those with China.

STRENGTHENING GLOBAL TRADE GOVERNANCE

For the transatlantic community, the key challenge in global trade governance is to revitalize and deepen the open multilateral trade order through the auspices of the WTO and ensure the participation of the rising powers in a liberal trading order. The United States and Europe should pursue a two-pronged strategy that allocates resources equally between two main objectives: completing the Doha Round and forming free trade agreements that enhance trade multilateralism. Beyond these main objectives, the transatlantic community should also strengthen the WTO as an institution, especially by using its dispute settlement mechanism.

First, the transatlantic actors should fully commit to delivering the Doha Round. Recent signs point to a revival of interest in completing the Doha Round, and there may now be a small window of opportunity even now, during the most serious global economic crisis since the Great Depression, as another presidential election looms closer in the United States and France and a transition of power is imminent in China. A completed Doha Round would go far in allaying fears of retrenchment in international trade and in pushing forward the recovery from crisis. In pursuing this objective, the EU should lead as the official “broker” in constructing a compromise package endorsed by the United States, the EU, and the rising powers China, Brazil, and India that is acceptable to the developed and developing worlds alike. The EU could be pivotal in breaking the impasse over contentious issues that impede the negotiations, such as the special safeguard mechanism in agriculture that stalemated

the last talks, and successfully completing negotiations over the remaining items in a Doha package. The United States, in turn, needs to secure domestic political support for a Doha package. To do so, the Obama administration must secure passage of the free trade agreements with Colombia, Panama, and Korea, currently pending in the U.S. Congress, so that resources may be wholly deployed to ensure successful approval of a Doha package. Equally important, President Obama should request, and Congress should grant, trade-promotion authority, which is critical for signaling to WTO members that the United States is indeed committed to a Doha package that would not have to be renegotiated in the domestic political arena.²

Second, the United States and the EU should continue to pursue separate free trade agreements as they deem appropriate. As the proliferation of free trade agreements is likely to continue unabated, the United

² Trade-promotion authority (TPA), also known as “fast-track” authority, allows the President to submit to Congress trade agreements that may be approved or disapproved but may not be amended or subject to filibuster.

States and the EU have the opportunity to conclude trade agreements that are strong models for advancing multilateral trade liberalization. The existing trade agreements concluded by the United States and the EU already share provisions in areas such as sanitary and phytosanitary measures, technical barriers to trade, antidumping,

state aid, trade in services and trade-related intellectual property rights. The United States and the EU should actively work together to pursue a set of “common standards” or “core provisions” in these WTO-plus areas, which fall under the WTO mandate but go further in their liberalization commitments. In doing so, they can define

the essential levels of commitments expected from agreement partners and thus advance a common transatlantic agenda for trade liberalization. Such a coordinated approach to free trade agreements would effectively multilateralize them, even if they are negotiated separately. Overlapping agreements are not as efficient in achieving

A Transatlantic Free Trade Agreement: Pros and Cons

The idea of a Transatlantic Free Trade Area (TAFTA) was formally articulated in 1995 by the German foreign minister Klaus Kinkel, building on an initial proposal by Canadian minister of international trade Roy MacLaren. Many governmental and nongovernmental initiatives followed, registering some 34 bilateral U.S.–EU agreements by 2006. These efforts toward institutionalizing market integration, however, have not been successful, though the pace of market integration itself has not slowed. Chancellor Angela Merkel’s proposal in 2006 to revive the idea of TAFTA renewed attention to this initiative in some circles, especially at a time when concluding the Doha Round seemed only a distant possibility.

The major drawback of a TAFTA is that it would undermine the WTO, signaling a lack of confidence in the multilateral trade regime by two of its largest economies. It would constitute an effective abrogation of leadership by the transatlantic actors and a severe loss of momentum within the multilateral regime for sustaining and advancing a liberal trading order. Moreover, its consequences would not serve transatlantic interests. A transatlantic FTA would undoubtedly be WTO-plus, a high-standard FTA that would advance trade liberalization, codifying rules in the new trade-related areas of services, investment, and intellectual property rights. This high-standard FTA could act as a “magnet” for other additional FTAs with like-minded states and states willing to accept strong liberalization commitments in exchange

for access to the largest combined economy in the world. However, it would also likely exacerbate regionalism and the developmental divide. A TAFTA would be one “hub” in world trade, coexisting with others, such as the expansive regional coverage represented by the ASEAN-China FTA, that mostly include developing countries and offer an institutional alternative for others unable or unwilling to make high-standard commitments.

Second, the transatlantic community does not actually *need* an FTA. Market-led integration so far has been effective without institutionalization at the transatlantic community level, a strong indication that private economic actors have successfully negotiated and enforced agreements among themselves. Indeed, the contracting costs of a transatlantic community-level agreement are almost prohibitive, given the scale of negotiations that would be required to cover the scope and depth of economic ties between the United States and the EU. Reliance on market-led integration by economic actors, however, greatly reduces contracting costs as the areas of negotiation are more narrowly defined between firms. On the enforcement side, there is no problem of “credible commitment” between economic actors in the transatlantic community that requires a governmental-level agreement to enforce legal obligations. Put differently, there is no problem of “trust” among actors in the transatlantic community. As deep and wide as the disagreements are across

the Atlantic on various trade issues, these reflect the difficulties of contracting, or coming to agreement on rules in the first place. Once agreement is reached, however, there is ample “trust” that signatories will abide by agreement provisions, and strong avenues of legal recourse exist in the transatlantic community and in the WTO to handle violations.

Finally, in spite of the potential setback for the WTO and the lack of necessity for a TAFTA, such a fundamental move may be seriously considered if the Doha Round should fail to be completed. The global trading order lacks an alternative to the WTO for building on the accomplishments to date of the GATT/WTO system. The WTO agreements define the future terrain of multilateral trade liberalization, but they are only a modest beginning. For the global trading order to continue to address trade-related governance issues, leadership is still necessary. If it cannot be achieved through a successful conclusion to the Doha Round, then a TAFTA would provide an important alternative path for trade governance, even if it is limited to those willing to participate. A TAFTA following the failure of Doha may galvanize countries willing to make high-standard commitments. Without a successful Doha round, a TAFTA may be the only viable alternative for advancing trade liberalization beyond the current mandate of the WTO. Nevertheless, TAFTA will likely be a distant second-best option for advancing multilateral trade liberalization.

common liberalization goals, as the United States and the EU together would “pay twice” for the same liberalization commitments. However, they provide valuable flexibility for the United States and the EU in pursuing individual political goals, such as rewarding economic reform among allies, advancing a strong labor and environmental agenda, and promoting development and democracy. Separate agreements also allow for variations in provisions as the transatlantic actors balance their common interest in trade liberalization with responses to demands from domestic interest groups and differences in their foreign policy agendas. In the case of free trade agreements, “paying twice” makes political sense.

Beyond the two main objectives of transatlantic cooperation, the United States and the EU should continue to strengthen the WTO itself, in particular through active use of the dispute settlement process under the Dispute Settlement Understanding (DSU). The DSU process allows members to self-enforce the rules of trade as enumerated in the WTO agreements. It is accumulating an ever-increasing number of cases that set precedent, perform rule-interpretation functions, and resolve trade conflicts between members.³ The heavy use of the DSU is evidence of the WTO's success in its judicial function, though it does carry the risk of the DSU also taking on rule-making functions beyond its juridical authority in areas that have yet to be collectively negotiated by WTO members. Nevertheless, as we await the fate of the Doha Round, the transatlantic community should do its part to ensure that existing WTO agreements continue to be interpreted and enforced through the DSU.

FOREIGN DIRECT INVESTMENT

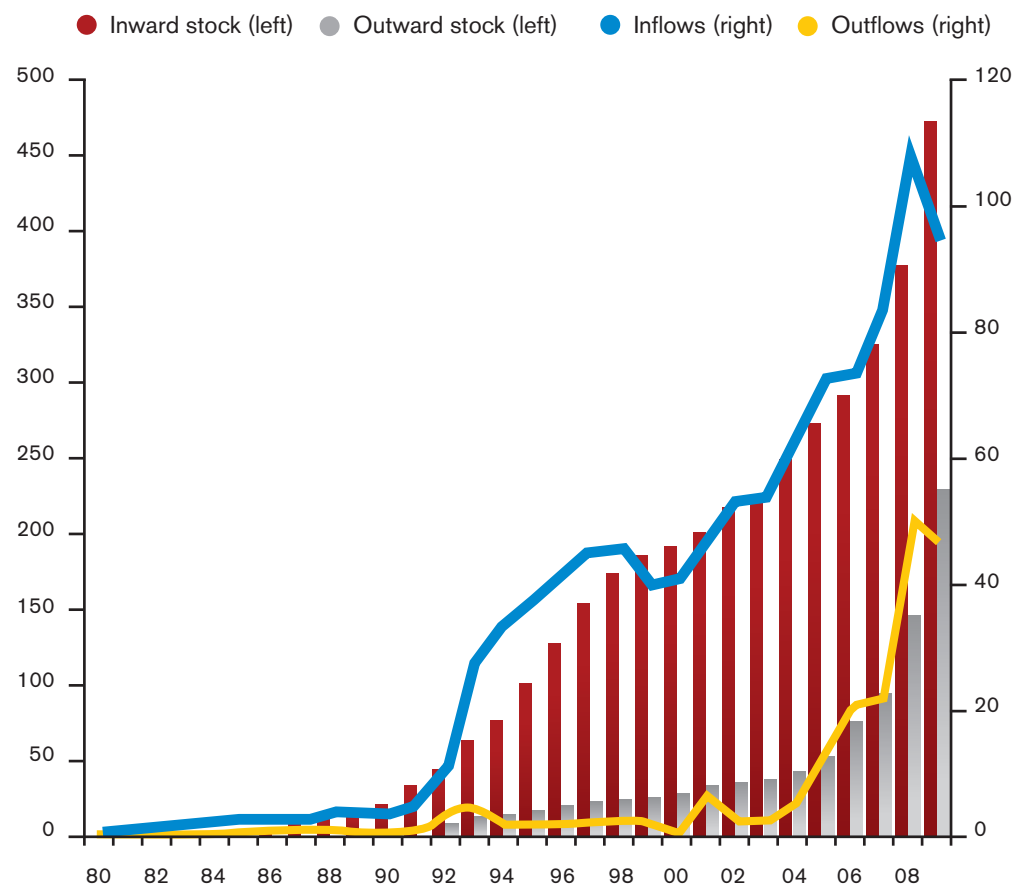
Through rapidly expanding foreign direct investments (FDI), emerging economies have entered the global competition for ownership of assets. With their rising private, corporate, and public wealth,

they are playing an increasingly active role as direct and portfolio investors, not least through sovereign wealth funds, at the international level, thus challenging the traditionally dominant positions of the United States and the EU as global investors. This trend is likely to accelerate further in the coming years as part of the fallout from the economic and financial crisis.

Again, the rise of China in world FDI activities offers a particularly telling perspective on this broader trend. Investment relations among America, Europe, and China are characterized by four key conditions. First, the United States and the EU remain the most potent international investors, with 23 percent and 35 percent of global annual investment outflows, respectively, and a combined \$39 billion of FDI in China between 2007 and 2009. Second, Sino-transatlantic investments have remained of limited relevance for China, and vice versa. U.S. and EU investments in China have been widely exceeded by those from Japan, South Korea, and Taiwan. Conversely, FDI in China makes up only 1 percent of EU and U.S. cross-border investments. Third, foreign investments in China nevertheless play a key role in its development. The more than 430,000 foreign-funded enterprises directly employ 45 million people and account for

Chinese Foreign Investments Still Slow But Rising Fast

Inward and outward foreign direct investments in China, stocks and flows, USD bn



Sources: UNCTAD, own calculations

³ Though the U.S. and European Union comprise the majority of the 420 cases currently filed under the DSU, newcomer China has also logged a significant case history with 7 cases as complainant and 21 cases as respondent.

28 percent of China's industrial output and 56 percent of exports. Finally, China is on the rise as an international investor. The strong growth of investments into China of more than 20 percent annually in the past two decades has been vastly outpaced by the dynamics of China's investment abroad. Outflows rose by 64 percent per year in that period, leading to an outward stock of investments of \$230 billion worldwide, impressive even if still substantially lower than the \$473 billion of inward stocks.

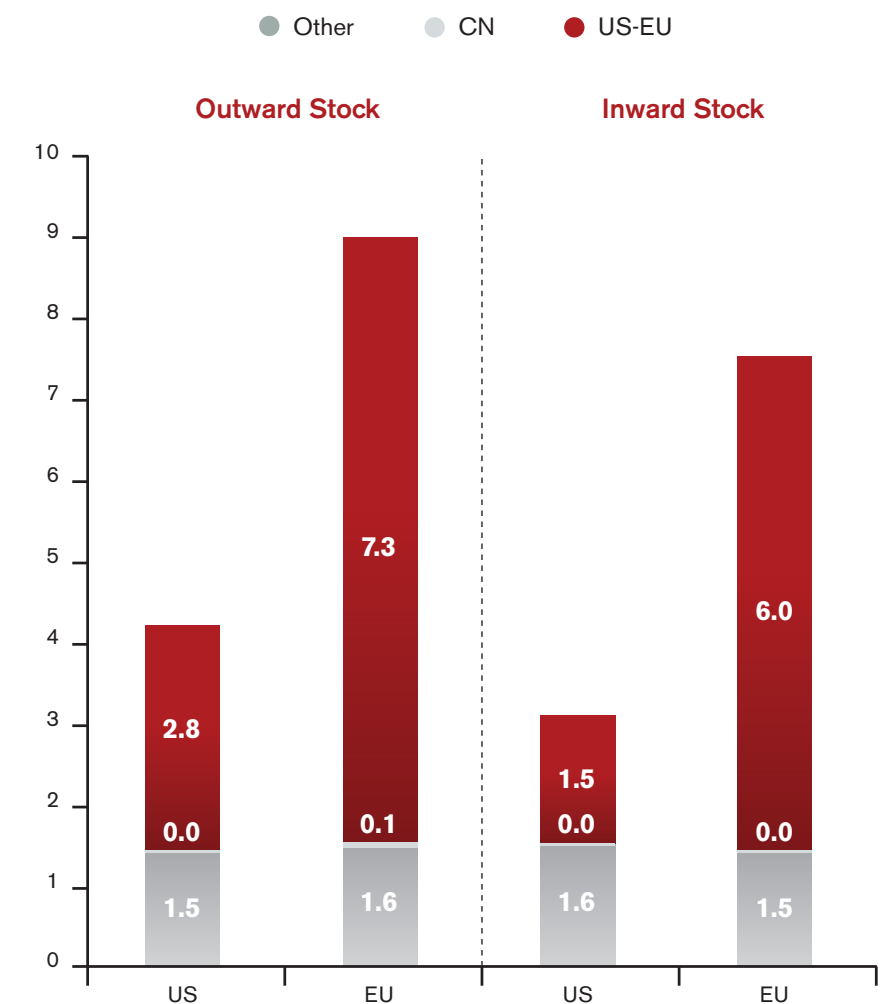
The benefits of foreign investment are obvious. At the transatlantic level alone, more than 12 million jobs are at present believed to be based on U.S.–EU investments. In relation to China, American and European corporations through their FDI have been able to tap the growing Chinese market and use it as a competitive location for export production. China, in turn, has benefited from new products and services and the transfer of technology and expertise.

At the same time, there is ample scope for enhancing Sino-transatlantic investment relations. Not only do the data suggest that these relations have only just started to flourish, investment flows are also still hampered by significant barriers to market access between the United States and the EU on the one hand and China on the other. China retains substantial barriers to FDI in the form of limitations on foreign ownership, investment rules, licensing regimes, and discriminatory legal and regulatory requirements. On the other hand, China is increasingly concerned about resistance to its rising direct investments in the United States and the EU.

In theory, a multilateral agreement on investments should optimally provide international standards so as to liberalize cross-border investments, comparable to the WTO framework established in the context of international trade policy. In practice, such a multilateral agreement has remained out of reach, owing to concerns in many OECD members and beyond about the potential

US and EU FDI China With Still Minor Role

Outward and inward stocks of foreign direct investments of US and EU, USD tr, end-2009



Sources: Eurostat, U.S. Bureau of Economic Analysis UNCTAD, own calculations

impact of critical foreign investments on national security. In contrast to the WTO regime, foreign investment policy has remained highly fragmented. While the OECD has made great efforts at establishing principles for sound investment policies, they remain bilateral or at best regional in nature, with the number of bilateral and international investment agreements and double taxation treaties now totaling more than 13,000.

Nevertheless, policymakers have responded to the growing importance of cross-

border investment flows with a number of policy measures. The G20 has committed to maintaining and promoting open investment policies through the OECD and beyond, despite the initial temptation of responding to the economic and financial crisis by limiting foreign capital flows. This commitment should be observed closely. In addition, consideration should be given to complementing existing OECD principles with a model bilateral investment treaty, with the aim of successively harmonizing the provisions in bilateral and multilateral agreements.

In the context of their third-country dialogues, the United States and the EU have addressed investment barriers in their bilateral economic dialogues with China. To enhance the effectiveness of these diplomatic efforts, Americans and Europeans should seek closer coordination and intensify their work with China. Calls for open investment policies by Americans and Europeans will lack international credibility as long as the two sides fail to resolve the remaining investment barriers between themselves. Reportedly, these include restrictions in areas such as aviation, science and technology, telecommunications, energy and maritime transport, and a host of service activities. The U.S.–EU Investment Dialogue will need to resolve these issues.

In terms of national investment policies, the United States and a number of EU member states tightened their frameworks in light of rising foreign investments, especially from sovereign entities in emerging economies. Governments should use these processes prudently and observe OECD investment principles. On the EU side, the single market must be complemented by an EU-wide investment policy aimed at providing harmonized rules for foreign investors.

Foreign investments remain one of the most controversial policy issues concerning the United States, the EU, and China. The asymmetry in market access between the United States and the EU on the one side and China on the other is a serious problem that places stress on Sino-transatlantic economic relations. But the United States and the EU have also failed to resolve important remaining barriers. In order to reap the full benefits of international direct investments, all three parties should cooperate closely as long as a multilateral solution remains politically out of reach.

ECONOMIC GOVERNANCE IN A MULTIPOLAR GLOBAL ECONOMY

With the G20 as the new forum of top-level economic policy coordination, global economic governance could make a quantum leap forward. The rationale of the G20 process was spelled out clearly at the first high-level meeting in November 2008. The two goals of the G20 are, first, to intensify policy cooperation across a broad range of economic policy issues and, second, to extend the circle of decision-makers to include key emerging economies. By including key emerging economies in

global economic policy coordination, the forum promises a more sustainable policy framework for the post-crisis environment.

The potential benefits of G20-level political cooperation are substantial. By intensifying policy cooperation and extending it to key emerging economies, a dialogue on macroeconomic policy options has become feasible among the governments that represent more than 80 percent of GDP and over two-thirds of the world's population. In financial market policy, a joint approach to regulation and supervision increases the overall level of financial market oversight and promises a more level playing field of regulation and a lower risk of regulatory arbitrage by market participants. In addition, closer cooperation among the supervisory authorities may contribute to a more effective handling of cross-border risks for international capital flows and transnational operations of financial firms.

However, two years after the first G20 summit meeting in Washington in November 2008, optimism has given way to sober realism. Reaching consensus among the G20 participants has proved a challenging task, reflecting the difficulties inherent in

an enlarged intergovernmental process. The likelihood of reaching agreement among the participants in the policy process diminishes with larger numbers and the heterogeneity of individual interests brought to the table. Moreover, the unexpectedly quick economic recovery after the crisis in many parts of the world has substantially diminished the sense of urgency for joint solutions. Cooperation may be further stymied by the multitude of negotiating bodies involved, especially as membership varies across the G20, the IMF, the WTO, the Financial Stability Board (FSB) and others. Finally, the question of the right scope of the G20 remains a latent issue, reflected in the changing list of observers that hosting governments have invited to summit meetings.

While all these difficulties play an important role, effective leadership is the key to an effective G20. The most important political disagreements observed so far have occurred between the United States and the EU, and occasionally with China. Taking their dominating political and economic weights and their critical role in G20 negotiations together suggests that the G20 can only be effective if the three parties arrive at consistent policy positions. A systematic triad between the United States, the EU, and China, as discussed above, would be an important step toward this objective.

Second, in the medium to long term, member states should consider the possibilities for institutionalizing the G20 as a standing coordinating framework. Measures may include a return to semi-annual meetings that would enable more intensive deliberations on the wide range of issues discussed at the summit level. Establishing a secretariat could promote greater consistency in the pursuit of a joint agenda and may facilitate mediating the discussions between the participating parties. Finally, ministerial-level cooperation can be strengthened. The existing meetings at the level of finance ministers have proved to be an important element in supporting and preparing top-level summit meetings as well as in enhancing mutual understanding

of diverging policy positions. Given the breadth of the G20 agenda, ministerial meetings may benefit from more frequent interaction and careful preparation also at the staff level. In addition, in view of the broad range of issues in play, ministerial portfolios other than finance may be brought in as required.

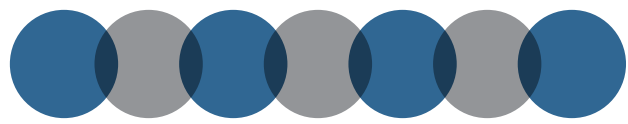
The scope for institutionalizing the G20 process remains limited for the time being. Sovereign policymaking based on national interests continues to be the basis for international policy cooperation, and even the current ad hoc format of the G20 marks an impressive and previously inconceivable progress. Making the process more systematic as described above, however, is a viable way toward effective governance of the global economy.

The G20 Political Agenda: Comprehensive Program for Global Reform

The G20 was started as an emergency meeting to take immediate measures to prevent the financial crisis from turning into a global economic depression. The G20's policy agenda has widened and deepened considerably over subsequent summits.

The Key Areas of Activity Today Include:

- Framework for Strong, Sustainable, and Balanced Growth
- International Financial Institution Reforms
- Financial Sector Reforms
- Fighting Protectionism and Promoting Trade and Investment
- Seoul Development Consensus for Shared Growth
- Financial Inclusion
- Energy Security
- Climate Change and Green Growth
- Anticorruption



GLOBAL SECURITY

The transatlantic community, and particularly its core security institution, NATO, was forged during the Cold War as a response to the imminent and proximate threat from the Soviet Union and its allies. With the collapse of the Soviet Union two decades ago, NATO's original objectives were realized, without a threat of comparable magnitude emerging to replace it. Declaring a peace dividend, NATO members substantially reduced their forces, and the United States and Europe concentrated on building a united, free, and peaceful Europe. In both of these periods, the West was extraordinarily successful in achieving its major historical aims, namely the containment and defeat of communism while avoiding war and the expansion of the zone of peace and prosperity across most of the continent. These successes have raised questions about the continued relevance and purpose of the NATO alliance and the transatlantic security community.

The rise of interdependence, the diffusion of global power, and the growing fragility of states in many parts of the world have created new vulnerabilities, threatening individual, national, and global security. Solely national security efforts will be insufficient to contain risks and manage threats, and international cooperation among both states and nonstate actors will be necessary. To carry out its stated goals of collective defense, cooperative security, and crisis management, NATO will increasingly partner with actors outside its traditional territory. To the extent that China creates widespread anxiety among its regional neighbors, the United States will increasingly be called on to bolster its security capacities and relationships in Asia. At the same time, nuclear arsenals,

proliferation, and terrorism will require further international governance, which will be difficult to achieve in a more multipolar world.

NATO AND THE EUROPEAN NEIGHBORHOOD

With the economic and military rise of China and Beijing's growing regional assertiveness, the United States has already begun shifting its military assets and diplomatic attention forcefully and dramatically toward the Pacific and Indian oceans. This development builds on the substantial and well-established American defense commitments to Japan and South Korea, as well as longstanding U.S. military relationships in Southeast Asia. Moreover, since the establishment of the People's Republic of China in 1949, the fate of Taiwan has been inextricably tied to the American security guarantee, and this commitment, more than any other, has put the United States at odds with China in the region. In contrast, with the end of colonialism, Europe no longer defends major strategic interests in the Asia-Pacific region, its increasing dependence on economic relationships with China and other Asian countries notwithstanding.

Sustaining a common transatlantic security policy will hinge upon the ability to convert these differences into an effective division of labor. Such a new arrangement should not be the result of an American *fait accompli* and should not imply that the Atlantic partners are going their separate ways but rather that they will coordinate their efforts to exploit their different strengths. This will require both the United States and Europe to adjust their longstanding attitudes toward American involvement in the continent's security affairs. Although a legacy of the Cold War, American dominance in European security has persisted over the past twenty years even in the face of changes in the global security environment. The United States, despite support for greater European capacity in foreign and defense policies, has also been ambivalent about it, fearing a possible decline in American influence, a diminishment of NATO's significance, and even the creation of a possible future rival. Going forward, the United States and Europe should agree that Europe will take primary responsibility for security and stability on the continent and in the immediate neighborhood.

This division of labor will entail a new pattern of commitments. The United States will remain a key player in dealing with Russia on strategic nuclear arms reductions, tactical nuclear weapons, ballistic missile defense, and conventional arms reductions. However, as NATO increasingly responds to common threats arising in distant parts of the world, the EU should assume the leading role in engaging Russia to resolve conflicts in its neighborhood. In pursuing these objectives, Europe should employ and enhance a full panoply of instruments, ranging from economic associations and assistance for the development of civil society and democracy to peacekeeping forces. Europe should also build on its Mediterranean presence and past efforts in places such as Cyprus and Lebanon to advance economic, political, and social development in societies undergoing rapid transformation.

In addition to relying on its traditional strengths as a "civilian power," Europe will need to consolidate and revamp its military capabilities. To date, the Europeans have lagged in meeting

even their own relatively modest military and civilian goals despite the establishment of a European Security Strategy and a European Defense Agency. Overall Europe spends a significant amount on its military, but these resources are inefficiently deployed due to duplication and waste

across separate military establishments and the failure to fulfill a common vision. The United Kingdom and France provide a good model for other European countries by agreeing, for example, to jointly operate aircraft carriers and by pooling research and development. In addition, the new French

military base in Abu Dhabi is a welcome indication of the greater willingness to respond to shared transatlantic concerns over the Iranian threat and the security of oil supplies through the Strait of Hormuz.

China and Europe – An Imperfect Partnership

Faced with an international environment fraught with perils for the stability of authoritarian regimes after the "Jasmine revolutions" in the Maghreb and the Middle East, and absorbed by a critical transition in the highest echelons of the communist party in 2012, it is understandable that China's top leaders should have a domestic focus in their policy calculus.

China's relations with the European Union thus remain "aspirational" in principle, and are firmly underpinned by pragmatic considerations. Chairman Mao once classified Europe as the "secondary intermediate zone" – a useful counterpoint to the two superpowers. Europe was later seen as instrumental in overcoming the most acute phase of the PRC's isolation after Tiananmen, and as a promising new pole in the context of an increasingly multipolar international system. When Brussels bowed to US pressure and chose not to lift the EU arms embargo against China in 2005, however, Europe's salience as an "independent" interlocutor in Beijing's eyes declined. It dropped further in 2010, when the Union proved unable to reach consensus among the 27 member states to formally recognize the PRC as a market economy.

Brussels' lack of military assets and limited strategic engagement with China's regional security issues (Over the last ten years,

European military expenditure is estimated to have grown at a mere 7%, compared with 71% in East Asia) ensure that on the security front the EU is of little interest to China. However, the EU's complex politico-bureaucratic process and the growing relevance of the European Parliament's role in the Union's post-Lisbon institutional framework, have worked to make EU-China political relations much more salient, and much more uncomfortable. The European Parliament has long had a critical attitude towards China's human rights record, reflecting widespread public sentiment in the Old Continent. Multiple surveys show that in none of Europe's major countries does a majority of respondents harbor a favorable view of China, with critically low rates in Germany (30%), but also in Turkey (20%).¹

Business circles too are wary: restrictive public procurement policies enacted by Beijing to boost indigenous technologies, coupled with an increasingly sour business climate for foreign companies in China and the endurance of problems in intellectual property rights protection are blamed by European executives for the EU's trade deficit with the PRC (128 billion Euros in 2009). There is not room for much optimism for the reduction of the number of anti-dumping measures taken by the EU against products of Chinese origin (some 55 out of the 135 in place as of 28th February

2011, worth over 20 billion Euros in lost trade).

The strategic partnership between the EU and the PRC launched in 2003 has scored tactical points (such as Beijing's support for the Euro during the 2010 sovereign debt crisis in fiscally weaker states of southern Europe) but has not yet proved able to rise to the long-term challenge of a more effective global governance. The main stumbling block is the incompatibility between the EU's normative agenda and China's core interest in regime stability. The PRC's evolution from the totalitarian Maoist republic into a more stable system of state-led capitalism and consultative Leninism has not rendered it less impervious to the engagement of European values. The call for "strategic patience" now being heard in the debate among EU member states and the emerging European External Action Service may buy some time, but does not per se facilitate progress towards addressing this fundamental contradiction.

Giovanni Andornino, Compagnia di San Paolo Fellow 2010, The Transatlantic Academy

¹ Pew Research Center, "Pew Global Attitude Project," section devoted to the opinion survey on China in 2010, asking the question "Do you have a favorable or unfavorable view of China?" available at <http://pewglobal.org/database/?indicator=24&survey=12&response=Favorable&mode=chart>, last accessed 01/14/2011.

THE CHINA CHALLENGE IN ASIA

Over the last decade, the most important changes in the global military balance of power have been occurring in Asia. The region's economic rise has been accompanied by military modernization, and China's recent naval buildup and activity have increased anxiety among its neighbors. China is involved in regional territorial disputes, most notably over Taiwan but also over the Paracel and Spratly Islands in the East and South China seas and the long Sino-Indian border.

The general transatlantic objective of preventing revisionist challenges to the territorial status quo in Asia will require effective balancing by states in the region, supported primarily by the

United States. At the same time, the United States and its regional partners should work with China to resolve conflicts and disputes peacefully. This requires a proactive diplomatic strategy of conflict resolution, crisis prevention, and the promotion of social and economic development.

Flashpoints and Territorial Disputes Involving China



- - - India/China disputed borders

The Debate over the EU Arms Embargo

In June 1989, as the world recoiled in dismay at the bloodstained images filtering from Tiananmen Square, the European Union and the United States, united in their condemnation, imposed an arms embargo on China.

More than twenty years later, however, the EU arms embargo to China has become a subject of fierce controversy, both across the Atlantic and within the EU itself.

The nature and scope of U.S. and EU arms export control measures toward China differ substantially. The U.S. arms embargo covers all military items, lethal and nonlethal, that appear on the U.S. munitions list. In contrast, arms export control regimes largely remain national within the European Union, with wide differences in restrictions and permissiveness. Similarly, the EU embargo declared by the European Council of Ministers in June 1989 against China was subject to divergent national interpretations. France and the U.K. have interpreted the embargo as solely covering "lethal" weapons and major weapon platforms. Thus both France and the U.K. exported to China certain forms of "nonlethal" military equipment, such as radars and surveillance and rescue helicopters, despite China's well-known tendency to reconfigure dual-use Western equipment into lethal weapon systems.¹

As China's economy and role on the world stage have grown, China's demands to have the embargo lifted became increasingly powerful and insistent. In response, some European leaders, spearheaded by France and Germany, have called for its abrogation, presumably so that interests in certain countries would be able to export major weapons platforms and other lethal equipment to China. These calls came to a head in 2004. When they encountered opposition both from within the European Union, the United States and other allies,

the demands were abandoned. The EU made a formal decision that the embargo would be lifted only if and when China ratified the UN Covenant on Civil and Political Rights, released all remaining Tiananmen prisoners, and improved its human rights record with regard to forced labor and the treatment of prisoners. Spain nevertheless declared during its rotating presidency of the EU in early 2010 that it was "in favor of lifting the arms embargo," and in December of that year the High Representative of European foreign policy, Lady Catherine Ashton, also argued that the arms embargo was a major impediment for developing stronger EU-China cooperation and should therefore be abolished. These calls have occurred at a time when the heavily export-dependent European defense sector is struggling and China's growing financial clout in a crisis-stricken Europe is becoming stronger, with Beijing recently offering to buy up more than \$7.9 billion of Spanish debt.

Opposition to lifting the EU embargo has come not only from the United States but also from the European Parliament, which in 2003 and 2008 voted symbolic resolutions in favor of maintaining the embargo, arguing that China's human rights violations remain far too widespread to justify such a major policy reversal. The U.S. Congress in 2005 proposed a resolution imposing sanctions on European nations that "exported, transferred, or otherwise provided to governmental or nongovernmental entities of the People's Republic of China any item or class of items on the United States Munitions List."²

The EU arms embargo has little chance of being reversed in the short to medium term, as it would require the consensus of all 27 European nations. Nevertheless, the periodic calls by segments of the European leadership to lift the embargo threaten to exacerbate tensions not only with the United States but also with Europe's

partners in Asia, such as Japan and Australia, which share concerns over China's military buildup.

In a globalized world, Asian stability affects European stability. The EU, which already is involved in Asian regional security organizations such as the ASEAN Regional Forum, should go beyond merely recognizing this interdependence. The EU should establish a common European arms export control regime and on that basis engage both the United States and China in ways that reflect European interests and responsibilities in Asian security.

¹ The Z-9 helicopter, for example, is a Chinese version of the French AS 356N Dauphin: a four-ton chopper with a two-ton payload which is also used by the US Coast Guard.

There are over 200 Z-9 helicopters in the People's Liberation Army (PLA) inventory and they have been retrofitted with an assortment of 23mm cannons, torpedoes, anti-tank missiles and air-to-air missiles.

² See provision section 1212 of the *National Defense Authorization Act for FY2006*.

GLOBAL NATO

Meanwhile, the growing challenges posed by terrorism, piracy, and state failure have led NATO to take on a more global orientation. Recognizing that the threat environment is increasingly transnational and global, the alliance articulated in its recent Strategic Concept the need to build partnerships with other institutions as well as with countries outside the Euro-Atlantic region. In 2006 the NATO Secretary General called for new global partnerships with four countries in the Asia-Pacific region: Australia, Japan, New Zealand, and South Korea. Each of these countries has assisted in the Afghanistan mission (with Australia participating in combat operations), and South Korea has participated in the counter-piracy operation in the Indian Ocean. Disputes within NATO regarding the nature of these partnerships have arisen; the United States and the United Kingdom argued for a new institutional framework to coordinate these relationships, but France opposed creating a more global organization on the grounds that it might compete with the United Nations. Europe should welcome increased NATO partnerships with countries in the Asia-Pacific region to fulfill its objectives on cooperative security and crisis management without fear that these efforts will weaken the transatlantic bond or diminish the UN.

NATO's first steps in Asia have been the establishment of dialogues with like-minded democracies to combat threats such as terrorism, WMD proliferation, and cyberwarfare. Going forward, NATO should develop its cooperative security relationships with these new global partners without triggering Chinese fears that the alliance is engaged in military encirclement. A NATO dialogue with China, in addition to a deepening of U.S.–China military-to-military talks, can help ensure the transparency necessary to pursue NATO's efforts to respond to global threats without creating Cold-War style antagonisms. Furthermore, wherever possible, NATO should seek to work with China on addressing common security problems.

In the emerging architecture of Asian security, India will play a pivotal role. Much depends on whether it departs from its longstanding attachment to nonalignment and strategic autonomy and enters into more binding strategic partnerships. NATO's effort to create a more stable Afghanistan has given the alliance and India a shared long-term objective, but American-Pakistani collaboration has frequently created friction. To date, India's relationships with Western partners have been conducted on a bilateral basis primarily through separate substantial independent military engagement with the United States, France, and the U.K. Currently, NATO maintains an ad hoc dialogue with India, but a more regular interaction would benefit both sides, even beyond the issue of Afghanistan.

NUCLEAR WEAPONS AND MULTIPOLARITY

The transatlantic community, in response to the Soviet threat, made heavy use of nuclear weapons to deter a conventional attack from the East. But at the same time, the allies realized that nuclear war would be a catastrophe and therefore attempted to achieve reconciliation with the USSR and establish binding international controls on the nuclear arsenals. Throughout the six decades of the nuclear era, the members of the transatlantic community have also placed a high priority on restraining the spread of nuclear weaponry, and the various regimes that have been fostered by this community remain a central feature of the global nonproliferation order. Since 9/11, there has been increasing attention on the prospects of terrorism through weapons of mass destruction (WMD) and the pursuit of a much more comprehensive containment of fissionable material.

In the past two decades, Asia has been the epicenter of nuclear proliferation in the Persian Gulf, South Asia, and East Asia. Iran's quest to acquire nuclear capability poses a serious threat and could possibly precipitate a cascade of nuclear proliferation

in the region. China has been a major source of proliferation, giving Pakistan its nuclear capability (and contributing to the damage caused by the A.Q. Khan smuggling network), sustaining the North Korean weapons program, and most recently assisting Iran in augmenting its strategic missile capabilities. China's traditional support for selective nuclear proliferation was part of its antihegemonic and balance-of-power strategy vis-à-vis the United States, the Soviet Union, and India, but Beijing has begun to recognize the dangers and costs of this approach, especially as it is itself increasingly vulnerable to nuclear terrorism, which, for instance, could originate from the very Pakistani program that it had assisted. Furthermore, the global nonproliferation regime will be severely undermined if China's threat to its neighbors triggers Japanese, South Korean, and perhaps even Vietnamese nuclear armament to offset Chinese conventional superiorities. These ominous nuclear risks underscore the vital importance of a proactive strategy to resolve conflicts in East Asia before they escalate. They also underscore the powerful benefits of China becoming a more responsible stakeholder in maintaining international order.

As the world moves toward nuclear multipolarity, arms control will need to become multilateral. China, India, and Pakistan are poised to become major players. Strategic nuclear arms control (the SALT and START agreements) has hitherto been bilateral, between the United States and Russia. As the United States and Russia reduce their strategic nuclear forces, and as China, India, and Pakistan increase their capabilities, the arms control regime will survive only if it becomes fully multilateral. Full nuclear multipolarity may be dangerously unstable, as each state seeks to deploy forces sufficient to deter or counter a worst-case scenario of a coalition of several nuclear states. But achieving multilateral nuclear arms reductions will be technically and politically even more

difficult than achieving them bilaterally. Furthermore, the substantial nuclear arsenals of Britain, France, and Israel will need to be included in any meaningful multilateral agreement. Sustaining the nuclear arms reductions project in this emerging multipolar environment will be dauntingly difficult and will require close coordination between the United States and Europe.

Difficult choices also lie ahead on tactical nuclear weapons. Throughout the Cold War period the most likely path to nuclear war was escalation from conventional conflict to the use of tactical nuclear weapons. This threat has not vanished with the end of the Cold War. Indeed, as both China and the United States deploy ever more sophisticated advanced conventional forces and maintain doctrines that emphasize lightning-fast pre-emptive strikes, the dangers of nuclear escalation loom ever larger. In addition, the prospect that NATO and Russia will negotiate a reduction of tactical nuclear weapons in Europe poses the danger that Moscow will redeploy its tactical arsenal east of the Urals, heightening concerns in Japan and China. In this world of increasingly coupled and long-range nuclear forces, the transatlantic community must work to ensure that improvements in security within the NATO core area do not lead to increases in insecurity in other regions.

TERRORISM

Terrorism and the prospect of WMD terrorism have added a complex and significant new security threat to the international community. Over the past decade, terrorist attacks on New York, Washington, London, Madrid, and Istanbul have created a greater sense of mutual threat and vulnerability than any other issue within the transatlantic community. Counterterrorist activities create a particular challenge for liberal democratic states, which must balance the need to combat terrorist threats effectively with the desire to preserve fundamental civil liberties. The difficulty of striking

an appropriate balance has at times caused divisions within the community in the aftermath of the panic created by September 11 and despite the immediate sense of solidarity fostered by the attacks. This terrorist threat has engendered broad and well-institutionalized cooperation within the Atlantic community — even during the worst periods of transatlantic discord over Iraq — in intelligence gathering, police enforcement, and interdiction of financial flows. This cooperation is a major and enduring accomplishment of the alliance and enjoys widespread popular support throughout the West.

The global nature of the terrorist threat, particularly pan-Islamic extremism, creates common interests and opportunities for cooperation among established and rising powers alike. Russia, India, and China all face substantial terrorist threats and have contributed to counterterrorism in various ways. Russia has provided intelligence in support of the NATO-led war in Afghanistan, and NATO countries have assisted Russia in combating terrorism emanating from the North Caucasus. The Mumbai attacks of 2008 served as a starting point for wide-ranging and institutionalized intelligence-sharing, particularly among India, the United Kingdom, and the United States; American national security officials provided the information that allowed the Indian government to track down the links between the attackers and their Pakistani handlers. China strongly supported the landmark U.N. Security Council Resolution 1373 outlawing terrorism, and counterterrorism has become an important part of the U.S.–China Strategic and Economic Dialogue. Despite these overlapping interests, however, there are substantial barriers to cooperation with countries such as China and Russia that do not share Western concerns about excessive state and police power. Furthermore, China's links to Pakistan have rendered it reluctant to classify certain groups as terrorists, undermining U.S. and Indian efforts at the UN Security Council.

The growing threat of terrorism is a prime example of the vulnerabilities associated with rising interdependence, and overall, the response of nearly all states has been strongly cooperative. Further progress in combating the threat of terrorism will require progress on two major fronts. First, no long-lasting solution to the terrorist threat is possible without addressing its sources. This requires political reconciliation and the resolution of a handful of very different thorny territorial, ethnic, and religious disputes in places such as Kashmir, Israel-Palestine, the North Caucasus, Tibet, and Xinjiang as well as the creation of socioeconomic and political stability in critical states, including Pakistan, Somalia, and Sudan. Second, the ominous prospect of WMD terrorism further underscores the need for strengthening the global nuclear arms control regime, so as to reduce the chances that nuclear warheads or fissile material would fall into the wrong hands.

THE UNITED NATIONS: RECASTING THE GLOBAL BARGAIN

Founded by the alliance against the Axis powers during World War II, the United Nations has Western origins but is an inherently universal institution. Its charter reflects humanity's age-old aspirations for a world of durable peace, freedom, prosperity, and human dignity, but it also enshrines the principles of national sovereignty, non-interference, and self-defense. Today, the United Nations represents both a global framework for negotiations and an important tool for the international community and its member states to address a variety of problems, ranging from peace and international security (nonproliferation, peace enforcement, peacekeeping) through development (Millennium Development Goals) and the environment (climate change) to issues of human rights (Human Rights Council, UNHCR). At the pinnacle of the UN system sits the Security Council, which currently contains an unprecedented number of rising powers, with Brazil,

India, and South Africa serving as nonpermanent members.

Long stymied by the East-West conflict, the UN was released from irrelevance and near-paralysis on issues of international peace and security in the late 1980s. The end of the Cold War offered the UN huge new opportunities, but the organization was confronted with a wide range of new challenges. While the UN engaged in a total of 13 peacekeeping operations from 1948 to 1987, since then there have been 54 operations, 14 of which are ongoing as of this writing. As the institution has struggled to keep up with what has been a very rapid growth in its responsibilities, the global shift has highlighted the need to recast the institutional structures and representation to more accurately reflect the configuration of power that exists today. The transatlantic community has an important stake in a vibrant United Nations as a core institution of global governance. Member governments should therefore, at a minimum, honor the pledges they have repeatedly made to help eliminate poverty around the globe, notably in the context of the Millennium Development Goals, but also at the G8 and the G20.

The United Nations Security Council will find it difficult to maintain a leading role in world affairs unless it successfully allows for a greater role for emerging powers such as India and Brazil. The need for reform of the Security Council, whose permanent membership represents the victorious coalition in World War II, is obvious, yet the debate about this in the United Nations has been deadlocked and reform is unlikely to move forward any time soon, not least due to China's veto of permanent membership for Japan. To help break the stalemate, France and the United Kingdom should first work toward a united European voice in the Security Council by closely synchronizing their respective positions and aligning this common position with that of the European Union's High Representative and other

member governments. Most important, London and Paris should also commit themselves to make available one of their permanent seats to a non-European country as part of a comprehensive Security Council reform, with the remaining permanent seat representing the European Union's common position. At the same time, the United States should commit itself to a double veto policy, challenging the other permanent members to follow suit. This would mean that the United States would only cast its veto against any decision in the Council if it were supported by at least one other permanent member of the UNSC.



ENERGY & THE ENVIRONMENT

The global energy system represents one of the critical infrastructures of the present international system. The spectacular growth in world economic development since the Second World War has been fueled by a rapid rise in energy consumption. Industrialization, beginning in Europe, the United States, and Japan, has now spread globally, and the rising economic giants China and India are rapidly increasing their demand for energy of all kinds. All of these nations are greatly dependent on international trade in energy, particularly oil, for much of their total energy needs. In addition, flows of know-how and investment capital connect countries across the world in a dense web of global energy interdependence.

The global energy system is closely intertwined with the global environment. The most obvious and important link is the impact of fossil fuel consumption on

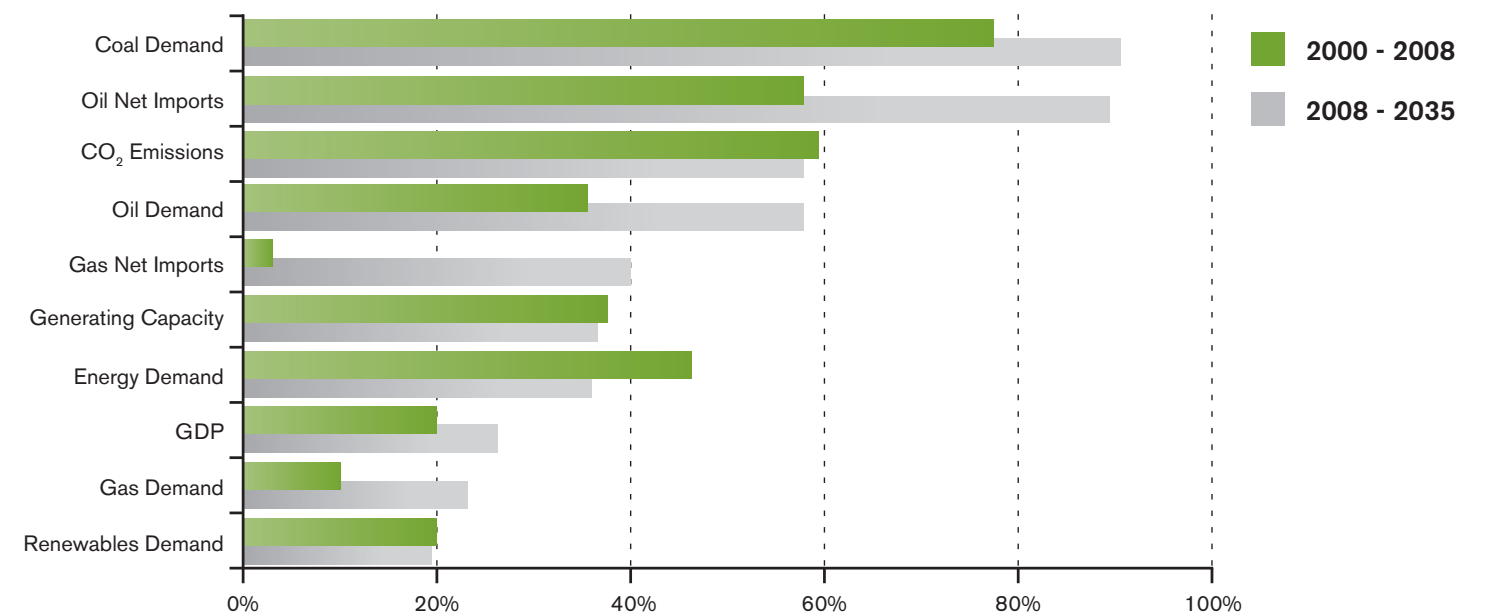
climate change. Energy use accounts for about two thirds of total carbon dioxide (CO₂) emissions. There is broad scientific agreement that atmospheric pollution from human sources is changing and will continue to alter the global climate in unpredictable and significant ways. Despite international political efforts to limit carbon emissions, they have risen strongly in recent years and are likely to continue to grow. The core of the problem is the proliferation of energy- and resource-intensive modes of production and lifestyles of industrial societies on a global scale amidst a world population that is still growing rapidly. The attraction of individual mobility provided by the automobile, in particular, accounted for more than one quarter of total global energy-related carbon emissions in 2008.

Even under optimistic assumptions, the International Energy Agency (IEA) projections and scenarios do not foresee

a stabilization of total greenhouse gas emissions in the course of this century, but only in the next, and then only at a level of more than 700 parts per million (ppm), well above the 450 ppm that scientists consider the maximum tolerable concentration to prevent unacceptably high risks and costs. (Today, levels of concentration are at about 390 ppm, the highest level they have been in the last 650,000 years.) Since the problem is global in nature, effective response will require globally coordinated action to shift the world economy onto a sustainable path.

China occupies a key role in the world's energy equation. Its large population and rapid economic growth imply that China will represent an increasingly important part of the overall world energy system. Its energy demand took off dramatically after 2001, growing even faster than the overall economy because of the rise in per capita income. Since 1980 three quarters of China's total

China's Share of the Projected Net Global Increase for Selected Indicators



Source: IEA

energy supply has come from coal, which is the largest source of CO₂ emissions among hydrocarbon fuels. China now also depends heavily on imported oil to meet the rapidly growing demand of the transport sector, and its import dependence is expected to grow sharply in the future. As a result of these trends, China recently overtook the United States as the single largest emitter of CO₂, and, according to IEA projections, China's energy-related emissions in 2035 could represent nearly 60 percent of the total projected global increase.

THE PATH TO ENERGY SUSTAINABILITY

Politically, climate change has been addressed in the context of the 1994 United Nations Framework Convention on Climate Change (UNFCCC), which established specific responsibilities for the advanced industrial countries. The 2005 Kyoto Protocol set a binding five-year target for 37 industrialized countries and the EU for greenhouse gas (GHG) emission reductions of an average of 5 percent (against 1990 levels). Unfortunately, these modest goals have been largely unmet, and a subsequent effort at the 2009 Copenhagen Convention largely collapsed in discord.

Global climate change poses daunting challenges. One problem is the global equity issue: the early industrializers in the West have cumulatively contributed the overwhelming bulk of emissions, and per capita emissions in rising industrializing countries like China remain far below per capita emissions in the wealthy West. In principle each human being should be entitled to equal emissions. To realize this, mechanisms should be established for the buying and selling of carbon emission entitlements. Such an arrangement would severely penalize the wealthier economies and entail a massive resource transfer to the global poor. The mechanisms must also ensure that the transfer of resources is devoted to realizing a sustainable energy transition. A second problem is that achieving compliance with any agreed-

upon commitments would be plagued by problems ranging from fraud to inaccurate data measurement. Finally, even effective reductions in emissions would do almost nothing to reduce the longstanding reservoir of carbon already loaded into the atmosphere by two centuries of industrialization, meaning that the problem will likely get worse for a long time before it gets better — even if policy efforts are successful. In sum, the challenges for effective multilateralism on global warming are staggering and

will require bold measures to combat the problem.

Given these realities, the transatlantic community will have to lead the global effort toward energy sustainability. The West primarily has caused the problem and remains a major contributor. It is also best equipped to bring about major change in its own societies as well as to assist the rest of the world. The most effective way to do this would be by creating reliable expectations

about future energy prices among both energy producers and consumers. The transatlantic community should therefore establish a long-term energy price trajectory through appropriate measures of taxation and/or international emission trading that would create the incentives for using energy much more efficiently and for developing sustainable alternative sources. Creating reliable expectations about future price levels would unleash powerful market dynamics for technological change and help secure the massive global investments required to shift the world energy system onto an environmentally sustainable path. Ideological preconceptions and vested interests on both sides of the Atlantic will be the greatest obstacle to the establishment of such a program for global sustainability.

STRATEGIC ENERGY VULNERABILITIES

The three major economies in the world, Europe, America, and China, are all heavily dependent on imported oil. U.S. domestic oil production has been declining since 1970, leaving the country increasingly dependent on oil imports to meet its growing energy demand. During this period, Europe shifted away from coal to imported oil as its primary source of energy. By 2009 both the United States and China were importing over half of their oil needs, while Europe's oil imports have now reached 85 percent.

Both oil importers and exporters face dependencies and vulnerabilities. Since 1970 the West's increasing import dependence on the Persian Gulf for oil has created a strategic vulnerability. Sources of supply are heavily concentrated, there are plausible scenarios for major and prolonged supply disruptions, the possibilities to remove the causes of the disruption are limited, and the impact of supply shortfalls on national and global economic activity are serious. Rapid, steep, and prolonged oil price hikes are a significant aspect of this strategic vulnerability. At the same time, many exporters of energy and nonfuel minerals depend heavily on revenues from

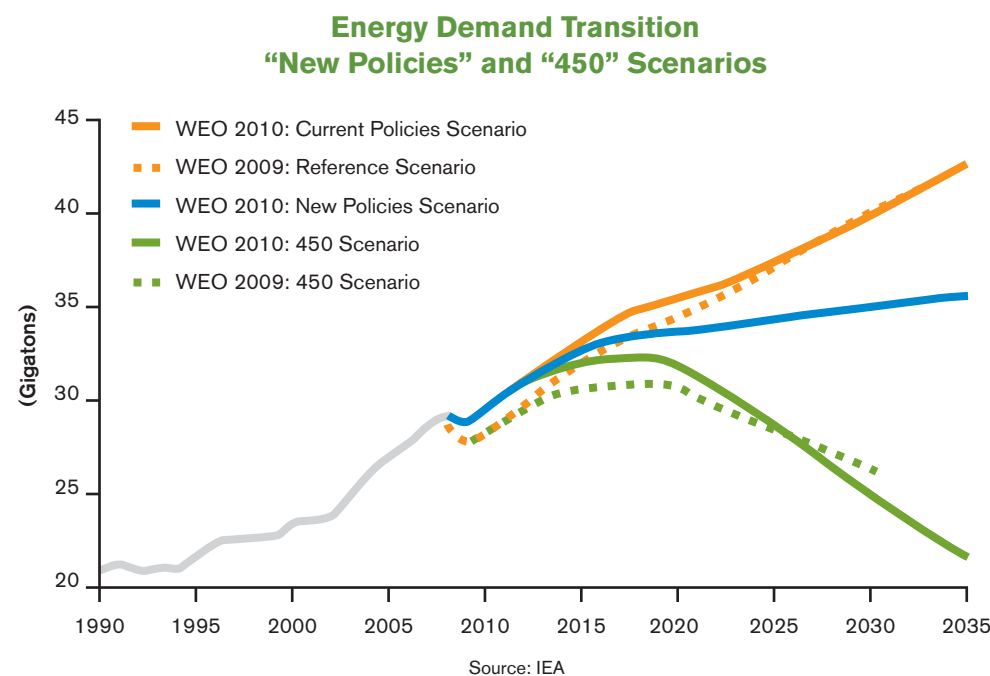
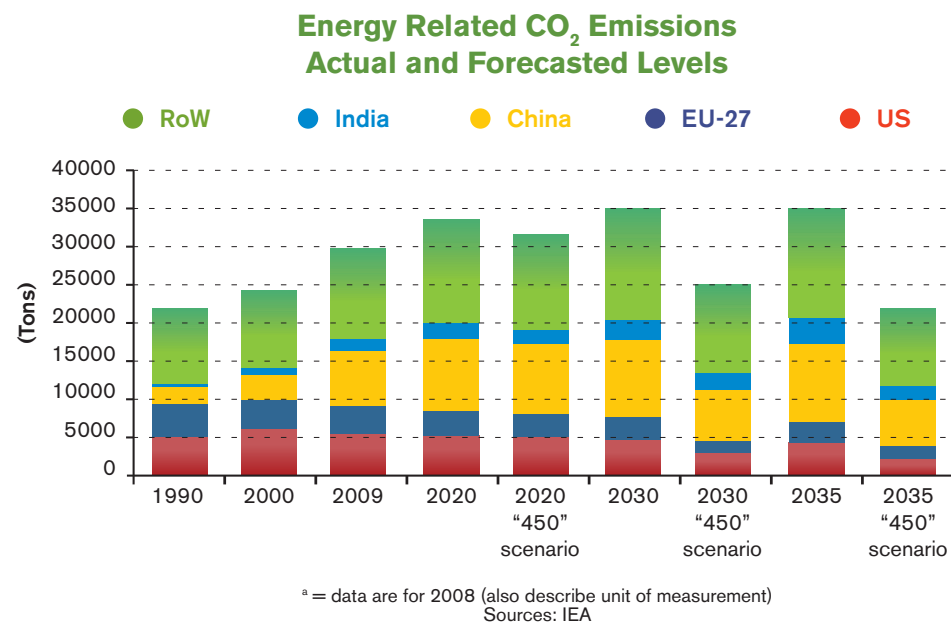
export earnings, as, for example, Saudi Arabia does on oil. Exporters also require long-term market access and sufficient price levels.

Strategic oil import vulnerability is likely to increase for the West as well as for China and India. These major oil importers will depend largely on a small group of oil suppliers, above all Saudi Arabia and the countries bordering the Persian/Arabian Gulf, as well as Libya, Venezuela, Nigeria, Kazakhstan, and Canada. Sources of disruption to global oil flows include domestic instability and revolution in Saudi Arabia and smaller Gulf states as well as war in the greater Middle East, particularly involving Israel and Iran. Those issues also have the potential to create frictions within the West, as they have done repeatedly in the past, most recently over Iraq in 2003.

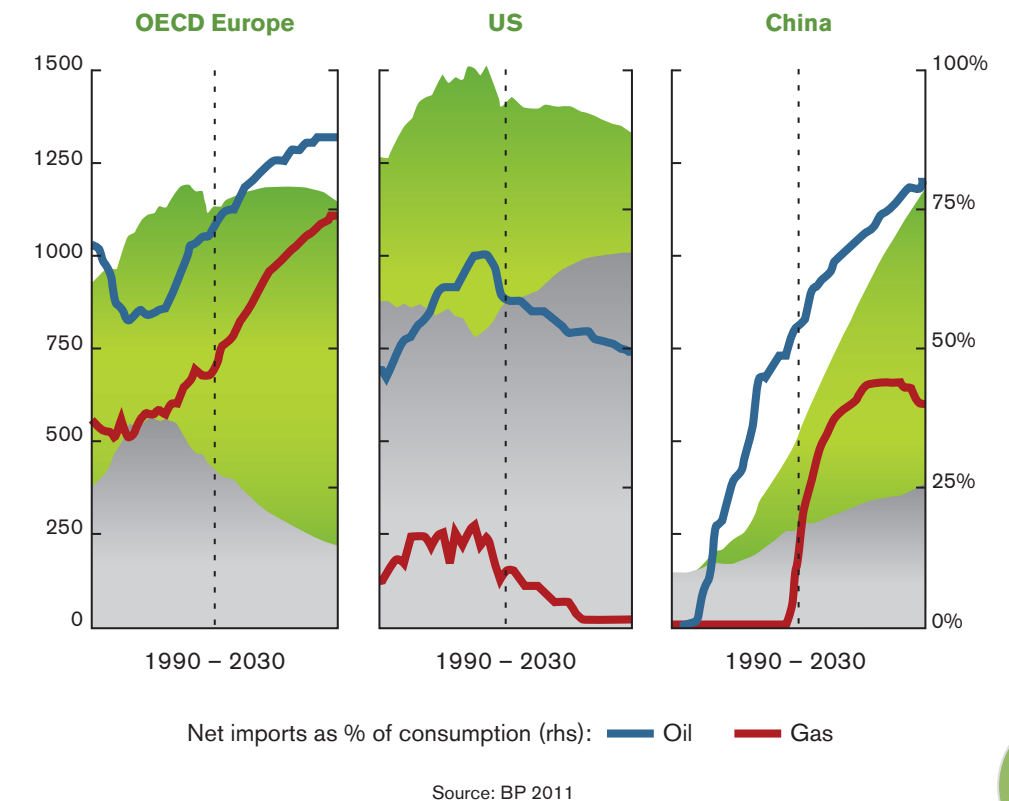
Lesser vulnerabilities exist for natural gas and nonfuel minerals. European dependence on Russian natural gas imports does constitute a regional case of strategic vulnerability. Nevertheless, Europe could address this problem relatively easily by completing the EU single internal natural gas market and pipeline grid as well as by enhancing emergency stockpiles. Strategic vulnerabilities in nonfuel minerals are even less pronounced. While China currently has a near-monopoly of world rare earth mineral supplies and recently curtailed exports unexpectedly and apparently for political reasons, the impact of the shortfalls was limited. Prudent stockpiling and diversification of sources are necessary to manage such import dependence.

RECASTING GLOBAL GOVERNANCE IN OIL

Oil will remain the strategically critical commodity both globally and for the transatlantic community. The current system of oil governance is informal and fragile. The decline of Western oil companies with vertically integrated production and their replacement by extensive market



Oil and Natural Gas Production, Consumption, and Import Dependence, 1990-2030



transactions has led to fragmentation. The expanded role of producer governments or their national oil companies has increased politicization. The governance of the global oil market hinges on the close bilateral relationship between the United States and Saudi Arabia. The United States provides security guarantees for the Saudi Arabian monarchy in exchange for a Saudi commitment to maintain oil supplies at moderate prices, to price oil in U.S. dollars, and to purchase arms and recycle oil revenues into dollar-denominated investments. This arrangement looks increasingly unstable and unsustainable due to the turbulence that has begun sweeping across the Arab world and the Middle East in 2011.

Europe, China, and the United States have a shared interest in creating a more stable

system of global oil governance. The transatlantic community should continue to bring China, India, and others into the IEA's contingency planning and crisis management framework and build coordination of national efforts to create stockpiles and spare production capacities to cope with short-term disruptions. Beyond this, exporters and importers of oil will need to come together on a regular basis to discuss alternatives for the future governance of the world oil market and to establish a framework for gradually rising prices to help combat global warming through decreased emissions.

FOOD AND WATER RESOURCES

America, Europe, and China play a decisive role in yet another area of global concern: food and water. In order to ensure sufficient availability of grains, livestock, and water to feed the fast-growing world population, the three economies in their role as the largest consumers of basic foods will need to find joint solutions in coming years.

The problems they and many other countries face are substantial. The world population is set to grow dramatically in the coming years — according to U.N. estimates, to 9 billion from the current 6.8 billion. The key question is whether and how these people can be fed on the basis of existing resources and in a sustainable manner.

The Sino-transatlantic Role in Global Food and Water Resources

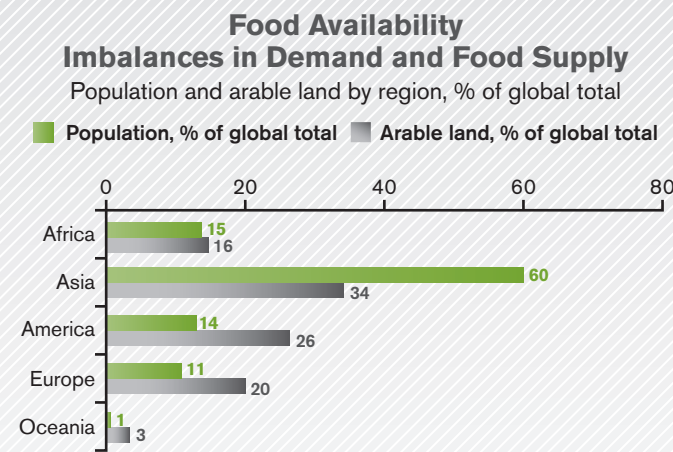
America and Europe are the largest consumers of basic foods. While making up one-quarter of the global population, food consumption per person is 30% higher than the global average. America and Europe also have the highest use of water, with the U.S. leading the field in terms of daily per capita consumption. At the same time, 46% of the world's arable land is concentrated

on the two continents, and a large part of the world's renewable water resources are located there.

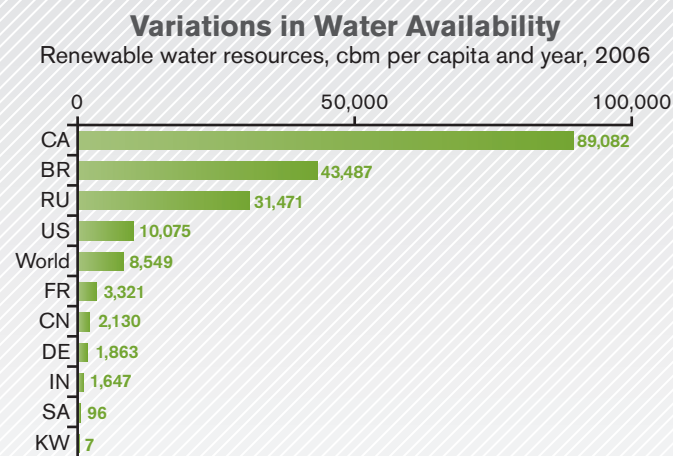
China is also among the largest food consumers, feeding one-fifth of the global population on 10% of the world's arable land. Rising food consumption and substantial losses of arable land due to environmental

degradation and desertification aggravate the situation and have only partially been met by higher levels of productivity.

All three economies, as the world's largest CO₂ emitters, play a key role in raising the risks to global food production associated with climate change.



Sources: Food and Agriculture Organization of the U.N., own calculations



Sources: U.N., own calculations

The situation is complicated by a number of critical factors: First, food consumption per person is rising, reflecting increasing levels of wealth and changing lifestyles. Second, food availability as the global population hike is concentrated in the emerging and developing economies, many of which have particularly limited access to basic foods and renewable water resources. Finally, there is the impact of climate change on the supply of food and water, including the impact of droughts, flooding, and other forms of natural disasters associated with global warming.

The long-term trends observed in this field pose tangible challenges already today. Most visibly, they have led to a significant and sustained increase in food prices across the whole range of basic foods worldwide and to rising price volatility on global commodity markets. Apart from

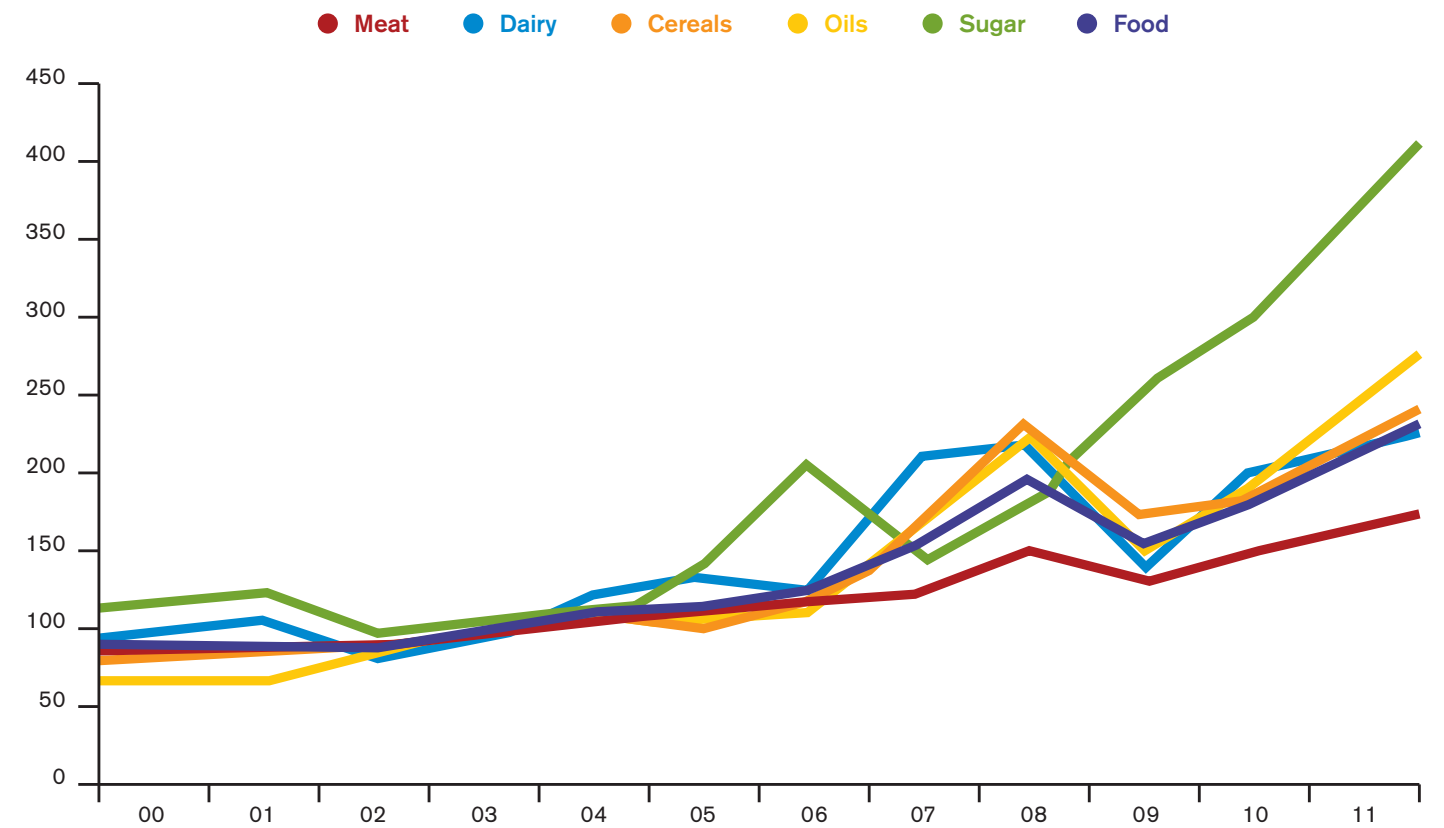
long-term trends in supply and demand, factors contributing to this surge include trade restrictions enacted in a number of economies in recent years with the aim of limiting the export of domestic produce at times of scarcity as well as the hoarding of reserves, for example in China, which reportedly holds more than 40 percent of the world's stockpiles of primary grains. In addition, although not fundamental to the problem, financial speculation is presumed to amplify these price trends.

The United States, the EU, and China are crucial economic and political actors in this policy field, and they will need to find joint solutions to these existential challenges. One key element in a coordinated response will be to promote innovation in farming, notably with smallholders, which is critical for enhancing production in the face of limited resources. International standards

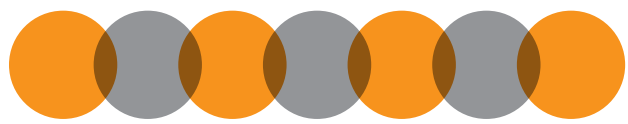
on strategic reserves and improved access to key data such as on grain stocks and weather forecasts could also help to alleviate the tight food supply situation. Most important, however, America, Europe, and China will need to agree on effective ways of reducing environmental damage, including global warming, so as to reduce the rate of environmental degradation of farm land and water supplies.

The global water sector also requires serious attention, not least because it is a critical factor in world food supplies. Agriculture consumes 70 per cent of global water supplies. Innovations in infrastructure, desalination and wastewater treatment, and more efficient use of water, will require investments that have been calculated at \$500 billion annually worldwide. Investments of this magnitude will require advances in public-private partnerships.

Increases in Global Food Commodity Prices
FAO Global Food Commodity Price Indices, 2001 - 2004 = 100



Sources: Food and Agriculture Organization of the U.N., own calculations



GLOBAL COMMONS

All nation-states are territorial, but they sit within and interact across several physical media, known as the global commons, that are not territorial. The principal global commons — the ocean, the atmosphere, and orbital (and, increasingly, cyber-) space — are essential for the flows of goods and information. Each is governed by a specific and elaborate regime allocating rights and responsibilities; in combination, these regimes are an important feature of the international order. Western states have led in the creation of governance for these domains in ways consistent with the values of openness and responsible use. All states reliant on trade have a great stake in the continued openness and preservation of the global commons. However, due to increased use, the global commons are becoming congested and degraded, and they are plagued by perennial questions about militarization. There are also longstanding pressures and tendencies for the incremental enclosure of these common domains, and sustaining open access and common use will require proactive strategies by the Atlantic community.

OCEANS

The oldest regime governing the commons, the Law of the Sea, has successively evolved across several centuries and in its most recent codification in the early 1980s has two main features: 200-mile exclusive economic zones, in which littoral states have sole resource extraction rights, and free passage outside of 12-mile territorial seas. Freedom of navigation is the foundation for maritime commerce, which carries 90 percent of world trade, and has been guaranteed since 1945 by American naval pre-eminence. While China has not

challenged the overall regime, it asserts a revisionist claim to prohibit innocent passage through its exclusive economic zone, and this has fostered considerable regional uncertainty and tension. The United States and China's Asian neighbors are steadfast in their opposition to this interpretation. As China deploys more naval forces in East Asian waters and beyond, there are increased possibilities for accidents and incidents between naval vessels, which could spark broader conflict. To address this danger, the United States, China, and other naval players in East Asia should attempt to create a multilateral incidents-at-sea regime, similar in scope to the one the United States and the Soviet Union successfully developed during the Cold War. More generally, establishing better military-to-military communications between China and the United States would limit the possibilities for unwanted escalation of hostilities and should be a high priority for both governments.

Meanwhile, the recent revival of piracy off the coast of East Africa has created an alignment of interests among established and rising powers alike in combating a challenge to free passage and international commerce. NATO and the EU have each established substantial flotillas in the area, and China, India, Russia, and others have deployed ships to the region. These efforts have not been fully effective and are not well coordinated. Even within the West, the NATO and EU operations have been largely independent, an example of the need for these two institutions to improve their coordination, as called for in NATO's 2010 Strategic Concept.

OUTER SPACE

For more than half a century, the human venture into outer space has opened another global commons in which military, commercial, and scientific activities have rapidly expanded. As with the oceans, there is a general regime, codified in the 1967 Outer Space Treaty, that guarantees free passage and prohibits the extension of territorial sovereignty claims beyond the atmosphere to orbital space and celestial bodies. The United States and the Soviet Union pioneered the development of space technologies and first exploited orbital space, but over the last several decades, space activities have become multipolar, as Europe, Japan, China, and India have all built significant civil space programs. To date, the basic principles of the outer space regime have wide and deep acceptance by the international community, and problem issues, most notably crowding in geosynchronous orbit, have been effectively managed through international institutions.

On the horizon, however, is a potentially major challenge to the regime's nonappropriation provision that will stem from the establishment by individual states of bases or colonies on the moon (or asteroids). Orbital space is a natural *res communis*, a realm owned by none and open to all. But celestial bodies such as the moon are *terra firma*, prone to enclosure and partition through the assertion of claims of ownership and sovereignty. Private corporations, increasingly active in space, want enclosure, and China, which is considering a lunar colony, also has a strong preference for governance based on state sovereignty.

Commercial rivalry has arisen in the transatlantic community, as Europe has developed a broad spectrum of first-rate commercial launch and satellite services, challenging the previous American near-monopoly in these areas. Of particular concern is the issue of navigation satellite services, which thus far have been solely provided by the U.S. military's NAVSTAR Global Positioning System (GPS). This system is a major component of the American globe-spanning military force structure, routinely providing valuable battlefield advantages to American conventional forces in places like Iraq and Afghanistan. However, GPS also is employed by a wide range of commercial users, from ships to automobiles. The Europeans, heavily reliant on this free commercial service, fear that the United States could cut off access, and they have considered building a parallel system called Galileo to make high-quality navigation information generally available. (China has a major investment in this project.) The United States in turn fears that this European effort could undercut an American field combat edge by equipping adversaries with capabilities comparable to those of American forces. Resolving this sensitive transatlantic issue to avoid expensive duplication, while satisfying the legitimate concerns of both partners, is an important priority for U.S.–European military and commercial relations.

Space debris, generated by defunct satellites, careless design, and antisatellite (ASAT) weapons tests, has emerged as the biggest challenge to the continued use of earth orbital space. Space debris is a problem because even tiny objects in orbit, traveling roughly 18,000 miles per hour, can cause catastrophic damage in the event of collision. The volume of space debris is rapidly increasing to the point where large zones of orbital space are dangerous for

human activities. Controlling space debris is also entangled with the question of space weaponization. The United States military relies far more heavily than any other state on a constellation of satellite systems, making it attractive for potential rivals to develop ASAT capabilities. Both the United States and China have tested ASATs, and their military doctrines call increasingly for the pre-emptive destruction of satellite architectures in the event of conflict, but neither has deployed substantial ASAT forces. Addressing the problem of orbital debris and the related emergent problem of space weaponization requires an effective ban on ASAT tests and the development of codes of conduct for routine space activities to minimize debris creation.

Manned activities in space have since their beginning had great symbolic significance. During the Cold War, the Soviet and American manned space efforts were the cutting edge of their rivalry and often a valuable surrogate for more direct military competitions. With the end of the Cold War, the Russians became a major partner in the International Space Station, which the United States and its European and Japanese allies had initiated. China has now joined the United States and Russia in the elite club of those with manned space capabilities, which have become a prominent symbol of Chinese national pride and achievement. The transatlantic partners should seek major Chinese participation in the International Space Station and begin looking together toward the creation of an international base on the moon devoted to scientific research. Joining these highly visible and technologically advanced space programs will provide a valuable common interest in the preservation of good political relations and strengthen the foundations for humanity's peaceful development of outer space.

The International Geophysical Year (IGY) of 1957 and the Antarctic Treaty of 1959 offer an important historical precedent of the link between large-scale international scientific cooperation and the maintenance of free access common domains. Before 1959 the seventh continent of Antarctica was subject to competing claims of sovereignty by several great powers but had not been colonized or developed due to its inhospitable climate. During the IGY, scientists from both sides of the Cold War conflict collaborated in exploring Antarctica, and the principles of the IGY became the foundation for the Antarctic Treaty regime. The Treaty suspended territorial claims, prohibited military activities, and mandated open scientific facilities, thus providing the first superpower on-site inspection arrangement.

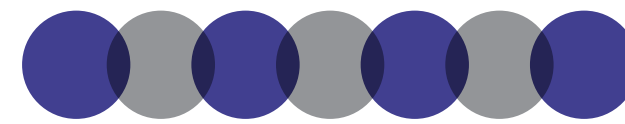
CYBERSPACE

Unlike the oceans and outer space, cyberspace is a man-made common domain, one that nevertheless has come to share important features of global reach and extremely wide access that mark the more familiar natural commons. The Internet is distinctive among the commons, as it is owned and operated almost entirely by private corporations and individuals. The explosive rise of the Internet has dramatically expanded human interaction and, consistent with Western values, has created possibilities for access to information and for freedom of expression on an unprecedented scale. While celebrated and spearheaded by the West, this empowerment of individual freedom has triggered efforts to restrict access by authoritarian regimes, which fear its liberating power, as witnessed most recently throughout the Arab world. Particularly for China, the creation of the Golden Shield Program, known colloquially as “the Great Firewall,” has become an important pillar of national sovereignty and regime security, thus posing a challenge

to open individual and commercial access as well as to the international character of the Internet. Authoritarian states are not alone in compromising the open character of the Internet: the United States, while rhetorically championing unfettered access, has often pioneered the use of the Internet for surveillance, espionage, and increasingly even warfare.

Beyond these conflicts over access, the future of the Internet is threatened by crime, espionage, and cyberwar. States share common interests in ensuring that their IT infrastructures are not penetrated and used by nonstate criminals and terrorists, although they have very different definitions of who qualifies as threatening actors. Meanwhile, states are developing national espionage, surveillance, and warfighting capabilities to use not just against illicit substate actors but against one another. The values of the transatlantic community support an agenda of sustaining access, which has been hampered by European and America differences over the privacy of corporations and individuals and over the proper role of the state in regulating the Internet.

NATO has recognized the growing importance of cyberthreats and has established a joint cyber command in Estonia, a country that was the target of cyberattacks emanating from Russian sources. The bulk of government activities of this sort, however, have remained the province of national military and intelligence organizations. America and Europe must decide how the rapid growth in espionage, surveillance, and offensive warfighting can be made compatible with the maintenance of free access for individuals and corporations. An important priority for the transatlantic community should be the early development of appropriate codes of conduct and ultimately a global treaty to govern this vital, but fragile, global common domain.



CONCLUSIONS

CONCLUSIONS

It is easy to be overwhelmed by the challenges of the 21st century. Terrorist attacks have brought home the ease with which shadowy groups can wreak havoc on our societies. The financial crisis has upended the global economic order, with the advanced industrialized countries struggling with significant unemployment and increasing debt burdens, while emerging economies continue to push forward. Power in the international system is rapidly diffusing, not just to rising states but also to nonstate actors. Issues like climate change require a coordinated international response, but there is little political will to do what is needed to stem the degradation of the planet.

Yet there is also excitement in the air. Protests across the Arab world have demonstrated once again the universal yearning for freedom and dignity. Young people have led these revolutions, bolstered by new technologies that allow them to connect to one another. While these protests have occurred without direct involvement by the West, the values that the transatlantic community has sustained and promoted over the decades are at the heart of the fervor.

These protests are a reminder that the transatlantic community's most powerful asset in world affairs is its shared commitment to freedom, justice, and human rights. The United States and Europe protected those values during the darkest days of the Cold War and spread them across the globe. The West has championed international law and free trade; more recently, it has argued for a sense of international obligation states have to protect populations at risk of violent

oppression. Western countries have not always followed their own standards and rules — engaging in protectionism, failing to intervene against genocide, and committing torture — and their future success depends on their ability to live up their ideals and lead by example.

The debate over China has come at a moment when the transatlantic community is gripped by self-doubt. What if the Chinese combination of authoritarian rule and integration into the global marketplace is the wave of the future? While China surges ahead, the United States and Europe are afflicted by political gridlock, fiscal shortfalls, and chronic unemployment. In addition, America and Europe are beset by anxieties over immigration and the preservation of traditional identities.

This report has suggested that the real challenge to the transatlantic community is internal and does not come from across the Pacific. Getting our own house in order is the number one priority as we respond to the global shift. China is indeed an emerging economic giant whose military power will inevitably grow, but it also faces enormous vulnerabilities and has an increasing stake in a stable world order.

Innovation made America and Europe wealthy and strong, and they now need to demonstrate again the adaptability of their political and economic systems to 21st-century realities. They also need to recast global institutional bargains proactively. When the transatlantic community founded the United Nations, the International Monetary Fund/World Bank, and the GATT, huge swaths of the globe had negligible roles in their governance. This is no longer

tenable. Sustaining and extending global governance will require the United States and Europe to work with rising powers as well as to develop a new mindset about themselves and the place of the transatlantic community in the world.

The West should welcome the rise of the emerging powers. The economic successes of countries such as China, India, and Brazil represent a triumph for capitalism and the liberal trading order fostered by the transatlantic community. The recommendations that follow are offered in that spirit: a call to renew our own community and to promote an effective division of labor in an increasingly diverse and interdependent world, a recognition that adapting the international order to a multipolar world is essential, and a belief that values of justice and freedom will continue to resonate across the planet.

Recommendations

MACROECONOMIC POLICY:

The United States, the EU, and China should establish a regular, at least annual, trilateral meeting on macroeconomic policy cooperation. The objective of the dialogue would be to inform each other about policy issues and measures of common interest in the areas of monetary, fiscal, and regulatory policy and provide a forum for making domestic policy decisions in a coordinated way.

The challenges associated with global imbalances and the evolution of the global currency system call for closer working relationships between the transatlantic actors and their emerging market partners in finding suitable institutional and regulatory

responses. Joint positions on how to approach these issues should be reached at the G20 level; global imbalances have been part of the G20 agenda but not much else as yet. An accord at the G20 level should be the primary objective, but agreement will first need to be reached among the key actors. Most importantly, the United States and the EU must arrive at a joint long-term strategy for managing global imbalances, a dialogue that needs to be extended to China.

The aims of the U.S.–EU–China triologue would be to prevent adverse economic developments resulting from inconsistent policy programs in the respective jurisdictions and to work toward a mitigation of major balance of payments issues and a gradual eradication of bilateral barriers to investment and capital flows. The triologue should be held at the ministerial level among the relevant representatives in the area of finance and economics as well as central bank presidents on a standing basis. On an ad hoc basis, the triologue may discuss policy matters in other remits and invite representatives accordingly. The triologue may over time replace existing bilateral dialogues and should be complementary to and supportive of the G20 process.

TRADE:

The United States and the European Union should pursue a two-pronged strategy to sustain an open multilateral trading order. They should push for the rapid completion of the Doha Round. At the same time, in pursuing separate free trade agreements as they deem appropriate, they should actively coordinate on “common standards,” a set of core WTO-plus provisions with essential levels of commitments that advances the transatlantic agenda for multilateral trade liberalization.

As the proliferation of free trade agreements is likely to continue unabated, the United States and the EU have the opportunity to conclude trade agreements that are strong models for advancing WTO-consistent

multilateral trade liberalization. The existing trade agreements concluded by the United States and the EU already share provisions in areas such as sanitary and phytosanitary measures, technical barriers to trade, antidumping, state aid, trade in services, and trade-related intellectual property rights. The United States and the EU should actively work together to pursue a set of “common standards” or “core provisions” in these WTO-plus areas, which fall under the WTO mandate but go further in their liberalization commitments. In doing so, they can define the essential levels of commitments expected from agreement partners and thus advance a common transatlantic agenda for trade liberalization. Such a coordinated approach to free trade agreements would effectively multilateralize them, even if they are negotiated separately.

Overlapping agreements are not as efficient in achieving common liberalization goals, as the United States and the EU together would “pay twice” for the same liberalization commitments. However, they provide valuable flexibility for the United States and the EU in pursuing individual political goals, such as rewarding economic reform among allies, advancing a strong labor and environmental agenda, and promoting development and democracy. Separate agreements also allow for variations in provisions as the transatlantic actors balance their common interest in trade liberalization with responses to demands from domestic interest groups and differences in their foreign policy agendas. In the case of free trade agreements, paying twice makes political sense.

SECURITY:

The United States, NATO and the European Union should comprehensively redefine and reshape their joint strategies for global peace and security and recast the transatlantic community through a new, closely coordinated division of labor between them. While America increasingly focuses on Asia, Europe should take care of its own security

and stability and that of its neighborhood to the East and the South. “Division of labor” does not equate with exclusion; on the contrary, to us it implies a common purpose, jointly set strategies, and coordinated but differentiated implementation through national and joint efforts.

NATO should increasingly focus its energies and military capabilities on the threats arising from outside Europe, including terrorism, proliferation of weapons of mass destruction, and piracy. Meanwhile Europe should take greater responsibility for stability and security in Eastern Europe and the Mediterranean. In Eastern Europe, this will imply continued efforts, working with those countries, to complete the peaceful unification of the European continent and the economic, social and political transformation of Ukraine, Moldova and Belarus, as well as Russia itself. In the Mediterranean, the “second Arab awakening” also offers huge opportunities for transformation, but it also poses major risks to European security, prosperity and stability if things go wrong. The European Union must therefore launch a determined effort to support transformational developments in North Africa and the Eastern Mediterranean. Money already has been earmarked in the context of the existing framework of cooperation and association between the EU and the Mediterranean; the real challenge is to make better use of available resources than in the past to ensure that the money is well spent. The EU also needs to revisit its very restrictive policies on food imports and immigration from North African countries. There is a real danger that short-sighted protectionism and appeasement of populist sentiments in Europe will lead to great problems for Europe further down the road.

The European Union will also have to become serious about its Common Security and Defense Policy. It is hard to understand why the collective defense of member states should not be the responsibility of member states themselves. In order to fulfill

its commitment to a common defense, as well as its growing commitments for international peace and security in the context of the United Nations, Europe will need to develop both its logistical and its operational capabilities. To this end, the CSDP should develop further joint European units, commands and taskforces. In the Mediterranean, these joint commands could build upon the preexisting military bases of countries such as France and the United Kingdom. The CFSP should also be given a proper common budget.

More needs to be done to foster a transatlantic world vision in security matters. The U.S. and the EU should therefore establish and institutionalize a high-level strategic dialogue on global and key regional security issues, including Asian security, involving both the EU High Representative and representatives from key ministries of foreign affairs and defense of member countries, so as to create better understanding about mutual concerns and develop common perspectives and strategies on both sides of the Atlantic.

UNITED NATIONS REFORM:

France and the United Kingdom should closely synchronize their respective positions in the United Nations Security Council and align this common position with the European Union’s High Representative and the other member governments. The aim should be to work towards a common European policy in the UNSC. London and Paris should also commit themselves to make available to a non-European country one of their permanent seats as part of a comprehensive Security Council reform. At the same time, the United States should commit itself to a double veto policy: it would veto any decision in the Council only if it were supported by at least one other permanent member of the Security Council, while challenging the others to follow the U.S. example.

The need for reform of the Security Council, whose permanent membership represents the victorious coalition in World War II, is obvious, yet the debate about this in the United Nations has been deadlocked and reform is unlikely to move forward any time soon, not least due to China’s veto of permanent membership for Japan. To help break the stalemate, France and the United Kingdom should first work toward a united European voice in the Security Council by closely synchronizing their respective positions and aligning this common position with the European Union’s High Representative and other member governments. Most important, London and Paris should also commit themselves to make available one of their permanent seats to a non-European country as part of a comprehensive Security Council reform, with the remaining permanent seat representing the European Union’s common position. At the same time, the United States should commit itself to a double veto policy, challenging the other permanent members to follow suit. This would mean that the United States would only cast its veto against any decision in the Council if it were supported by at least one other permanent member of the Security Council.

ENERGY AND THE ENVIRONMENT:

The United States and the European Union should commit themselves as early as possible to the principle of progressively increasing the price of CO2 emissions over the next decade through appropriate measures of taxation and/or emission trading.

The community would thus ensure, in a verifiable way, that the cost of carbon emissions from domestic energy consumption in member economies rises by a commonly agreed rate every year. The rate could be determined by the rate of global economic growth and inflation. The

community should also seek to persuade other countries, including China and India, to commit to a similar policy. Without increasing the cost of energy consumption, carbon emissions in the atmosphere will grow unabated, thereby precluding any chance of limiting large-scale global warming and climate change.

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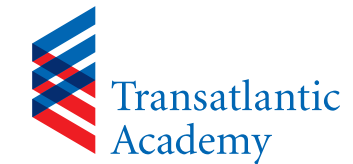
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Robert Bosch **Stiftung**



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