CHAPTER 1

HEADLINE TRENDS:
A Pivotal Year for the Transatlantic Economic Partnership

More than five years after the U.S.-led global financial crisis and recession, the global economy is still struggling to find its footing. Global growth of 3.0% in 2013 was again below the long-term average of 3.7%, marking three consecutive years of subpar growth for the world. In 2013, the U.S. economy expanded by 1.9%, while growth in the euro area contracted 0.4%, following a 0.7% decline in 2012. Growth in Japan was better—1.7% in 2013. For the developed countries as a whole, the economic expansion was rather feeble last year—clocking in at just 1.3%.

Even the developing countries struggled in 2013, achieving growth of just 4.7%, the second consecutive year of sub-5% growth for this cohort. Remove China from the mix, and emerging market growth was even weaker than the headline figure. Over the course of the year, Brazil, Russia, India and many other emerging markets failed to maintain forward economic momentum. The U.S. economy grew just as fast, if not faster, than Brazil, South Africa and many other emerging markets. China underperformed as well, with real GDP growth of 7.7% in 2013—that's good but not great by China's standards, and well off the 10% growth levels of just a few years ago.

Here's 2013's silver lining: global economic activity, led by the U.S., picked up in the second half of the year, with the U.S. economy expanding by an annualized rate of 4.1% in the third quarter and 3.2% in the fourth quarter. Pleasantly surprising to virtually everyone, the U.S. unemployment rate dropped to 6.7% by December 2013 and ticked lower (6.6%) in January 2014. Thanks to a robust stock market and a rebound in home prices, the net worth of U.S. households continued to rise over 2013, boosting consumer confidence and spending over the balance of the year. Corporate earnings ended the year at near-record highs, while America's energy revolution helped to boost U.S. trade figures and U.S. global competitiveness.

Notwithstanding all of the above, the key question for the U.S. economy is the following: can the economy reach and sustain growth in the 3.0-3.5% range without the extraordinary help of the U.S. Federal Reserve, which has pumped unprecedented levels of liquidity into the U.S. economy since the collapse of Lehman Brothers in September 2008? As the Federal Reserve "tapers," or removes liquidity from the credit markets, will the U.S. economy be able to stand on its own two feet?

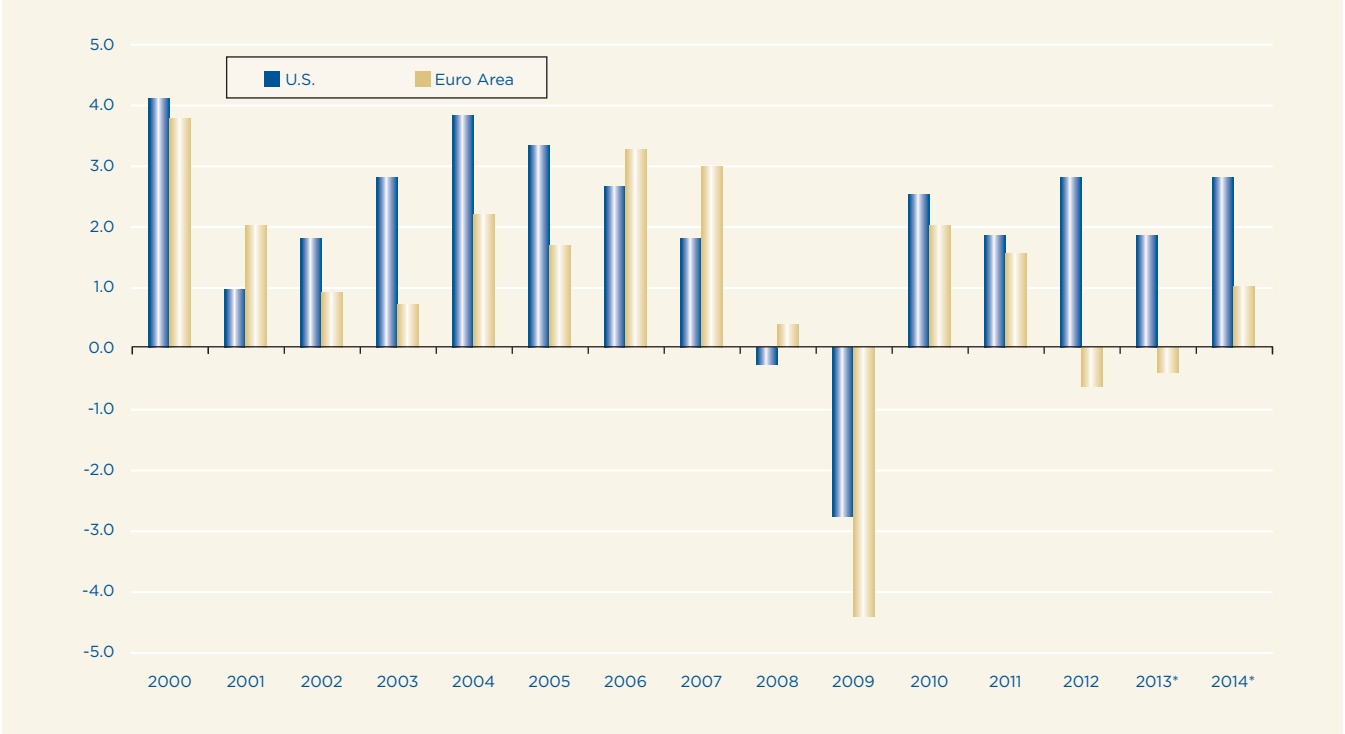
We believe the U.S. economy will achieve growth in excess of 3% in 2014, with consumption, investment and trade leading the way. There will be less of a fiscal drag in 2014, adding more forward economic momentum. For some perspective on the fiscal drag in 2013, the squeeze on fiscal spending was 2.7% of GDP, according to the OECD, which equates to one of the biggest belt-tightening packages since World War II.

Meanwhile, the balance sheets of U.S. households and U.S. corporations are robust, which should support rising consumption and investment levels this year. Even the finances of the U.S. federal government have improved (at least in the short run), with the U.S. federal budget deficit (in an absolute and relative sense) improving sharply in 2013. Add to the above: manufacturing activity has revived; productivity rates continue to improve; inflationary pressures remain mute; wages are tame; the U.S. housing and automobile markets remain robust; and foreign capital inflows to the U.S. remain strong, providing the U.S. economy with liquidity even in the face of Fed "tapering."

2014 is a pivotal year for the United States. It should be the year the economy finally escapes from the devastating and lingering effects of the financial crisis of 2008.

It's also a pivotal year for Europe. Across the pond, the question is whether or not the European Union can advance and build on the fragile economic recovery of

TABLE 1: U.S. VS. EURO AREA - REAL GDP, ANNUAL PERCENT CHANGE



** 2013: Estimate; 2014: Forecast.*
Source: IMF

2013. The acute phase of the euro crisis is over—that is the good news. The not-so-encouraging news is that Europe's economic recovery remains very shaky—deflation, stagnant economic activity, and stubbornly high unemployment levels all remain real threats to Europe's rebound. The region's recession technically ended in the first quarter of 2013. However, subsequent growth has been anemic and driven in large part by increased activity from Germany, Europe's strongest and largest economy. Presently, while Ireland, Portugal and Spain are in recovery mode—with much of Europe's periphery now running current account surpluses—France and Italy have slipped back into recession, placing a sizable drag on growth for the continent. How much traction can Europe gain if France doesn't grow, considering that the French economy is the second largest in Europe after Germany? Italy is the fourth largest economy, and the country's continuing woes represent another potential drag on overall EU growth.

What's more, the deleveraging that has transpired in the United States has yet to really happen in Europe. Private sector debt remains a key concern in Europe, with total domestic non-financial sector debt (households, non-financial firms, and the general government) some 232% of GDP at the end of 2012, up from 203% of GDP in 2007. In addition, European banks are not as well capitalized as their U.S. counterparts; hence in 2014, the European Central Bank (ECB) will assess the banks' balance sheets as part of its Asset Quality Review, with some banks expected to fail, placing more strain on European credit markets. The sector will come out stronger in the end from the exercise, but near-term credit volatility is expected.

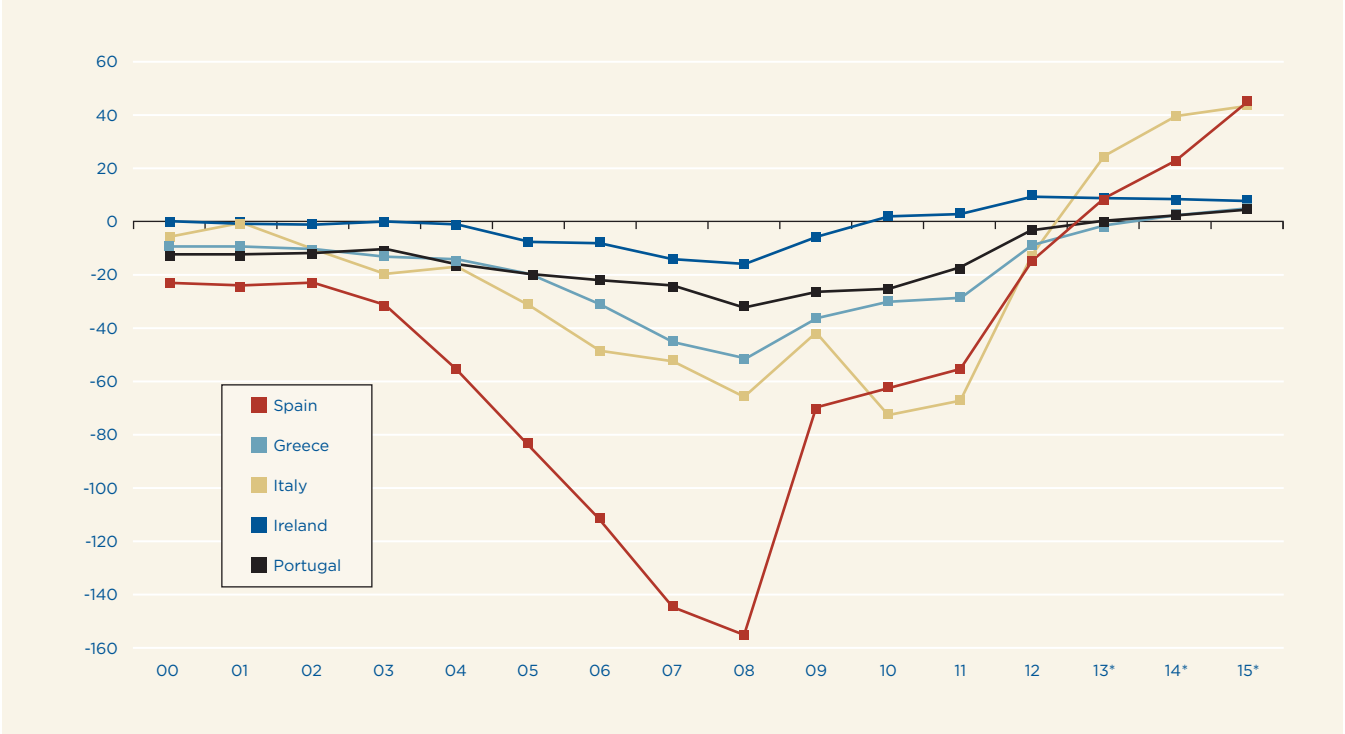
Given all of the above, the pivotal question for Europe is this: can the region build on the fragile foundation upon which it sits? Can policy makers in Brussels, at the ECB, and in national capitals work together to turn the recovery into a full-fledged expansion, or will Europe backslide into recession, creating more problems for itself and its transatlantic partner, the United States?

Our hunch is that Europe will muddle through this year, not backslide on growth, and slowly rebuild a competitive base for future growth. But many risks remain.

Finally, 2014 is also a pivotal year for the U.S. and Europe together, as the two partners negotiate a potentially transformative Transatlantic Trade and Investment Partnership (TTIP).

Over the past year, while the negotiators from the U.S. and Europe negotiated, reams of analysis and commentary were

TABLE 2: CURRENT ACCOUNT BALANCE OF PIIGS (1-YEAR MOVING TOTAL, BILLIONS OF $)



**Projections by the Organization for Economic Co-operation and Development (OECD)*
Source: OECD.

manufactured on both sides of the pond, with the general consensus being that the benefits of TTIP would outweigh the costs and that the deal should get done. Whether this happens remains to be seen, however; TTIP faces formidable political pressures and obstacles on both sides of the pond. It is unlikely that a deal would be concluded this year.

That said, why TTIP?

The Benefits from a Comprehensive TTIP Agreement

At first glance, the idea that the United States should hitch its wagon to struggling Europe via comprehensive arrangements on free trade, investment and other areas could appear misguided. Yet such a comprehensive agreement would grant U.S. companies greater market access to the world's largest and wealthiest economy—the European Union (EU)—and help drive future sales and earnings for many firms. Conversely, for numerous European firms already embedded in the United States, a transatlantic pact would help strip away multiple barriers to doing business in the U.S., boosting sales and profits over the long-term as well.

The deal, in short, would be a win-win for both sides, and not just for U.S. and European multinationals. Small and medium-sized firms could in fact be the main beneficiaries. While a high degree of market integration already exists between the U.S. and Europe thanks to past and existing trade and investment agreements, much more can be done to fuse the world's two largest economies together. A transatlantic agreement would reduce tariffs to near zero across most product categories, but even greater gains would be realized through reductions in non-tariff barriers and harmonizing the web of regulatory standards that inhibits transatlantic trade and investment flows and adds to the cost of doing business on both sides of the ocean.

We are not talking about sexy topics here: recognizing each other's food safety standards to be compatible or essentially equivalent; establishing e-commerce protocols; resolving data privacy issues; standardizing a myriad of services-related activities in such sectors as aviation, retail trade, maritime, telecommunications, procurement rules and regulations; and promoting "upstream" regulatory cooperation for new technologies. The move towards a more barrier-free transatlantic market would also include product standardization so that a car tested for safety in Stuttgart can be sold without further tests in Spartanburg. Or a drug approved by the Federal Drug Administration in Washington is deemed safe and market-ready in Brussels.

Technical regulations and safety standards are not exciting topics. But when these hurdles to doing business are stripped away, the end results are lower costs for companies and greater demand for their goods and services. Consider the crash test dummy. U.S. carmakers run their autos into walls with essentially the same human-dimensioned test device aboard as do European carmakers. Safety standards are high and similar. Yet to export their cars, automakers must run the test again to meet the other government's measurement standards. If the United States and the European Union would recognize each other's crash tests and related standards, estimates are that price savings could range up to 7% on each car or truck.[1] Another example is packaging of pharmaceutical products in both the U.S. and Europe. Reuters cites a German pharmaceutical executive as saying that when selling asthma inhalers in both the U.S. and Europe, the company had to spend $10 million just to prepare the product for the two markets because of the two different standards of dose counters.

Given the influence of the transatlantic economy, U.S.-EU standards are likely to set the tone for global standards, reducing the likelihood that other nations like China would impose protectionist or less safe or healthy requirements for products or services.

An agreement that included efforts to remove barriers to services would have an even greater impact on jobs and growth. As we have documented elsewhere,[2] services represent the sleeping giant of the transatlantic economy. Most American and European jobs are in the services economy, which accounts for over 70% of U.S. and EU GDP. The U.S. and EU are each other's most important commercial partners and major growth markets when it comes to services trade and investment. Deep transatlantic connections in services industries, provided by mutual investment flows, are not only important in their own right; they are also the foundation for the global competitiveness of U.S. and European services companies. A good share of U.S. services exports to the world are generated by European companies based in the U.S., just as a good share of EU services exports to the world are generated by U.S. companies based in Europe. Yet protected services sectors on both sides of the Atlantic account for about 20% of combined U.S.-EU GDP—more than the protected agricultural and manufacturing sectors combined. Major services sectors such as electricity, transport, distribution and business services suffer from particularly high levels of protection. A targeted opening of services could present vast opportunities to firms and huge gains to consumers in both the EU and the United States. Removing barriers in these sectors would be equivalent to 50 years' worth of GATT and WTO liberalization of trade in goods. An initial transatlantic initiative could be a building block for more global arrangements. Such negotiations would be likely to trigger plurilateral negotiations to include other partners.

As for tariffs, average transatlantic tariffs are relatively low, at about 3-4% on average, although tariffs remain quite high in such categories as agriculture, textiles and apparel, and footwear. So there is room for barriers to come down. In addition, since the volume of U.S.-EU trade is so huge, eliminating even relatively low tariffs could boost trade significantly. A report by the European think tank ECIPE estimated that a transatlantic zero-tariff agreement could boost U.S. and EU exports each by 17%—about five times more than under the recent U.S.-Korea free trade agreement.[3] Moreover, since a large percentage of transatlantic trade is intra-firm, or trade in parts and components within the firm, even small tariffs can add to the cost of production and result in higher prices for consumers on both sides of the ocean. The more intense the intra-industry trade component of trade between two parties, like the one that characterizes U.S.-EU commerce, the greater the effects and benefits of lower tariffs.

At a broader and more macro level, a study by the EU Commission found that eliminating or harmonizing half of all non-tariff barriers on bilateral commerce would add 0.7% to the size of the EU's economy and 0.3% to America's economy by 2018. Such an effort would be 3 times more beneficial to the U.S. and EU economies than current offers on the negotiating table in the Doha Round regarding manufacturing, services and sectoral agreements.[4] Even a 25% reduction in non-tariff barriers could lead to a $106 billion increase in combined EU and U.S. GDP.

Such a deal would help create jobs and income on both sides of the Atlantic, and give U.S. and European firms a leg up in the world's two largest markets, the European Union and the United States.

The bottom line is this: while a U.S.-EU "free trade plus" deal may sound illogical right now for numerous reasons, such a deal makes plenty of sense for both parties over the long term. Trade pacts may not be exciting and rarely garner the attention of Wall Street. But this deal would be a blockbuster and help revive and reinvigorate the transatlantic economy and U.S. and European firms embedded on both sides of the pond. The geo-strategic implications of such a deal would also be significant. If leaders on both sides of the Atlantic grasp the moment, the first U.S. 'Pacific President' and his EU partners may well become best known for having re-founded the Atlantic Partnership.

TABLE 3: THE FOUR ENGINES OF THE WORLD ECONOMY (% OF WORLD TOTAL, 2012)

	Engine One: North America	Engine Two: Europe	Engine Three: Asia	Engine Four: Commodity Producers
GDP (Purchasing Power Parity)	21.3	20.8	36.5	21.4
Population	5.0	8.6	55.8	30.6
Private Consumption Expenditure*	29.3	25.3	26.8	18.6
Exports	11.4	34.8	33.0	20.8
Imports	15.7	34.1	32.7	17.5
International Reserves**	2.0	13.2	57.8	27.1

Sources: IMF, UN
**Personal or household consumption expenditure*
***Excluding gold*

In the end, transatlantic economic activity will pivot on three variables in 2014. First, the level of activity (think trade, investment, profits, employment, etc.) will be determined by whether or not the U.S. economy finally breaks free from the lingering effects of the 2008-09 recession and expands/grows by better than 3% annually this year. Second, activity will be determined by Europe's ability to avoid an economic relapse or recession this year, and continue to build on the fragile recovery of 2013. Finally, transatlantic commerce will be influenced by the TTIP negotiations—whether or not U.S. and EU trade negotiators can demonstrate tangible progress toward reaching one of the most ambitious and far-reaching commercial agreements in history in the face of stiff political headwinds on both sides of the pond. A successful deal would be a catalyst for more transatlantic trade and investment, and its positive spillover effects. Failure, on the other hand, could be a demoralizer and disincentive to more transatlantic business and commerce.

Time will tell. In the meantime, it is worth underscoring the importance of Europe in the world economy by revisiting our model framework— the world economy as a Boeing 747.

Europe's Place in the Global Economy

When framing Europe's role in the global economy, it is useful to think of the world economy as a four-engine Boeing 747. Engine Number One is composed of the United States and Canada, accounting for over one-fifth of world GDP based on purchasing power parity, according to the IMF. Although Engine One is home to just 5% of the world population, this engine nevertheless accounts for 29.3% of global consumption and for 15.7% of world imports. These are impressive figures. But the numbers are even larger when considering Engine Two.

Engine Two consists of the 28 member states of the European Union and a few neighboring countries like Switzerland and Norway. This engine accounts for 21% of world GDP and over one-quarter of global consumption. The EU is the world's largest exporting entity and the world's largest trader in goods and services. It is the top supplier of goods to developing countries and is the largest trading partner of each of the BRICs—Brazil, Russia, India, China. It is the largest provider and recipient of foreign direct investment among all world regions. These metrics underscore the fact that Europe plays a key role in keeping the global economy aloft. Against this backdrop, it is little wonder that Europe's lingering sovereign debt crisis and depressed growth levels have placed a tremendous strain on the other engines of the world economy.

Engine Three is Asia, the largest region in the world in terms of output and population. This engine stretches from India to Japan, and as we have learned in the past four years, Engine Three cannot fly solo. Weakness in Engine Two (Europe) has translated into declining exports from Asia, notably China, reducing real economic growth rates across the region.

Europe still matters—just ask thousands of Asian exporters whose orders and revenues have declined on account of the eurozone crisis. Or ask the commodity producers who make up the bulk of Engine Four. Their export receipts have declined sharply over the past few years due to softening global demand. Although this is a diverse group, encompassing such regions as Latin America, the Middle East, Russia, central Asia, central Europe and Africa, the common link holding Engine Four together is their combined role as the world's supplier of primary commodities. Their fortunes are tied to global economic activity—rising global output is typically associated with rising commodity prices, and vice versa. Hence, with Europe acting as a significant drag on global growth, the pain and aftershocks have been felt far and wide among the world's commodity exporters.

TABLE 4: COUNTRIES' BANKS: CROSS-BORDER EXPOSURE (AS OF END SEPTEMBER 2013)

Exposure to...	Belgian banks	French banks	German banks	Greek banks	Irish banks	Italian banks	Portuguese banks	Spanish banks	UK banks	U.S. banks
Belgium		$224.134	$32.4 bn	$292 m	$206 m	$5.1 bn	$172 m	$6.1 bn	$16.4 bn	$19.7 bn
France	$31.2 bn		$204.3 bn	$1.5 bn	$5.5 bn	$40.0 bn	$5.3 bn	$41.1 bn	$224.5 bn	$226.7 bn
Germany	$10.7 bn	$199.4 bn		$2.3 bn	$1.7 bn	$235.8 bn	$1.2 bn	$59.3 bn	$174.6 bn	$162.5 bn
Greece	$5 m	$2.1 bn	$30.6 bn		$190 m	$1.5 bn	$166 m	$632 m	$11.9 bn	$11.4 bn
Ireland	$19.6 bn	$37.9 bn	$70.8 bn	$319 m		$9.8 bn	$6.8 bn	$5.3 bn	$120.3 bn	$62.0 bn
Italy	$10.0 bn	$345.8 bn	$126.8 bn	$562 m	$662 m		$4.2 bn	$27.8 bn	$47.7 bn	$47.9 bn
Portugal	$430 m	$15.7 bn	$22.4 bn	$24 m	$359 m	$1.5 bn		$72.0 bn	$14.6 bn	$3.8 bn
Spain	$12.2 bn	$107.0 bn	$124.1 bn	$215 m	$3.0 bn	$21.0 bn	$20.1 bn		$84.6 bn	$52.1 bn
UK	$24.9 bn	$174.7 bn	$452.1 bn	$10.7 bn	$91.8 bn	$51.9 bn	$3.2 bn	$394.0 bn		$545.1 bn

**Exposure to Belgium and Greece as of the end of June 2013.*
Sources: Bank for International Settlements; Financial Times.
Data for foreign claims by nationality of reporting banks, immediate borrower basis.

All of the above serves as a template by which to view the world economy. Too much attention is typically paid to the United States and Asia, led by China, as key growth engines of the world, with only passing consideration given to Europe. Yet Europe's economic weight and stature is just as critical. Europe matters—a fact the world has painfully come to realize over the past few years.

How the Eurozone Crisis has been Transmitted to the United States

The dense weave of U.S.-European commercial interconnections amplifies both positive and negative economic trends across the Atlantic. Just as the U.S. financial crisis had a major impact on the European economy, the European financial crisis has affected U.S. economic prospects. The contagion has been transmitted to the United States via three channels—through the capital markets, through trade and investment, and through U.S. corporate earnings. Each channel is discussed briefly below.

Channel One: The Credit and Capital Markets

One of the most direct ways Europe's financial crisis has manifested itself in the U.S. has been through shifting money flows in the transatlantic capital markets, the largest in the world. Transatlantic capital flows have been quite volatile since the U.S. financial crisis, which dramatically curtailed the cross-border movement of capital as banks and other nonfinancial institutions globally retrenched and redirected capital back home. U.S. banks pulled money out of Europe and European banks pulled capital out of the United States, an expected and rational response in times of financial stress and uncertainty. In addition, with bank capital requirements soaring on both sides of the Atlantic, U.S. and European banks have had to rebuild their capital base through asset sales, reduced deal financing and less cross-border lending, resulting in a corresponding weakening in cross-border flows.

Europe's sovereign debt crisis only served to make banks even more risk-adverse, although as mentioned above, a more aggressive ECB has helped alleviate credit fears over a possible sovereign default. The credit cycle in Europe is gradually improving. That said, however, Europe remains highly financially interdependent, hence the lingering fear that financial stress in one corner of the eurozone will quickly spread to others.

Table 4 underscores this interdependence. Notice the exposure of German banks to Spain, Greece and Portugal. At the end of September 2013 Germany's bank exposure totaled roughly $31 billion to Greece and $22 billion to Portugal, but a staggering $124 billion in Spain. French banks have significant exposure in Italy ($346 billion) and Spain ($107 billion). These numbers have declined over the past few years but nevertheless remain significant. Given this deep interdependence, it is easy to understand the mounting panic in global capital markets over 2010-12 when Europe's sovereign debt crisis threatened a number of countries. The good news is that the panic has subsided; ECB President Mario Draghi's pledge of "whatever it takes" in the summer 2012, supported by German Chancellor Angela Merkel's determination that the euro would not fail, helped break the cycle of fear and financial panic, and was instrumental in engender confidence across the continent last year.

As for the United States, given the interdependence of the transatlantic capital markets, Wall Street has not been spared Europe's financial crisis. U.S. banks are not overly exposed to either Greece or Portugal: outstanding U.S. loans/claims in Greece totaled just $11 billion and $3.8 billion in Portugal in late 2013. Yet U.S. financial institutions are quite heavily exposed to the United Kingdom, Italy, France and Germany, which in turn are highly leveraged to some of Europe's most financially stressed nations. Transatlantic financial linkages, in other words, are thick and very much entangled across borders, meaning that a financial problem in one nation in the eurozone is a problem for the entire continent, and potentially the United States.

Against this backdrop, portfolio flows from Europe to the United States declined again in 2013, and sharply. According to figures from the U.S. Treasury Department, purchases of U.S. assets (U.S. Treasuries, government agency bonds, corporate bonds, and equities) from the EU15 (or developed Europe) plunged 16% in the first eleven months of 2013 versus the same period a year ago. EU15 purchases of U.S. Treasuries declined by 58% over the period, while purchases of U.S. equities were down 33%. In total, portfolio inflows from the EU15 amounted to roughly $115 billion last year, one of the lowest levels since the early 1990s.

This plunge reflects the credit and capital stress of Europe, with more investors—private and public—needing to raise capital at home to cover their expenses and credit obligations. The downturn also reflects, in part, investor unease with how the U.S. government conducts business, with the government shutdown in late 2013 leading to large selling of U.S. securities among foreigners.

As for foreign direct investment flows, FDI inflows from Europe to the United States have also trailed off over the past few years. Indeed, in the first nine months of 2013, European FDI to the U.S. plunged 37% from the same period a year earlier. This came on the heels of a 17.7% decline in inflows in 2012. For the year, we estimate that Europe's FDI investment in the United States totaled roughly $80 billion, one of the weakest levels in years.

But last year's decline is attributable to massive disinvestment (or outflows) from Belgium, a point worth highlighting. U.S. FDI inflows from Belgium in the first three quarters of 2013 were a net -$13.3 billion, a massive disinvestment figure that distorts total FDI inflows. Indeed, excluding Belgium, FDI inflows from Europe to the U.S. dropped by 7.6% as opposed to the 37% decline with Belgium included in the figures.

By country, FDI inflows from Germany to the United States plunged 118% from the same period a year earlier; year-over- year declines were also posted by the Netherlands (-30%), France (-66%), Sweden (-108%), and the United Kingdom (-10%). In general, recessionary conditions in Europe have hampered the global expansion plans of many European firms, many of which facing declining earnings at home, higher capital costs and greater caution on the part of senior management. All of these factors have converged to lower European FDI flows to the United States.

Channel Two: Cross-Border Trade and Investment

Not unexpectedly, America's trade deficit with the European Union widened again in 2013, with the U.S. posting a $125 billion merchandise trade deficit with the EU for the year. The figure was 8% larger than the prior year but more than double the deficit in 2009 ($60 billion).

Germany, incidentally, accounted for just over half the deficit, with the U.S. posting a $67 billion trade deficit with Europe's largest economy in 2013, a rise of 12.2% from the levels of 2012. In 2013, U.S. exports to Germany fell 2.8%, to $47.4 billion, while imports rose 5.5%, to $114.6 billion.

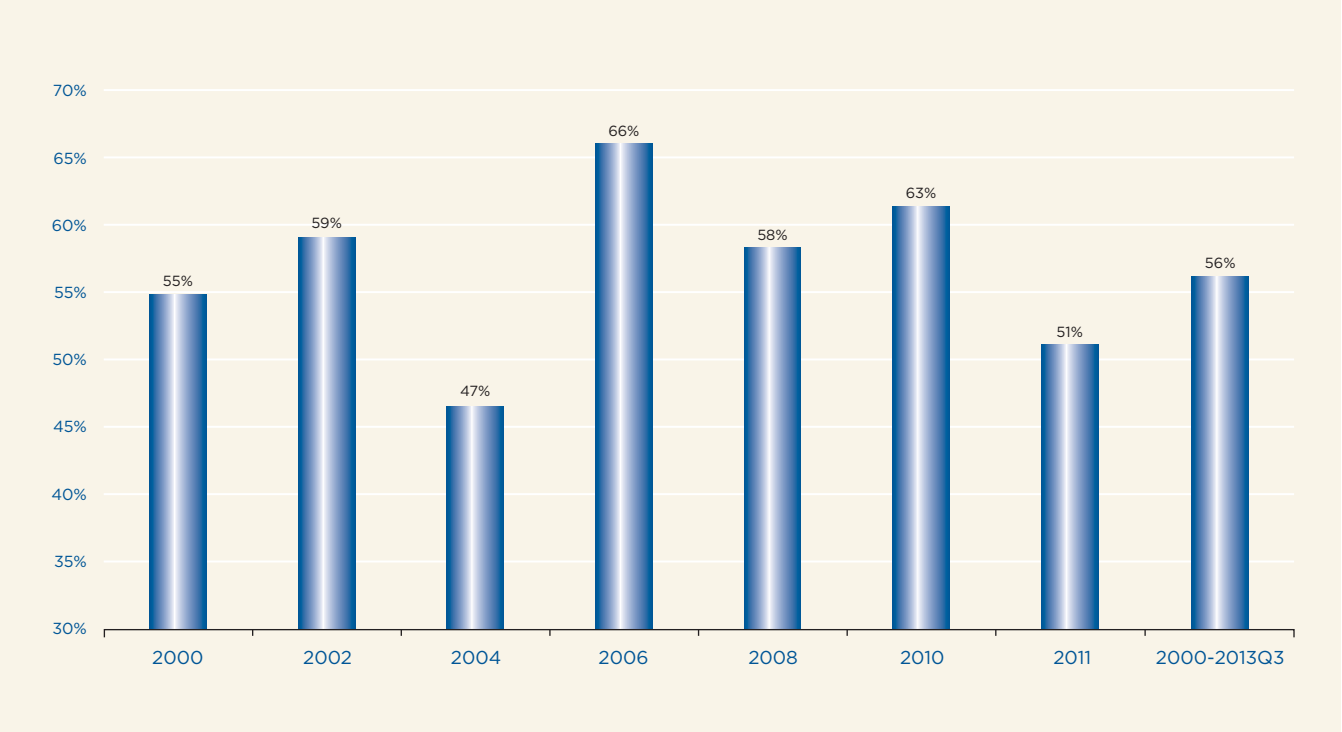
U.S. exports posted gains to Belgium (+7.7%), France (3.8%), Italy (2.6%), the Netherlands (5%) and a host of smaller nations in 2013. The largest declines were reported with Ireland (-10.4%), Sweden (-17.9%) and the United Kingdom (-13.7%). After Germany, the U.S. posted large trade deficits with France ($13.3 billion), Ireland ($25 billion), Italy ($22.1 billion), and the United Kingdom ($5.3 billion).

In this context it is important to note that while the United States has been registering consistent merchandise trade deficits with Europe, it also continues to register consistent services trade surpluses with Europe. While the services data is not up to date as the merchandise trade data, the trends are clear. In 2012 the United States enjoyed a near $67 billion trade surplus in services with all of Europe, and in the first nine months of 2013 the United States posted a $51 billion trade surplus in services with Europe.

Channel Three: U.S. Corporate Earnings

Finally, it is not just finance and trade where the ill effects of the European crisis have hurt the United States. The impact has also been evident in earnings—the bottom line—of many U.S. corporations. Whether autos and capital goods, or high-end retail or transportation, numerous American firms have struggled to post profits in Europe since the financial crisis started in late 2010.

TABLE 5: CORPORATE AMERICA'S BIAS TOWARD EUROPE
(U.S. FOREIGN DIRECT INVESTMENT (FDI) OUTFLOWS TO EUROPE AS A PERCENT OF TOTAL)



Source: Bureau of Economic Analysis
Data through 3Q2013

When Europe struggles, so does a large part of Corporate America, given the region's outsized influence on corporate profits. No other region of the world is as important to the global success of U.S. multinationals as Europe, due to the simple fact that over the past few decades no place in the world has attracted more U.S. foreign direct investment than Europe. Over the 1980s, for instance, Europe accounted for 55% of total cumulative outflows from the United States. Europe's aggregate share of U.S. investment dipped to 53.5% in the 1990s before rebounding in the first decade of this century, edging up to 55% of the global total.

Not much has changed in this decade thus far. Although Europe has been in the throes of a financial crisis, since the start of this century it has attracted just over 56% of total U.S. investment (see Table 5). That is a robust share considering the emergence of rising markets elsewhere and all the misplaced hype about U.S. firms decamping from high-cost locales—the U.S. and Europe—for cheaper destinations in China and India. The evidence suggests otherwise.

Table 6 offers numerous metrics—the number of foreign affiliates, affiliate employment, R&D expenditures, compensation, total assets—that rank Europe at the top of the list. In good times, these transmission belts of economic integration amplify opportunities for growth, profits and jobs. But by the same token, when things go sour, as they have in the past few years in Europe, the ill effects are quickly transmitted to the bottom line of many U.S. multinationals.

These interlinkages meant that U.S. affiliates registered a slight gain in income in 2013. U.S. affiliate income—a proxy for the earnings of U.S. companies in Europe—totaled $172 billion in the first nine months of 2013, up slightly, or 1.2% from the same period a year earlier; we estimate that for the year, affiliate income totaled $230 billion. As is typically the case, affiliate income varied by country—declines in income were reported in the first nine months of the year in France (-12%) and Germany (-63%), as well as the recession-weary nations of Greece (-114%) and Italy (-65%). Offsetting increases were reported in Ireland (1.1%), the Netherlands (7%), and the United Kingdom (12.8%).

Near-Term Outlook: The Worse is Over, but Risks Linger

Plenty of risks linger over the transatlantic economy in 2014, but for the most part, the balance is tilted towards more upside surprises than downside disappointments over the near term. As *The Economist* has noted, "the West is looking sprightlier, with output growing simultaneously in its three big regions—America, Japan and Europe—a rarity in recent years."[5]

TABLE 6: EUROPE IS NUMBER ONE FOR U.S. FOREIGN AFFILIATES*

	Value	% of Total	Global Rank**
Number of Affiliates	13,415.0	52.3%	1
Thousands of Employees	4,191.4	35.6%	1
Manufacturing Employment (Thousands)	1,780.9	37.4%	1
Total Assets (Bil. US$)	12,175.1	58.8%	1
Net Property Plant & Equipment (Bil. US$)	450.8	37.5%	1
Total Sales (Bil. US$)	2,847.8	47.7%	1
Sales of Goods	2,052.1	47.1%	1
Sales of Services	698.5	50.3%	1
Net Income (Bil. US$)	621.9	55.8%	1
Capital Expenditures (Bil. US$)	63.6	33.5%	1
R&D Expenditures (Bil. US$)	27.7	60.4%	1
Gross Product ("Value Added", Bil. US$)	697.8	48.3%	1
Compensation of Employees (Bil. US$)	283.3	52.9%	1
The following data is for 2012			
US Foreign Direct Investment Outflows (Bil. US$)	188.5	51.4%	1
Affiliate Income (Bil. US$)	226.4	50.4%	1
Direct Investment Position on a Historical-Cost Basis (Bil. US$)	2,477.0	55.6%	1

**Majority-owned bank and nonbank foreign affiliates; data for 2011, latest available.*
***Ranked against Canada, Latin America ex. Other Western Hemisphere, Africa, Middle East and Asia & Pacific.*
Source: Bureau of Economic Analysis.

A rarity, indeed. 2014 could turn out to be the year the transatlantic economy becomes more in sync, with 3% plus growth in the United States giving Europe the added lift to reach a stable growth path. Improving prospects in the latter, in turn, would greatly benefit Corporate America's massive investment stakes in Europe. Consumer and business confidence is building on both sides of the pond—a positive setting for the transatlantic economy. However, confidence can be a very fleeting and fickle commodity—here today, gone tomorrow—leaving many constitutencies disappointed and frustrated.

Speaking of disappointed and frustrated, any enthusiasm over the near-term outlook for the transatlantic economy has to be tempered by the employment challenges confronting both the United States and Europe. While America's jobless rate has declined to 6.6% of the workforce, the headline figures don't tell the entire story. Structural unemployment remains quite high in the U.S.; the labor force participation rate is declining, while the number of workers considered to be long-term unemployed remains at record levels. Much work remains to be done.

An even greater employment challenge confronts Europe. Employment growth across the continent has been very anemic, with Europe's unemployment rates early in 2014 still stubbornly high and politically dangerous; the swollen ranks of Europe's unemployed remain a lightning rod for social instability. The EU's unemployment rate was 10.8% in November 2013, near a record high, and well beyond the U.S. figures. But more worrisome than the headline figure is the fact that the unemployment rate was higher than 27% in Greece in November 2013 and above 26% in Spain.

Meanwhile, the jobless rate among Europe's youth remains staggering—in November 2013, youth employment (ages 15-24) averaged 23.6% in the EU. In Italy, the figure was 41.6%, 36.8% in Portugal, 57.7% in Spain, and 54.8% in Greece. These figures sometimes include students and other categories of young people that obscure the true state of unemployment, but regardless of specifics, the situation is troubling.

Between the United States and EU, there were some 37.4 million workers counted as unemployed in November 2013, a staggering figure and an astounding waste of human potential.

The swollen ranks of the unemployed on both sides of the pond have fueled a fierce and emotional debate over

Who is America's Dance Partner, Europe or Asia?

There is nothing more fashionable today than writing about Europe's demise, notably in light of Europe's sovereign debt crisis and lingering fears that the euro zone still might break apart. Weak real economic growth, along with threats of deflation and high unemployment, only detract from Europe's allure.

Add it all up and it is easy for American firms to think they should just cut and run from Europe and invest elsewhere. It may be tempting to think that Washington should not waste any political capital on Europe and focus instead on dynamic Asia and the completion of the Trans-Pacific Partnership (TPP) trade pact, an idea that has also gained some traction in the past year. This has become the general consensus. But it is misguided.

As Table 7 highlights, if the U.S. is going to invest energy negotiating a trade agreement with either Europe or Asia, by virtually all metrics a transatlantic deal is where there is more bang for the proverbial buck. The Trans-Pacific Partnership (TPP) does not include either China or India, two of Asia's largest economies. Hence its economic heft is not as sizable as most believe, and underwhelming relative to Europe.

When negotiating with the European Union, the United States is engaging the largest and wealthiest economic entity in the world. Europe's economy is almost 50% larger than the TPP cohort, more populated and far wealthier. The latter is key—the per capita income of the European Union ($32,797) is 33% larger than the nations of TPP.

Not surprisingly, personal consumption in Europe is well above the level of TPP members—$9.7 billion versus $7.1 billion, a 38% difference between TTIP and TPP. Europe is also a much larger exporter and importer than the TPP construct. And finally, as various metrics like FDI, affiliate income, and affiliate sales indicate, Corporate America's greatest stakes are in Europe, not Asia. The Transatlantic Trade and Investment Partnership that the U.S. and EU are now negotiating could deepen these ties to the mutual benefit of both parties.

TABLE 7: COMPARING FREE TRADE AGREEMENTS (BILLIONS OF $ UNLESS OTHERWISE SPECIFIED)

	Transatlantic Trade and Investment Partnership	Trans-Pacific Partnership	NAFTA
GDP (Purchasing Power Parity)	15,993	10,755	3,272
% of World Total	19.2%	12.9%	3.9%
Population (thousands)	508,381	483,649	155,685
% of World Total	7.2%	6.8%	2.2%
Per Capita Income ($)	32,797	24,587	19,262
Personal Consumption Expenditures	9,720	7,066	1,815
% of World Total	23.2%	16.9%	4.3%
Exports	5,583	2,801	824
% of World Total	31.3%	15.7%	4.6%
Imports	5,734	2,934	917
% of World Total	31.1%	15.9%	5.0%
U.S. Outward FDI Stock to...	2,238	934	452
% of U.S. Total	50.3%	21.0%	10.2%
U.S. Inward FDI Stock from...	1,642	620	240
% of U.S. Total	61.9%	23.4%	9.1%
U.S. FDI Income Earned Abroad	196	96	44
% of U.S. Total	43.6%	21.4%	9.8%
Foreign FDI Income Earning in the U.S.	107	37	16
% of U.S. Total	70.9%	24.6%	10.3%
Foreign Affiliate Sales of U.S. MNC's in...*	2,375	1,852	871
% of U.S. Total	39.8%	31.0%	14.6%
U.S. Affiliate Sales of Foreign MNC's from...*	1,857	909	267
% of U.S. Total	52.9%	25.9%	7.6%

Sources: IMF; UN; BEA.
Data for 2012
**Data for 2011*

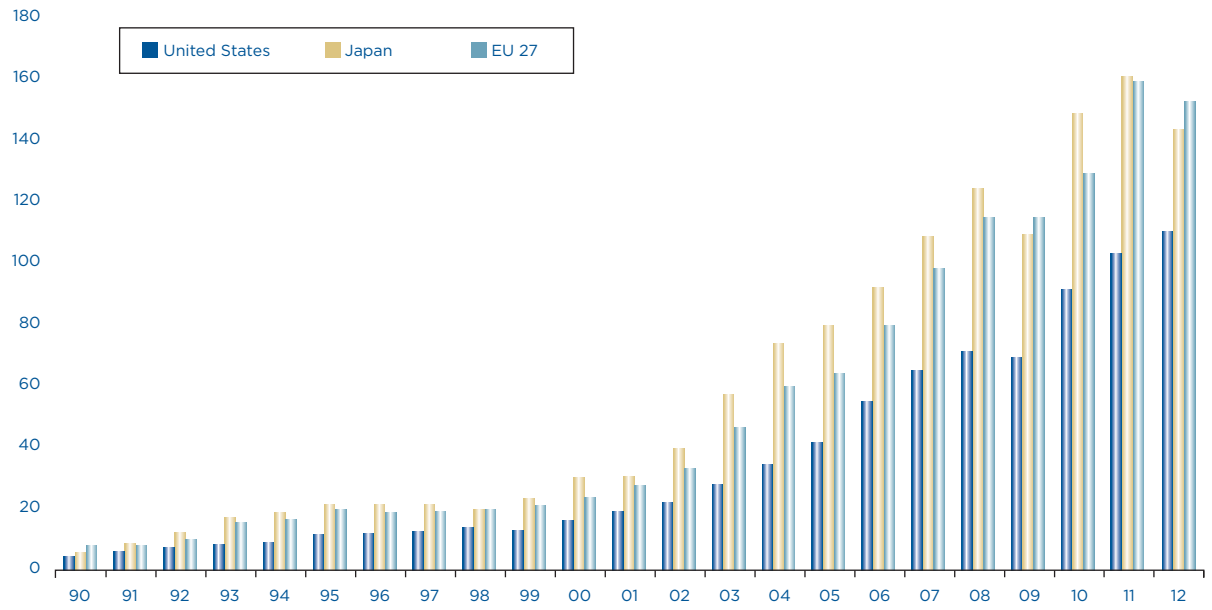
Trading with China: Who Has the Advantage?

U.S. and European multinationals, well entrenched in each other's markets, are scrambling to win the hearts and wallets of Chinese consumers, and for good reason: China is home to one of the largest and fastest growing consumer markets in the world. China now accounts for nearly 10% of world imports, a share greater than any country in Europe. Germany ranked third behind China in 2012; the United States was Number One.

European firms are prime beneficiaries of this little-known fact. They are way out in front of their U.S. counterparts when it comes to providing goods to the Middle Kingdom. For instance, in 2012, EU exports to China totaled $153 billion, some 39% larger than U.S. exports to China. The EU was even ahead of Japan, whose exports to China totaled $144 billion. Germany is the largest exporter to China among European exporters, with Germany exports totaling $68 billion in 2012, the last year of full data. In the first nine months of 2013, EU exports to China amounted to $121 billion, a rise of 6.5% from the same period a year earlier; Japan's exports totaled $94 billion, down 15%, while exports from the U.S. were valued at $83 billion, up 5%. High-end French and Italian luxury items, German automobiles and capital goods, Swiss pharmaceuticals—all of these products have become more attractive to China and help underwrite trade gains with one of the largest and dynamic markets in the world. To this point, German exports to China increased nearly 8-fold 2000 ($8.6 billion) and 2012 ($68 billion). Italy's exports also soared, rising from $2.2 billion at the start of the century to $11.4 billion in 2012. The UK's exports rose from $2.2 billion to $9.5 billion over the same time frame.

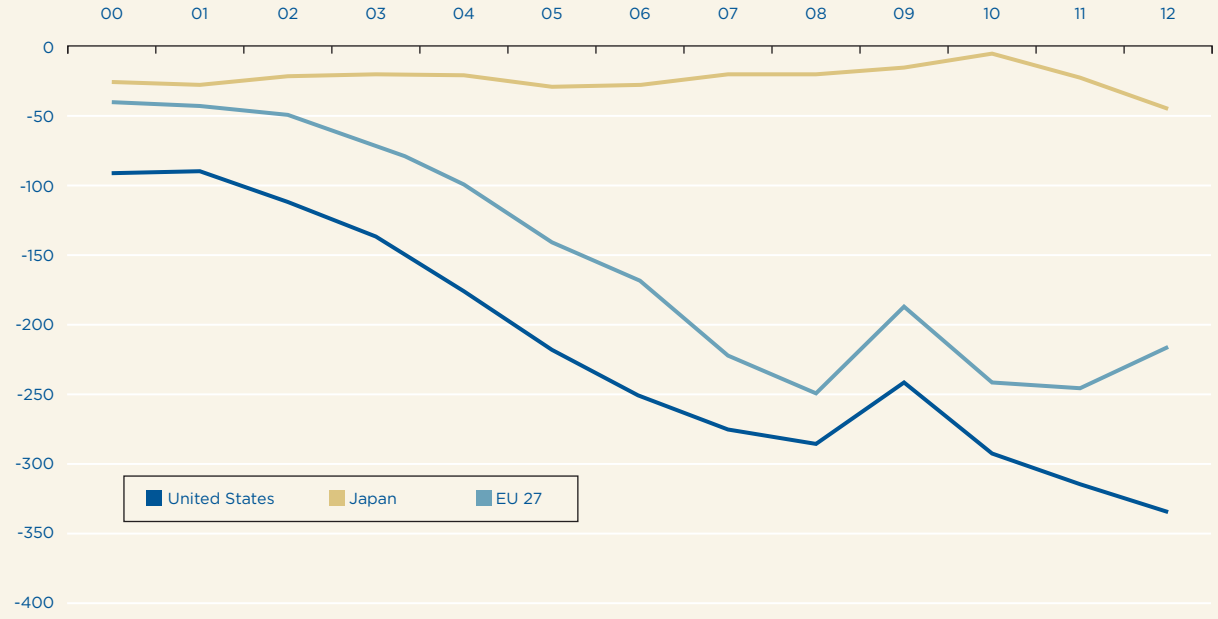
The downside is that the U.S., EU and Japan each runs a trade deficit with China, and the trade gap of the U.S. and Europe is quite large.[6] As Tables 8 and 9 highlight, the EU's trade deficit with China totaled $215 billion in 2012, a significant jump from the shortfall in 2000 ($40 billion). The U.S. trade deficit with China was in excess of $333 billion in 2012, and continued to widen in 2013. Japan's imbalance is not as great—less than $40 billion through the first nine months of 2013.

TABLE 8: U.S., EUROPE AND JAPAN EXPORTS TO CHINA - (BILLIONS OF $)



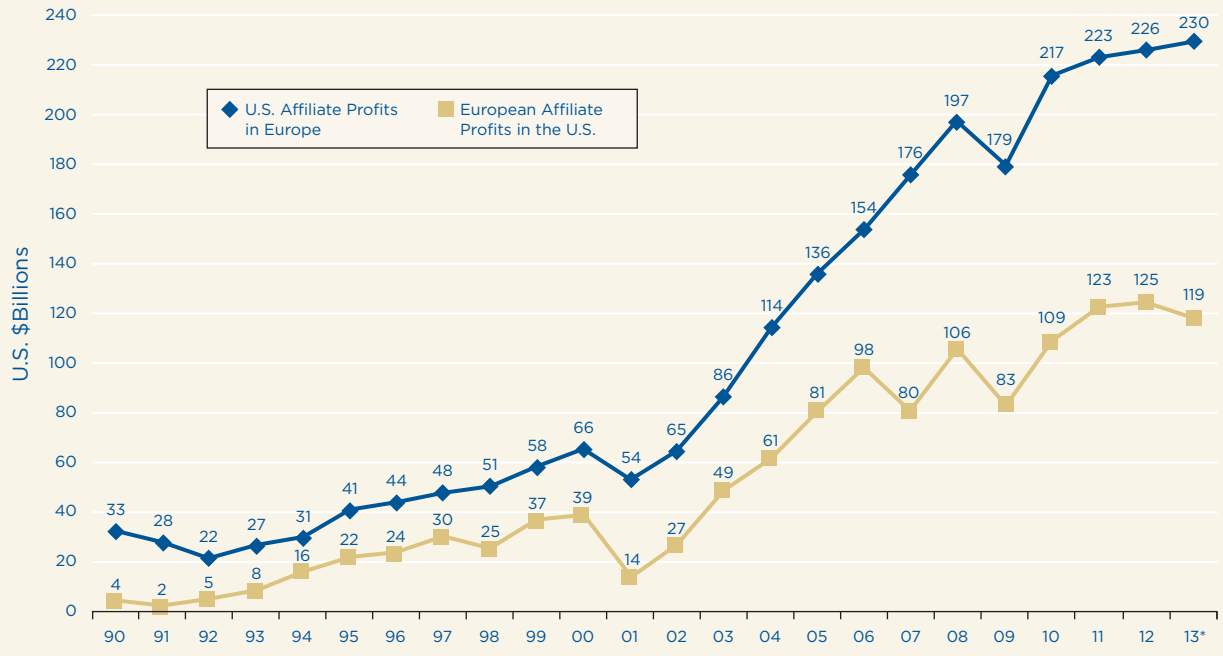
Sources: IMF
Data through 2012

TABLE 9: U.S., EU AND JAPAN TRADE BALANCE WITH CHINA - (BILLIONS OF $)



Sources: IMF
Data through 2012

TABLE 10: U.S. PROFITS[1] IN EUROPE UP; EUROPEAN PROFITS IN AMERICA DOWN



[1]Income of affiliates
**Data through 3Q2013. 2013 data is annualized for full year estimate*
Source: Bureau of Economic Analysis

income inequality. Evidence of a widening gulf between "haves" or "have nots" threatens to engender more populist and xenophobic policies across both the United States and Europe. Selling TTIP is not going to be easy against a backdrop of stubbornly high unemployment levels in both the United States and Europe.

The Way Ahead

If there is a silver lining to the transatlantic economy's grim employment picture, it is this: unemployment levels across Europe have peaked, and they are declining in the United States. The figures are still very challenging, but "less bad." Getting the army of idle workers on both sides of the pond back to work is among the key challenges for policy makers.

Another bright spot: as in previous crises over the past decades, the turbulent times of the past few years are set to fade. On both sides of the ocean, real growth is set to resume. Companies are set to hire again. Consumers are becoming less cautious and spending again. Economies are restructuring and resetting. New winners and losers are emerging, like previous crises. To this point, the crisis-stricken nations of the past—like Sweden (1994) and South Korea (1997)—are among the strongest in the world today. It was not that long ago that Germany was considered the "sick man of Europe;" now Germany ranks as among the strongest in Europe and the world, after it undertook painful reform measures. In other words, today's negative headlines regarding the European debt crisis and America's inability to deal with its structural challenges hardly portend or divine the future.

Who would have guessed that as 2014 began, the developing countries would be the weak link of the global economy? This year will be the first time in three years that both the U.S. and EU economies will be expanding. Growth will be slow and uneven, but the transatlantic pie is poised to expand.

Against this backdrop, key metrics like U.S. capital flows to and from Europe, as well as affiliate income, are likely to remain quite volatile in the near term, and continue to ebb and flow with the transatlantic business cycle. In the first nine months of 2013, U.S. foreign direct investment (FDI) to Europe fell 6.7% from the same period a year earlier. FDI flows to Germany fell sharply after sliding in 2012. Meanwhile, after rebounding in 2012, U.S. investment to France dropped 30% in the first three quarters of 2013 from the same period a year earlier. U.S.

TABLE 11: THE POWER BROKERS OF THE GLOBAL ECONOMY COMPARED

	Eurmerica	Asia	Chindia	Chinmerica
GDP, PPP	39.6%	35.7%	20.4%	34.3%
GDP, Nominal	47.2%	30.7%	13.9%	33.9%
Market cap. (as of 2/11/2014)	$35.9 trillion	$17.8 trillion	$4.6 trillion	$25.2 trillion
Personal consumption exp.	49.9%	29.3%	9.7%	33.8%
M+A Sales	65.8%	17.7%	4.0%	24.7%
M+A Purchases	31.0%	35.9%	12.9%	38.0%
Inward FDI stock	55.4%	24.9%	4.6%	20.9%
Outward FDI stock	69.5%	19.7%	2.7%	24.2%
Inflows (2000-2012)	53.1%	24.9%	8.0%	21.0%
Outflows (2000-2012)	68.8%	19.2%	3.3%	21.3%
Exports* (Goods)	24.7%	42.0%	17.1%	26.2%
Imports* (Goods)	30.2%	40.8%	16.0%	28.8%
Military Spending	$987.2	$385.8	$205.9	$826.4
(U.S. $ billions at constant 2012 prices)	57.0%	22.3%	11.9%	47.7%

** Total does not inclu. Intra-EU28 + Norway, Switzerland, & Iceland trade.*
Sources: IMF; Bloomberg; UN; SIPRI.
All data for 2011 otherwise noted

outflows to Poland, Ireland and the Netherlands were strong, but outflows were notably weak to the United Kingdom, Spain and a host of other countries.

Overall, U.S. FDI outflows to Europe rose by 6% in 2013, totaling an estimated $200 billion. Not bad for a region deep in crisis and on the verge, allegedly, of a "lost decade."

U.S. FDI inflows from Europe dropped at a steep rate in 2013, or by roughly 24%, to $80 billion. This follows investment inflows of $105 billion in 2012 and $128 billion in 2011, data points that underscore the jaggedness of transatlantic investment flows of late. To a large degree, the downturn in FDI from Europe was less about difficult economic conditions in the United States, and more about European firms (financials) sending capital back home or downsizing their global operations in the face of weakening global demand.

U.S. affiliates in Europe increased their earnings in 2013, although the gains were marginal, with affiliate income rising to $230 billion from $226 billion in 2012. That is a weak performance but still a record high. In the first nine months of the year, affiliate income was relatively flat, with weak affiliate income most notable in France and Germany, where it declined 12% and 63%, respectively, versus a year earlier. The Netherlands, Ireland and the United Kingdom were outliers; affiliate income rose 12.8% in the UK in the first nine months of the year and 1.1% in Ireland. Income rose 7% in the Netherlands, another key source of European income for U.S. multinationals.

In the U.S., European affiliates posted income declines of 5.5% in the first nine months of the year. For the year, we estimate that European affiliates earned $119 billion; that is sizable sum, but down 4.8% from 2012 record levels.

Trends in transatlantic capital flows reflect many of the variables just mentioned. While Europe remains a key provider of capital to the United States, U.S. capital inflows from the European Union (including the global money centers, the United Kingdom and Luxembourg) dropped again in 2013, as highlighted above. Total inflows amounted to around $115 billion, one of the lowest annual figures in decades. In contrast, U.S. capital outflows to the EU15 totaled roughly $185 billion in 2013, a sharp rise from the previous year ($86 billion). A large part of this gain was related to U.S. investors allocating more capital towards European bonds and equities in anticipation of Europe's economic rebound.

In terms of foreign holdings of U.S. Treasuries, China and Japan still rank number one and two, respectively; as of November 2013, China held $1.3 trillion in Treasuries, or 23% of the total; Japan held $1.2 trillion, or 21% of the total. Europe's total holdings, including those of the UK,

Luxembourg and Switzerland, were in excess of $1 trillion, or on par with Japan, or 21% of the total. OPEC's share was around 4%. In short, it's not just the Asian creditors of China and Japan that are important sources of capital to the U.S. So is Europe.

Finally, the services economies of the United States and Europe have never been as intertwined as they are today, notably in such services activities as financial services, telecommunications, utilities, insurance, advertising, computer services, and other related activities. While the latest figures are not as current as others, it is important to note that five of the top ten export markets for U.S. services are in Europe and that the U.S. enjoyed a near $56 billion trade surplus in services with the EU in 2012, compared with its $116 billion trade deficit in goods with the EU. For all of Europe in 2012, the surplus in services was larger—roughly $67 billion. In the first nine months of 2013, U.S. services exports to Europe totaled $187 billion, a 5.3% rise from the same period a year earlier. Over the same period, the U.S. posted a trade surplus in services with Europe to the tune of $51 billion. Moreover, foreign affiliate sales of services, or the delivery of transatlantic services by foreign affiliates, have exploded on both sides of the Atlantic over the past few decades and become the overwhelming mode of delivery, topping more than $1 trillion. The U.S. and EU are each other's most important commercial partners and major growth markets when it comes to services trade and investment. Moreover, deep transatlantic connections in services industries, provided by mutual investment flows, are the foundation for the global competitiveness of U.S. and European services companies.

In the end, despite the turbulence of past years and a stronger but fragile economic backdrop again in 2014, the United States and Europe remain each other's most important foreign commercial markets, a fact still not fully appreciated by opinion leaders and policy makers on either side of the transatlantic, much less elsewhere around the world. Put simply, no other commercial artery in the world is as integrated and fused together as the transatlantic economy.

We estimate that the transatlantic economy continues to generate over $5.0 trillion in total commercial sales a year and employs up to 15 million workers in mutually "onshored" jobs on both sides of the Atlantic. These workers enjoy high wages, good incomes and high labor and environmental standards. In addition, we continue to espouse the view that the transatlantic economy remains at the forefront of globalization—meaning that the commercial ties between the U.S. and Europe are deeper and thicker than between any other two continents. Recent economic troubles have only underscored the deep integration of the transatlantic economy and the importance of healthy transatlantic economic ties for millions of U.S. and European workers, consumers, and companies. This is quite evident from this survey.

That said, there's more work to do. The transatlantic relationship needs a catalyst, and current efforts towards completing a comprehensive "free trade plus" transatlantic economic agreement is just the undertaking that could breathe new life and more vigor into the world's most important partnership.

TTIP represents a pivotal moment for the U.S. and Europe. It's a pivotal year in general for the United States and Europe, and the transatlantic partnership. Events this year will have a profound effect on the relationship well into this decade and beyond.

Endnotes

1. See the analysis by Garel Rhys in Daniel Hamilton and Joseph P. Quinlan, *Deep Integration: How Transatlantic Markets are Leading Globalization* (Washington, DC: Center for Transatlantic Relations, 2005).
2. Daniel S. Hamilton and Joseph P. Quinlan, *Sleeping Giant: Awakening the Transatlantic Services Economy* (Washington, DC: Center for Transatlantic Relations, 2008).
3. Fredrik Erixon and Matthias Bauer, "A Transatlantic Zero Agreement: Estimating the Gains from Transatlantic Free Trade in Goods," ECIPE Occasional Paper No. 4/2010 (Brussels: ECIPE, 2010). See also Koen Berden, et. al, *The Impact of Free Trade Agreements in the OECD: The Impact of an EU-US FTA, EU-Japan FTA and EU-Australia/New Zealand FTA* (Rotterdam: Ecorys, 2009).
4. Koen Berden, et. al, *Non- Tariff Measures in EU-US Trade and Investment: An Economic Analysis* (Rotterdam: Ecorys, 2009).
5. *The Economist*, The World in 2012, "The West's Turn."
6. New "added value" trade measurements by the OECD and WTO suggest that the trade deficits may be lower than those derived by conventional assessments of gross trade. But the most recent "value added" data stems from 2009, so we have chosen most recent data available, which is derived from conventional trade measurements.