Chapter 7

Deepening the Transatlantic Economy: The Key Role of Services

Daniel S. Hamilton and Joseph P. Quinlan

Service activities are the sleeping giant of the transatlantic economy—an economic factor that, if awakened and unbound, would further deepen the commercial stakes between the United States and Europe and enhance the global competitiveness of both parties. At present, however, the full potential of the transatlantic services economy remains hampered by internal barriers, regulation, and obstacles in the U.S. and in Europe.

The Size and Nature of the Transatlantic Services Economy

Services sector reform offers such potential benefits to the U.S.-European economic relationship because of the size and nature of the transatlantic economy. No global commercial artery is as large and as thick as that which the United States and Europe. Though often overlooked, the transatlantic economy remains the most important global economic entity in the world due in part to the transatlantic convergence in such key areas as industry deregulation (media, energy and telecoms), technology use, and financial market liberalization. Similar stages of economic development and commonly shared economic principles have also played a part in making the transatlantic economy the leading player in the global economy. Bolstered by all of the above, the majority of U.S. and European foreign investment flows continues to be directed toward each other, rather than to low-cost developing nations or "big emerging markets."

Indeed, despite market liberalization measures in India, robust economic growth in China, the economic revival of central Europe, or sweeping privatization measures in Latin America —the majority of U.S. and European foreign direct investment throughout the 1990s, and throughout this decade, have been directed at each other.

Over the 1990s, for instance, six countries in Europe were among the top ten destinations of U.S. foreign investment. The United Kingdom ranked first again, followed by Canada (2), the Netherlands (3), Switzerland (4), Mexico (5), Ireland (6), Germany (7), Singapore (8), Japan (9) and Italy (10). Moreover, U.S. investment stakes in Europe have expanded sharply this decade, with Europe attracting over half of all total U.S. foreign direct investment over the 2000-06 time frame. The bias towards Europe runs counter to the hype and angst associated with U.S. outsourcing to such low-cost locales like China and India, and the common belief that it is the low-cost destinations of East Asia that have attracted the bulk of U.S. investment.

U.S. foreign direct investment to China and India has jumped dramatically this decade, notably to China. Total U.S. investment to China, for instance, surged to nearly $11 billion (on a cumulative basis) in the first half of this decade, nearly double U.S. flows to China in the second half of the 1990s. Although that represents a dramatic rise, it is important to put this in perspective. U.S. investment in the tiny European country of Ireland over the same period ($36 billion), for instance, was three times larger than U.S. investment in China. Similarly, although U.S. foreign investment to India doubled in the first half of this decade to $2.5 billion, over the same period U.S. firms ploughed more capital into such smaller European economies like Norway ($3 billion), Denmark ($5 billion) and Belgium ($6 billion).

The discrepancy in U.S. investment flows to Ireland, Denmark and other European nations on the one hand, versus U.S. investment in China and India on the other, reflects many impediments that plague inflows to developing nations. A nation such as Ireland, on the other hand, remains attractive due to its low-cost, English-speaking labor force, first class infrastructure, and access to the larger European Union market. U.S. firms have been drawn to Denmark on account of its technological skills, to Norway due to its natural resources, and to Belgium for a variety of reasons, including its world-class infrastructure, access to the EU market and Brussels' position as the center of political power within the European Union. In contrast, securing an investment stake in India and China, while attractive on paper, is a much more laborious process, requiring more time, due diligence and investment capital, on account of the many deficiencies still plaguing both nations.

Europe's Investment Bias Towards the United States

The collapse of the Berlin Wall and the demise of communism opened new markets right in the backyard of western Europe, and not unexpectedly, European multinationals jumped at the opportunity. Europe's leading firms ploughed billions into Hungary, Poland and the Czech Republic over the 1990s, drawn by the region's cheap labor, raw materials, and new market opportunities. Late in the decade, the prospects of EU enlargement sustained healthy investment inflows to central Europe.

Yet, despite western Europe's investment push into central Europe over the 1990s, the amount of capital sunk in such places as Hungary, Poland and others pales in comparison to the amount of capital sent across the Atlantic over the same period. After averaging $22.2 billion over the first half of the 1990s, foreign direct investment inflows to the U.S. from Europe soared to an annual average of nearly $110 billion in the second half of the decade, marking one of the most explosive periods of inward foreign investment in U.S. history. For the entire decade, European firms sank nearly $660 billion into the United States, accounting for roughly three-quarters of total U.S. investment inflows over the 1990s. European investors accounted for a similar percentage again in the first half of this decade, with the United Kingdom, Switzerland and France ranked as the top three foreign investors in the U.S. over the 2000-04 period.

Many variables lie behind the large and expanding European investment stake in the United States. As the largest and wealthiest markets in the world, the U.S. is considered too important to neglect. As Krish Prabhu, chief operating officer of Alcatel at the time, put it to the *Financial Times*," So much of company strategy is driven out of the United States today. No serious player can afford not to have a presence there." In addition to market access, many European firms have entered the U.S. to obtain U.S. technological capabilities, or so-called "created assets." Other firms have crossed the Atlantic to gain greater market access in U.S. services sectors like utilities, financial services and telecommunications. Indeed, greater service linkages between the United States and Europe have been at the heart of greater transatlantic deepening.

Deeper Transatlantic Convergence through Services

Cross-border investment in services has been a particularly important factor powering the surge in transatlantic investment over the past decade and a half. Once national in character, various service activities in the United States and Europe have been fused and are now more transatlantic in nature. Functions that were once considered nontradable (data processing, education, medical services) are now being traded regularly. Activities long classified as domestic endeavors (advertising, legal services, consulting) today easily take place across borders. Industries in both the U.S. and Europe that were once the domain of the public sector (telecommunications, insurance, electric utilities) have been privatized and opened to foreign competition. Both the European Union and Switzerland opened and deregulated their telecommunications markets at the start of 1998, which came on the heels of industry deregulation in such sectors as utilities, insurance and financial services.

Many of these national efforts to liberalize service activities in both the U.S. and Europe were encouraged and advanced in part by supporting multilateral trade agreements. The General Agreement on Trade in Services (GATS), for instance, was chief among them. The agreement, reached in 1995, was the first multilateral deal to provide enforceable rights covering trade and investment in the services sector.

Meanwhile, under the auspices of the World Trade Organization, GATS and two other seminal multilateral deals—the Information Technology Agreement (ITA) and the Basic Telecommunications Agreement—were concluded in the second half of the 1990s. The ITA helped eliminate tariffs on a range of information technology products and promote trade in computer hardware, software, and semiconductor manufacturing equipment and other products. The Basic Telecommunications Agreement, meanwhile, was the first multilateral telecommunications trade package ever reached and was signed by 69 nations, which accounted for more than 90 percent of world telecom revenue. In particular, the agreement paved the way for more foreign investment and participation in telecommunications services and facilities in both the United States and Europe. In general, the Information Technology and Basic Telecommunications agreements helped construct an information highway linking the United States with Europe.

The agreements came into effect at the end of the decade and have subsequently underpinned robust levels of transatlantic cross-border foreign direct investment in telecommunications, software, semiconductors, scientific instruments, banking, insurance and the securities market.

Another critical element promoting more transatlantic services linkages was the European Union's Single Market program, announced in the second half of the 1980s and implemented in the early 1990s. The program triggered a wave of EU-wide restructuring and deregulation of services, fostering greater U.S. foreign investment in services across Europe. Intra-EU services investment also rose as the Single Market was implemented. This helped create even larger and more competitive European service giants that ultimately targeted the United States as a primary source of growth area in the late 1990s.

Transatlantic services investment in such sectors as electricity, telecommunications, water, and various business services (like advertising and legal services) soared over the 1990s, with mergers and acquisitions the most widely used mode of entry by transnationals. Indeed, massive deal making between and among the services giants of the transatlantic economy fueled the global boom in M&A over the second half of the 1990s. According to the United Nations:

> On average, more than three-quarters of global M&A transactions in the services sector took place among developed countries during 1987-2003. Intra-Western Europe transactions (the bulk of which comprise intra-EU transactions) and transatlantic transactions dominated the picture. Led by U.S. and European service leaders, services accounted for 64 deals among the top 100 cross-border M&A deals over the 1996-2003 period, versus 36 deals of the top 100 over the 1987-1995 timeframe. Viewed in another way, roughly three-quarters of U.S. foreign investment to Europe in the first half of this decade was in service activities. Services also accounted for nearly 80 percent of total European investment in the U.S. over the same period.

The role of services in underpinning transatlantic investment flows has also been shaped by the accelerating pace of technological change. In Europe and many other parts of the world, technology advances

have appreciably lowered the cost of communications, making it more feasible and efficient to retrieve process and disseminate multiple forms of information. Just as container ships made the physical export of goods possible in the past, fiber-optic cables have made it possible to export more data, information and other knowledge-based services that used to be considered non-tradable. In short, communications technology increasingly allows firms to split and disperse parts of service functions to foreign affiliates or to non-equity joint partners.

As communication costs have fallen, the information infrastructure has expanded and the internet has proliferated, knowledge-based services of both the United States and Europe have become more linked, promoting more trade and foreign investment in services. Industry deregulation, a more liberal investment environment and falling communication costs all converged in the 1990s to drive a transatlantic investment boom in services. Other variable supporting transatlantic services investment include the rising share of services in economic activity on both sides of the Atlantic; the growing services intensity of the production of goods; and greater competitive pressures in services markets that have pushed firms to seek markets abroad and strengthen their competitiveness.

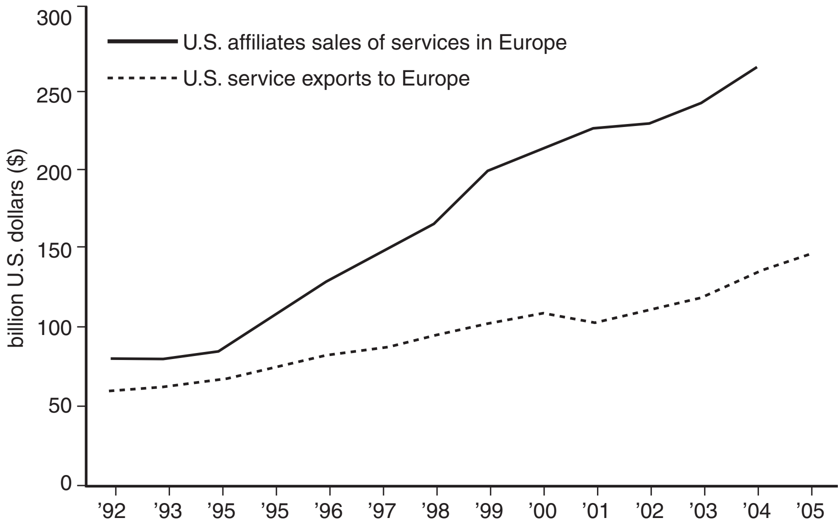
Today, the services economies of the United States and Europe have never been as intertwined as they are today, notably in such activities as financial services, telecommunications, utilities, insurance, advertising, computer services and other related functions.

Enhanced Economic Integration through Services

Following in the footsteps of manufactures, U.S. and European services companies now deliver their services more through foreign affiliate sales than through trade. In the 1970s and 1980s, firms delivered services primarily via trade. In the 1990s, however, foreign affiliate sales became the chief mode of delivery.

Sales of services by U.S. foreign affiliates in Europe soared from $85 billion in 1994 to roughly $264 billion in 2004, the last year of available data. That marks more than a three-fold increase from the early 1990s, and was about double the $134 billion in U.S. services exports to Europe in 2004.

Figure 7.1: U.S.-Europe Services Linkages



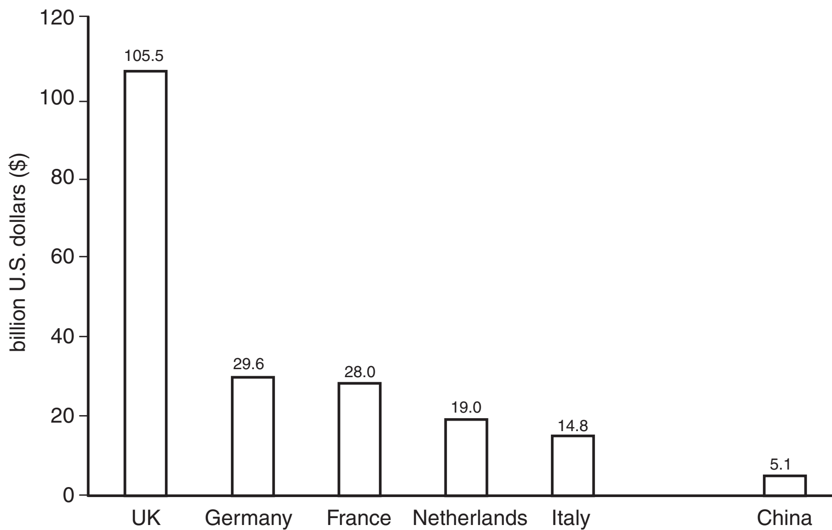
Source: Bureau of Economic Analysis, U.S. Department of Commerce

Europe is the most important market in the world for U.S. foreign affiliate sales of services, just as it the most important market for U.S. foreign affiliate sales of goods. Indeed, of total affiliate services sales of $490 billion in 2004, Europe accounted for 54 percent of the total, with Asia (with a share of 23.3 percent) and Latin America (11.7 percent) a distant second and third, respectively.

By country, the United Kingdom, whose various services sectors are most aligned with those of the U.S. accounted for the largest share of U.S. affiliate sales not only in Europe but also the world. In fact, foreign affiliate service sales in the UK in 2004 ($105 billion) were nearly as large as total foreign affiliate services sales in all of Asia ($113 billion). In Europe, Germany ($29.6 billion), France ($28 billion), and the Netherlands ($19 billion) trailed the UK.

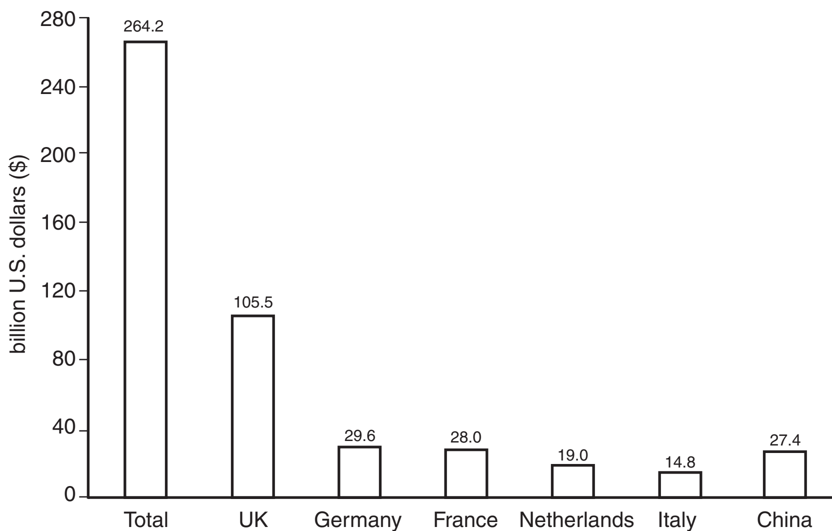
Sales of services by U.S. affiliates of European firms have also soared over the past decade. As Europe’s investment position in services has expanded in the U.S., so have foreign affiliate sales of services in the U.S. The latter totaled $260 billion in 2004 versus $86 billion in 1994, a three-fold increase. U.S. services imports from Europe expanded over the same period, by roughly 120 percent, well below

Figure 7.2 Services Sales of U.S. Foreign Affiliates Abroad—Europe vs. China



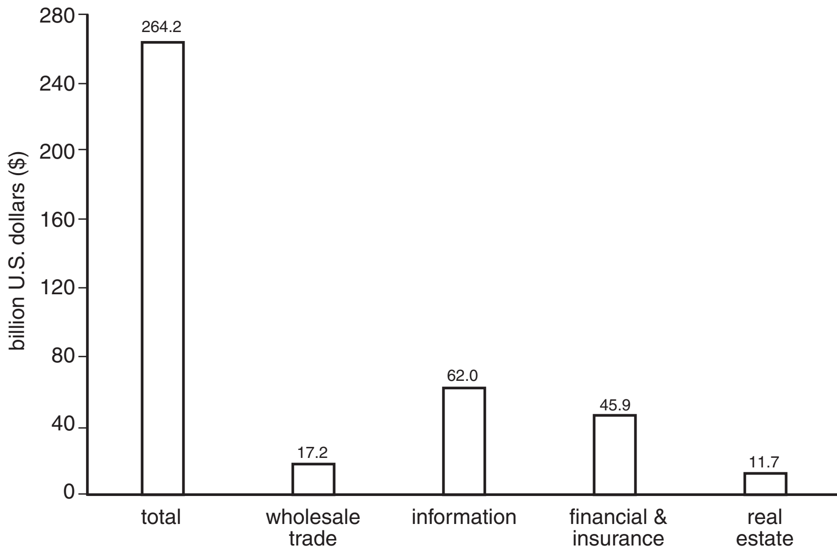
Source: Bureau of Economic Analysis

Figure 7.3 Sales of Services to Europe by U.S. Affiliates, by Country, 2004



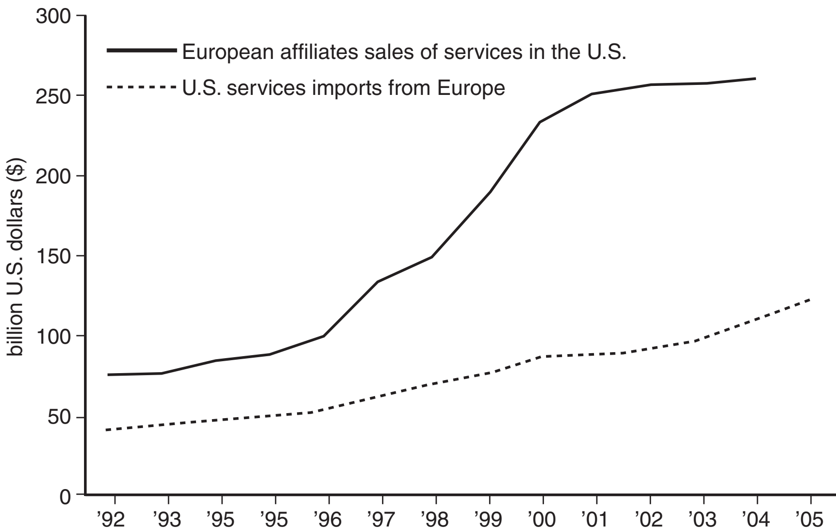
Source: Bureau of Economic Analysis

Figure 7.4 Sales of Services to Europe by U.S. Affiliates, by Industry, 2004



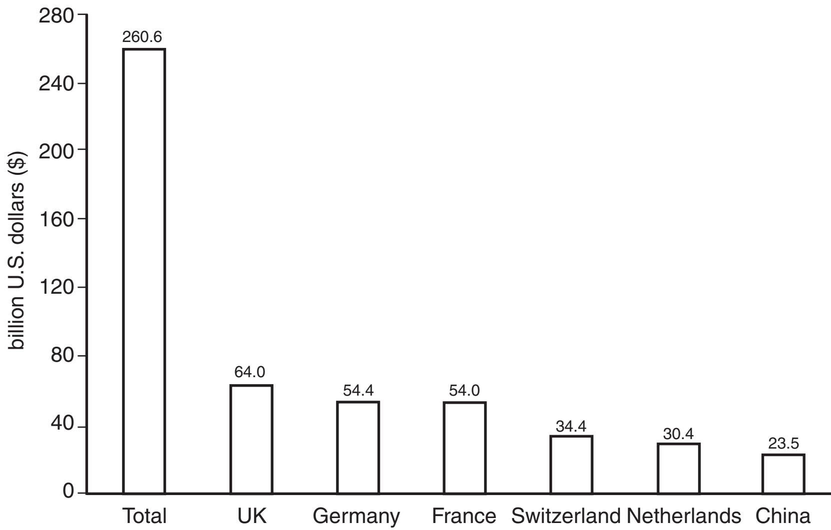
Source: Bureau of Economic Analysis

Figure 7.5 Europe-U.S. Services Linkages



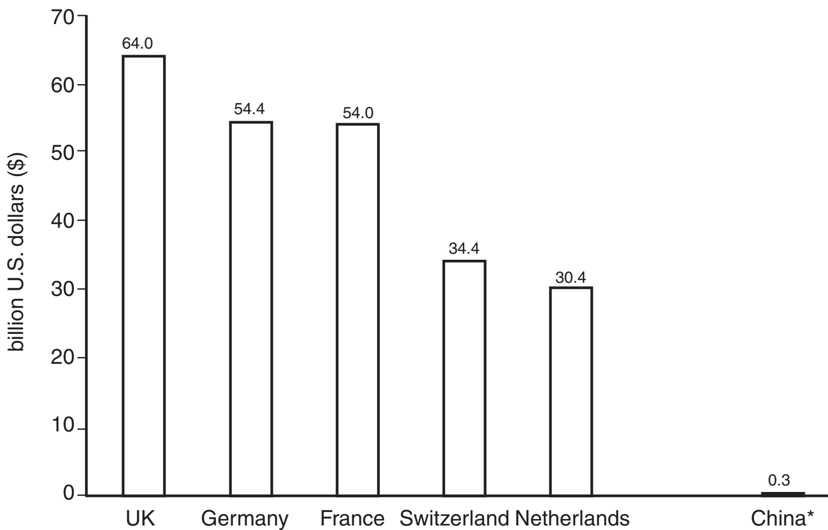
Source: Bureau of Economic Analysis

Figure 7.6 Sales of Services to U.S. by European Affiliates, by Country, 2004



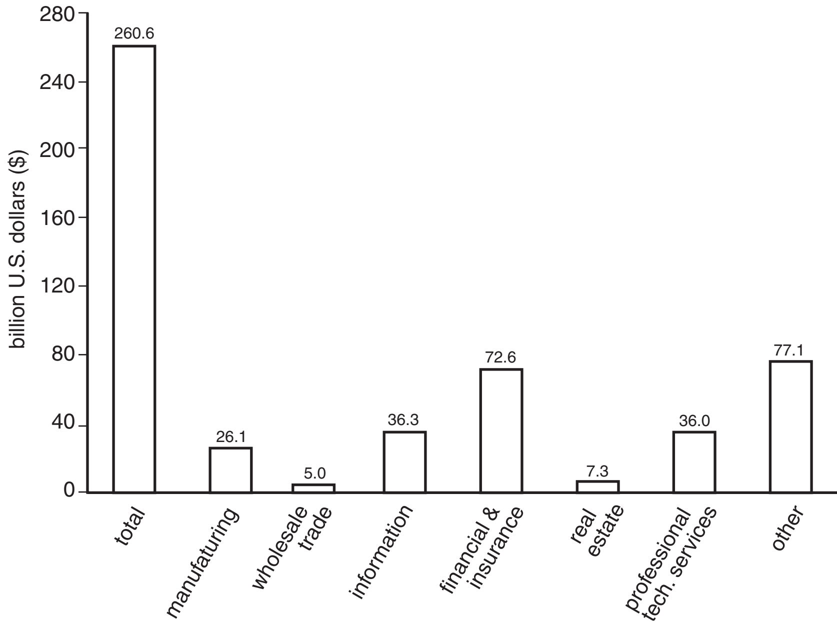
Source: Bureau of Economic Analysis

Figure 7.7 Services Sales of Foreign Affiliates in the U.S.—Europe vs. China, 2004



*Data for 2002
Source: Bureau of Economic Analysis

Figure 7.8 Sales of Services to U.S. by European Affiliates, by Industry, 2004



Source: Bureau of Economic Analysis

the rate of growth of affiliate sales of services. Services imports totaled $110 billion in 2004.

Leading the way were British services firms, whose U.S. affiliate sales in services totaled $64 billion in 2004, or roughly a quarter of total European affiliate sales. German, French and Dutch affiliates in the U.S. posted substantial sales of services as well, totaling $54.5 billion, $54 billion, and $30.3 billion, respectively, in 2004.

Financial and insurances services accounted for nearly 28 percent of total services sales in the U.S. by European affiliates, with sales totaling $72 billion in 2004. This was followed by information services ($36.3 billion), manufacturing services ($26 billion), professional and technical services ($23 billion), and a variety of other services sectors.

In short, foreign affiliate sales of services on both sides of the Atlantic have exploded over the past decade. In fact, affiliate sales of

services have not only become a viable second channel of delivery for U.S. and European multinationals, they have become the overwhelming mode of delivery in a rather short period of time. Moreover, nations where services accounted for close to 60 percent of overall employment—such as the UK, the U.S., and the Netherlands and Norway—had the best record of job creation within the OECD.[1]

Europe's Services Directive and the Impact on the Transatlantic Economy

Despite the major significance of the transatlantic services economy, barriers remain on both sides of the Atlantic. U.S. barriers are most prominent in maritime, legal, engineering, architectural and accounting services. In the EU-15 as a whole, barriers appear highest for domestic and foreign firms in accounting, maritime and legal services, and higher for foreign firms relative to domestic firms in distribution and maritime activities.[2] The key issue, however, remains the continued existence of services barriers within the EU itself. Liberalization of inner-EU services would be the single most important stimulus to the transatlantic services economy.

The EU has been committed to a common market for services and goods since its inception in 1957. The EU Single Market was supposed to come into effect on January 1, 1993, providing freedom of movements in goods, capital, people, and services. Seven years later, EU leaders announced a strategy for the removal of barriers to services, although progress has been very slow and piecemeal. Relatively speaking, goods move across the Union largely without difficulty; however, services remain hampered by 27 different sets of national rules and regulations—even though services account for almost 70 percent of GDP and jobs in the EU.

Through an initiative called the Services Directive, the EU commission seeks to break down services barriers all at once, rather than by tackling liberalization sector by sector. The Directive was adopted

[1] Tobias Buck, "OECD stresses services market reform benefits," *Financial Times*, April 27, 2005.

[2] OECD, *The Benefits of Liberalising Product Markets And Reducing Barriers to International Trade and Investment: The Case of The United States and the European Union*, *Economics Department Working Paper 432*, (Paris: June 2005).

at the end of 2006; member states have three years to implement it. While some elements of the Directive were widely opposed by EU members, analysts estimate that it could be an important initiative to improve the continent's competitiveness and employment, and deepen the linkages of the transatlantic economy.

Implementing the Services Directive would be akin to waking the sleeping giant of the transatlantic economy—services—and ultimately producing a number of benefits and gains for the U.S. and EU, including the following:

- *Boosting transatlantic foreign direct investment flows.* Like the Single Market program, which trigged a sharp rise in more foreign direct investment, the elimination or reduction of barriers to services activities in Europe would attract more foreign direct investment from leading services firms in the U.S. Under such a scenario, Europe would most likely remain the top destination of U.S. foreign direct investment, continuing the trend of the past half-century. Services deregulation would also promote more intra-European foreign investment.
- *Lowering prices while raising productivity and growth.* Services reform and deregulation would trigger greater cross-border competition in services, which would ultimately lead to lower prices, benefiting both consumers and businesses. Productivity levels would rise as costs declined and as firms leveraged more competitively priced services. Since services are a critical component of many manufacturing industries, greater service deregulation in Europe would yield a competitive boost to Europe's manufacturing sector. Finally, falling prices, combined with rising productivity would help boost real economic growth in the EU and a rise in European corporate earnings.
- *Improving wages and creating jobs.* The services sector of the EU already accounts for nearly 70 percent of total employment; a new regulatory framework that removes tariffs and non-tariffs to services would drive the percentage even higher. Net employment gains would be most noticeable in the new enlargement members, where services jobs (as a percentage of the total) lag the EU average.

- *Stimulating grater cross-border trade in services.* A more deregulatory environment for services would promote greater cross-border transactions in services, helping to boost not only intra-EU trade in services but also cross-border transatlantic trade in services. Cross border trade in services is already quite robust but would become even stronger under a more deregulatory climate.

The Way Forward

Removing barriers to trade and investment in services represents a key opportunity for the transatlantic community. While services presently account for the largest share of gross domestic product in virtually all of the nations that comprise the transatlantic economy, the role of services could be even larger and growth-enhancing if the political will was present to push ahead with even more services deregulation and reform.

At this juncture the lack of services reform represents a significant opportunity cost to the U.S., EU and the transatlantic economy. The lack of reform could very well undermine the growth and attraction of the transatlantic economy. On the other hand, services reform would only embellish and fortify the transatlantic economy's leading global role. The EU Services Directive is one step in the right direction, but others should follow—on both sides of the Atlantic—if the full potential of the transatlantic economy is to be realized.