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The economic global challenge facing an expanding Europe

Globalization is becoming a very misused and misinterpreted term. For its detractors, it is synonymous with concerted aims to create a hegemony for the U.S. dollar. It shouldn't be but the advocates of the absolute supremacy of the dollar tend to use the word this way. Those people who see through the pretence come to over-react. The result is destructive antagonism. This helps nobody, either in the short, medium or long term.

What does help is recognition of what globalization truly represents. In my view, it is the use of Foreign Direct Investment as a strategic tool for the acquisition of market share and, incidentally, industrial rationalization. As such it distinctly strengthens the economic muscle of the outwardly investing country even as it helps to develop the economy of the receiving nation. And it is practised by many enterprises both in the U.S.A. and the European Union.

Contextual background

The relationship between the Euro and the U.S. Dollar reflects what has been happening as a result of the strategic taking of these very many cross border investment positions. Global flows of foreign direct investment are set to top $1,000 billion during the year 2000. About $250 billion of this flow was between the EU and the U.S.A. Despite promising prospects for the EU economy, European companies continued to invest so massively in M. & A. deals with U.S. industries that the net balance of the flow has been around $84 billion in favor of the dollar. Additionally, U.S. companies raised another $80 billion via the Euro corporate bond market, which they promptly converted to dollars.

It was these FDI flows that gave the Euro and the European Central Bank such a headache. Media and market perceptions were of secondary importance. And it was mainly because of the FDI flows that the U.S. Federal reserve only had to raise interest rates quite modestly, in order to ensure that the annual auctions of treasury bonds would attract enough buyers to enable the U.S.A. once again to finance its huge current account deficit.

The present situation

The world has continued to finance the development of the U.S. economy. Unless it did so, there would be a much more rapid collapse of the dollar than the world's financial markets could manage to survive. Also, by ensuring the continued development of the U.S. economy, other nations are insuring the prospects for businesses in their own country.

Allow me to stress that I do not support the idea of unbridled capitalism. The greed and utter selfishness that result from the adherence to that idea are, without any doubt at all, the things that generate more unemployment, misery and degradation than most other characteristics of the human species.

Even so, it does look as if I may mean that what has been good for the U.S.A. was necessarily good for the EU. Nonetheless, this is not what I imply. What I would like to get across is the idea that monetary and financial activities in the EU and the

U.S.A. are, of necessity complementary. This not only cuts across the idea of confrontation between the EU and the U.S.A. It indicates the concept that dynamic economic cooperation will be more beneficial for both. And using cooperative approaches can easily resolve otherwise intractable conflicts of interest.

Future prospects

According to Hayek, dynamic competition is a process of discovery. It enables us to open up new frontiers of knowledge. The future will show which new knowledge is in fact useful and which technologies will quickly become obsolete. We have to be ready to welcome this winnowing process, if we wish to realize our full potential for economic development. This implies encouraging research, while conserving those national cultural values that are needed to maintain each nation's psychological balance. Optimism about the future is more than welcome but it has to be tempered with the desire to hold on to enough of what has lasting value to preserve a stable, yet forward-looking, society. Hope and the wish to create a better world are not the same as “damn the torpedoes, full speed ahead”.

According to Herbert Giersch, the outcome of dynamic competition may often be the form of cooperation that evolves within the pattern of a deepening division of labor. People want to make use of their comparative advantages. They want to specialize and increase their own particular knowledge and expertise. They are likely to pursue the path of learning by doing. This means that they will require to develop complementary roles with others in their own enterprises as well as with suppliers and customers. This implies cooperation all along the line.

I maintain that cooperation within whole industries is merely an extension of co-operation within one enterprise. The aim is to create a strong base within a competitive world, from which each person or company may realize better results, leading to a better quality of life all round. Cooperation tends to centralize many operations, enabling reductions in costs in catering for wider markets. It also generates lower purchasing costs and improves efficiency.

As with individuals, companies and regional industries, so with nations. This can readily be seen within the European Union. Competitive pressure is constantly bearing down on national governments and through them onto regional and local authorities in their dealings with industry, agriculture, viniculture and fisheries. Their only available defence has been through the development of complementary, cooperative, national roles.

As more and more countries become integrated into a globalized economy the greater will be the competitive pressures. A widening EU together with the North American Free Trade Area may presently represent a large proportion of the world’s productive power. The proportion may be less and less predominant. It follows that the EU and the U.S.A. will have to continue paths of entrepreneurial as well as monetary cooperation. Otherwise, neither of these trading blocs is likely to have enough economic muscle to prosper in what is already a global market for goods, services, information and, of course, finance. Globalization is becoming a very misused and misinterpreted term. For its detractors, it is synonymous with concerted aims to create a hegemony for the U.S. dollar. It shouldn’t be but the advocates of the absolute supremacy of the dollar tend to use the word this way. Those people who see through the pretence come to over-react. The result is destructive antagonism. This helps nobody, either in the short, medium or long term.

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CONTEXTUAL BACKGROUND

The relationship between the Euro and the U.S. Dollar reflects what has been happening as a result of the strategic taking of these very many cross border investment positions. Global flows of foreign direct investment are set to top $1,000 billion during the year 2000.[1] About $250 billion of this flow was between the EU and the U.S.A. Despite promising prospects for the EU economy, European companies continued to invest so massively in M. & A. deals with U.S. industries that the net balance of the flow has been around $84 billion in favor of the dollar.

To compound the effect, much of the inward flow to the EU was not converted into Euros but retained in dollars. Thus, the net results in favor of the U.S. dollar was close to $167 billion, without including another important factor. U.S. companies raised another $80 billion via the Euro corporate bond market, which they promptly converted to dollars, bringing the total effect to around $247 billion. This meant that virtually none of the FDI flow between the EU and the U.S.A. favored the Euro's rate of exchange.

It was these FDI flows that gave the Euro and the European Central Bank such a headache. Media and market perceptions were of secondary importance. And it was mainly because of the FDI flows that the U.S. Federal reserve only had to raise interest rates quite modestly, in order to ensure that the annual auctions of treasury bonds would attract enough buyers to enable the U.S.A. once again to finance its huge current account deficit.

1 World Investment Report 2000, U.N.C.T.A.D.

THE PRESENT SITUATION

The world has continued to finance the development of the U.S. economy. Unless it did so, there would be a much more rapid collapse of the dollar than the world's financial markets could manage to survive. Also, by ensuring the continued development of the U.S. economy, other nations are insuring the prospects for businesses in their own country.

Allow me to stress that I do not support the idea of unbridled capitalism. The greed and utter selfishness that result from the adherence to that idea are, without any doubt at all, the things that generate more unemployment, misery and degradation than most other characteristics of the human species.

Even so, it does look as if I may mean that what has been good for the U.S.A. was necessarily good for the EU. This is not what I imply. What I would like to get across is the idea that monetary and financial activities in the EU and the U.S.A. are, of necessity, complementary. This not only cuts across the idea of confrontation between the EU and the U.S.A. It indicates the concept that dynamic economic *cooperation* will be more beneficial for both. And using cooperative approaches can easily resolve otherwise intractable conflicts of interest.

Attempts to develop this particular kind of cooperation have to take into account two background factors:

1. The question of whether transatlantic relations can be seen on both sides of the ocean as truly transcending the NATO and WTO scenarios in the way provided for by the New Transatlantic Agenda and its Action Plan.

2. The rate at which it is recognized that the threat to the Atlantic Partnership is no longer so much military as it is economic. That there is no uniting military threat to bring all the members of the alliance to close ranks on a consistent basis does not, of course, mean that the alliance has no significant purpose. Instead, it implies the need for the constant vigilance and contingency planning that will allow the partners in the alliance to react effectively and efficiently to the emergence of military adventurism.

At the same time, though, we are reminded that nearly all wars have been fought for territorial or economic reasons. Territorial reasons are intrinsically economic, just as the ideological ones are propagandized in order to motivate peoples to get into wars they would otherwise be unwilling to engage in. Whereas, in modern contexts, we can say that the battles being fought are basically economic in character. Globalization is but one, if very important, illustration of this concept. It makes it all the more evident that the U.S. and E.U. economic scenes are interdependent. Something that implies the absolute need for cooperation rather than confrontational competition.

In this context maybe we should mention that Europe has a chip on her shoulder. Nobody likes the person who saves her life and Uncle Sam has saved Europe's life twice in the last century. We are not grateful. Nor are we happy to have our viewpoint largely disregarded. We don't like being a minor partner.

FUTURE PROSPECTS

Talk of using cooperative methods sounds like heresy to many advocates of allowing market forces to dictate outcomes. Until, I suggest they reflect deeply on the question of what are the main objectives to be achieved; and ask themselves what is wrong with cooperating with competitors, if in the end everyone benefits and, essentially, if your own side's specific goals are going to be attained? Particularly when it looks as if these aims are unlikely to be fulfilled by straightforward competition within the prevailing economic circumstances.

Let's take a closer look, therefore, at what the essential differences between competition and cooperation may be. According to Hayek, the 1974 Viennese Nobel prize-winning political economist whose ideas strongly influenced Lady Thatcher in the middle of her years as Britain's Prime Minister, dynamic *competition* is a process of discovery. It enables us to open up new frontiers of knowledge. The future shows which new knowledge is useful and which technologies will quickly become obsolete. We have to be ready to welcome the winnowing process, if we wish to realize our full potential for economic development. This implies encouraging research, while conserving those national cultural values that are needed to maintain each nation's psychological balance.

Notice that the need to conserve national cultural values is stressed even by this proponent of innovation. So maybe we should remind ourselves of the cultural heritage that continues to be that of the peoples of North America as well as those of Europe. I mean the commonly held values based on Christian precepts that formed the basis for Western civilization.

The Treaty of Rome talked about the uniting of people who share a common culture. In the field of world policy, President Franklin D. Roosevelt dedicated the United States to the policy of the good neighbor; a dedication that, as far as I know, has never been repudiated by any of his successors[2]. Surely, therefore, this gives secure grounds for the peoples on both sides of the Atlantic to aim for economic development along parallel paths. This is not, I submit, something that an untrammeled process of globalization is likely to achieve. The ferocity of unbridled competition would provide conditions of life far from the Future Perfect for the majority of the populations of the dominated countries.

Clinging on to outmoded values, of course, is no substitute for building a dynamic future. There is no Past Perfect except in grammar. Nonetheless some values have eternal character. This fact justifies the proposition that optimism about the future may always be welcome, so long as it is tempered with the desire to hold on to enough of what has lasting value. Hope and the wish to create a better world are not the same as 'damn the torpedoes, full speed ahead'.

Indicating that there is no real dichotomy between competition and cooperation, Herbert Giersch[3] drew the conclusion that the outcome of dynamic competition may often be the form of cooperation that evolves within the pattern of a deepening division of labor. At every level, people want to make use of their comparative advantages. They want to specialize and increase their own particular knowledge and expertise. They are likely to pursue the path of learning by doing. This means that they will require to develop complementary roles with others in their own enterprises as well as with suppliers and customers. This implies cooperation all along the line.

I maintain that cooperation within whole industries is merely an extension of co-operation within one enterprise. The aim is to create a strong base within a competitive world, from which each

2 First Inaugural Address, 4 March 1933

3 Lessons from German Experience, Keynote Address to Schumpeter Society, 1994

person or company may realize better results, leading to a better quality of life all round. Each is nonetheless in a position to try to be the best at playing its particular game. A good football team exemplifies what is required: the coordination of efforts to achieve goals, touchdowns or tries, depending on which kind of football is being played. At the same time, it involves doing many things to help the other team members play a better game. And jointly taking up the strain when one or more players are beset by problems.

Cooperation tends to centralize many operations, enabling reductions in the costs involved in catering for wider markets. It also generates lower purchasing costs. It is a catalyst for a better world, in which the social advance of many rejects the winner-take-all mentality. It increases cash flows and the multiple effects that these have throughout the area. It is a prime example of what I would call 'harmonic' capitalism.

As a Christian, I define harmonic capitalism as being at one with a good neighbor mind-set. The harmonic element involves an approach where *the central precept will be the optimization, as opposed to the maximization, of profit*. In essence this means that the management of enterprises have always to cater for two sets of interests on an equitable basis. Both the interests of the shareholders and the interests of all the people who collaborate in producing the profits have to be worked for. In a way similar to the approach taken by Zeiss as it transformed itself. In my visualization, this is the approach that will enable the EU to achieve economic development with social cohesion.

Now and then I am asked whether I believe that there is much real hope such a goal being achieved. I can only reply that I believe it to be highly possible. Its achievement depends, principally, on the amount of energy brought to bear by the various individuals who care. The tasks facing an expanding European Union demand the implicit new mindset. It is the only one that adequately answers the challenges of globalization, while availing itself of the benefits that the latter can bring.

As with companies and, particularly, regional industries, so with nations. Competitive pressure constantly bears down on national governments and through them onto regional and local authorities in their dealings with industry, agriculture, viniculture and fisheries. Their only true defense has lain through the development of complementary, cooperative, regional *and national* roles.

As more and more countries become integrated into a globalized economy the greater will be the competitive pressures. A widening EU together with the North American Free Trade Area may currently constitute a large proportion of the world's productive power. The proportion may become less and less predominant. Two thirds of the world's population are to be found in China, India, Pakistan, Indonesia and the rest of South East Asia. At present, the great majority of their peoples subsist on little more than one meal a day. The GNP of their nations is nevertheless growing apace. Their need to find markets for their goods and services will be compelling within as little as the next six to ten years.

As the rate of the growth of knowledge accelerates even greater will be the pace of the rate of economic integration. It follows that the EU and the U.S.A. will have to continue along more and more paths of entrepreneurial as well as monetary cooperation. Otherwise, neither of these trading blocs is likely to have enough economic muscle to prosper in what is already a global market for goods, services, information and, of course, finance.

There is one element in particular that will have to provide the scenario within which the two kinds of cooperation can be played out. This is the stability of the relationship between the Euro and the U.S. dollar together with the resulting potential of this relationship as a harmonic factor for international economic development. I don't see that there is any longer any point in discussing whether the U.S. economy will continue to be the engine that pulls the world economy along: or even whether the wider European economy will or is able to substitute for it. We have reached a point where they will have to do it together.

One of the constants of the international money markets is the factor of perception. Fundamentals count for relatively little in the value of a currency. The most important consideration at any given moment is what people believe to be its worth *in the short term*.

This means that for a currency relationship to be regarded as stable the movers of money have to be brought to believe that there are strong reasons why there is an endemic, short, middle and long term balance of the flows between the two currencies.

Because, whatever the authorities and central bankers say about their respective currencies' merits, the market will place its own interpretation on what is happening in the economies concerned and buy or sell in accordance with this, its own, interpretation. It is against this background that the European Central Bank (the ECB) will have to cooperate with the U.S. Federal Reserve Bank (the Fed), if both are agreed that it will be a good thing to do.

Before we envisage what kinds of moves these two institutions may have to consider taking in order to cooperate to an adequate extent, maybe we have a brief glimpse at a penetrating analysis of currency management. In the early part of a paper delivered by Paul J. Welfens of Potsdam University to Working Group No. 3 of the Fourth ECSA Conference[4], he stated:

'While flexible exchange rates generally facilitate the control of the money supply and thus are helpful in achieving ECB credibility, one may doubt that the traditional US policy stance would be adequate for Europe. The U.S. largely pursued a benign neglect attitude, according to which market forces should determine the exchange rate, even if this included large deviations from purchasing power parity (PPP). An exception was the Plaza Accord, which sought to moderate a strong dollar appreciation trend that, undoubtedly, was prone to fuel protectionist forces in the U.S.

A strong overvaluation of a currency – misalignment 'from above' – is an implicit subsidy to imports of goods and services and an implicit subsidy to foreign direct investment outflows and net capital exports, respectively. With a given overvaluation there is, of course, no equivalence to a domestic interest rate reduction, since the currency overvaluation concerns only tradables – not the non-tradables sector – and since the mirror effect is an undervaluation of the currency of major partner countries, whose export sector will be stimulated artificially.'

Although this citation gives a lot to be absorbed, I have quoted Welfens' ideas because they provide a prelude to consideration about whether the ECB may have pursued a somewhat benign neglect policy towards the roughly 25% decline in the value of the Euro. It assuredly looked as though this 'de facto' devaluation saved the Eurobloc economy from a recession. At the same time, it can be said that stronger Euro would have complicated many

[4] *Euro Exchange Policy: Theory, International Integration and Policy Options*, Brussels, Sep., 1998

issues for the U.S., particularly when it generated a current account deficit of close to $400 billion.

Perhaps, therefore, it wasn't such a bad idea for the ECB to have abstained from intervention in the way that it did. After all, from the viewpoint of an outside central bank looking at the continually mounting U.S. current account deficit, the strength of the dollar did create an undervaluation of the Euro. As a consequence, the Eurobloc's export sector was indeed stimulated at a time when its economic growth was staggering from the blow of the Asian crisis. To have intervened to preserve an artificially, if psychologically significant, exchange rate might easily have nipped Europe's slow economic recovery in the bud.

What about the future scenario now that the M. & A. flow appears to have reversed itself a little and the purchase or retention of dollars has slowed? It looks as though the esteemed status of the dollar could well diminish, not just because of the current slowdown in the U.S. economy but also because of the unstopped increase of its recurring current account deficits. It is nonetheless still clear that monetary and financial activities on both sides of the Atlantic are interdependent. Probably the best way to keep them in balance is to keep the relationship between the two currencies stabilized in parity with one another.

The ECB will have to resist the temptation to let the chips fall as they may. The Fed will have to be content to keep its interest rates in check. Both institutions will have to design a dynamic of cooperation that allows for the financing and reduction of the U.S. current account deficit as a result of keeping the dollar from becoming overvalued. This could help to moderate FDI outflows and net capital exports. It would not, nor should it, stop the outflows but it could moderate them in such a way as to stabilize the flows between the two currencies. On both sides of the Atlantic policy planners could breathe more easily and devote more of their attention to maintaining the development of the West's economic muscles.

There are at least three ways available to finance and reduce the U.S. current account deficit. In cooperation with the ECB the Fed would probably use a combination of all three. There may well be more ways in which independent central bankers could permute several bilateral agreements so as to ensure their objectives would be achieved. The bankers only have to be sufficiently decided that the success of the operation is paramount. For both

Central Banks the operation would be justified as within their remit, because maintaining the two currencies within a narrow range around parity would reduce the threat of either currency area exporting its inflation to the other. And once it is clear to the international community that this form of parity is and will be maintained as their joint goal, the operation will be self-fulfilling.

Corporate finance officers, recognizing that it will no longer matter whether they hold their assets in dollars or in euros, will be saved the need for hedging between the two currencies. There will also be no point in speculating in that segment of the money markets. The perception all round will be that the relationship between the two currencies has been and will, deliberately, be kept stable. Businessmen will be reassured that they can trade and plan cross-border investments without concern about exchange rate movements. The way will have been opened for development along parallel paths.

Conclusions

Development along parallel paths brings a specific challenge to relations between the EU and the USA. It calls for cooperation at many levels and in many areas. And it calls for mutual respect for their different approaches to resolving economic problems. The EU, for instance, emphasizes the need for social cohesion, whereas the USA still favors pure ‘market’ capitalism.

The very target of economic development with social cohesion in peace and security complicates the picture for ECOFIN and the ECB. There is a great desire to have the Euro fully respected as the major currency that it is becoming, in that it is a currency that already serves over 350 million people. Yet, in an expanding Europe, providing a single market framework for all of the Central and Eastern European countries during the transformation of their economies means that capitalism without a social conscience just will not serve.

This intrinsic difference of approach itself suggests the strong need for understanding on the part of the US, particularly when it detects the resistance of the EU to what the latter perceives as US dominated processes of globalization. And it presents the EU with its greatest economic challenge so far. The requirement, *while still attempting to widen and deepen its union*, to restrain its desire to have the strong exchange rate for the Euro that would reflect its hoped for reserve currency status. The challenge, in essence, to restrain this desire and pursue a more essential aim: cooperation to stabilize the relationship between the Euro and the US dollar so that their respective trade areas may develop their economic muscle so as to, jointly, compete in the global marketplace of the twenty-first century.

Epilogue

The foregoing text is an expanded version of *The Economic Global Challenge Facing an Expanding Europe* as delivered in the Royal Castle, Warsaw, December 14-15, 2000 at the international conference on Prospects for EU-US Relationship. By now it could easily be regarded as having been overtaken by events, especially in the aftermath of the tragedy of September 11th 2001. Even so, I have the temerity to suggest that the hypothesized needs for cooperation have become ever stronger.

The world has changed, irrevocably, in such ways that the very fabric of Western civilization could unravel. Perhaps we should note, however, how rapidly the Vice-President of the Federal Reserve moved to secure international money markets very, very soon after the attacks on the World Trade Center and the Pentagon, while Mr. Greenspan was out of the United States. Along with several other methods of ensuring liquidity, a by previous standards enormous currency swap of around €770 billion was enabled by the ECB and the Federal Reserve without the least hesitation. The need for instant cooperation was clearly evident to everyone concerned. That was for the immediate emergency. What we have to remember is that, faced by the hatred of the nihilists of terror, from now on the component countries of Western Civilization will have to close ranks and cooperate on daily bases.