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CENTER FOR TRANSATLANTIC RELATIONS JOHNS HOPKINS UNIVERSITY | PAUL H. NITZE SCHOOL OF ADVANCED INTERNATIONAL STUDIES

THE TRANSATLANTIC ECONOMY 2013

Annual Survey of Jobs, Trade and Investment between the United States and Europe

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Preface and Acknowledgements

This annual survey offers the most up-to-date picture of the dense economic relationship binding European countries to America's 50 states. The survey consists of two volumes. Volume One offers Headline Trends for the transatlantic economy, and updates with the latest facts and figures our basic framework for understanding the deeply integrated transatlantic economy via 'eight ties that bind.' Volume Two provides the most up-to-date information on European-sourced jobs, trade and investment with the 50 U.S. states, and U.S.-sourced jobs, trade and investment with the 28 member states of the European Union, as well as Norway, Switzerland and Turkey.

This annual survey complements our other writings in which we use both geographic and sectoral lenses to examine the deep integration of the transatlantic economy, and the role of the U.S. and Europe in the global economy, with particular focus on how globalization affects American and European consumers, workers, companies, and governments. In Daniel Hamilton's recent book *Europe's Economic Crisis* (Washington, DC: Center for Transatlantic Relations, 2011), co-edited with Nobel Prize Laureate Robert Solow, leading experts provide context and grounding for understanding Europe's current economic tribulations, and how they might best be addressed. His book *Europe 2020: Competitive or Complacent?* (Washington, DC: Center for Transatlantic Relations, 2011) assesses the EU's global competitive position and maps its connections to 12 other world regions in terms of goods, services, money, energy, people and ideas. Joseph Quinlan's recent book, *The Last Economic Superpower: The Retreat of Globalization, the End of American Dominance, and What We Can Do About It* (New York: McGraw Hill, 2010), analyzes the global aftershocks of the "Made in America" financial crisis, the attendant rise of developing countries and the impact on the standard bearers of the global economy: the United States and Europe.

We would like to thank Lisa Mendelow, James Medaglio, Andrew Vasylyuk and Dylan Meola for their assistance in producing this study.

We are grateful for generous support of our annual survey from the American Chamber of Commerce to the European Union and its member companies, particularly Caterpillar, Covington and Burling LLP, Facebook, Fleishman Hillard, Nielsen, and UPS; and the Transatlantic Business Council and its member companies.

The views expressed here are our own, and do not necessarily represent those of any sponsor or institution. Other views and data sources have been cited, and are appreciated.

Daniel S. Hamilton
Joseph P. Quinlan

EXECUTIVE SUMMARY

- Despite continuing transatlantic economic turbulence, the U.S. and Europe remain each other's most important markets. No other commercial artery in the world is as integrated.
- The transatlantic economy generates $5.3 trillion in total commercial sales a year and employs up to 15 million workers in mutually "onshored" jobs on both sides of the Atlantic.
- Ties are particular thick in foreign direct investment, portfolio investment, banking claims, trade and affiliate sales in goods and services, mutual R&D investment, patent cooperation, technology flows, and sales of knowledge-intensive services.
- The transatlantic economy is the largest and wealthiest market in the world, accounting for over 50% of world GDP in terms of value and 41% in terms of purchasing power.
- The EU accounts for 22% of world GDP and over one-quarter of global consumption. It is the world's largest exporting entity; the world's largest trader in goods and services; the top supplier of goods to developing countries; and 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.
- The U.S. remains by a wide margin the most productive and wealthiest large economy in the world. It continues to attract more foreign direct investment (FDI) than any other single national economy—$227 billion in 2011.
- As globalization proceeds and emerging markets rise, however, transatlantic markets are shifting from a position of preeminence to one of predominance – still considerable, but less overwhelming than in the past.
- China, Japan and Europe hold roughly equal shares of U.S. Treasuries. As of November 2012, China held $1.2 trillion (21.2%); Japan $1.1 trillion (20.7%); Europe over $1 trillion (20%). OPEC's share was 5%.

Cautious Optimism

- The European financial crisis has been transmitted to the U.S. via three channels—through the capital markets; through trade; and through U.S. corporate earnings.
- U.S. banks are not overly exposed to Greece and Portugal, but they are heavily exposed to banks in the UK, Italy, France and Germany, which are highly leveraged to some of Europe's most indebted countries.
- Risks linger over the transatlantic economy in 2013. The eurozone is expected to contract slightly and the U.S. set to grow by 2%.
- The eurozone crisis is not over, but the most dangerous phase has passed. Europe is in for another grinding year, but the foundation for stronger, sturdier growth is slowly being laid.

Transatlantic Investment: Still Driving the Transatlantic Economy

- Trade alone is a misleading benchmark of international commerce; mutual investment dwarfs trade and is the real backbone of the transatlantic economy. The U.S. and Europe are each other's primary source and destination for foreign direct investment.
- Together the U.S. and Europe accounted for only 25% of global exports and 31% of global imports in 2011. But together they accounted for 57% of the inward stock of foreign direct investment (FDI), and a whopping 71% of outward stock of FDI. Moreover, each partner has built up the great majority of that stock in the other economy.

In short, mutual investment in the North Atlantic space is very large, dwarfs trade, and has become essential to U.S. and European jobs and prosperity.

» Foreign investment and affiliate sales power transatlantic trade. 61% of U.S. imports from the EU consisted of related-party trade in 2011. That is much higher than U.S. related-party imports from the Pacific Rim nations (37.2%) and South/Central America (37%), and well above the global average (48.3%). The percentage was even higher in the case of Ireland (88.5%) and Germany (68.7%). Related-party trade also accounted for 31.3% of U.S. exports to the EU but nearly half of total U.S. exports to the Netherlands in 2011.

» While Europe remains a key provider of capital to the United States, U.S. capital inflows from the EU dropped again in 2012. In the first ten months of the year, EU15 purchases of U.S. securities totaled just $73.1 billion, a 40% decline that directly reflects the financial stress of Europe and the attendant need to repatriate capital back to Europe. U.S. capital outflows to the EU15 totaled $61 billion, a sharp decline from the previous year.

The U.S. in Europe

» Over many decades no place in the world has attracted more U.S. foreign direct investment (FDI) than Europe. From 2000-2009 Europe attracted 56% of the global total, and since the start of 2010, Europe has continued to snag 56% of total U.S. investment.

» Overall, U.S. FDI outflows to Europe were an estimated $206 billion in 2012, a nearly 9% decline from 2011 but the 3rd strongest annual level on record.

» U.S. investment to France rebounded in 2012. U.S. outflows to Poland and Switzerland were strong but notably weak to the United Kingdom, the Netherlands, Germany, Spain and a host of other nations.

» U.S. flows to Europe in 2012 ebbed and flowed: outflows to Europe totaled roughly $70 billion in the first quarter of the year; fell to just $21.4 billion in the second quarter as concern over the eurozone crisis mounted; and then picked up to $61.4 billion in the third quarter as prospects for a resolution of the crisis seemed to appear.

» The UK ($36 billion), the Netherlands ($35.3 billion) and Ireland ($22.5 billion), the top three destinations for U.S. firms over the January-September 2012 period, accounted for just over 60% of U.S. investment to Europe.

» U.S. FDI flows to Poland soared by over 250% in the first nine months of 2012 from the same period a year earlier, reaching $662 million; U.S. investment to Turkey was $1.5 billion, a rise of 85%; and inflows to Switzerland were quite strong, $16 billion, a 73% surge.

» U.S. FDI to Spain and Italy has fallen sharply over the past few years: U.S. inflows to Italy tallied just $761 million and inflows to Spain totaled just $248 million in the first nine months of 2012. Egypt reported more U.S. investment than Italy and Spain combined.

» U.S. FDI is shifting within Europe. Belgium has attracted 2.4% ($13.4 billion) of total U.S. investment this decade, down 1 percent from prior decade. France's share amounts to just 0.9% this decade, down from a share of 3% over 2000-2009 and 6.2% over the 1990s. Germany's share has dropped from 6.8% over the 1990s, to 5.2% last decade, to just 2.2% thus far this decade. The shares of Italy, Spain and Switzerland have also declined. One caveat: a substantial percentage of U.S. investment in the Netherlands, Luxembourg and Belgium finds its way to France and Germany.

» Ireland's share of U.S. investment has jumped 4.4% this decade to 14.4% versus a share of 10% over 2000-2009 and just 4.6% over the 1990s. Ireland trails only the Netherlands (24.5%) and the UK (21.3%).

» U.S. investment stock in eastern Europe has expanded greatly. U.S. investment stock in Poland rose from just $1 billion in 1995 to over $12 billion in 2011, larger than America's investment position in Indonesia ($11.6 billion) and slightly below Malaysia ($13.9 billion). U.S. investment stock in the Czech Republic was $5.3 billion in 2011, on par with America's investment presence in the Philippines.

» Within Europe, America's top overseas market has shifted from the UK to the Netherlands. The UK has traditionally served as an export platform for U.S. affiliates to greater Europe, but the euro, the Single Market, and EU enlargement have all galvanized more U.S. firms to use the Netherlands a key export platform and pan-regional distribution hub. The bulk of total U.S. foreign affiliate sales in the Netherlands are exports going to other EU members.

- U.S. firms invested $31 billion into China between 2000 and Q3 2012, just 1.1% of total global U.S. investment, and behind U.S. investments in Belgium, France, Germany, Ireland, the Netherlands Spain, Switzerland and the UK.
- U.S. investment in Ireland over the 2000-Q3 2012 was more than 6 times larger than U.S. investment in China. U.S. investment in the Netherlands was more than 14 times larger and in the UK more than 11 times larger.
- Most surprising: over the past two years U.S. companies have actually *dis*invested in China. They on balance *withdrew* investments from China of $1.7 billion in 2011 and $4.8 billion in 2012, while investing $224.3 billion in Europe in 2011 and $203.3 billion in 2012.
- Since 2000, U.S. firms have invested more in the Netherlands ($442 billion) alone and in the UK ($356 billion) alone than in South and Central America, the Middle East, and Africa combined ($308 billion).
- U.S. cumulative investment in Brazil since 2000 ($43.8 billion) is roughly 80% of total investment in Belgium ($53 billion) and roughly one-fifth of total investment in Ireland.
- FDI in Russia since 2000 ($10.2 billion) has been less than in such smaller European markets as Norway ($14.4 billion) and Denmark ($13.5 billion).
- Since 2000 Corporate America has invested about the same in India ($26.6 billion) as in Italy.
- On a historic cost basis, the U.S. investment position in Europe was 14 times larger than the BRICs and nearly 4 times larger than in all of Asia at the end of 2011.
- U.S. investment in the Netherlands alone is about 4 times greater, and U.S. investment in the UK 3 times greater, than U.S. investment in all the BRICs.
- America's investment stakes in Ireland ($188 billion) were much greater than total U.S. capital sunk in South America ($148 billion).
- There is more U.S. investment in Germany ($107 billion) than in all of Central America, including Mexico ($104 billion).
- U.S. investment in Switzerland ($125 billion) is more than double all of U.S. FDI investment in Africa ($57 billion).
- Corporate America's foreign assets totaled a staggering $21 trillion in 2011. 57% of these assets—$12 trillion—were located in Europe. Largest share: the UK (23%, $4.7 trillion).
- U.S. assets in the Netherlands ($1.8 trillion) were the second largest in the world in 2011.
- America's asset base in Germany ($683 billion) in 2011 was over 50% larger than its asset base in all of South America.
- America's collective asset base in Poland, Hungary, and the Czech Republic (roughly $147 billion, up from $85 billion in 2008) was much larger than the size of corporate America's assets in India (est. $95 billion).
- U.S. assets in Ireland totaled $900 billion in 2011, more than total U.S. assets in either Switzerland or France. Ireland accounted for 7.6% of total U.S. assets in Europe in 2011.
- Total output of U.S. foreign affiliates in Europe in 2011 ($615 billion) and of European affiliates in the U.S. ($441 billion) was larger than the output of such nations as the Netherlands, Turkey or Indonesia.
- U.S. affiliate output in Europe rose 3% in 2011 to total $615 billion, still below the pre-crisis high of $660 billion in 2008.
- Aggregate output of U.S. affiliates globally reached nearly $1.3 trillion in 2011; Europe accounted for 46% of the total.
- The UK accounted for 25% of total U.S. affiliate output in Europe, followed by Germany (14%) and France (8%).

- These 3 countries accounted for 47% of total U.S. affiliate output in Europe in 2011, down from 63% of the total in 2000, reflecting greater diffusion of U.S. affiliate production across Europe. A big winner has been Ireland, whose share of U.S. foreign affiliate output more than doubled between 2000 (5%) and 2011 (10.5%).
- By sector, output was almost evenly split between services (52%) and manufacturing (48%). Germany, the UK and Ireland accounted for roughly half of total U.S. affiliate manufacturing output in Europe.
- U.S. affiliates accounted for over 25% of Ireland's total output in 2011; 6.4% of the UK's output; 5.8% of Norway's output; 5.2% of Switzerland's output; and 5.0% of Belgium's total output.
- U.S. foreign affiliate output in Belgium in 2011 (roughly $25.6 billion) was more than 40% larger than U.S. foreign affiliate output in India (est. $18 billion).
- U.S. affiliate output in Poland totaled an estimated $10.9 billion in 2011, exceeding U.S. output in Russia and in more developed markets like Austria, Portugal, and Denmark. There was a five-fold increase in affiliate output in Poland between 2000 and 2011.
- U.S. affiliate output in Hungary ($4.0 billion) was larger than output in Greece (estimated at $2.9 billion); output in Turkey ($8.1 billion) was over a quarter larger than output in Austria.
- U.S. affiliate sales in Europe of $2.6 trillion accounted for 47% of worldwide U.S. affiliate sales in 2011. We anticipate a new record sales high in Europe of $3 trillion by 2014.
- Sales of U.S. affiliates in Europe in 2010 were roughly double comparable sales in the entire Asia/Pacific. Affiliate sales in the UK ($599 billion) were double sales in South America.
- While U.S. affiliate sales in China have soared over the past decade, they do so from a low base, and still remain well below comparable sales in Europe. For instance, U.S. affiliate sales of $170 billion in China in 2010 were below those in Switzerland ($262 billion) or Ireland ($260 billion), the Netherlands ($204 billion) or France ($199 billion).
- Europe remains the most profitable region of the world for U.S. companies. U.S. foreign affiliate income earned in Europe rose modestly in 2012 to an estimated $214 billion—a record high. Since 2000, Europe has accounted for over 56% of total U.S. foreign affiliate income.
- Affiliate income soared 55% in Poland for the first 3 quarters of 2012, and was up 12% in the UK and 4% in Ireland. Affiliate income declined in France (-25%) and Germany (-32%), Spain and Greece (each -73%), Italy (-41%), and Portugal (-33%).
- U.S. affiliate income from China and India together in 2011 ($13.1 billion) was only one fourth of what U.S. affiliates earned in the Netherlands ($55 billion) and less than half U.S. affiliate earnings in the UK ($31 billion) or Ireland ($29 billion).
- In the first nine months of 2012, U.S. affiliate income from Europe—$160 billion—was more than combined U.S. affiliate income from Latin America ($67 billion) and Asia ($57 billion). U.S. affiliate income in China ($9 billion) and Brazil ($7 billion) combined was well below affiliate income in Ireland ($23 billion) alone, but each was above that in Germany ($2.7 billion) and France ($2.5 billion).

Europe in the U.S.

- European investment in the U.S.—on a historic cost basis—totaled $1.8 trillion in 2011, or 71% of total foreign direct investment in the U.S. Historic cost basis represents the stock of foreign investment in the U.S. Major investors include firms from the UK ($442 billion), the Netherlands ($240 billion), Germany ($216 billion) and Switzerland ($212 billion).
- Deep investment ties with Europe generate additional U.S. exports. U.S. affiliates of foreign firms generated about 21% of America's exports in 2011. More than half were provided by European companies based in the United States.
- The downturn was less about difficult economic conditions in the U.S. and more about European firms (financials) sending capital back home or downsizing their global operations in the face of weakening global demand.

- U.S. assets owned by eurozone banks fell from a peak of $1.5 trillion in second quarter of 2008 to $936 billion in the second quarter of 2012, before recovering to $1 trillion in the third quarter.
- By country, FDI inflows from Germany to the U.S. plunged 91% from the same period a year earlier; year-over-year declines were also posted by the Netherlands (-76%), Norway (-72%), Spain (-58%), Switzerland (-67%), Italy (-45%), and the United Kingdom (-30%).
- Nonetheless, even in bad year 2011 Europe's investment flows to the United States were some seven times larger than comparable flows to China.
- In 2011 total assets of European affiliates in the U.S. were an estimated $8.6 trillion. UK firms held $2.2 trillion, followed by German firms ($1.5 trillion), Swiss and French (roughly $1.3 trillion each) and Dutch firms ($959 billion).
- The U.S. remains the most important market in the world in terms of earnings for many European multinationals. We estimate that European affiliate income in the U.S. rose slightly in 2012 to a record $117 billion.
- French, Italian and Belgian affiliate income in the U.S. in the first nine months of 2012 rose 31%, 28%, and 13% respectively.
- European affiliate output in the U.S. rose by nearly 4% in 2011, totaling over $440 billion, a record high.
- The output of British firms in the U.S. in 2011 reached nearly $119 billion—more than a quarter of the European total. German affiliate output totaled $81 billion, or almost one-fifth of the total. French affiliate output ($60 billion) accounted for 14% of the total.
- Beyond European affiliates, only Corporate Japan has any real economic presence in the U.S.—Japanese affiliate output totaled $82 billion in 2010, well below UK output and roughly similar to German affiliate output.
- Overall, foreign affiliates contributed nearly $672 billion to U.S. aggregate production in 2011, with European affiliates accounting for roughly two-thirds of the total.
- Affiliate sales, not trade, are the primary means by which European firms deliver goods and services to U.S. consumers. In 2011 European affiliates sales in the U.S. ($1.9 trillion) were more than triple U.S. imports from Europe ($632 billion). Affiliate sales rose roughly 4% in 2011.
- Sales by British affiliates in the U.S. totaled an estimated $440 billion in 2011, followed by German affiliate sales ($389 billion).

Transatlantic Trade

- U.S.-EU merchandise trade totaled an estimated $650 billion in 2012, up 68% from $387 billion at the start of the new century.
- U.S. merchandise exports to Europe were relatively robust, with many U.S. states posting double-digit gains. The export picture softened in 2012, however, as Europe's economic engine continued to sputter.
- The U.S. 2012 merchandise trade deficit with the EU surged to $107 billion in the first 11 months of the year, a near 13% rise. For all of 2012, the U.S. trade deficit with the EU is forecast to be roughly double the 2009 level. Germany accounted for nearly half the deficit.
- Over this same period, U.S. exports to the EU fell by roughly 1%, with exports to Germany dropping 12.5% to Spain; 4.8% to the Netherlands; and 3.2% to Ireland. U.S. imports from Europe were up 4.3% in the first eleven months of 2012, with imports rising 10.8% from Germany; 8.8% from the UK; and 4.8% from France.
- The top 20 U.S. state exporters to Europe registered mixed results in 2012. Indiana, Michigan and Louisiana rebounded and enjoyed good growth. Export growth to Europe slowed from Texas as well as Florida, Ohio, Illinois, New York, Georgia, and New Jersey. Exports to Europe from California, Connecticut and Tennessee were flat, and exports fell from North Carolina, Virginia, Washington, Utah, Pennsylvania, South Carolina and Massachusetts.

- Despite Europe's uneven economy, 45 of 50 U.S. states still exported more to Europe than to China in 2012, and by a wide margin in many cases. In the January-September period Florida's exports to Europe were more than 11 times its exports to China; New Jersey's exports to Europe were 9 times greater than to China. New York, Connecticut and Virginia each exported 7 times as much to Europe as to China. Texas, the leading U.S. state exporter to Europe, sent almost 4 times as many goods to Europe as to China. Illinois' exports to Europe were more than triple its exports to China. California, Michigan and North Carolina each exported twice as much to Europe as to China.
- By destination, Germany was the top European export market for 19 U.S. states in 2011. The UK ranked second, the top European export market for 11 states. The Netherlands ranked third as the top European destination for 9 states.
- Global Value Chains, which render a country's exports essentially the product of many intermediate imports assembled in many other countries, are changing traditional understanding of the patterns and structure of international trade. Under new WTO/OECD ''value-added'' calculations, the U.S. in 2009 was the major customer and supplier for Germany, the UK, France and Italy. Germany followed only Canada as the most important export market for the United States, ahead of Mexico and China.

Services: The Sleeping Giant of the Transatlantic Economy

- The U.S. and Europe are the two leading services economies in the world. The U.S. is the largest single country trader in services, while the EU is the largest trader in services among all world regions.
- The EU ranks number one in each major category of global services trade in 2011, accounting for 41.1% of world travel receipts; 47.6% of world exports of transportation services; and half of world exports of other commercial services.
- By country, the U.S. was number one in the world in terms of world travel receipts in 2011, with a 14% share; number one in world transportation receipts, with a 9.2% share; and the world's top exporter of other commercial services, with a global export share of 16%.
- Europe and the U.S. continue to lead the world when it comes to many different global services. For instance, of global exports of communication services in 2010, Europe's global share was 55.7%, North America's 16.4%. Of insurance exports, Europe's share was 54.2% to North America's 25.9%; financial services—Europe 55.7%, North America 24.8%; computer and information service exports—Europe 55%, North America 8.2%: royalties and fees—Europe 43%, North America, 40.3%: and "other business services"—Europe 50%, North America, 12.5%.
- Europe accounted for 38.4% of total U.S. services exports and for 41.1% of total U.S. services imports in 2011. Five of the top 10 export markets for U.S. services are in Europe.
- U.S. services exports to the EU more than doubled between 2001 and 2011, rising from around $102 billion to $225 billion. The U.S. enjoyed a near $52 billion trade surplus in services with the EU in 2011, compared with its $100 billion trade deficit in goods with the EU.
- For all of Europe in 2011, the U.S. surplus in services was roughly $62 billion, compared with its $118 billion trade deficit in goods.
- In the first 3 quarters of 2012 U.S. services exports to Europe totaled $176 billion, a 3.5% rise from the same period a year earlier. Over the same period, the U.S. posted a $39 billion trade surplus in services with Europe.
- 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.
- Sales of services by U.S. foreign affiliates in Europe—$576 billion in 2010—were more than two and half times U.S. services exports to Europe in 2010.
- The UK alone accounted for around 32% of all U.S. affiliate sales in Europe in 2010—$187.2 billion, more than

combined U.S. affiliate sales of services in South and Central America ($132 billion), Africa ($11.8 billion) and the Middle East ($15 billion).

- On a global basis, Europe accounted for nearly 51% of total U.S. services sales.
- Sales of services by U.S. affiliates of European firms totaled $435 billion in 2010. French and German affiliates sold more services in the U.S. in 2010 than American affiliates sold in France and Germany. European affiliate sales of services were more than two and a half times larger than U.S. services imports—a fact that underscores the ever-widening presence of European services leaders in the U.S. economy.
- New WTO/OECD ''value added'' measurements indicate that services accounted for 60% of the value of all UK gross exports; 56% of all U.S. exports; 55% of all EU exports; and 50% of all German exports in 2009.

Transatlantic Jobs

- Despite stories about U.S. and European companies decamping for cheap labor markets in Mexico or Asia, most foreigners working for U.S. companies outside the U.S. are Europeans, and most foreigners working for European companies outside the EU are American.
- The number of workers employed by U.S. affiliates in Germany, France and the United Kingdom is more than double those employed in China.
- European companies in the U.S. employ millions of American workers and are the largest source of onshored jobs in America. Similarly, U.S. companies in Europe employ millions of European workers and are the largest source of onshored jobs in Europe.
- Between 2000 and 2010, U.S. foreign affiliate employment in Europe rose by nearly 11%, increasing from 3.7 million workers in 2000 to over 4.1 million a decade later.
- Roughly 36% of the 11.5 million people employed by U.S. majority-owned affiliates in 2011 lived in Europe – with roughly half working in the UK, Germany and France.
- U.S. affiliates employed many more manufacturing workers in Europe (1.7 million) in 2010 than they did in 1990 (1.6 million). Yet the geographic distribution has shifted within Europe towards lower cost locations like Ireland and Poland. Between 2000 and 2010 U.S. affiliate manufacturing employment fell by roughly 33% in the UK; 20% in France; and 9.5% in Germany. Poland was a big gainer: U.S. affiliate manufacturing employment there doubled between 2000 and 2010, climbing from 51,000 to 100,000.
- U.S. affiliates employ more Europeans in services than in manufacturing. Manufacturing accounted for just 42% of total employment by U.S. affiliates in Europe in 2010. Wholesale employment was among the largest sources of services-related employment by U.S. affiliates in Europe, which includes employment in such areas as logistics, trade, insurance and other services-related activities.
- Even with the decline of manufacturing employment in Germany, the manufacturing workforce of U.S. affiliates in Germany alone totaled 351,000 workers in 2010—above the number of manufactured workers employed in Brazil by U.S. affiliates (313,000) and India (126,000) yet below the figures of China (562,000).
- European majority-owned foreign affiliates directly employed roughly 3.5 million U.S. workers in 2011—some 563,000 less workers than U.S. affiliates employed in Europe. The top five European employers in the U.S. in 2011 were firms from the UK (910,000, down from 978,000 in 2008), Germany (589,000, down from 617,000 in 2008), France (489,000, down from 554,000 in 2008), Switzerland (416,000, up from 389,000 in 2008) and the Netherlands (350,000, up from 349,000 in 2008). European firms employed two-thirds of all U.S. workers on the payrolls of majority-owned foreign affiliates in 2011.
- The top five U.S. states in terms of jobs provided directly by European affiliates in 2010 were California (280,800), New York (226,600), Texas (211,600), Pennsylvania (159,000) and Illinois (135,700).

The Transatlantic Innovation Economy

- In 2010 U.S. affiliates invested $24.4 billion in research and development in Europe, or roughly 62% of total global R&D expenditures by U.S. foreign affiliates of $39.5 billion. R&D expenditures by U.S. affiliates were greatest in Germany, the UK, Switzerland, France, the Netherlands, Belgium and Ireland. These seven countries accounted for nearly 86% of U.S. global spending on R&D in Europe in 2010.
- In the U.S, R&D expenditures by majority-owned foreign affiliates totaled nearly $41.3 billion in 2010. R&D spending by European affiliates totaled $31.3 billion, up from $30 billion the prior year, and accounting for three-fourths of all R&D performed by majority-owned foreign affiliates in the United States.
- Swiss-owned R&D in the U.S. totaled $9 billion in 2010 and accounted for 21% of total affiliate R&D in the United States. British, German and French affiliates accounted for a 14.5%, 13.6% and 13.0% share respectively.

CHAPTER 1

CAUTIOUS OPTIMISM:
Laying the Foundation for a Transatlantic Economic Recovery

"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

- European Central Bank President Mario Draghi, July 26, 2012

Whatever it takes. With three simple words, European Central Bank (ECB) President Mario Draghi dramatically changed the mood and tenor of the eurozone crisis in 2012.

The crisis is not over—not by a long shot. But Draghi's emphatic pledge in July 2012 to backstop the euro and the eurozone's heavily indebted nations helped break a vicious cycle of weaker-than-expected economic growth, rising credit spreads, ever increasing debt levels, and calls for more austerity measures. In early September, Draghi backed up his "whatever it takes" stance by announcing that under certain conditions the ECB would engage in the unlimited purchase of government bonds on the secondary market.

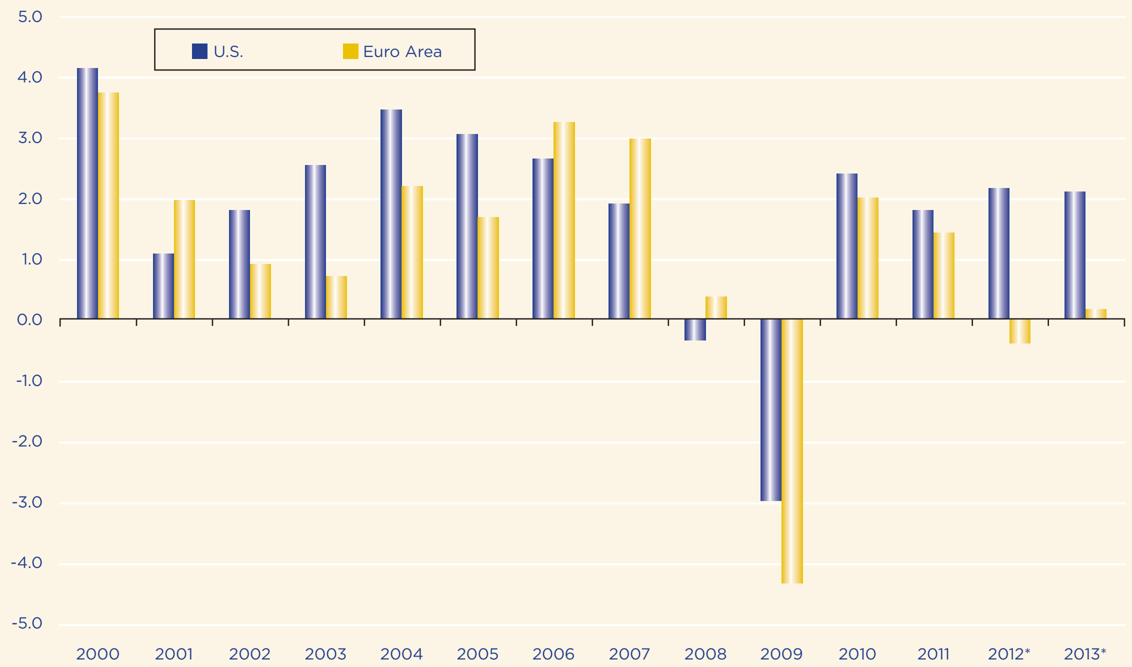
No nation has signed up for the money yet due to the conditionality of the agreement. However, the ECB helped lower yields in the eurozone's peripheral markets by making it very clear to jittery capital markets that it was ready to act as a lender of last resort. As yields fell, the debt dynamics and economic prospects of the troubled peripheral countries improved. All of this occurred without the ECB spending a single euro to buy the bonds of Spain or Italy. Falling spreads also gave struggling sovereigns more time to implement key structural reforms.

Meanwhile, the ECB, the Bank of England and the U.S. Federal Reserve have all been very active in the past few years in expanding their balance sheets to help reduce borrowing costs and funding risks of many banks. As we highlighted in our last survey, the European Central Bank's Long-Term Refinancing Operation (LTRO) has been hugely successful in easing liquidity conditions across the continent.

Two other events in September 2012 helped brighten the mood: one, Germany's constitutional court backed the creation of the European Stability Mechanism (ESM), securing the establishment of a eurozone permanent rescue fund totaling $650 billion; and the EU Commission laid out a blueprint for joint European banking supervision, viewed by many as the first critical steps towards a European banking union. Both steps were taken as signs that Europe was moving toward more, not less, integration. Perceptions began to shift. As *The Economist* noted, "When history books trace the evolution of the euro crisis, September 2012 will mark the beginning of a new chapter."[1]

A more European-minded Germany was also a major part of the solution. Draghi's ''whatever it takes" was given force by Chancellor Angela Merkel's decision, made without fanfare, to save Greece ''no matter what." Merkel was able to forge a consensus in Berlin that a fractured eurozone would be more detrimental to German interests than Greece's voluntary or involuntary exit. Yet Germany has been a reluctant savior throughout the crisis, and for good reason. Berlin insisted that eurozone debtor nations first undertake structural reforms that improve their finances and competitiveness before expecting any credit, debt forgiveness and related assistance from itself or other eurozone creditors. German support for multiple rescue packages and the EU's own bailout fund have by some estimates put it on the hook for €300 billion, or the equivalent of Germany's annual budget.[2] Berlin is concerned about open-ended commitments. As the

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



** 2012: Estimate; 2013: Forecast.*
Source: IMF

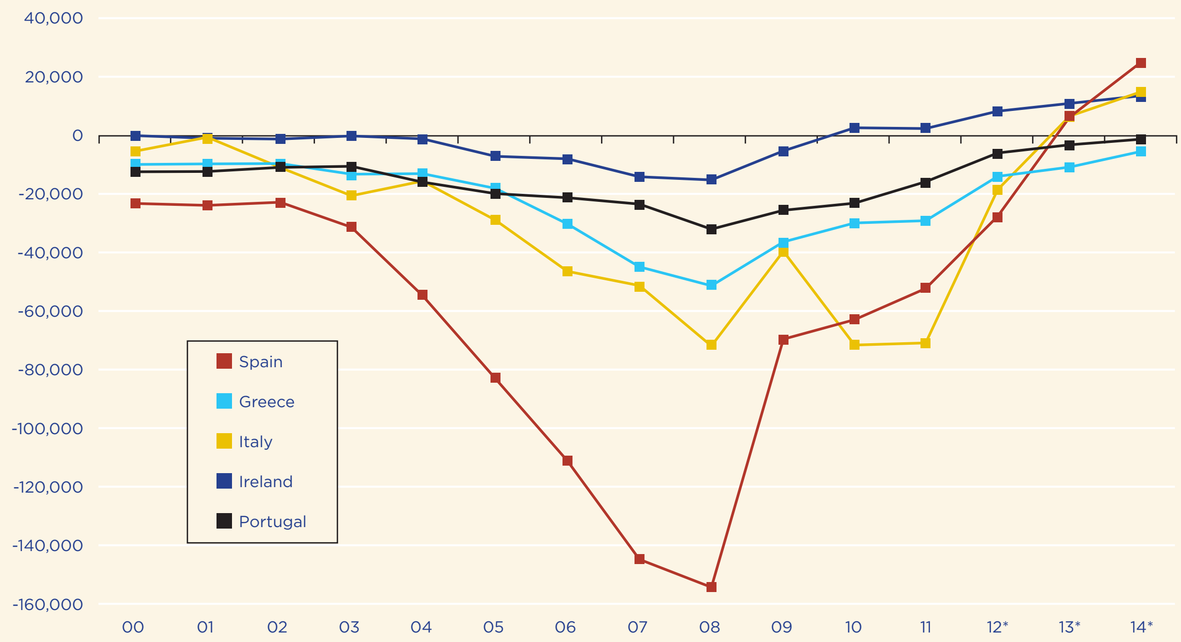
price for its agreement to a European banking union, it has demanded that the ECB police tough rules on budget and debt limits and that the EU offer better incentives for structural reforms that could create the conditions for sustainable growth.

Problems persist. EU governments refused to write off some Greek debt, which means that Greece still has a debt load that the International Monetary Fund calls "unsustainable." Further rescues may still be in the cards. The financial problems of tiny Cyprus could develop into another big headache for the eurozone.Spain and Italy may not hit their deficit-reduction targets. Unemployment is very high in all peripheral countries, and they are not the only ones struggling; France faces serious competitiveness challenges, the German economy contracted in the fourth quarter of 2012, and the UK is mired in austerity politics and low growth, amidst talk of Scottish devolution and questions about continued EU membership. Europe's ability to emerge from its crisis is likely to rest as much on the success of national reform policies as Europe-wide initiatives.

By and large, however, despite street fights, name-calling and considerable popular indignation, Greece, Italy, Spain, Portugal and Ireland have swallowed the bitter medicine of austerity in return for more financial assistance. Markets are responding. In 2012 European stocks on average fared better than U.S. stocks; Greek stocks, surprisingly, rebounded 33 percent from recent lows, double the return of U.S. stocks in 2012. Irish, Portuguese and Greek bonds yielded 29%, 56%, and 112% returns respectively in 2012.[3] Other signs are also encouraging. Table 2 highlights the dramatic improvement in the current account balances of Portugal, Italy, Ireland, Greece and Spain (PIIGS). Through private and public sector spending cuts, and improving export competitiveness, Europe's periphery has seen a dramatic improvement in its external balances. Ireland actually posted a current account surplus in 2012, while other deficits shrank dramatically. PIIGS exports shot up 26% from the depressed levels of 2009 to total $1 trillion in 2011. Exports weakened again in 2012 due to softer global demand, but prospects are good for 2013. The net effect has been to soothe fears that the eurozone's periphery was incapable of implementing tough, austere policies; and to bolster confidence among investors in the crisis-weary region.

The eurozone crisis is not over and many challenges remain. But the most dangerous phase has passed. During 2012 much progress was made in creating the

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



**Portugal, Italy, Ireland, Greece, Spain. Projections by the Organization for Economic Co-operation and Development (OECD)*
Sources: OECD; Haver Analytics

institutions and mechanisms that will safeguard against the next crisis and ultimately deepen the integration of the continent. In other words, Europe did more than "muddle through" last year; contrary to the negative headlines, some heavy lifting was accomplished. In particular, the role of the ECB was significantly enhanced and made more effective; more crisis resolution tools were put in place; the outlines of a banking union were agreed upon; the competitiveness and economic adjustments of the peripheral nations became more transparent; and the first steps were taken towards a fiscal union, involving greater fiscal convergence and surveillance, among other policies.

That's progress—halting and incomplete, but progress. The seeds are being sown for a more integrated and dynamic Europe. That is the good news. The more discouraging news for Europe's transatlantic partner, the United States, is that the EU economy remains at a standstill or in recession.

Revving the Engines

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 rates from the IMF. Although Engine One is home to just 5% of the world population, this engine nevertheless accounts for 29% of global consumption and for 15% of world imports. These are impressive figures. But the numbers are even larger when considering Engine Two.

Engine Two consists of the 27—soon to be 28—member states of the European Union. The EU, overlooked by many, is the largest economic entity in the world and among the wealthiest. This engine accounts for 22% 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 the keeping the global economy aloft. Against this backdrop, it is little wonder that Europe's lingering sovereign debt crisis and Europe's inability to get ahead of the crisis has placed a tremendous strain on the other engines of the world economy.

Engine Three is Asia, the largest in the world in terms of output and population. This engine stretches from

TABLE 3: THE FOUR ENGINES OF THE WORLD ECONOMY (% OF WORLD TOTAL, 2011)

	Engine One: North America	Engine Two: Europe	Engine Three: Asia	Engine Four: Commodity Producers
GDP (Purchasing Power Parity)	20.9	22.0	35.9	21.3
Population	5.0	8.6	56.9	29.4
Private Consumption Expenditure*	29.0	27.4	25.6	18.0
Exports	10.9	36.0	32.2	20.9
Imports	15.0	35.8	30.1	19.1
International Reserves**	2.1	11.6	60.3	26.0

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

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 the 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.

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 (perhaps Cyprus) will quickly spread to others.

Table 4 underscores this interdependence. Notice the exposure of German and French banks to Greece and Portugal. At the end of June 2012 Germany's bank

TABLE 4: COUNTRIES' BANKS: CROSS-BORDER EXPOSURE (AS OF END JUNE 2012)

Exposure to...	Belgian banks	French banks	German banks	Greek banks	Irish banks	Italian banks	Portuguese banks	Spanish banks	UK banks	U.S. banks
Belgium		$242.2 bn	$27.3 bn	$302 m	$221 m	$3.3 bn	$215 m	$5.4 bn	$20.5 bn	$20.9 bn
France	$36.9 bn		$189.8 bn	$1.8 bn	$4.4 bn	$37.1 bn	$7.4 bn	$37.1 bn	$248.8 bn	$200.0 bn
Germany	$13.1 bn	$196.3 bn		$2.8 bn	$2.3 bn	$242.0 bn	$1.9 bn	$57.2 bn	$309.1 bn	$184.8 bn
Greece	$89 m	$35.3 bn	$24.6 bn		$119 m	$1.1 bn	$6.9 bn	$798 m	$7.8 bn	$3.1 bn
Ireland	$25.6 bn	$33.8 bn	$86.2 bn	$489 m		$12.1 bn	$9.4 bn	$7.8 bn	$137.3 bn	$58.8 bn
Italy	$9.7 bn	$248.1 bn	$125.3 bn	$514 m	$1.0 bn		$2.4 bn	$30.1 bn	$50.4 bn	$38.4 bn
Portugal	$749 m	$18.2 bn	$24.0 bn	$22 m	$360 m	$2.0 bn		$74.2 bn	$18.0 bn	$3.4 bn
Spain	$9.4 bn	$112.6 bn	$122.5 bn	$422 m	$4.1 bn	$21.8 bn	$20.8 bn		$80.0 bn	$46.7 bn
UK	$32.2 bn	$250.2 bn	$441.3 bn	$14.7 bn	$121.5 bn	$54.7 bn	$5.4 bn	$434.5 bn		$605.8 bn

Sources: Bank for International Settlements; Financial Times.
Data for foreign claims by nationality of reporting banks, immediate borrower basis.

exposure totaled nearly $25 billion to Greece and $24 billion to Portugal. The comparable figures for France were $35 billion and $18 billion, respectively. These numbers have declined over the past few years but nevertheless remain significant. Germany's combined exposure to Italy and Spain is even more significant, roughly $250 billion, and France's exposure is even larger—$361 billion. Given this deep interdependence, it is easy to understand the mounting panic in global capital markets last year as the risk grew that both Italy and Spain might be shut out of the private capital markets. Europe's entire banking sector would have capsized had such an event occurred. This prospect remains slim, but it is worth remembering that back in early 2010, when the financial crisis first erupted in Europe, no one ever thought Greece would ultimately default on its debt.

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 $3.1 billion and $3.4 billion in Portugal in mid-2012. 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.

At a minimum, financial contagion in Europe has added more volatility to U.S. capital markets. More worrisome, Europe's sovereign debt crisis and the attendant need for European banks to raise capital, pay down debt, or both has forced numerous financial entities to shed their U.S. assets at a frantic pace.

The phenomenon may be called transatlantic financial deglobalization: U.S. assets owned by eurozone banks fell from a peak of $1.5 trillion in second quarter of 2008 to $936 billion in the second quarter of 2012, before recovering to $1 trillion in the third quarter.

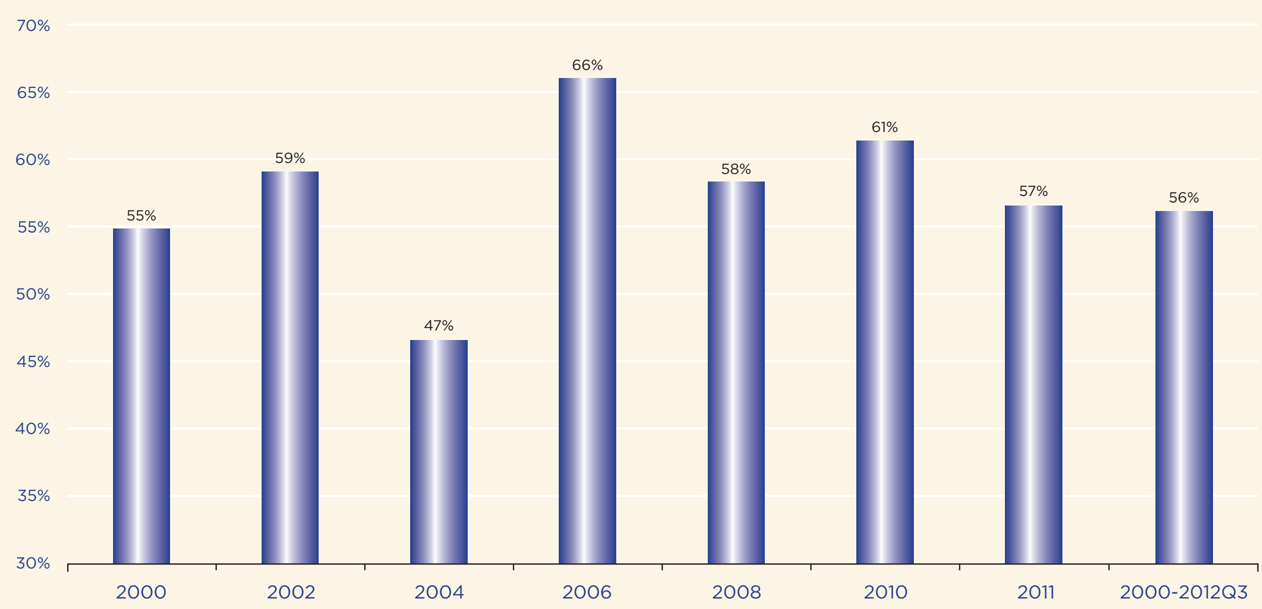
Against this backdrop, it is little wonder that in line with plunging cross-border capital flows, foreign direct investment from Europe to the United States fell sharply again in 2012. In the first nine months of the year, for instance, European FDI to the U.S. plunged 21% from the same period a year earlier. This came on the heels of an 11.8% decline in inflows in 2011. For the year, we estimate that Europe's FDI investment in the United States totaled roughly $100 billion, one of the weakest levels in years.

By country, FDI inflows from Germany to the U.S. plunged 91% from the same period a year earlier; year-over-year declines were also posted by the Netherlands (-76%), Norway (-72%), Spain (-58%), Switzerland (-67%), Italy (-45%), and the United Kingdom (-30%).

Channel Two: Cross-Border Trade and Investment

Not unexpectedly, America's trade deficit with the European Union widened again in 2012, with the U.S. posting a $107 billion merchandise trade deficit with the EU in the first eleven months of the year. The figure was nearly 19% larger than the same period a year

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 3Q2012

earlier. For all of 2012, the U.S.'s trade deficit with the EU is forecast to be roughly double the level of 2009, underscoring the dramatic shift in transatlantic trade over the past few years.

Germany, incidentally, accounted for nearly half the deficit, with the U.S. posting a $54 billion trade deficit with Europe's largest economy in the January-November period.

Over this same period, U.S. exports to the EU fell by roughly 1%, with exports to Germany dropping 0.2%, while declining by 3.2% to Ireland. Exports to Italy, the Netherlands and Spain fell 0.1%, 4.8%, and 12.5%, respectively. U.S. imports from the EU were up 4.3% in the first eleven months of 2012, with imports rising 4.8% from France, 8.8% from the United Kingdom and 10.8% from Germany.

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 painfully 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 struggled to post profits in Europe in 2012, with many, notably U.S. automakers, posting significant losses on account of deteriorating conditions in Europe.

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 56% of the global total.

Not much has changed in this decade thus far. Europe, despite being in the throes of a financial crisis, has since the start of 2010 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: EUROPE IS NUMBER ONE FOR U.S. FOREIGN AFFILIATES*

	Value	% of Total	Global Rank**
Number of Affiliates	13,159.0	52.2%	1
Thousands of Employees	4,079.4	36.8%	1
Manufacturing Employment (Thousands)	1,740.4	37.6%	1
Total Assets (Bil. US$)	11,395.9	58.1%	1
Net Property Plant & Equipment (Bil. US$)	432.1	38.4%	1
Total Sales (Bil. US$)	2,505.6	48.5%	1
Sales of Goods	1,782.6	48.0%	1
Sales of Services	636.3	51.6%	1
Net Income (Bil. US$)	599.0	58.7%	1
Capital Expenditures (Bil. US$)	57.6	34.6%	1
R&D Expenditures (Bil. US$)	24.4	61.8%	1
Gross Product ("Value Added", Bil. US$)	597.6	48.1%	1
Compensation of Employees (Bil. US$)	261.4	53.6%	1
The following data is for 2011			
US Foreign Direct Investment Outflows (Bil. US$)	224.3	56.5%	1
Affiliate Income (Bil. US$)	212.8	46.5%	1
Direct Investment Position on a Historical-Cost Basis (Bil. US$)	2,307.7	55.5%	1

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

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 transmissions 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 2012. While affiliate income—a proxy for the earnings of U.S. companies in Europe—totaled $160 billion in the first nine months of 2012, down roughly 1% from the same period a year earlier, affiliate income for the full year 2012 rose slightly from 2011 to total an estimated $214 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 (-25%) and Germany (-32%), as well as the crisis-inflicted nations of Spain and Greece (each -73%), Italy (-41%), and Portugal (-33%). Modest declines in income were reported in Switzerland (-2%) and the Netherlands (-1%), but offsetting increases were reported in Russia (2%), Ireland (4%), the United Kingdom (12%) and Poland (55%).

Near-Term Outlook: Risks Linger on Both Sides of the Pond

Plenty of risks linger over the transatlantic economy in 2013. As the year began, most of Europe was in or on the edge of recession. Greece is in the grips of a modern day Depression, as it enters its sixth straight year of recession. Hungary, Slovenia, Portugal, Spain, and Italy are expected to remain in recession this year, while Germany and France should barely eke out positive growth. In the aggregate, the OECD forecasts -0.1% growth for the eurozone in 2013, following a decline of 0.4% in 2012.

Meanwhile Europe's unemployment rates remain stubbornly high and politically dangerous; the swollen ranks of Europe's unemployed remain a lightning rod for social instability. The eurozone's unemployment rate was 11.8% in November 2012, a record high, and up from 10.6% the year before. But more worrisome than the headline figure is the fact that the unemployment rate topped 25% in Greece and Spain in 2012, with youth joblessness in both nations twice that rate.

Given all of the above, Europe will again face economic headwinds in 2013 in the form of sluggish consumer spending, flaccid private investment and more government austerity. A rebound in exports is expected, thanks to rising demand in the United States and the emerging markets, but improving external balances will not be enough to offset indigenous cyclical impediments to growth. Europe is in for another grinding year, although the foundation for stronger, sturdier growth is slowly being laid.

America is in better shape, but hardly as fit as it has been in the past. The U.S. economy is expected to expand by 2% this year, a better rate than Europe but hardly anything to write home about. On the plus side, employment growth is gaining momentum in the U.S.; the housing and auto industries are humming, providing a large multiplier effect to the economy. Consumer debt burdens are down, the banking system has been recapitalized and restructured, and manufacturing industries have become more efficient. Energy costs have plunged, and the S&P 500 index is near its all-time high—a sign of renewed investor confidence in Corporate America.

Yet the rancorous uncertainty of Washington politics could further dampen growth. While the U.S. fiscal cliff was avoided at the beginning of 2013, the confidence-sapping debate about America's finances rages on. The debt ceiling debate and sequester cuts in federal spending are key issues for Washington to resolve before the economy can reach trend-line growth of 3%. The way out is a bipartisan package of spending cuts, deficit reduction, tax reform and additional revenue. But the bickering continues and a deal won't be easy. Meanwhile, political squabbling is deferring attention from deeper challenges—stubborn unemployment; decaying infrastructure; inadequate educational achievements; low savings; exploding healthcare costs, and surging inequality.

The outcome is important for Europe, because without U.S. fiscal solvency, economic growth, and job creation, Washington is unlikely to be the type of consistent, outward looking partner that Europeans need and want. The U.S. has the same stake in Europe's success. Europe's protracted sovereign debt crisis threatens to drain U.S. confidence in Europe and its institutions and derail U.S. support for major transatlantic policy initiatives. The single most important effort the partners could make to improve their ability to act together abroad is for each to get its act together at home.

Getting Back on Track

Fiscal austerity is now the norm for both Europe and the United States after years, if not decades, of debt-fueled growth. That translates into subpar economic growth for both partners in the near term as each restructures and resets to today's new economic realities. The process will not be painless, it will not be uniform, and it will not be done in concert. Some eurozone nations will move faster than others when it comes to making difficult economic decisions. What electorates are willing to accept and tolerate varies across Europe and differs between the United States and Europe.

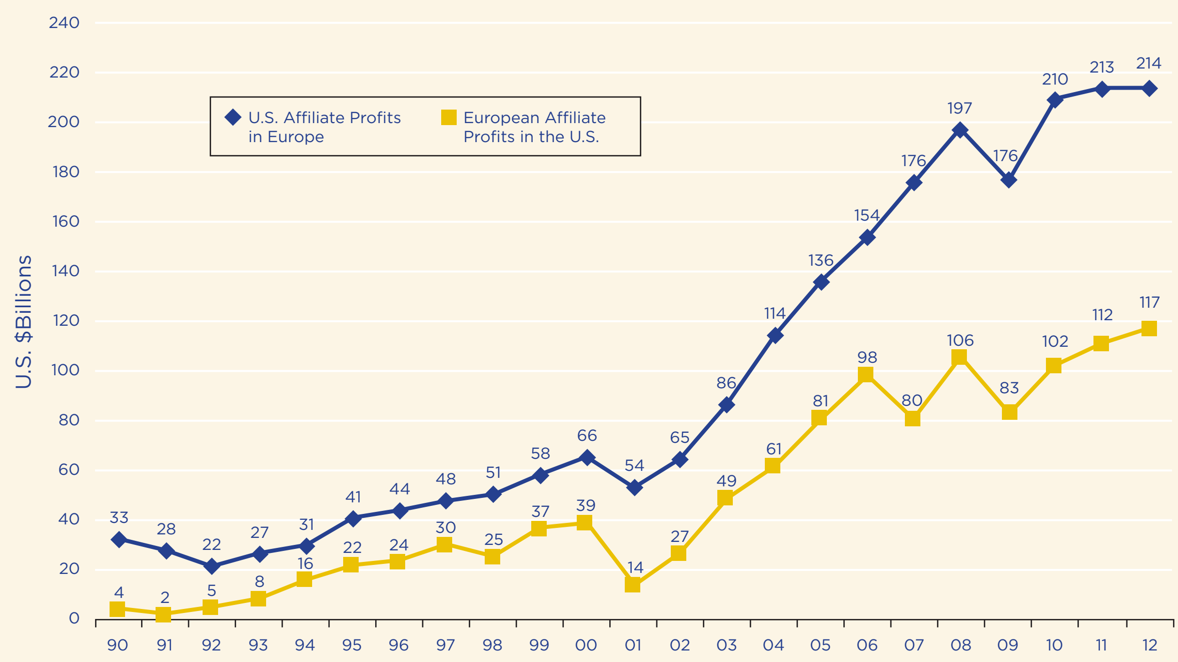
Yet, as in previous crises over the past decades, these turbulent times will pass. On both sides of the ocean, real growth will resume. Companies will hire again. Consumers will spend again. Economies will restructure and reset. New winners and losers will emerge. To this point, the crisis-stricken nations of the past—like Sweden (1994), Indonesia (1997), Brazil (1998)—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 fiscal debt hardly portend or divine the future.

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 2012, U.S. foreign direct investment (FDI) to Europe plunged 20% from the same period a year earlier. FDI flows to Germany fell sharply following a surge in investment in 2011. Meanwhile, after a significant decline in 2011, U.S. investment to France rebounded in 2012. Beyond the core of Europe, U.S. outflows to Poland and Switzerland were strong but notably weak to the United Kingdom, the Netherlands, Spain and host of other nations.

Overall, U.S. FDI outflows to Europe declined by nearly 9% in 2012, totaling an estimated $206 billion. Yet if our estimate for the year is correct, 2012 would mark the third strongest annual level of U.S. investment to Europe on record. 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 2012, or by roughly 25%, to $100 billion. This follows investment inflows of $150 billion in 2010 and $133 billion in 2011, data points that underscore the jaggedness of

TABLE 7: PROFITS[1] REACHING PEAK AGAIN



[1]Income of affiliates
Source: Bureau of Economic Analysis
Data through 3Q2012. 2012 data is annualized for full year estimate.

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.

Affiliates on both sides of the ocean actually increased their earnings in 2012, although gains in some cases were nominal. For instance, by our estimate U.S. affiliate income earned in Europe in 2012 rose by less than 1%, to $214 billion. That is a weak performance but still a record high. In the first nine months of the year, affiliate income was relatively flat, with affiliate income weakness most notable in France and Germany, where affiliate income declined 25% and 32%, respectively, versus a year earlier. Ireland and the United Kingdom were outliers; affiliate income rose 12% in the UK in the first nine months of the year and 4% in Ireland. Income dropped 1% in the Netherlands, another key source of European income for U.S. multinationals.

In the U.S., European affiliates posted income gains of 2% in the first nine months of the year. For the year, we estimate that European affiliates earned a record $117 billion, with the earnings boost from the U.S. a critical offset for many European firms beset with financial challenges in Europe.

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 2012. In the first ten months of the year, EU15 purchases of U.S. securities totaled just $73.1 billion, a 40% decline that directly reflects the financial stress of Europe and the attendant need to repatriate capital back to Europe. In contrast, U.S. capital outflows to the EU15 totaled $61 billion, a sharp decline from the previous year.

In terms of foreign holdings of U.S. Treasuries, China and Japan still rank number one and two, respectively; as of November 2012, China held $1.2 trillion in Treasuries, or 21.2% of the total; Japan held $1.1 trillion, or 20.7% of the total. Europe's total holdings, including those of the UK, Luxembourg and Switzerland, were in excess of $1 trillion, or nearly 20% of the total. OPEC's share was just 5%. In short, it's not just the Asian creditors of

Choosing a Free Trade Partner: Europe or Asia?

There is nothing more fashionable today than writing about Europe's demise. Europe's leaders have made hash of the sovereign debt crisis and thanks to a host of self-inflicted wounds, the continent is in recession. Unemployment continues to soar and has become tinder for more political uncertainty and social instability.

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 trade pact (TPP), an idea that has also gained some traction in the past year. This has become the general consensus. But it is misguided.

As Table 8 highlights, if the U.S. is going to spend the energy on negotiating a ''free trade plus'' agreement with either Europe or Asia, the former, by virtually all metrics, is where there is more bang for the proverbial buck. The TPP does not include either China or Japan, Asia's two largest economies, nor Asia's other giant: India. 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 three times as large as the TPP cohort, more populated and far wealthier. In addition, personal consumption in Europe is nearly three times larger than the TPP membership. 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 8: COMPARING FREE TRADE AGREEMENTS (BILLIONS OF $ UNLESS OTHERWISE SPECIFIED)

	Transatlantic Trade and Investment Partnership	Transpacific Partnership	NAFTA
GDP (Purchasing Power Parity)	15,853	5,802	3,062
% of World Total	20.1%	7.3%	3.9%
Population (thousands)	501,917	346,079	149,143
% of World Total	7.2%	5.0%	2.1%
Per Capita Income ($)	35,087	16,329	19,397
Personal Consumption Expenditures	10,195	3,243	1,744
% of World Total	25.2%	8.0%	4.3%
Exports	5,854	1,976	802
% of World Total	32.8%	11.1%	4.5%
Imports	6,063	1,957	882
% of World Total	33.1%	10.7%	4.8%
U.S. Outward FDI Stock to...	2,094	727	410
% of U.S. Total	50.4%	17.5%	9.9%
U.S. Inward FDI Stock from...	1,573	307	225
% of U.S. Total	61.8%	12.0%	8.8%
U.S. FDI Income Earned Abroad	177	95	53
% of U.S. Total	38.7%	20.9%	11.5%
Foreign FDI Income Earning in the U.S.	95	18	13
% of U.S. Total	62.9%	11.9%	8.5%
Foreign Affiliate Sales of U.S. MNC's in...*	2,107	1,321	761
% of U.S. Total	40.8%	25.6%	14.7%
U.S. Affiliate Sales of Foreign MNC's from...*	1,609	309	245
% of U.S. Total	52.1%	10.0%	8.0%

Sources: IMF; UN; BEA.
Data for 2011
**Data for 2010*

TABLE 9: THE POWER BROKERS OF THE GLOBAL ECONOMY COMPARED

	Eurmerica	Asia	Chindia	Chinmerica
GDP, PPP	40.0%	35.9%	19.9%	33.4%
GDP, Nominal	48.4%	30.2%	13.1%	32.0%
Market cap. (as of 1/8/2012)	$28.8 trillion	$17.1 trillion	$4.3 trillion	$20.2 trillion
Personal consumption exp.	53.2%	25.6%	8.9%	32.8%
M+A Sales	63.6%	18.4%	4.5%	27.6%
M+A Purchases	50.5%	29.4%	7.7%	31.3%
Inward FDI stock	56.7%	23.4%	4.5%	20.7%
Outward FDI stock	70.6%	18.6%	2.3%	23.0%
Inflows (2000-2011)	54.9%	23.8%	7.9%	21.4%
Outflows (2000-2011)	71.0%	17.5%	2.9%	20.6%
Exports* (Goods)	24.8%	42.1%	16.5%	25.2%
Imports* (Goods)	31.1%	40.4%	15.7%	28.4%
Military Spending	$993.3	$327.6	$173.6	$818.9
(U.S. $ billions at constant 2010 prices)	61.1%	20.2%	10.7%	50.4%

** Total does not include Intra-EU27 + Norway, Switzerland, & Iceland trade*
Sources: IMF, Bloomberg, UN, SIPRI
All data for 2011 otherwise noted

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 $52 billion trade surplus in services with the EU in 2011, compared with its $100 billion trade deficit in goods with the EU. For all of Europe in 2011, the surplus in services was larger—roughly $62 billion. In the first nine months of 2012, U.S. services exports to Europe totaled $176 billion, a 3.5% 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 $39 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 an uncertain economic backdrop again in 2013, 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 $5.3 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 spark or 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.

A Comprehensive U.S.-EU Trade and Investment Partnership: Good for Jobs, Good for Growth

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—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 be less about reducing tariffs and more about reducing 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 Bonn can be sold without further tests in Boston. 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.[4] 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,[5] 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

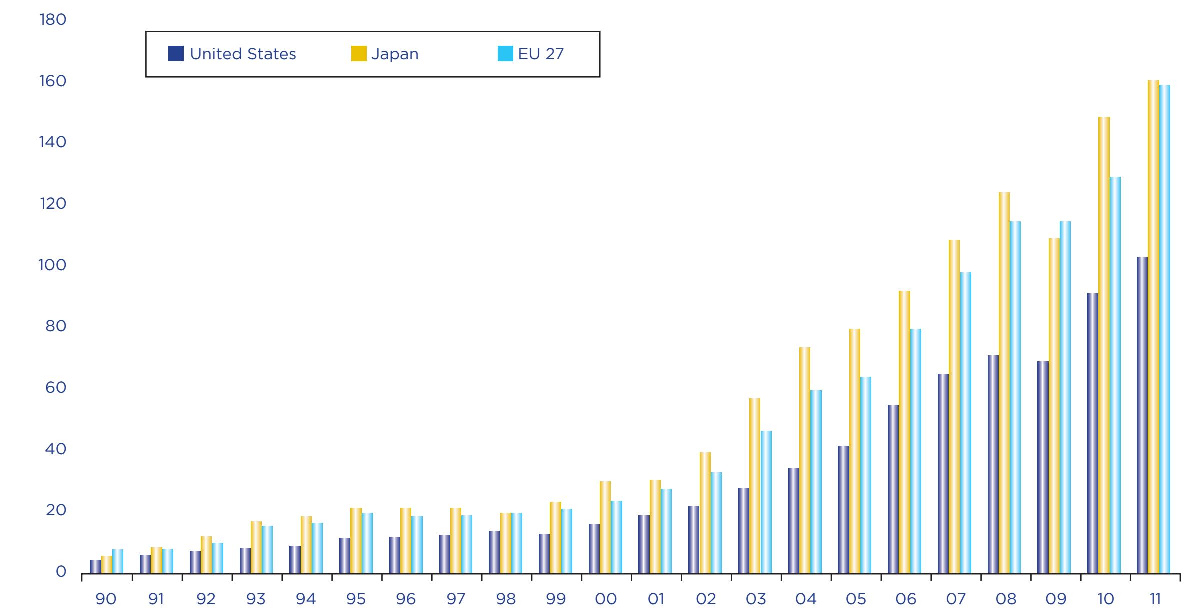
Trading with China: Who Has the Advantage?

U.S. and European multinationals, well entrenched in each other 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.

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 2011, EU exports to China totaled $160 billion, some 54% larger than U.S. exports to China. The EU slightly lagged Japan, whose exports to China totaled $162 billion. In the first eight months of 2012, EU exports to China amounted to $106 billion; Japan exported a similar amount, while exports from the U.S. were valued at $66 billion. 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.

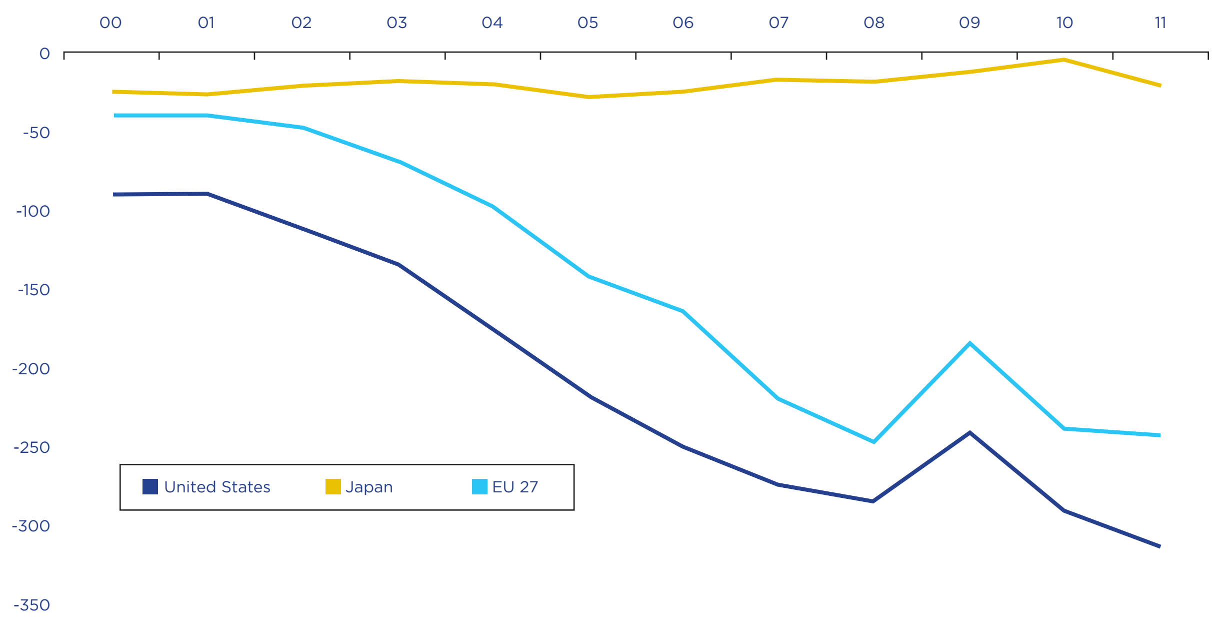
The downside is that the U.S., EU and Japan each runs trade deficits with China, and the trade gap of the U.S. and Europe is quite large.[6] As Tables 10 and 11 highlight, the EU's trade deficit with China totaled $242 billion in 2011, a significant jump from the shortfall in 2000 ($40 billion). The U.S. trade deficit with China was in excess of $300 billion in 2011, and continued to widen last year. Japan's imbalance is not as great—less than $25 billion through the first eight months of 2012.

TABLE 10: U.S., EU AND JAPAN EXPORTS TO CHINA - (BILLIONS OF $)



Sources: IMF
Data through 2011

TABLE 11: U.S., EU AND JAPAN TRADE BALANCE WITH CHINA - (BILLIONS OF $)



Sources: IMF
Data through 2011

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.[7] 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.[8] 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.

Endnotes

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2. Matthew Kaminski, "Trying to Save Europe 'Step by Step,'" *The Wall Street Journal*, December 2, 2012, p. A17.
3. Chris Mayer, "What investors should focus on," *The Washington Post*, January 13, 2013; "Germany leads resurgence in European stocks," *Financial Times*, December 7, 2012; "Irish issue shows way back for the periphery," *Financial Times*, January 9, 2013.
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5. Daniel S. Hamilton and Joseph P. Quinlan, *Sleeping Giant: Awakening the Transatlantic Services Economy* (Washington, DC: Center for Transatlantic Relations, 2008).
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.
7. 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).
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CHAPTER 2

THE POST-CRISIS TRANSATLANTIC ECONOMY: The Eight Ties that Still Bind

America's strategic pivot to Asia and daily prophesying from pundits that the future of the world economy lies with the "Rest," notably China, suggest that Europe is becoming less and less relevant to the global success of Corporate America. Similarly, the undercurrent of doubt running through Europe about the ability of America's political class to restore financial and fiscal health to the U.S. economy suggests that European firms should look elsewhere for profitable opportunities, notably among the developing nations.

On both counts conventional wisdom is wide of the mark.

To be sure, it has been a rocky decade for the transatlantic economy, defined here as the highly integrated economic space inhabited by the United States and Europe. In the past ten years the transatlantic partnership has been buffeted by economic recessions, military conflicts in the Middle East, a U.S.-led financial crisis-cum-global recession, and Europe's sovereign debt crisis. The latter has made Europe the weak link of the global economy, but as discussed in Chapter 1, we believe the tide has turned in Europe, and for the better.

While Europe's unfolding recession has been well covered by the media, less attention has been paid to underlying trends that suggest that real growth in the EU will rebound later in 2013, underpinned by the cheap cost of capital, a revival in consumer and business confidence, and strong external demand. In addition, the crisis itself has triggered EU-wide structural reforms that will make Europe stronger, not weaker, in the long term. Not all economies in Europe are created equal, of course; some are more competitive, in better financial shape, and more prudently managed than others. The upshot is a mixed European economic outlook, with the low debt, highly competitive economies of the north outperforming the debt-laden, uncompetitive economies of the south.

The popular narrative has missed these points. This eurozone crisis will ultimately pass, just like previous crises over past decades. Real growth will resume. Companies will hire again. Consumers will spend again. Economies will restructure and reset. New winners and losers will emerge. To this point, crisis-stricken nations of the past—like Sweden (1994), Indonesia (1997), Brazil (1998)—are among the strongest in the world today. It was not that long ago that Germany was considered the "sick man of Europe;" now it ranks as among the strongest in Europe and the world after undertaking painful reforms. In other words, the negative headlines of today regarding the European debt crisis hardly portend or divine the future.

Leading U.S. multinationals understand this and invest their money based on their practical experience with European marrkets. They will continue to leverage the European Union to their strategic advantage. European firms will continue to do the same in the United States, where even the most skeptical pundits have been surprised by the resiliency of the U.S. economy over the past year. Against this backdrop, the current downturn in transatlantic foreign direct investment is more cyclical than structural, temporary as opposed to permanent.

American and European firms are building out their in-country presence in the developing nations, and for good reasons. Growth rates are above the global average, most populations are young and want Western goods and services, and the technological skill levels of some nations are now on par with many developed nations. It makes perfect sense for U.S. and European firms to invest outside the transatlantic economy.

But this dynamic does not signal a retreat on the part of U.S. and European firms from the transatlantic economy. It's more about global rebalancing, with many transatlantic firms rushing to deepen their footprint in the developing nations, replicating the deep ties that are the hallmark of the transatlantic partnership. In fact, that U.S. and European companies are using global value chains to integrate the value added other countries can contribute to particular products and services into transatlantic bonds of investment and trade.

What makes the transatlantic economy distinctive in this world of rising powers and emerging markets? As we have highlighted in the past, it is foreign investment—the deepest form of global integration—that binds the transatlantic economy together far more than trade. The latter, the cross-border movement of goods and services, is a shallow form of integration and often associated with the early phases or stages of bilateral commerce. In contrast, a relationship that rests on the foundation of foreign investment is one in which both parties are extensively embedded and entrenched in each other's economies. Such a relationship is more job-creating, income-producing, and wealth-generating for both parties than one based solely on trade.

This deep commercial integration epitomizes the transatlantic economy, which is wound and bound together by symbiotic ties between investment and trade in goods and services. Because of this relationship, the global primacy of foreign affiliate sales over trade continues to expand dramatically. To this point, global foreign affiliate sales (sales of affiliates from around the world) in 1990 totaled $5.1 trillion, versus global exports of $4.4 trillion, according to figures from the United Nations. By 2011, however, global foreign affiliate sales tallied a staggering $33 trillion, a figure three-fourths larger than global exports ($18.7 trillion). The widening gap in part reflects rising cross-border investment and commerce between the United States and Europe.

Against this backdrop, most American foreign affiliates in Europe are indistinguishable from local German, British, or Dutch firms, while European affiliates operating in the United States are barely distinguishable to U.S. consumers who enjoy European goods and services on a daily basis without much thought. U.S. firms and their global counterparts in Europe, Japan and now even China, Brazil and other countries prefer to deliver goods and services via foreign direct investment (foreign affiliates) rather than trade (exports).

We do not mean to downplay the importance of transatlantic trade, which remains considerable. Indeed, transatlantic trade (defined here as U.S. exports plus imports of goods from the European Union) totaled an estimated $650 billion in 2012, up from $387 billion at the start of the new century. Transatlantic trade is sizable and important to both economies. But one must add investment to the picture to get a true sense of the size and dynamism of the transatlantic economy, particularly compared to any other bilateral economic relationship either partner has in the world.

Companies invest abroad for various reasons. They may want to make a strategic investment, for instance to introduce a new product or service. "Build where you sell" is a mantra of many successful multinationals, and this requires an in-country/region presence in many different parts of the world. They may seek resources, such as acquiring access to specialized knowledge or particular technologies. They may want to win share in new markets, or they may want to achieve greater efficiencies by gaining access to cheap factors of production. While much media and political attention focuses on the resource- or efficiency-seeking motivations behind such investments, particularly the need for cheap foreign labor, the reality is that the increasingly critical need for companies is to position themselves within pan-continental markets, and to generate new sources of knowledge that they can turn into new sources of profit. These latter motivations drive a good deal of mutual investment across the Atlantic.

Moreover, these companies and affiliates invest in local communities. European affiliates in the United States employ millions of American workers and are the largest source of onshored jobs in America. Similarly, U.S. corporate affiliates in Europe employ millions of European workers and are the largest source of onshored jobs in Britain, Ireland and across the European continent.

The Transatlantic Economy in the World

There is no commercial artery in the world as large as the one binding the United States and Europe together. The transatlantic economy still accounts for over 50% of world GDP in terms of value and 41% in terms of purchasing power, is the largest and wealthiest market in the world, is at the forefront of global R&D, and drives global foreign direct investment and global mergers and acquisitions activity.

All told, by our estimate roughly $5.3 trillion in commerce takes place between U.S. and European companies and their affiliates each year. Hence, when one half of the transatlantic partnership suffers or goes into recession, like Europe in 2012, the other half suffers as well. As discussed in Chapter 1, while the economic downturn in Europe has yet to derail the U.S. economy, Europe's problems are quite evident via declining capital flows from Europe to the U.S., plummeting U.S. exports to

Europe, a widening U.S. trade deficit and weaker-than-expected U.S. corporate earnings for many companies with extensive links to Europe (think U.S. automakers). Should Europe's sovereign debt crisis intensify this year and growth/demand across the continent weaken further, the risks of a U.S. recession will only rise. On the contrary, a sustained economic rebound in the EU will be hugely beneficial to Corporate America given its extensive links with the EU.

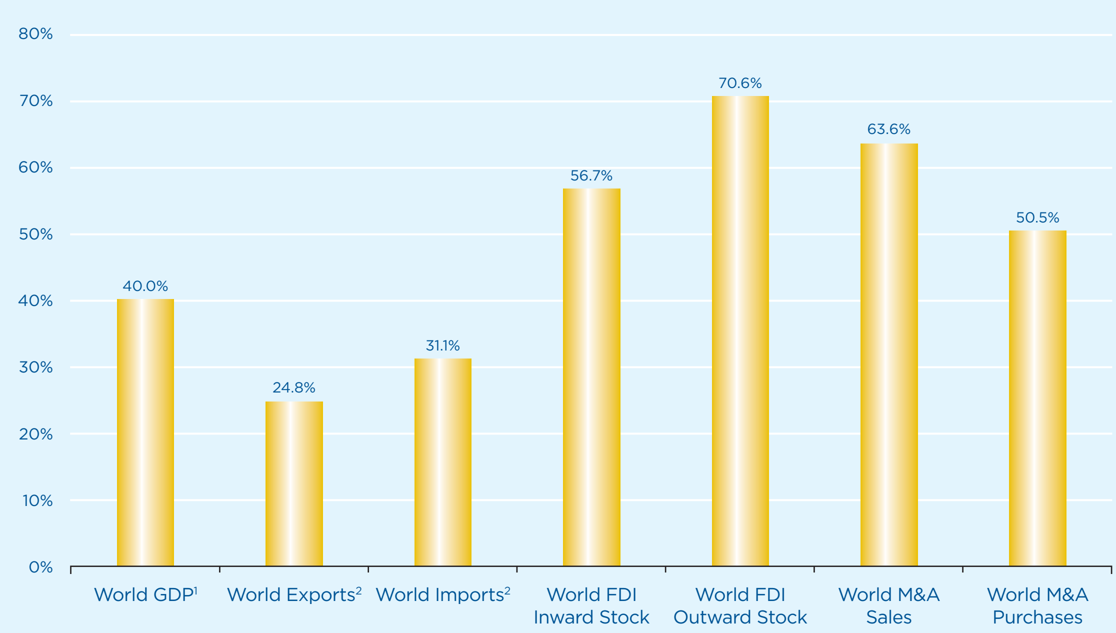
U.S. economic challenges, by the same token, have consequences for Europe, given that the U.S. is one of the top country export destinations for EU goods and services, the EU's leading source and destination of both FDI and private portfolio investment, and a key innovation partner for European economies seeking to maintain their competitive position in knowledge-based activities.

In other words, the transatlantic economy still has some heavy lifting to do over the next twelve months. Success or failure in one part of the relationship will affect the other since no two regions of the global economy are as economically fused as the two parties straddling the Atlantic.

That said, it has long been our contention that one of the most dangerous deficits affecting the transatlantic partnership is not one of trade, values, or military capabilities but rather a deficit in understanding among opinion leaders of the vital stakes Americans and Europeans have developed in the success of each other's respective economies. Hence, transatlantic differences over financial sector reform, divergent fiscal and monetary policies, and other critical issues like global climate change are cause for concern. With so much attention devoted to the rise of the Chinese economy and shifting trade flows in both the United States and Europe, many on both sides of the Atlantic have forgotten about the importance of investment and the unappreciated, invisible and little understood activities of foreign affiliates, which represent the real backbone of the transatlantic economy.

This is illustrated in Table 1, which illustrates the weight of the transatlantic economy in the overall global economy. Taken together U.S. and European exports to the world accounted for 25% of global exports in 2011; combined U.S. and European imports accounted for 31% of global imports. But the U.S. and Europe together accounted for 57% of the inward stock of foreign direct

TABLE 1: THE TRANSATLANTIC ECONOMY VS. THE WORLD - SHARE OF WORLD TOTAL



Sources: UN, IMF, figures for 2011
1. Based on PPP estimates,
2. Excluding intra-EU, Norway, Switzerland and Iceland trade.

investment (FDI), and a whopping 71% of outward stock of FDI. Moreover, each partner has built up the great majority of that stock in the other economy. In short, mutual investment in the North Atlantic space is very large, dwarfs trade, and has become essential to U.S. and European jobs and prosperity.

All in all, the transatlantic economy remains the dominant force in the global economy. Rising powers are resetting the global economy, but they haven't done so yet. Such a transformation is neither complete nor pre-ordained. And a different world economy is not necessarily a worse one for Americans and Europeans—if they use the coming decade to leverage global growth, human talent and innovation while tackling related challenges of deficits and debt, building on their own considerable strengths, and exploiting the full potential of the transatlantic economy. That is a big "if," but each side is laying the groundwork for economic recovery, and both are launching negotiations to further open transatlantic markets and position themselves for the world rising before them.

The Ties that Bind—Quantifying the Transatlantic Economy

Foreign affiliates on both sides of the Atlantic have constructed a formidable commercial presence over the past half century. Remarkably, notwithstanding all the stress and strain on the transatlantic partnership over the past decade, this infrastructure remains solid and dynamic. Even in the face of the transatlantic recession of 2008/09, and the economic relapse in Europe in 2011/12, the transatlantic foundation remains firm. Many measures of economic performance declined sharply in 2009 due to the transatlantic recession, rebounded in 2010 and softened again in 2011 and 2012, reflecting the cyclical dynamics of the transatlantic economy. The structural foundation of the transatlantic economy remains robust but the near term will remain challenging for companies on both sides of the Atlantic.

Over the past few years we have suggested eight key indices that offer a clearer picture of the "deep integration" forces shaping the transatlantic economy. This chapter updates those indices with the latest available data. Each variable, in general, has ebbed and flowed with the cyclical swings of transatlantic economic activity, but has nevertheless grown in size and importance over the past decade.

If there is a common theme to the data below, it is this: most metrics declined in 2009 due to the transatlantic recession, rebounded in 2010 but remained below 2008 peak levels. Further healing was evident in 2011 and 2012. More improvement is expected in 2013 as the U.S. continues to expand and the EU economy gathers strength and comes out of recession.

1. Gross Product of Foreign Affiliates

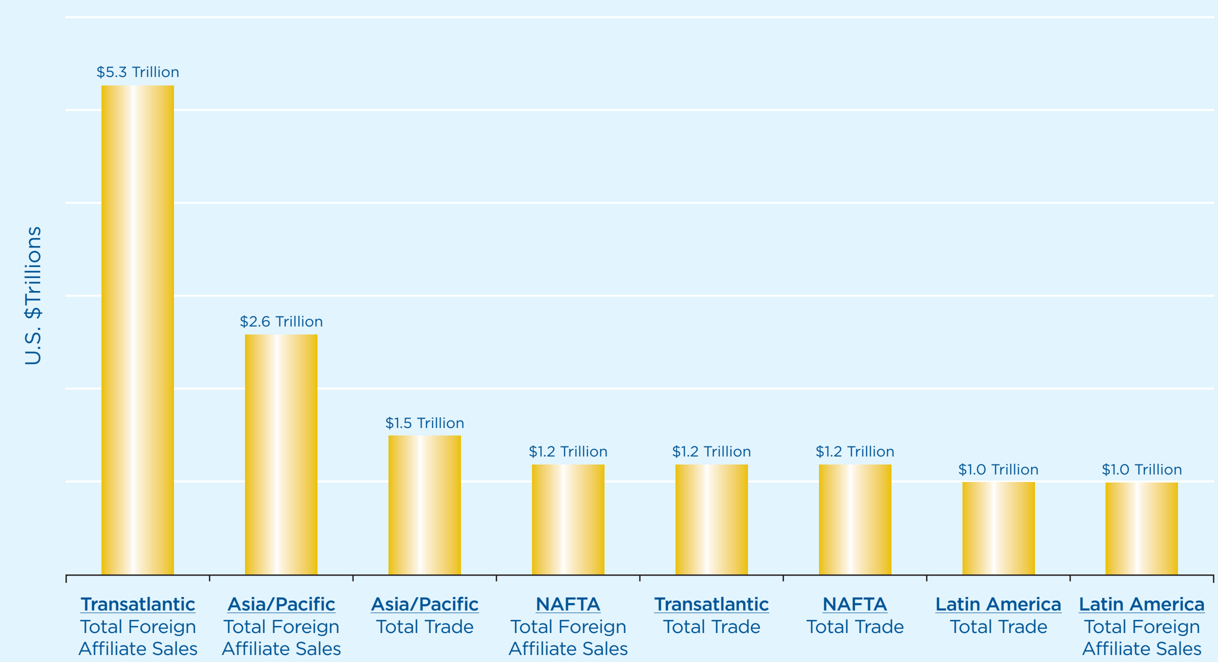
In their own right, U.S. affiliates in Europe and European affiliates in the United States are among the largest economic forces in the world. For instance, the total output of U.S. foreign affiliates in Europe (an estimated $615 billion in 2011) and of European affiliates in the U.S. ($441 billion) was greater than the total gross domestic output of most countries. Combined, transatlantic foreign affiliate output in 2011—in excess of $1 trillion—was larger than the output of such nations as the Netherlands, Turkey or Indonesia.

By our forecast, U.S. affiliate output in Europe rose by a modest 3% in 2011. Meanwhile European affiliate output in the U.S. rose by nearly 4%, totaling over $440 billion, a record high. European affiliate output in the U.S. has recovered and expanded since falling to a cyclical low of $391 billion in 2009. In contrast, U.S. affiliate in output in Europe has yet to reach pre-crisis levels; the high was in 2008, when output totaled $660 billion, meaning that output in 2011 (an estimated $615 billion) was off some 6.8% from the levels of 2008.

This difference reflects relative stagnation in Europe, which adversely affected U.S. affiliate output, in contrast to an expanding American economy, which helped to boost affiliate output of European affiliates operating in the United States. Production by U.S. auto affiliates was notably weak, given plunging car sales across Europe. Most likely there were most pockets of strength, most probably in the north, but these positive trends were more than likely offset in Europe's recession-wracked periphery.

On a global basis, aggregate output of U.S. affiliates reached $1.3 trillion in 2011, with Europe accounting for roughly 46% of the total. The latter figure was down from 48% from 2010, a slide that reflects the cyclical downswing in demand due to Europe's recession. The United Kingdom, where U.S. investment ties are among the deepest, accounted for around 25% of total affiliate output in Europe in 2011, followed by Germany (14%) and France (8%). These three countries accounted for nearly half of total U.S. affiliate output in Europe in 2009 and 2010, and a 47% share in 2011. However, the same three nations accounted for 63% of the total in 2000, with the declining share reflecting the greater diffusion of affiliate production across Europe. A big winner has

TABLE 2: AMERICA'S MAJOR COMMERCIAL ARTERIES



Foreign Affiliate Sales: Estimates for 2011. Total Trade: Data for goods & services, 2011.
Source: Bureau of Economic Analysis.

been Ireland, whose share of U.S. foreign affiliate output more than doubled between 2000 (5%) and 2011 (10.5%). By sector, output was almost evenly split between services (52%) and manufacturing (48%). Germany, the United Kingdom and Ireland accounted for roughly half of total U.S. affiliate manufacturing output in Europe in 2010, the last year of available data.

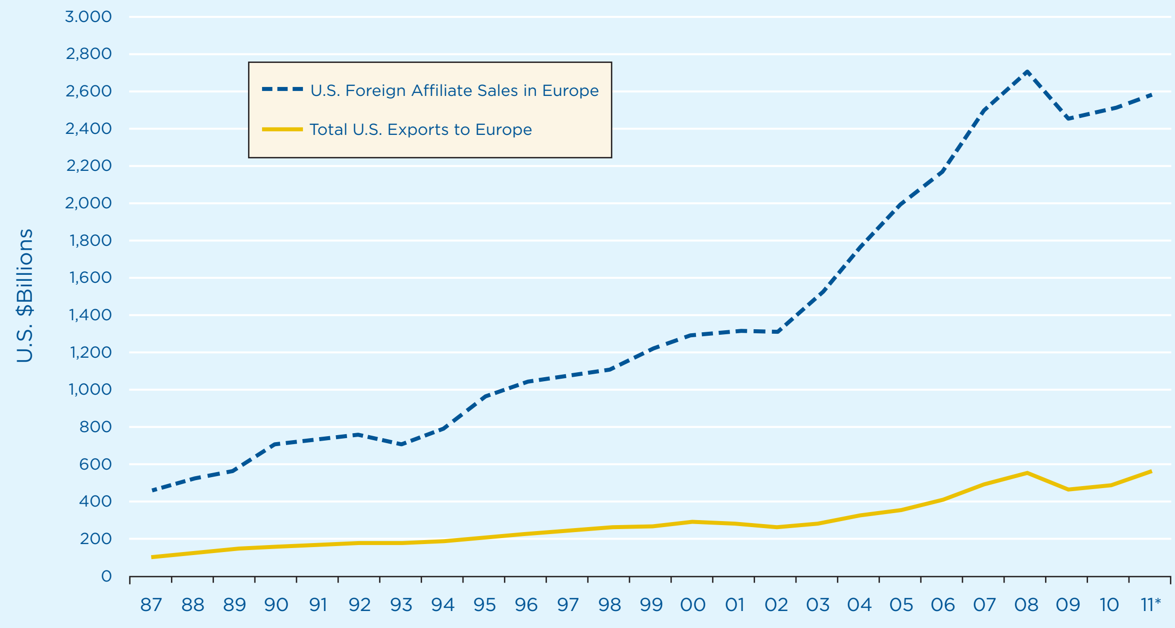
The presence of U.S. affiliates in some European countries is particularly noteworthy. The gross output of American affiliates in Ireland, for instance, represented over one-quarter of the country's gross domestic product in 2011 by our estimates, a staggering contribution on both an absolute and relative basis. This dynamic reflects in part the large U.S. investment base, notably among U.S. life science and technology companies, in Ireland, which despite its own economic difficulties remains a favorite global destination of U.S. firms.

Elsewhere, by our estimates, U.S. affiliates accounted for 6.4% of the United Kingdom's aggregate output in 2011; 5.8% of Norway's aggregate output; 5.2% of Switzerland's aggregate output; and 5.0% of Belgium's total output. It is interesting to note that U.S. foreign affiliate output in Belgium in 2011 (roughly $25.6 billion) was more than 40% larger than U.S. foreign affiliate output in India (est. $18 billion).

Also, slowly but surely, more U.S. firms are taking advantage of the EU's expanded Single Market and are incorporating central and eastern European member states, as well as such key non-EU countries as Turkey and Russia, into their European and global production networks. U.S. affiliate output in Poland, for instance, totaled an estimated $10.9 billion in 2011, exceeding U.S. output in more developed markets like Austria, Portugal, and Denmark. There was a five-fold increase in affiliate output in Poland between 2000 and 2011. Meanwhile, U.S. affiliate output in Hungary in 2011 ($4.0 billion) was larger than output in Greece (estimated at $2.9 billion); U.S. output in Russia ($9.4 billion in 2011) easily surpassed output in Portugal ($4.4 billion); and total output in Turkey ($8.1 billion) was over a quarter larger than output in Austria.

In the United States, European affiliates are major economic producers in their own right, with British firms of notable importance. Their U.S. output reached $119 billion in 2011, more than a quarter of the European total. For the same year, output from German affiliates operating in the U.S. totaled $81 billion by our

TABLE 3: SALES OF U.S. AFFILIATES IN EUROPE VS. U.S. EXPORTS TO EUROPE



**Estimate for sales*
Source: Bureau of Economic Analysis
Majority-owned non-bank affiliates data: 1987 - 2008. Majority-owned bank and non-bank affiliates: 2009 - 2011.

estimates, or almost one-fifth of the total, while output from French affiliates ($60 billion) accounted for 14% of the total.

Beyond European affiliates, only Corporate Japan has any real economic presence in the United States. Japanese affiliate output totaled an estimated $82 billion in 2011, below output from British affiliates but slightly above output from German affiliates. Overall, foreign affiliates contributed nearly $672 billion to U.S. aggregate production in 2011, with European affiliates accounting for roughly two-thirds of the total.

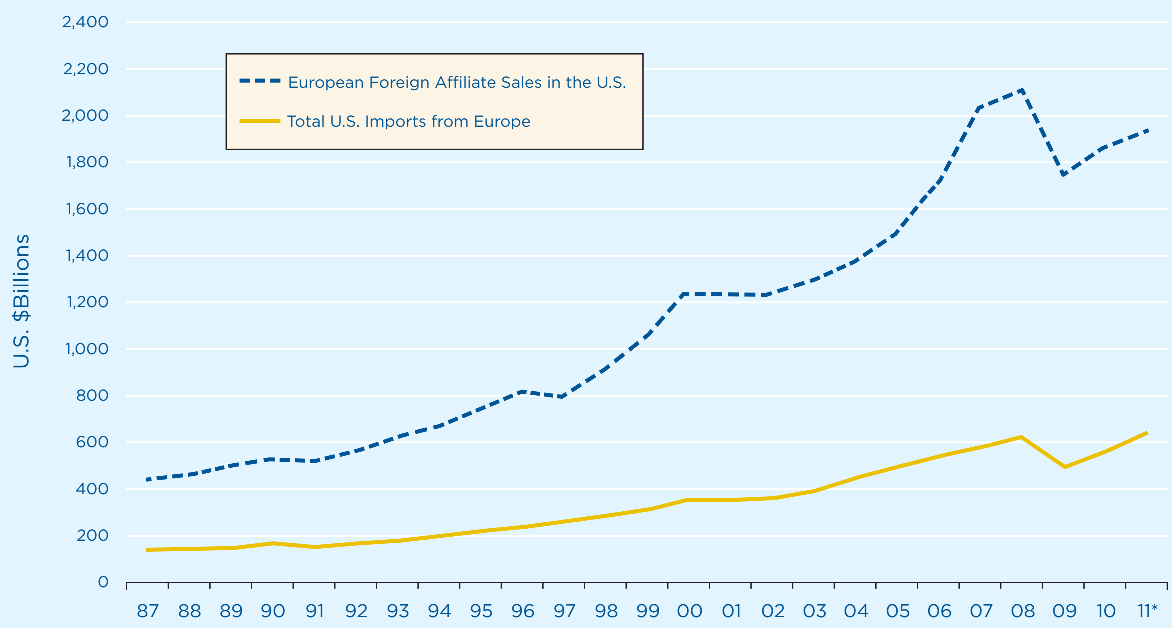
2. Assets of Foreign Affiliates

America's global commercial presence, in the form of foreign assets of majority-owned U.S. foreign affiliates, totaled roughly $21 trillion in 2011, a staggering sum and metric of the global reach and ambition of corporate America. By our estimates, U.S. foreign assets (bank and non-bank) were valued at roughly $12 trillion in Europe, or around 57% of the global total. Within the region, the bulk of U.S. assets were in the United Kingdom, with U.S. assets totaling an estimated $4.7 trillion, or 23% of the global total.

U.S. assets in the Netherlands ($1.8 trillion) were the second largest in Europe and the world in 2011. America's sizable asset base in the Netherlands reflects its strategic role as an export platform/distribution hub for U.S. firms doing business in the rest of the European Union. To this point, more than half of affiliate sales in the Netherlands are for export, namely within the EU. Meanwhile, America's asset base in Germany ($683 billion in 2011 was over 50% larger than its asset base in all of South America in the same year. America's collective asset base in Poland, Hungary, and the Czech Republic (roughly $147 billion) was much larger than the size of corporate America's assets in India (est. $95 billion). As for Corporate America's in-country presence in Ireland, U.S. assets totaled roughly $900 billion in 2011, more than total U.S. assets in either Switzerland or France. Ireland accounted for around 7.6% of total U.S. assets in Europe in 2011.

As for foreign-owned assets in the United States, Europe's stakes are sizable even after declining in 2009 in response to the U.S. recession. Total assets of European affiliates in the United States were valued at $8.6 trillion in 2011 by our estimate. The United Kingdom ranked first as the largest holder of U.S. assets in 2011 (est. $2.2 trillion),

TABLE 4: SALES OF EUROPEAN AFFILIATES IN THE U.S. VS. U.S. IMPORTS TO EUROPE



**Estimate for sales*
Source: Bureau of Economic Analysis
Majority-owned non-bank affiliates: 1987 - 2006. Majority-owned bank and non-bank affiliates: 2007 - 2011.

followed by German firms ($1.5 trillion), and Swiss and French firms, with assets of roughly $1.3 trillion in 2011. U.S. assets of Dutch firms totaled an estimated $959 billion in the same year.

3. Affiliate Employment

When it comes to hiring workers overseas, the conventional wisdom is that the bulk of corporate America's overseas work forces toils in the developing nations. This is simply not true. Most foreign workers on the payrolls of U.S. foreign affiliates are employed in the industrialized countries, notably in Europe.

Indeed, between 2000 and 2010, U.S. foreign affiliate employment in Europe rose by nearly 11%, increasing from 3.7 million workers in 2000 to over 4.1 million a decade later. Figures for 2011 are not yet available, although we estimate that the number of workers employed by U.S. affiliates rose to roughly 4.1 million.

Aggregate employment levels continue to rise but manufacturing employment fell slightly, from 1.9 million at the start of the century to 1.7 million in 2010, the last year of available data. The largest declines in manufacturing employment among U.S. affiliates was reported in the United Kingdom, with the total manufacturing work force declining to 289,000 in 2010 from 431,000 in 2000. Employment in France dropped from 249,000 to 198,000, declines of 388,000 to 351,000 was recorded in Germany. Poland was a big gainer: U.S. affiliate manufacturing employment there doubled between 2000 and 2010, climbing from 51,000 to 100,000 in 2010.

On a global basis, U.S. majority-owned affiliates (banks and non-banks) employed roughly 11.5 million workers in 2011, with the bulk of these workers—roughly 36%—toiling away in Europe. That share is down from 41% in 2008 although the decline reflects, in part, the cyclical fall in output and employment across recession-rankled Europe. It also reflects the fact that a rising share of U.S. overseas capacity (manufacturing and services) is expanding at a faster pace in the high-growth emerging markets versus slow growth developed nations.

The bulk of affiliate employees in Europe are based in the United Kingdom, Germany and France, a trend little changed from previous years. What has changed, however, is the following: the European workforce of U.S. majority-owned foreign affiliates is shifting towards more services activities as opposed to manufacturing.

Manufacturing employment accounted for just 42% of total employment in 2010, the last year of available data. The top industry in terms of manufacturing employment was transportation, with U.S. affiliates employing nearly 371,000 workers, followed by chemicals (271,000 workers). Wholesale employment was among the largest sources of services-related employment, which includes employment in such areas as logistics, trade, insurance and other services-related activities.

Although services employment among U.S. affiliates has grown at a faster pace than manufacturing employment over the past decade, it is interesting to note that U.S. affiliates employed more manufacturing workers in Europe in 2010 (1.7 million) than in 1990 (1.6 million). However, while the aggregate number has increased, the geographic distribution of U.S. manufacturing employment in Europe has shifted over the past few decades.

In general, the shift has been towards lower cost locations like Ireland, Poland and Hungary, at the expense of the United Kingdom, France and Germany. To this point, the later three nations accounted for 67% of total U.S. affiliate manufacturing employment in Europe in 1990. In 2010, the share had been reduced to 48%. The United Kingdom took the biggest hit, with the UK's share of U.S. affiliate manufacturing employment accounting for just 16.6% of the total in 2010 versus a share of 29% in 1990. Between 1990 and 2010, U.S. affiliate manufacturing employment in the United Kingdom and Germany fell by roughly 35% and 9%, respectively. Meanwhile, manufacturing employment in Ireland soared by over 40% over the same period. From virtually zero in 1990, the combined share of affiliate manufacturing employment in Poland, the Czech Republic and Hungary totaled 10.8%, indicative of the eastern spread of U.S. European operations.

Interestingly, even with the decline of manufacturing employment in Germany, the manufacturing workforce of U.S. affiliates in Germany alone totaled 351,000 workers in 2010 – above the number of manufactured workers employed in Brazil by U.S. affiliates (313,000) and India (126,000) yet below the figures of China (562,000).

When it comes to affiliate employment, trends in the United States are similar to those in Europe. In other words, despite stories on the continent about local European companies decamping for cheap labor markets in central Europe or Asia, most foreigners working for European companies outside of Europe are Americans. Based on the latest figures, European majority-owned foreign affiliates directly employed roughly 3.5 million U.S. workers in 2011 – some 563,000 less workers than U.S. affiliates employed in Europe. By our estimates, the top five European employers in the U.S. were firms from the United Kingdom (910,000), Germany (589,000), France (489,000), Switzerland (416,000) and the Netherlands (350,000). European firms employed roughly two-thirds of all U.S. workers on the payrolls of majority-owned foreign affiliates in 2011.

In the aggregate, the transatlantic workforce directly employed by U.S. and European foreign affiliates in 2011 was roughly 7.6 million strong, up modestly from the levels of the year before. In 2012, modest gains in employment were most likely achieved as employment rebounded due to increased hiring among European affiliates based in the U.S. That said, as we have stressed in our last survey, these figures understate the employment effects of mutual investment flows, since these numbers are limited to direct employment, and do not account for indirect employment effects of nonequity arrangements such as strategic alliances, joint ventures and other deals. Moreover, affiliate employment figures do not include jobs supported by transatlantic trade flows. Trade-related employment is substantial in many U.S. states and many European regions.

TABLE 5: THE U.S. - EUROPEAN EMPLOYMENT BALANCE THOUSANDS OF EMPLOYEES, 2011[1]

Country	European Affiliates of U.S. Companies	U.S. Affiliates of European Companies	Employment Balance
Austria	40.8	13.3	-27.5
Belgium	131.1	154.8	+23.7
Denmark	33.9	23.5	-10.4
Finland	19.5	27.0	+7.5
France	510.2	489.0	-21.2
Germany	586.0	589.5	+3.5
Ireland	100.5	133.4	+32.9
Italy	216.9	83.1	-133.8
Luxembourg	15.6	33.5	+17.9
Netherlands	215.4	350.1	+134.7
Norway	39.4	6.8	-32.6
Spain	170.6	75.9	-94.7
Switzerland	90.5	416.4	+325.9
United Kingdom	1,209.3	910.0	-299.3
Europe	4,087.6	3,524.5	-563.1

Note: Employment balance "+" favors the United States
Source: Bureau of Economic Analysis
1. Estimates
Majority-owned bank and non-bank affiliates

In total, and adding in indirect employment, we estimate that the transatlantic work force numbers some 13-15 million workers. Europe is by far the most important source of "onshored" jobs in America, and the U.S. is by far the most important source of "onshored" jobs in Europe.

4. Research and Development (R&D) of Foreign Affiliates

While most multinationals still tend to cluster their R&D expenditures and activities in their home country, foreign affiliate R&D has become more prominent over the past decade as firms seek to share development costs, spread risks and tap into the intellectual talent of other nations. Alliances, cross-licensing of intellectual property, mergers and acquisitions and other forms of cooperation have become more prevalent characteristics of the transatlantic economy in the past decade. The internet, in particular, has powered greater transatlantic R&D. The complexity of scientific and technological innovation is leading innovators to partner to share costs, find complementary expertise, gain access to different technologies and knowledge quickly, and collaborate as part of "open" innovation networks. Cross-border collaboration with foreign partners can range from a simple one-way transmission of information to highly interactive and formal arrangements. Collaboration with foreign customers and/or suppliers helps firms develop new products, processes or other innovations.[1]

Bilateral U.S.-EU flows in research, development and innovation are the most intense between any two international partners. In 2010, the last year of available data, U.S. affiliates sunk $24.4 billion on research and development in Europe, or roughly 62% of total R&D expenditures of total global R&D by U.S. foreign affiliates of $39.5 billion. R&D expenditures by U.S. affiliates were greatest in Germany, the United Kingdom, Switzerland, France, the Netherlands, Belgium and Ireland. These seven countries accounted for roughly 86% of U.S. global spending on R&D in Europe in 2010.

In the United States, meanwhile, expenditures on R&D performed by majority-owned foreign affiliates totaled nearly $41.3 billion in 2010, up 2.2% from the prior year. As in previous years, a significant share of this R&D spending emanated from world-class leaders from Europe, given their interests in America's highly skilled labor force and first-class university infrastructure. Most of this investment took place among European firms in such research-intensive sectors as energy, chemicals, telecommunications, and automobiles. In 2010, R&D spending by European affiliates totaled roughly $31.3 billion, a sizable high valued-added capital investment, representing three-fourths of all R&D performed by majority-owned foreign affiliates in the United States.

By country, Swiss-owned affiliates were the largest foreign source of R&D in the United States in 2010. Swiss-owned R&D in the U.S. totaled $9 billion in 2010, up from $8.9 billion the year before. Swiss firms accounted for 21% of total affiliate R&D in the United States. British affiliates accounted for the second largest percentage of affiliate R&D expenditures, with a 14.5% share in 2010. Germany's share of R&D spending was 13.6% of the global total, and mainly concentrated in transportation equipment, pharmaceuticals and machinery. French R&D investment accounted for nearly 13% of the global total.

As Table 6 underscores, some of the world's most innovative companies are domiciled in the United States and Europe.

5. Intra-Firm Trade of Foreign Affiliates

While cross-border trade is a secondary means of delivery goods and services across the Atlantic, the modes of delivery—affiliate sales and trade—should not be viewed independently. They are more complements than substitutes, since foreign investment and affiliate sales increasingly drive cross-border trade flows. Indeed, a substantial share of transatlantic trade is considered intra-firm trade or related-party trade, which is cross-border trade that stays within the ambit of the company.

Intra-firm or related-party trade occurs when BMW or Mercedes of Germany send parts to BMW of South Carolina or Mercedes of Alabama; when Lafarge or Michelin send intermediate components to their plants in the Greater Cincinnati area, or when 3M ships components for its office products or communications sectors from St. Paul to affiliates in Germany or the UK. The tight linkages between European parent companies and their U.S. affiliates are reflected in the fact that roughly 61% of U.S. imports from the European Union consisted of related-party trade in 2011. That is much higher than the related party imports from the Pacific Rim nations (37.2%) and South/Cental America (37%), and well above the global average (48.3%). The percentage was even higher in the case of Ireland (88.5%) and Germany (68.7%). Meanwhile, roughly one-third (31.3%) of U.S. exports to Europe in 2011 represented related-party trade, but the percentage is higher for some countries. For instance, almost half of total U.S. exports to the Netherlands in 2011 (45%) was classified as related-party trade.

Adding Value to Transatlantic Trade

Global Value Chains, which render a country's exports essentially the product of many intermediate imports assembled in many other countries, have become a central feature of today's global economy. A good produced in the U.S. and exported to the EU might include components from Mexico or China, using raw materials from Canada or Australia or services from Turkey or Switzerland. Goods and services are increasingly from "everywhere," rather than exclusively from "somewhere," as they are defined today.[2] They are unlikely fully to be "made in Germany," and "made in China" does not necessarily mean ''made by China.''

This growing process of international fragmentation is changing traditional understanding of the patterns and structure of international trade. Traditional measures do not show how supply is driven by the final customer or reveal where the creation of value-added occurs, in terms of wages and profits. They also underplay the role of services in overall trade.[3]

The OECD and the WTO have now created a tool that transforms our understanding of trade flows by revealing what was hidden before. This new ''value-added'' approach tracks the direct and indirect flows of value-added associated with international trade. It shows where value is actually created. Their findings lead to some surprising conclusions, and reinforce our understanding of the dense binding forces of transatlantic integration.

Take German-U.S. trade. Under traditional measures, the U.S. ranked slightly behind France in 2009 as Germany's major export market and ranked only fourth as an exporter to Germany, behind France, the Netherlands and China. But under the value-added approach the U.S. jumps ahead to be both Germany's most important single export market, accounting for 11% of German exports, and also Germany's most important supplier, accounting for over 12% of German imports.[4] This bilateral trade relationship can also be seen as more lucrative than previously understood, since Germany exports and imports more to and from the U.S. in value-added terms than in gross terms.

The value-added lens also shows that U.S. bilateral trade with many other EU countries, and with the EU as a whole, is even more important than previously understood. In value-added terms the EU exports (and imports) relatively more to (from) the United States and relatively less to (and from) China.

The United States also replaces Germany as Italy's top trading partner when exports are viewed on a value-added basis. This is because many of the inputs that Italy provides to other European partner countries, particularly Germany, become part of final goods that ultimately are exported to the U.S.

The value-added approach gives a similar lift to French-American trade. The U.S. emerges as France's number one trading partner, in terms of both exports and imports, whereas conventional measures rank its third behind Germany and Belgium.

The value-added approach does not change America's position as the main destination for UK exports, but it does reveal that it actually received a much higher share of UK exports (21% vs 16%) than when trade is evaluated in gross terms during the baseline year of 2009. This suggests that, like Italy and France, UK exports to other EU countries are at least partly intermediate services and inputs that are then further processed and shipped elsewhere, especially to the United States. Moreover, under the value-added approach the U.S. displaces Germany as the UK's main supplier. While the EU as a whole is a more important trading partner for Britain than the U.S., more of Britain's lucrative exports head across the Atlantic than previously believed.

The U.S. is engaged in a variety of dynamic regional value chains with NAFTA partners Canada and Mexico, similar to those that EU member states conduct among themselves. Trade within NAFTA is extensive. But much of it is composed of intermediate goods and services that are processed in Canada or Mexico and re-exported to the U.S. The final export destination may lie elsewhere, with Europe garnering a higher share than previously

Adding Value to Transatlantic Trade (continued)

understood. For instance, according to conventional methods Germany was America's 6th largest export market in 2009. But according to value-added estimates Germany followed only Canada as the most important export market for the United States, ahead of Mexico and China. In addition, according to value-added calculations, the U.S. trade deficit with China is a quarter lower than estimated under conventional measurements, and is redistributed to Japan, Korea, Germany and other intermediate input suppliers to China.

The value-added approach not only underscores the continuing importance of the transatlantic economy, it offers two important lessons for current policy debates.

First, a country's capacity to sell to the world depends on its readiness to buy from the world. Since many exports from any given country are comprised of intermediate inputs that have been imported by the same country, measures by that country to block imports can hurt domestic producers and exporters and damage its own productivity growth and ultimately its competitiveness. About one-third of the total value of motor vehicles exported from Germany, for instance, actually comes from other countries. About 40% of the total value of China's electronics exports comes from foreign sources.

This is an important consideration as the U.S. and EU consider removing tariff barriers across the Atlantic. Since many of these barriers are relatively low, skeptics wonder about the benefits of going to ''transatlantic zero.'' But given that many U.S. and EU exports in the end result from many different intermediate imports, and that related-party trade, or trade among affiliates of the same company, is so important in transatlantic commerce, even relatively low tariffs can have multiple knock-on effects all down the value chain. As the OECD notes, ''Success in international markets today depends as much on the capacity to import world class inputs as on the capacity to export. Protection measures against imports of intermediate products increase costs of production and reduce a country's ability to compete in export markets: tariffs and other barriers on imports are a tax on exports.'' Moreover, given the size of the transatlantic economy, even small changes can have big effect.

The second policy implication of the value-added approach has to do with services. Traditional trade figures suggest that services account for less than one quarter of global trade. But these new data highlight that services are not just exported through trade in services, they are integral to manufacturing trade as well. Transport equipment, electrical equipment and food products are manufacturing industries with significant services content. For the EU economy as a whole, 55% of the value of all gross exports originates in the services sector. The figure for the U.S. is 56%—roughly the same. For many EU member states, including the UK, the percentage is even higher; on average, 60% of the value of UK gross exports is comprised of value-added originating from the services sector. And the high value content of Britain's services sector exports to the U.S. make them more valuable than they may first appear.

Germany is perhaps an even more surprising example. While Germany tends to specialize in manufacturing industries, its exports of manufacturing goods incorporate significant shares of services value-added—over 40% in food, textile products and transport vehicles. In fact, fully half of the value of gross German exports represents services value-added.

Two lessons emerge. First, if you want to improve your manufacturing performance, you must improve your services performance. Manufacturing produces for the services sector, and the services sector contributes to manufacturing. The two are increasingly intertwined; the supposed trade-off between manufacturing and services is a false choice. Second, liberalization of services trade would not only allow for more efficient and higher quality services, it would enhance the competitiveness of manufacturing firms as well. The U.S. and the EU are the world's most important services economies, and each other's most important and profitable services markets. In the current policy environment, freeing the transatlantic services economy would be the single most important external initiative either side could take to spur growth and create jobs on both sides of the Atlantic.

TABLE 6: THE INNOVATION TOP 20

		R & D Spending			
Rank 2011	**Company**	**2011, $US Billions**	**Change from 2010**	**Headquarters Location**	**Industry**
1	Toyota	9.9	16.5%	Japan	Auto
2	Novartis	9.6	5.5%	Europe	Healthcare
3	Roche Holding	9.4	-2.1%	Europe	Healthcare
4	Pfizer	9.1	-3.2%	North America	Healthcare
5	Microsoft	9.0	3.4%	North America	Software and Internet
6	Samsung	9.0	13.9%	Asia	Computing and Electronics
7	Merck	8.5	-1.2%	North America	Healthcare
8	Intel	8.4	27.3%	North America	Computing and Electronics
9	General Motors	8.1	15.7%	North America	Auto
10	Nokia	7.8	0.0%	Europe	Computing and Electronics
11	Volkswagen	7.7	26.2%	Europe	Auto
12	Johnson & Johnson	7.5	10.3%	North America	Healthcare
13	Sanofi	6.7	15.5%	Europe	Healthcare
14	Panasonic	6.6	6.5%	Japan	Computing and Electronics
15	Honda	6.6	15.8%	Japan	Auto
16	GlaxoSmithKline	6.3	3.3%	Europe	Healthcare
17	IBM	6.3	5.0%	North America	Computing and Electronics
18	Cisco Systems	5.8	9.4%	North America	Computing and Electronics
19	Daimler	5.8	26.1%	Europe	Auto
20	AstraZeneca	5.5	3.8%	Europe	Healthcare
	Top 20 Total	**153.6**	**9.9%**		

Source: Booz & Company

6. Foreign Affiliate Sales

U.S. majority-owned foreign affiliate sales on a global basis (goods and services) totaled an estimated $5.5 trillion in 2011, having rebounded from the decline in 2009 caused to the global recession. Total U.S. exports, in contrast, were $2 trillion in 2011—a sizable difference that underscores the primacy of foreign affiliate sales over U.S. exports. One of the best kept secrets in Washington is how U.S. firms actually deliver goods and services to foreign customers.

As usual, Europe accounted for the bulk of U.S. affiliate sales in 2011. We estimate that U.S. foreign affiliate sales in Europe totaled $2.6 trillion In 2011, a modest 3% increase from the year before, but still representing roughly 47% of the global total. Our estimated foreign affiliate sales figure for 2011 is still some 11% below the peak year of 2008. However, we expect foreign affiliate sales to gather momentum this year and approach a new record high of $3 trillion by 2014.

TABLE 7: RELATED PARTY TRADE, 2011

	US Imports: "Related Party Trade," as % of Total	US Exports: "Related Party Trade," as % of Total
European Union	61.0	31.3
Germany	68.1	34.3
France	51.9	29.2
Ireland	88.5	24.0
Netherlands	64.6	44.7
United Kingdom	55.2	27.3

Source: U.S. Census Bureau

Reflecting just how important Europe is to Corporate America, sales of U.S. affiliates in Europe in 2010, the last year of available data, were roughly double comparable sales in the entire Asia/Pacific region. Affiliate sales in the United Kingdom ($599 billion) were double aggregate sales to South America. Sales in Germany ($307 billion) were roughly double combined sales in Africa and the Middle East. While U.S. affiliate sales in China have soared over the past decade, they have done so from a low base, and still remain well below comparable sales in Europe. For instance, U.S. affiliate sales of $170 billion in China in 2010 were below those in France ($199 billion), the Netherlands ($204 billion) and Switzerland ($262 billion). U.S. foreign affiliate sales in Ireland ranked fourth in Europe at nearly $260 billion in 2010—a good share of these sales, however, take the form of U.S. affiliate exports to the EU and other third markets.

Affiliate sales are also the primary means by which European firms deliver goods and services to consumers in the United States. In 2011, for instance, we estimate that majority-owned European affiliate sales in the U.S. ($1.9 trillion) were roughly triple U.S. imports from Europe (roughly $632 billion). Affiliate sales rose by roughly 4% in 2011, by our estimate. By country, sales of British firms led the way, totaling an estimated $440 billion in 2011, followed by Germany ($389 billion). For virtually all countries in Europe, foreign affiliate sales were easily in excess of their U.S. imports in 2011.

7. Foreign Affiliate Profits

After plunging in 2009, transatlantic affiliate profits rebounded in 2010 and continued to increase, albeit moderately in some cases, over the balance of 2011 and 2012. Looking just at 2011, U.S. affiliate income in Europe inched up to $213 billion from $210 billion the year before. In the first nine months of 2012, U.S. affiliate income totaled $160 billion, down slightly from the same period a year earlier. In the aggregate, income rose very modestly in 2012, by less than 1% by our estimate, to $214 billion. The slight rise represents an all-time high for what U.S. affiliates earned in Europe, yet masks deep declines over many parts of Europe.

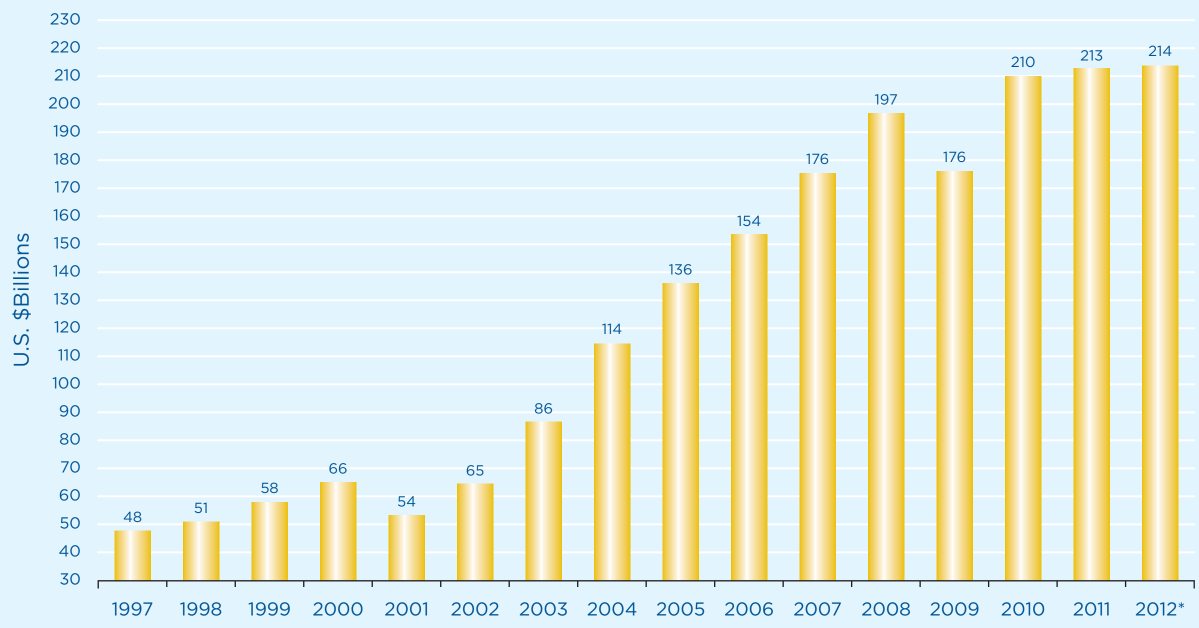
The general weakness in U.S. affiliate income in Europe was widespread—for instance, affiliate income in France and Germany in the January-September 2012 period was down 25% and 32%, respectively, from the same period a year earlier. Income fell 73% in Greece and 41% in Italy over the same period. U.S. affiliate income in Spain plunged 73%. On the positive side, affiliate income in the January-September period was up a robust 55% in Poland (year over year), and rose 12% in the UK and 4% in Ireland. Without these strong gains, U.S. affiliate income would have declined for the year.

In 2013, we expect a gradually improving performance among U.S. foreign affiliates in Europe. Affiliate earnings weakened over the second half of 2011 as the European debt crisis triggered widening credit spreads, a contraction in lending, a drop in consumer and business confidence, and pushed many parts of Europe into recession. Europe limped into 2012 but is gaining some strength in 2013. The situation is likely to improve moderately as the year wears on.

Despite a very soft earnings backdrop for U.S. affiliates in Europe in 2012, the region still accounted for roughly half of global foreign affiliate income for the first three quarters of the year. Hence, Europe remains an important market to U.S. firms. Indeed, since 2000, Europe has accounted for over 56% of total U.S. foreign affiliate income.

On a comparative basis, U.S. affiliate income from Europe is simply staggering, with foreign affiliate income in Europe—$160 billion in the first nine months of 2012—more than the combined affiliate income of Latin America ($67 billion) and Asia ($57 billion). It is interesting to note that combined U.S. affiliate income from China and India in 2011 ($13.1 billion) was only a fourth of what U.S. affiliates earned in the Netherlands ($55 billion) and less than half U.S. affiliate earnings in the United Kingdom ($31 billion). or Ireland ($29 billion). These trends continued into 2012; U.S. affiliate income in Ireland between January-September 2012 of $23 billion was more than double U.S. affiliate income from China ($9 billion).
However, there is little doubt that the likes of India, Brazil and China are becoming more important earnings engines for U.S. firms. To this point, in the first nine months of 2012, U.S. affiliate income of $9 billion in China alone was well in excess of affiliate income in Germany

TABLE 8: U.S. EARNINGS FROM EUROPE HITTING NEW HIGHS (U.S. FOREIGN AFFILIATE INCOME FROM EUROPE)



Source: Bureau of Economic Analysis
** Data through 3Q2012. Data annualized for full year estimate*

($2.7 billion), France ($2.5 billion) and Spain ($1.9 billion). U.S. affiliates in Brazil earned nearly $7 billion in the January-September period, a figure well above that earned in many European nations.

All of that said, we see rising U.S. affiliate earnings from the emerging markets as a complement, not a substitute, to earnings from Europe. The latter very much remains a key source of prosperity for corporate America.

Similarly, the United States remains the most important market in the world in terms of earnings for many European multinationals. Profits of European affiliates in the United States plunged 21.3% in 2009, soared in 2010—by 22.3%—and continued rising in 2011 and 2012. In the first nine months of 2012, the income of European affiliates rose 2% from the same period a year earlier. For all of 2012, we estimate European affiliate income in the U.S. totaled $117 billion, a record high.

Over the first nine months of 2012, strong gains were reported by various countries, with French affiliate income rising 31% from the levels of 2011. Affiliate income among Italian and Belgium affiliates rose 28% and 13%, respectively.

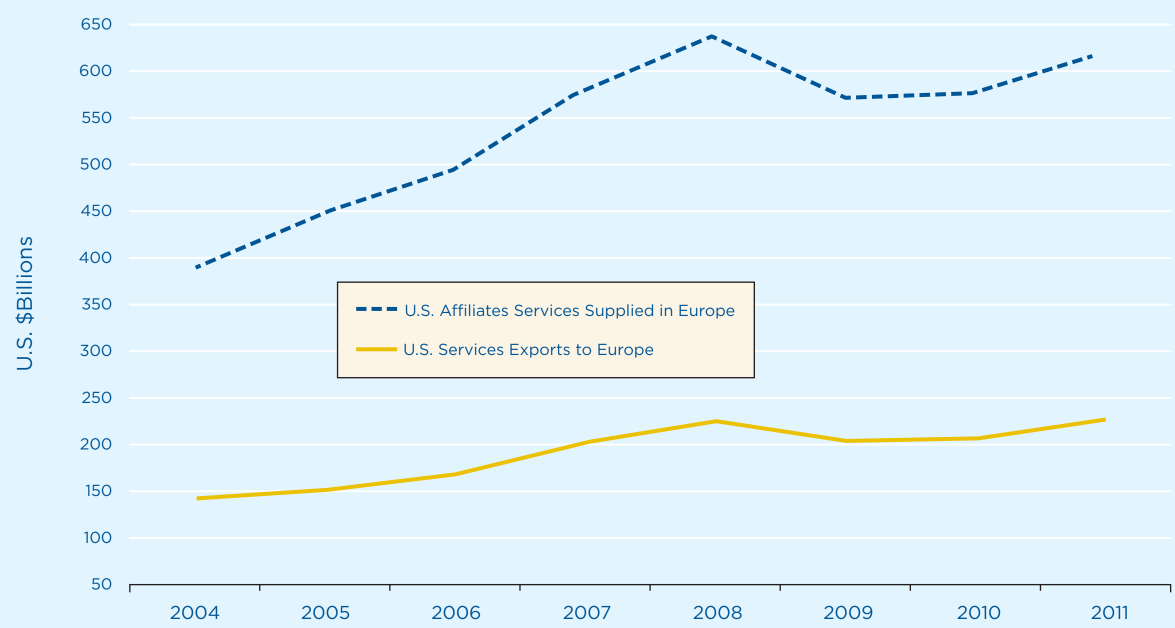
8. Transatlantic Services Linkages

Services are the sleeping giant of the transatlantic economy—the one key area where there exists significant opportunities to strengthen and deepen transatlantic commercial ties.[5]

The United States and Europe are the two leading services economies in the world. According to the World Trade Organization, the U.S. is the largest single country trader in services, while the EU is the largest trader in services among all world regions. Among the three largest components of global services trade—travel, transportation and other commercial services—Europe ranks number one in each category, accounting for 41% in world travel receipts, 47.6% of world exports of transportation services, and half of world exports of other commercial services, whose activities range from communication services, insurance, finance and many other activities.

By country, the U.S. ranked number one in the world in terms of world travel receipts in 2011 with a 14% share. Turkey ranked 7th and Switzerland 10th. Meanwhile, the U.S. accounted for 9.2% of world transportation services (receipts) in 2011, ranked Number 1 once again. Russia

TABLE 9: U.S. - EUROPE SERVICES LINKAGES



Source: Bureau of Economic Analysis
Majority-owned bank and non-bank affiliates. Services Supplied in Europe estimate for 2011.

ranked 8th and Norway 9th in the world, the only two European nations in the global top ten. Finally, in terms of world exports of "other commercial services," the U.S. was tops again in the world and by a wide margin; the U.S. global share was roughly 16% in 2011, well above second place India with a share of 4.5%. Only Switzerland, reflecting its status as a global financial hub, ranked in the top ten among European nations, coming in 6th in 2011.

That said, Europe and the United States continue to lead the world when it comes to many different global services. For instance, of global exports of communication services in 2011, Europe's share global share was 55.7%, North America's 16.4%. Of insurance exports, Europe's share was 54.2% to North America's 25.9%; financial services—Europe 55.7%, North America 24.8; computer and information service exports—Europe 55%, North America 8.2%: royalties and fees—Europe 43%, North America, 40.3%: and "other business services"—Europe 50%, North America, 12.5%.

All of the above underscores the underlying strength of U.S. and European services exports; both economies are world-class leaders in a host of services-related activities.

Transatlantic services trade figures are impressive. But the more important services linkages are actually in mutual flows of foreign direct investment. The services economies of the United States and Europe have become even more intertwined over the past year, with cross-border trade in services and sales through affiliates posting strong gains. By sectors, transatlantic linkages continue to deepen in financial services, insurance, education, telecommunications, utilities, advertising, and computer services. Other sectors such as aviation and e-health are slowly being liberalized and deregulated.

On a regional basis, Europe accounted for 38.4% of total U.S. services exports and for 41.1% of total U.S. services imports in 2011.[6] Five out of the top ten export markets for U.S. services in 2011 were in Europe. The United Kingdom ranked #2, followed by Ireland (4th), Germany (6th), Switzerland (8th) and France (10th). Similarly, the five countries just mentioned were among the top ten services providers to the U.S. The United Kingdom ranked #1, followed by Germany (4th), Switzerland (5th), and France (7th). The U.S. enjoyed a $61.8 billion trade surplus in services with Europe in 2011, compared with its $118 billion trade deficit in goods with Europe.

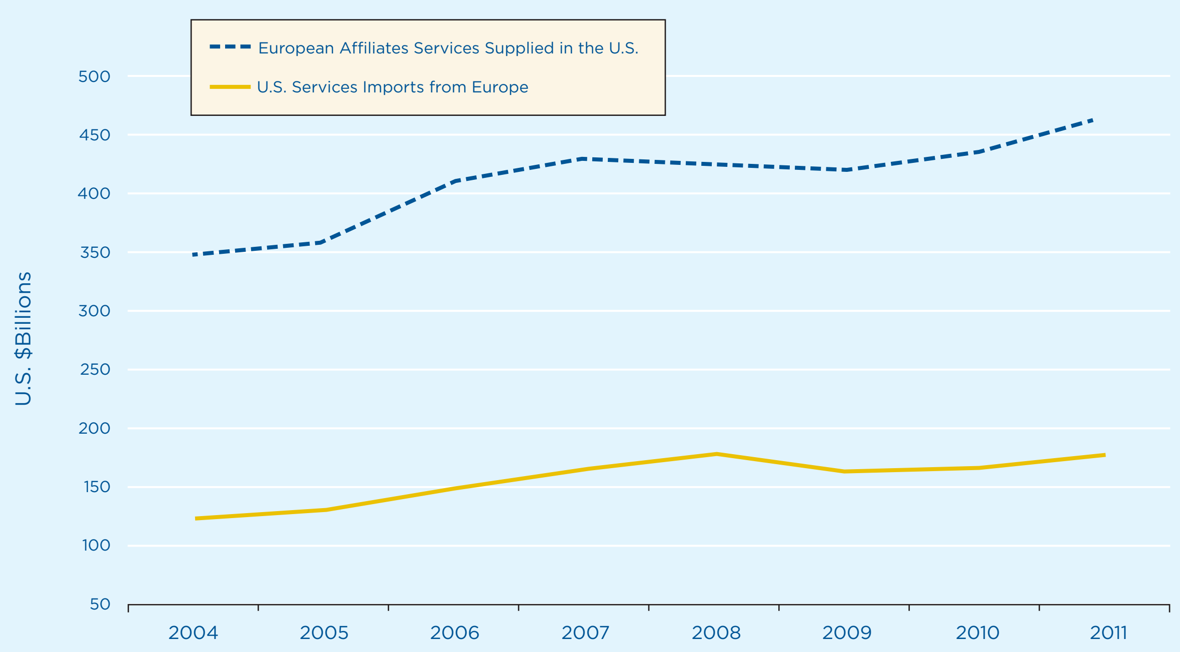
Thanks to a variety of factors—stronger growth, the weaker dollar, EU enlargement, industry reform and deregulation—U.S. services exports to the European Union more than doubled between 2001 and 2011, rising from around $102 billion to $225 billion. U.S. services exports to Europe plunged by 9.6% in 2009 but rose 2% in 2010. Exports rose by just over 9% in 2011, helped by rising exports (or receipts) of a number of services-related items like travel, passenger fares, and royalties and license fees. Gains were also reported among exports of "other private services," or in such value-added activities as computer processing, engineering, advertising and related activities. In this category, U.S. exports to Europe totaled $105 billion in 2011, yielding a $25 billion trade surplus.

U.S. private services imports from Europe, meanwhile, also rebounded in 2011, rising nearly 8% from the prior year. Services imports peaked at $166.2 billion in 2008, more than double the levels of 1999. The same top countries that ranked in the top ten U.S. services export markets also ranked among the top ten services providers to the U.S. On a regional basis, Europe accounted for just roughly 42% of total U.S. services imports in 2011.

Meanwhile, while the U.S. recorded a $100 billion deficit in goods exports with the European Union in 2011, a sizable amount of the deficit in goods was offset by America's $52 billion surplus in services. That was up from a surplus of roughly $49 billion in 2010. The U.S. enjoyed a sizable surplus in many activities, including financial services, telecommunications and in particular in "other private services," notably in activities associated with "business, professional and technical services." The latter surplus was roughly $18 billion in 2011. By activity, the U.S. registered a surplus in computer and information services, management consulting, legal services, construction engineering, and operational leasing with Europe in 2011. Top U.S. business services exports to Europe included management, consulting, and public relations services ($19.2 billion in 2011), research, development, and testing services ($12.6 billion); and computer and information services ($7.1 billion).

Beyond services trade, there are the foreign affiliate sales of services, or the delivery of transatlantic services by U.S. and European foreign affiliates. Sales of affiliates have exploded on both sides of the Atlantic over the past decade; indeed, affiliate sales of services have not only supplemented trade in services but also become the overwhelming mode of delivery in a rather short period

TABLE 10: EUROPE - U.S. SERVICES LINKAGES



Source: Bureau of Economic Analysis
Majority-owned bank and non-bank affiliates. Services Supplied in the U.S. estimate for 2011.

of time. To the latter point, affiliate sales of U.S. services rose more than 10-fold between 1990 and 2010, topping $1 trillion for the first time in 2007. In the same year, U.S. services exports were roughly half the level of affiliate sales of services.

Not unexpectedly, and reflecting the transatlantic recession, sales of services of U.S. foreign affiliates in Europe declined in 2009 but rebounded modestly in 2010, the last year of available data. Sales rose to $576 billion in 2010, up from $571 billion in 2009. Notwithstanding this modest rise, sales of services by U.S. affiliates in Europe were more than two and half times U.S. services exports to Europe in 2010. The United Kingdom accounted for around 32% of all U.S. affiliate sales in Europe; UK services sales totaled $187.2 billion in 2010, a decline of 7% from the prior year but nevertheless greater than total affiliate sales of services in South and Central America ($132 billion), Africa ($11.8 billion) and the Middle East ($15 billion). On a global basis, Europe accounted for nearly 51% of total U.S. services sales.

U.S. affiliate sales of services in the EU continue to exceed sales of services by U.S. affiliates of European firms. The latter totaled $435 billion in 2010, the former some $576 billion. However, on a country-by-country basis, French and German affiliates sold more services in the U.S. in 2010 than American affiliates sold in France and Germany. Of particular note, European affiliate sales of services were more than two and a half times larger than U.S. services imports—a fact that underscores the ever-widening presence of European services leaders in the U.S. economy.

TABLE 11: AMERICA'S FDI ROOTS IN EUROPE (BILLIONS OF $)

Industry	US FDI to Europe	% of Industry Total
European Total	2,308	56%
Manufacturing	277	47%

TABLE 12: EUROPE'S FDI ROOTS IN THE US (BILLIONS OF $)

Industry	US FDI from Europe	% of Industry Total
Total from Europe	1,812	71%
Manufacturing	676	81%

Note: Historic-cost basis, 2011
Source: Bureau of Economic Analysis

In fact, the U.S. and EU each owe a good part of their competitive position in services globally to deep transatlantic connections in services industries provided by mutual investment flows. A good share of U.S. services exports to the world are generated by European companies based in the United States, just as a good share of EU services exports to the world are generated by U.S. companies based in Europe.

In the end, these eight indices convey a more complete and complex picture of global engagement than simple tallies of exports and imports. Foreign direct investment and foreign affiliate sales, not trade, represent the backbone of the transatlantic economy. The eight variables just highlighted underscore the depth and breadth of the transatlantic commercial relationship.

Endnotes

1. OECD, *Science and Technology Indicators 2009.*
2. Launch of the OECD-WTO Database on Trade in Value-Added. Introductory remarks by Angel Gurría, OECD Secretary-General, Paris, 16 January 2013, http://www.oecd.org/about/secretary-general/launchoftheoecd-wtodatabaseontradeinvalue-added.htm
3. http://www.wto.org/english/res_e/statis_e/miwi_e/tradedataday13_e/paul_schreyer_e.pdf
4. http://www.oecd.org/sti/industryandglobalisation/TiVA%20Germany.pdf. All data presented here are drawn from the joint OECD/WTO Database on Trade in Value-Added.
5. For a closer examination of the transatlantic services economy, see Daniel S. Hamilton and Joseph P. Quinlan, eds., *Sleeping Giant: Awakening the Transatlantic Services Economy* (Washington, DC: Center for Transatlantic Relations, 2007).
6. Bureau of Economic Analysis, U.S. International Services, Cross-Border Services Exports and Imports by Type and Country, 2009; Eurostat.

Notes on Terms, Data and Sources

EMPLOYMENT, INVESTMENT, AND TRADE LINKAGES FOR THE 50 U.S. STATES AND EUROPE

Data for investment as well as investment-related jobs are from the U.S. Commerce Department's Bureau of Economic Analysis. Investment data measure gross property, plant, and equipment of affiliates. Europe includes Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland, and the United Kingdom. Trade data are from the International Trade Administration's Office of Trade and Industry Information at the U.S. Commerce Department. Europe includes Albania, Andorra, Armenia, Austria, Azerbaijan, Belarus, Belgium, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Cyprus, Denmark, Estonia, Faeroe Islands, Finland, France, Germany, Georgia, Gibraltar, Greece, Iceland, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Macedonia, Malta, Moldova, Monaco, Montenegro, Netherlands, Norway, Poland, Portugal, Romania, Russia, San Marino, Serbia, Slovakia, Slovenia, Spain, Svalbard, Sweden, Switzerland, Tajikistan, Turkey, Ukraine, United Kingdom, Vatican City. The top ten exports to Europe bar chart employs a logarithmic scale to facilitate cross state comparisons.

INVESTMENT AND TRADE FOR THE EU 27, NORWAY AND SWITZERLAND AND THE U.S.

Investment data are from the Bureau of Economic Analysis. Trade data are from the IMF Trade Statistics. Data for the top ten U.S. imports bar charts are from the Office of Trade and Industry Information of the International Trade Administration. They employ logarithmic scales to facilitate cross-country comparisons.

TERMS

Throughout this report, the term "EU" refers to all 27 member states of the European Union. The term EU15 refers to the older EU member states: the United Kingdom, Ireland, Belgium, Luxembourg, the Netherlands, Austria, Spain, Italy, Greece, France, Germany, Portugal, Sweden, Finland, and Denmark. The term EU12 refers to the newer EU member states: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Malta, Cyprus, Romania and Bulgaria. The EU27 data does not yet include Croatia, which on July 1 2013 becomes the 28th member state of the European Union. But we have included data and charts for U.S.-Croatian economic ties in Volume 2.

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DANIEL S. HAMILTON and **JOSEPH P. QUINLAN** have been producing *The Transatlantic Economy* annual survey since 2004. They have authored and edited a series of award-winning books and articles on the modern transatlantic economy, including *Germany and Globalization* (2009); *France and Globalization* (2009); *Globalization and Europe: Prospering in a New Whirled Order* (2008); *Sleeping Giant: Awakening the Transatlantic Services Economy* (2007); *Protecting Our Prosperity: Ensuring Both National Security and the Benefits of Foreign Investment in the United States* (2006); *Deep Integration: How Transatlantic Markets are Leading Globalization (2005); and Partners in Prosperity: The Changing Geography of the Transatlantic Economy* (2004). Together they were recipients of the 2007 Transatlantic Leadership Award by the European-American Business Council and the 2006 Transatlantic Business Award by the American Chamber of Commerce to the European Union.

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THE

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Annual Survey of Jobs, Trade and Investment between the United States and Europe

VOLUME 1:
Headline Trends

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