Shrinking the Atlantic: Europe and the American Economy

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EXECUTIVE SUMMARY

With Europe now in the grip of a long recession, and Asian markets continuing to boom, it has become fashionable to speak of America's Asia-Pacific future. Although understandable, such commentary has tended to mask the massive and growing economic links between the United States and Europe. This paper outlines those links in terms of trade, investment flows, and technology, and contrasts them with similar links between the United States and Asia.

1. Trade

Asia has finally become the biggest U.S. gross export market. Taken in conjunction with the huge populations and hence potential markets in Asia, exports underpin the claim that Asia represents the future of U.S. foreign economic relations. This argument is overly simplistic:

- **The nature of the trade exchange with Asia is worrying.** The United States tends to exchange raw materials for high tech goods with Asia. This is not the case with Europe.

- **The trade deficit with Asia is less susceptible to normal macro-economic management.** A falling dollar has been accompanied by continued deterioration in the U.S.-Asia trade balance.

- **Trade in some specific sectors.** Despite transatlantic trade rows in telecommunications, aircraft, and computers, Europe remains a prime export market in each industry; the U.S. trade balance with Europe is strongly positive in each.

- **If exports equal jobs, then trade balances reflect jobs won and lost through trade.** **U.S. trade balances with Asia are disastrous.** Japan and China alone account for more than 70 percent of the U.S. trade deficit. Without the surpluses America runs outside Asia, the global U.S. deficit would be much larger.
2. Foreign direct investment in the United States (FDIUS)

Much U.S. attention during the 1980s was focused on the rapid runup in Japanese investment in the United States. Japan has now become the second largest investor in the United States, after Britain. Once again, though, perception distorts reality:

- **Europe is still the biggest investor in the United States.** Europe accounts for about 59 percent of overall FDIUS; Asian firms (including Japan) account for around 26 percent. In manufacturing, the figures are 71 percent and 14 percent respectively;

- **Taxes.** European firms in 1990 accounted for $7 billion in U.S. corporate income taxes, as against only $100 million from Asian firms. That differential is 70:1, while the investment ratio is only 6:1;

- **Trade.** European firms operating in the United States account for about 22 percent of the substantial trade deficit run up by foreign affiliates; Japan alone accounts for about 60 percent;

- **Trends in investment.** The trend now strongly favors Europe. Japanese investment in the United States is slowing drastically, and is unlikely to resume previous inflows. European investment is on the contrary likely to increase.

Centuries of investment in the United States by Europeans has created a massive capital stock, which Asian investors will take decades to match, even in the unlikely event that they maintain recent rates of investment. Europe will remain the primary investor in the United States for the foreseeable future.

3. U.S. direct investment abroad (USDIA)

USDIA allows U.S. firms to penetrate otherwise closed markets, gets them closer to customers, provide big flows of cash and profits (which have saved large U.S. firms like Ford and GM), and opens access to foreign technology. Yet U.S. firms have highly unequal investment opportunities abroad:

- **Europe dominates USDIA.** Europe accounts for 49 percent of overall USDIA, while Asia accounts for 16 percent; in manufacturing, those figures are 59 percent and 17 percent respectively;

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• **Japan is still closed.** From a tiny base, USDIA in Japan has now reached $26 billion -- about 5 percent of total USDIA. But USDIA in Europe is growing equally fast.

• **Revenues.** U.S. affiliates in Europe generate revenues of around $800 billion annually, equivalent to 12 percent of U.S. GDP;

• **Trade.** U.S. affiliates in Europe maintain a positive trade balance with the United States of $20 billion; those operating in Asia have a trade deficit of $6 billion;

• **Majority-owned affiliates.** Only 6 percent of MOFA assets are held in Japan, compared to 60 percent in Europe. Europe provides $40 billion in net income from MOFAs, one-third more than the rest of the world put together.

USDIA is now shifting toward Asia. Despite the European recession, however, U.S. investment in Europe between 1989 and 1992 grew by more than $54 billion -- more than twice as much as U.S. direct investment in Asia. It will probably be many more years before the levels of related revenues and net incomes are equal.

4. **Technology**

Technology flows have two main components: foreign access to U.S. technology, and U.S. access to foreign technology. In both areas, the relationship across the Atlantic seems quite different from that across the Pacific:

• **R&D investments in the United States.** European firms invest about $7 billion in R&D in the United States each year; Asian firms invest only $0.5 billion;

• **Technology imports.** European firms import vastly more technology into the United States from their parent companies than do Asian companies, even per dollar of invested capital. This disparity is reflected in royalty payments.

• **Targeting.** Asian firms specialize in buying up small U.S. firms in critical component sectors. They accounted for more than 60 percent of such purchases from 1988-1993, as against less than 25 percent for Europe.
• **Access to technology programs.** Europe has widely included U.S. firms into its technology programs, with U.S. participants now numbering in the hundreds. Access to Asian technology programs is much less widely available.

• **Strategic alliances.** Recent data suggests that in six core manufacturing sectors, U.S.-European alliances account for 46 percent of all alliances, as against less than 33 percent for U.S.-Japanese alliances. This ratio has shifted only slowly since 1985.

5. Conclusions

In each of the four dimensions, the link between Europe and the United States is central to U.S. economic relationships. In most areas, relations with Europe are much more important quantitatively than are similar U.S. relations with Asia. The evidence strongly suggests that this will remain true well into the next century.

Moreover, it is the Europeans who share most strongly U.S. views about the future of the world economic order. Although there are clear differences between American capitalism and European capitalism, they are dwarfed in comparison with the gulf existing across the Pacific. On a number of economic issues central to the next decade and the next century -- trade law, competition policy, labor law -- U.S. interests and those of the Europeans are tightly aligned.

From this analysis flow some important policy prescriptions. First, it is crucial not to mistake policy differences for conflicts over principle. The United States fundamentally agrees with the Europeans on most major issues concerning the organization of the international economic order.

Second, if the United States is to influence significantly the rapidly emerging new global economy, it will need allies. Many of these allies are to be found within Europe.

Third, the Europeans take U.S. works and U.S. actions seriously. Words said at conferences in Seattle and Seoul are read carefully in Bonn and Barcelona. It is unwise to push Europe into considering a future without close links to the U.S. In particular, the notion of the United States playing an Asian card against Europe should be buried.

Finally, both Europe and the United States need to consider new ways to support and manage joint interests. Currently, there are serious policy dislocations across the Atlantic and insufficient mechanisms for integrating the needs of the public and private sectors. New channels of communication inside and especially outside government are clearly needed.
Two specific sets of steps should be taken.

First, North America and Europe should open exploratory discussions aimed at broadening and deepening economic relations among those countries fully committed to market-based economic systems. Although talks would begin around a North American-European core (possibly building on current, low-level U.S.-European Union discussions of regulatory harmonization) their scope would not be limited by geography. Non-Atlantic countries that would be excellent early candidates for inclusion would be Chile and Singapore. Moreover, participation -- and the benefits of freer trade, investment, and technology flows -- would be open to countries willing to conform with the group's core principles and practices.

These discussions would encourage the world's most market-oriented countries to resolve their remaining differences not only on international economic policy but on those domestic issues that bear heavily on international commerce, such as labor policy, competition policy, and environmental and other forms of non-economic regulation. It would also offer an opportunity to develop more strategic and longer-term views of the world economy, while allowing these countries to work more closely together to address the many difficult domestic problems that have emerged in a world of rapidly accelerating economic, technological, and social change.

Such discussions should not be seen as a challenge or threat either to the new World Trade Organization or to any less market-oriented economy. The former should simply be seen as a platform from which like-minded countries can go further in integrating their economies on terms that they find mutually acceptable; the latter would simply find further encouragement to move in directions that both the United States and European Union would applaud.

These discussions would, in short, start the United States and Europe down the path toward an economic parallel to NATO. The latter has provided a forum for the development of joint policies with specific aims and objectives. As US and European concerns shift from military security to economic security, it is equally important to develop a similar forum for economic issues, both international and domestic. It is the continuing absence of such a forum which has placed the spotlight squarely on US-EU quarrels in recent years, rather than on shared practices and mutual interests and objectives.

Second, as this effort proceeds, business leaders on both sides of the Atlantic should set up a forum through which they can communicate their views to their governments. Businesses around the Pacific Basin have benefited from the creation of the Pacific Basin Economic Council, which serves as a private-sector voice and promotes business interests and expanded trade and commerce among North America, Pacific Latin America, East and Southeast Asia, and Australasia. Businesses in North America and Europe could secure the same benefits by creating an Atlantic Basin Economic Council.
INTRODUCTION

Former American ambassador to Tokyo Mike Mansfield was fond of calling the U.S.-Japan relationship the most important bilateral relationship in the world. Yet for all the undeniable importance of the interaction of the world's two largest national economies, this statement is an exaggeration. The U.S.-Japan relationship continues to be outweighed by America's ties with the European Union (EU). And the U.S.-European relationship remains Number One not only in the security sphere, but in the economic sphere as well.

Nonetheless, transatlantic relations stand at a critical juncture, and much evidence indicates that their continuing importance is not fully appreciated in the United States. Some of the reasons are understandable. The Asia-Pacific region's sheer size, its breathtaking economic and technological progress, and its staggering potential -- both as market and as rival -- make it easy to overlook a European Union whose unemployment rates are too high, whose growth rates are too low (when they are positive at all), and whose once promising integration plans seem to have stalled out.

But not only does the European Union -- which will soon expand its membership, at least -- still represent America's biggest and most profitable economic partner. Washington's frustration with alleged European foot dragging at the recently concluded world trade talks and the resulting talk of an American tilt toward Asia overlook the fact that, in the realm of economics, what unites America and the European Union is more important than what has been driving them apart. As highly developed industrialized regions with fully democratic governments and relatively generous welfare states, the United States and the EU share common values and common problems. Some of the latter involve the economic challenges posed by the distinctive, closely related systems of capitalism that have sprung up all around the Pacific Rim. Although these systems all use mechanisms, they
differ qualitatively from their U.S. and European counterparts in areas such as business structures and openness to foreign commerce. Other shared problems include coping with technology-generated unemployment, finding affordable ways of providing health care for aging populations, preserving the environment, and preventing the welfare state from smothering economic incentives. The United States and the European Union may not be able to -- and may not want to -- forge a common approach to deal with these challenges. But because the two parties seem to have forgotten many of their common interests (or maybe because they take them for granted), they risk missing an opportunity to explore promising new modes of cooperation.

The United States and Europe must do nothing less than adjust to sweeping global change. Their modern relationships are products of the Age of Aggressive Totalitarianism. From 1941 to 1991, America and European democracies were drawn together by the need to resist first fascism and then communism. Security considerations dominated policy making -- at least in Washington. As has been widely noted, the collapse of Soviet totalitarianism has called this policy framework into question. Economic relationships, which have been more complicated and so far more divisive, are attracting growing attention. Currently, transatlantic economic relations are being driven by a series of quarrels over trade policy issues, such as steel, telecommunications, various agricultural commodities, semiconductors, public procurement policies, the new World Trade Organization (WTO), and dealing with Japan. These disputes and others like them should not obscure the two regions' numerous common ties and interests nor prevent their cooperation to achieve a new world economic structure compatible with their shared values.

This study attempts to shed light on the true nature of U.S.-European and U.S.-Asian economic linkages, and to draw policy conclusions.

These linkages are defined in terms of four economic dimensions:
trade, inward investment, outward investment, and technology flows. This study assesses both the current status and likely trends in these areas.

This detailed analysis shows that Europe remains by far the most important economic partner for the United States. This does not mean that recent efforts to develop an appropriate U.S. policy for Asia, or for China, or for Japan, should be halted or even slowed. It is obvious after all that Asia is a booming part of the world economy, and that no sensible U.S. policy can ignore or slight it.

But this conclusion does indicate that America's stake in a close and friendly economic relationship with Europe should not be an afterthought of U.S. policy. Instead it needs to be a central plank.

This is in itself an important conclusion. Yet its significance is much enhanced by two other sets of challenges now facing the United States, both of which underscore the importance of close and friendly links with Europe.

First, the period of U.S. global economic predominance is over. Yet the need for U.S. influence over that economy has never been greater, as growing trade and investment flows have an increasing impact on the U.S. economy. Obviously, the United States will need steady, reliable, and powerful allies as
it seeks to ensure that the new world economic order corresponds to both its ideological and its practical objectives. As the basics of a world economy predicated on free trade are put into place, issues for which a partnership with Europe makes sense will come increasingly to the fore. These include competition policy, labor rights, consumer protection, the environment, intellectual property rights, and many other fields. In each case, global policies are needed, and global policies are possible only if powerful global actors can collectively agree on them.

Second, the United States faces tremendous domestic challenges, as it adjusts to a world of intensified competition, especially for low-skill jobs. These challenges are in many respects identical to those which have emerged in Europe. Europe has apparently chosen to respond to this challenge with higher wages and high unemployment -- hardly an ideal solution. But the U.S. policy of lower wages and lower unemployment is certainly no permanent solution to the problem of structural transformation, either. Both Europe and the United States stand to benefit by pooling resources and sharing experiences in cooperative efforts to face these challenges.

Hence regardless of the deepening relations between the United States and Asia, both Europe and the United States must make much greater efforts to shrink the Atlantic. Given the needs of both sides, it would be truly perverse to allow quarrels over day-to-day issues to poison the well of shared objectives and shared ideologies; it would be even worse to do so on the basis of a faulty understanding of the real economic issues at stake.
I. TRADE

The argument for tilting U.S. policy toward Asia is largely based on the region's huge potential markets. They are indeed huge -- potentially. Thus, a more Asia-oriented economic policy thus appears as the natural culmination of an apparently inevitable reordering of global economic clout.

Even in terms of trade relations, though, this argument misses more than it covers. Its proponents tend in many cases to equate gross exports with net benefits to the U.S. economy. As a result, they badly undervalue the qualitative and quantitative importance of trade with Europe for the U.S. economy.

This section begins with a review of broad trade patterns, and considers how they have changed in response to shifts in exchange rates (the primary macroeconomic balancing tool). It then discusses trade in manufactures and primary goods, and proceeds to examine the manufacturing sector in more detail, focusing on telecommunications, civilian aircraft, and office equipment. These three sectors were selected because each has generated highly public conflicts between the United States and Europe. At each level, comparisons will be drawn with Asia and in some cases with Japan in particular. Once again, though, it is important to remember that the purpose of the comparison is to illuminate the contribution of Europe, not to denigrate U.S. ties to Asia.
U.S. trade with Europe\(^1\) and Asia\(^2\)

The broadest levels of analysis show that Asia is America's largest export market (Figure 2).

![Figure 2. U.S. Exports, by Region, 1993](image)

Yet a review of trade balances, rather than simply exports, tells a rather different, and much more disturbing, regional story (Figure 3):

\(^{1}\)For the purposes of this study, and unless otherwise noted, Europe is defined as the 12 members of the European Union, plus Norway, Sweden, Austria, Switzerland, Finland, and Iceland.

\(^{2}\)Asia does not include the Asian parts of the former Soviet Union.
Thus although Asia has indeed finally overtaken Europe to become the largest export market for the United States, this has done nothing to staunch the huge hemorrhage of U.S. dollars flowing east. Given the equation frequently made between trade and domestic jobs, this fact clearly indicates the balanced impact of Europe on the U.S. jobs market.

**Regional balances and exchange rates**

The sheer sums involved are staggering. Since 1980, the United States has accumulated fully $1.25 trillion in trade deficits. Of that deficit, Asia has accounted for $882 billion, while the EU accounts for only $10 billion. In 1992, the trade deficit with Asia ($103.8 billion) accounted for 98 percent of the total U.S. deficit. These huge imbalances emerged during the mid-1980s, and have not shifted much since then, as Figure 3 indicates.
The big Asian deficits have not responded as expected to the application of the one macroeconomic tool specifically designed to deal with them: changes in the exchange rate. The U.S. dollar has fallen on a trade-weighted basis from an indexed level of 170 in 1985 to 100 in 1992;\(^3\) during that period, America's deficit with Japan actually increased in nominal dollar terms, even though the dollar has fallen from ¥220 to around ¥101 (see Figure 4). The primary effect seems to have been to cut the cost of U.S. assets by half, in yen terms.

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\(^3\)IMF, *Direction of Trade Statistics Yearbook*, 1993
The story for Asia as a whole is rather more complex; some of the Asian currencies are tied directly to the dollar, while some other economies have adjusted by shifting U.S. bound production to other Asian countries, notably China. The use of other economies as trans-shipment points ensures that exchange-rate shifts can have only a minor impact. What is clear, however, is that the trade-weighted decline of the dollar does not seem to have had much effect in shrinking the U.S. deficit with Asia.

The picture for Europe is very different, and shows substantial effects from exchange-rate shifts. Beginning in 1985, the U.S. dollar fell substantially and, after the expected lags, the EU's merchandise trade balance shifted accordingly.

The composition of trade

Deficits matter. But the composition of the deficit is also important. It matters whether the United States is a nation of extractors and commodity suppliers, or one manufacturing high value products and providing high value services.
At the broadest level, a distinction can be drawn between industries that are primary or extractive, and those containing high-value manufacturing and services. Very crudely, these two groups of industries tend to correspond to groups 0-4, and 5-9, respectively in the U.S. Commerce Department's Standard Industrial Trade Code classification system. Figure 6 compares U.S. trade balances with Asia and with Europe for these two industry groupings:

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**Figure 6. Merchandise Trade Balance, U.S.-Asia**

Primary Products, Manufactures

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

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4SITC 0-4 includes: food and live animals; beverages and tobacco; crude materials, inedible, not including food; mineral fuels, lubricants, etc. SITC 5-9 includes: chemicals; manufactured goods by chief material; machinery and transport equipment; miscellaneous manufactured articles; commodities and other transactions.
Figures 6 and 7 show that, for primary products, the United States typically maintains a small surplus with both Asia and Europe. For the latter, the U.S. balance in manufactured goods responded quite rapidly to changes in the exchange rate in the late 1980s, shifting from substantial deficit to a small surplus by 1990. For Asia, though, the balance in manufactures has not responded at all to declining U.S. exchange rates. The balance went heavily negative in the early 1980s, and has remained heavily negative since then.\(^5\)

This is the factual basis for arguing that the United States has become a classic third world economy in relation to Asia in general and Japan in

\(^5\)Simply looking at SITC 0-4 and 5-9 is of course a simplification; specifically, the case for Japan as an outlier becomes stronger if SITC codes 5, 6, 7, and 8 are disaggregated. Conversely, the case can be made that the rest of Asia is a better trade partner than it appears from the more aggregated data. Yet neither refutes the argument that the balances with Europe are quite different from those with Asia, and better from the U.S. standpoint as well.
particular: the United States has a positive trade balance in raw materials, but maintains a massive and continuing deficit in manufactured goods. That is not a propitious basis on which to build a 21st century economy in America.

The heart of the matter: core manufacturing industries

The heart of an advanced manufacturing economy is found in SITC codes 71-79, which include telecommunications, computers, autos, aircraft, machine tools, and power generating equipment. Chair of the President's Council of Economic Advisors Laura D. Tyson and others have shown that there are substantial spillover effects from these industries across the economy in terms of high value-added production and hence high-wage manufacturing jobs.

In eight of the nine SITC 71-79 industrial sectors, the United States has a vastly better trade balance with the EU than it does with Asia. U.S. merchandise trade balances with Europe and Asia for SITC Codes 71-79 are displayed in Figure 8 below:

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6SITC 71-79 include: Metalworking machinery, power generating equipment, general industrial machinery, office machines and computers, telecommunications equipment, electrical machinery, road vehicles, and other transportation equipment (including aircraft and parts).
Figure 8 indicates that although the fall of the dollar after 1985 did have some effect on U. S. trade in manufactures with both Europe and Asia, that effect was sufficient to entirely reverse the deficit only with Europe. For Asia, the impact was both rather small (reducing the deficit by about 15 percent from 1991 to 1992) and temporary (the deficit returned to its previous peak by 1993, despite the growth in the U.S. economy after early 1992).

Within the "manufacturing core" itself, it is worth looking in particular at three industries. These are cases where the story caught by the headlines and the reality portrayed by the data are quite different. They spotlight the reality that underlies apparent problems in the U.S.-EU trade relationship.

Three key sectors: telecommunications, electronics, civilian aircraft

From the newspaper headlines and talk shows, one would gather that U.S. firms have been shut out of EU markets in all three of these crucial sectors.

Recent transatlantic fights over telecommunications have focused on public sector procurement. Ironically, the real successes achieved in starting the liberalization of European procurement rules have been overtaken by debates
about whether AT&T was actually a public utility -- and hence subject to
agreed public procurement rules -- or a private company, facing market
disciplines. Also prominent has been the issue of how quickly EU
telecommunications markets would be opened.

The most serious conflicts over electronics have involved tariffs, with the
Europeans doggedly sticking to 14 percent tariffs for semiconductors (to be
cut in half by 1988, under the recent GATT agreement). Other conflicts have
focused on rules of origin and European public procurement rules, as well as
arguments over European anti-dumping and anti-circumvention regulations.
New U.S. technology policy initiatives in this sector now seem likely to
restart a U.S.-EU argument about foreign access to such programs on both
sides of the Atlantic (the argument over "conditional national treatment").

Finally there has been the long-running row over Airbus, which has received
by most accounts approximately $13-17 billion in "launch aid" from European
governments. How this -- or U.S. government support for the commercial
aerospace industry via military procurement programs, or, for that matter,
alogous European military subsidies for the aerospace sector -- affects the
current cost of commercial airliners remains a controversial question.

The data underlying each of these arguments are in dispute, and the
arguments themselves have been very high profile. Yet the fact is that, taken
together, Europe has been the best customer in the world for U.S. exports in
these sectors over the past five years. The United States also consistently runs
large trade surpluses with the EU in each sector, and the trends continue to
move in directions favorable to the United States.

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7See Office of Technology Assessment, Competing Economies, Appendix B,
Other estimates are rather higher.
Telecommunications equipment\(^8\)

Currently, news and business journals are filled with stories about the telecommunications opportunities in Asia. AT&T has recently broken through into the China market, and some industry observers anticipate sales in the hundreds of millions of dollars by the year 2000.\(^9\) The Asian boom is already being reflected in U.S. export figures, as Figure 9 below shows very clearly. After several years in which U.S. exports to Europe actually grew faster than exports to Asia (1988-90), the recession in Europe and boom in Asia have suddenly reversed this trend. Today, even though the United States sends around $2.8 billion annually of these goods to Europe, the U.S. exports almost two-thirds as much again to Asia. Nonetheless current U.S. exports to Europe in this sector are still more than twice the level of exports to Japan (less than $1.2 billion.).

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\(^8\)The definition of “telecommunications equipment” is difficult, and different authorities use different definitions. SITC data seems likely provide sufficient clarity and coherence for purposes of regional comparison.

Yet Asia’s advantage as an export market in telecommunications is not reflected in trade balances. U.S. imports from Asia vastly outpace those from Europe (especially since major European equipment suppliers such as Siemens have a manufacturing presence in the United States). As a result, the United States faces continuing and expanding trade deficits in telecommunications equipment with Asia, while maintaining a modestly positive trade balance with Europe.

![Fig. 10. U.S. Trade Balance, Asia and Europe](image)

In fact, Figure 9 shows that the U.S. trade deficit with Asia in this sector is more than 3 times the total level of U.S. exports to Asia.

**Computers and office equipment**

Talk to any big office equipment manufacturer in the United States, and they will probably tell you that sales to Europe, and profits from Europe, are crucial for their companies.
U.S. exports of office equipment (including computers) to Asia have grown rapidly in recent years, and have now reached $8 billion. Yet they still do not approach exports in this sector to the EU, which are running at more than $12 billion. Moreover, until the recession began in Europe, exports to Asia were growing no faster than exports to Europe. And despite the Asian boom, U.S. exports to the region have been flat since 1990, which may indicate a structural change in this sector -- perhaps the outsourcing of more production to the Far East (see Figure 10).

![Figure 11. U.S. Exports to Europe and Asia](image)

Partly because export growth has slowed, the U.S. office equipment trade deficit with Asia has widened rapidly during the past ten years, and has now reached $27 billion -- again, 3 times the level of U.S. exports. In contrast, the U.S. sectoral trade surplus with Europe is almost $9 billion, despite Europe's deep recession, trade barriers, and restrictive government policies (see Fig. 11, below).
Civilian aircraft

This final case is especially significant. The U.S.-EU row over Airbus is among the most serious in the long history of U.S.-EU trade conflicts. It is -- especially in the press -- sometimes taken to indicate that European markets are largely closed, and that Boeing and McDonnell Douglas have only severely limited opportunities there. The latter may be the case, but the former is not.

Only with the recent deep recession in Europe have U.S. civilian aircraft exports to Asia overtaken exports to Europe. As late as 1990, exports to Europe maintained a comfortable lead of more than $2 billion in sales annually. The recession and other factors have led to a collapse in the European market just when new opportunities have been emerging quite rapidly in Asia. As a result, the United States now exports almost twice as much in this sector, by value, to Asia as it does to Europe.
Whether this sudden divergence presages a fundamental shift in purchasing patterns is unclear. It is almost certainly true that the European aircraft industry faces a period of prolonged shakeout, which could reduce demand overall, while Asian growth may produce accelerating demand. European liberalization, however, is just as likely to open opportunities for U.S. firms, while Asian growth could lead to the development of indigenous aircraft industries in the region.
Once again, the trade balance reveals much more than trade volumes. Although the recession has reduced U.S. aerospace exports to Europe, and although the European countries plainly have targeted civilian aircraft as a strategic industry, America still enjoys a trade surplus of more than $5 billion with the EU in this sector.

The point in this case is rather simple, and one similar to those in the other sectors under discussion: despite the recent downturn, Europe still constitutes an extremely important export market for the United States in each of these sectors.

Trends in trade

Although existing trade patterns are important, trade trends are at the heart of arguments for prioritizing U.S. linkages to Asia. Proponents claim that whatever the current trade balance, the huge potential of Asian markets means that the United States must focus on "the most dynamic economic region in the world." This view is reflected in several recent documents from the Export Administration at the Department of Commerce.  

Just how dramatic are these trends, even taken at face value? They start from current circumstances -- the fact that Asia has become the biggest purchaser of U.S. exports, accounting for 27.2 percent of all purchases in 1992, compared with 26.3 percent for Europe (see Figure 2). In the core of the manufacturing sector, SITC 71-79, U.S. exports to Asia reached $70 billion in 1993, compared with $50 billion to Europe. To this is added the recent growth rates in many Asian economies (especially China), projected some decades into the future. This data is then leveraged against demographic data, which indicates the massive size of potential Asian markets, and their likely continued growth due to expanding populations. The conclusion is


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that U.S. exports to Asia are likely to grow explosively during the coming decades.

How good are these arguments?

To begin with, past and present are not always prologue; current trends often come to an end (as every roulette player knows). Each trend needs to be placed in context, a task far beyond the scope of this paper. Yet the process of describing the context can at least be begun.

In the case of Asia, some of the trends are almost certainly topping out (economic growth in Japan, for example, is unlikely to regain the 5-7 percent level of the 1960s and 1970s). Similarly, assumptions about huge Asian consumer markets require careful scrutiny.\(^\text{11}\)

Simple straight-line extrapolation will not do. On the Asian side, uncertainties include:

- **Slowing growth?** Economic growth is now leveling off for a number of East Asian economies, not just Japan; China may not be able to sustain double digit growth without explosive inflation or severe internal dislocations;

- **The role of China.** China remains a huge question-mark for political reasons as well, and because it has a strong historical attachment to self-sufficiency;

- **Tough markets to crack.** In many industries, U.S. exporters have continued to find it hard to crack the biggest Asian markets, notably those in Japan. Recent policy efforts notwithstanding, there is no sign that U.S. exports to Japan are about to take off;

\(^{11}\)U.S. business has gone through successive cycles of unrequited excitement about the Asian market about every 25 years since Commodore Perry reached Japan in 1853. Today's Asia enthusiasts should remember the "800 million pairs of (Chinese) feet to be shod!", marketing copy from the 1920s.
A regional bloc? Intra-regional trade in Asia is growing much faster than trade outside the region, forging links that may tend to shut out U.S. exporters;

Japanese influence. Japanese firms have already staked out large leads in markets and investments in many East and Southeast Asian nations. These markets may be tougher going for U.S. firms in the future.

Limits of export-led growth strategies. The export-led growth relied on by the Asian economies will be much harder to maintain in the future, now that all the major powers have turned their full attention to economic competitiveness and jobs;

As a result of these and no doubt many other factors, it would probably be a mistake to extrapolate directly from the substantial growth of the past 20 years into the next 20. Yet even if Asia's growth continues at healthy rates, the widespread tendency to ignore or slight Europe's current and future importance is unwarranted. In fact, a similar look at Europe provides almost a mirror image, even though West European economies are currently stagnant, and anticipate only slow growth in 1994.

U.S. firms have already done reasonably well in Europe. But European governments still protect domestic markets, and these policies have affected industries where U.S. firms are especially competitive, notably autos, electronics, computers, telecommunications, semiconductors, and aerospace.

Now these European barriers are being reduced across the board under the driving impact of the Single Market. Along with the GATT agreement, this development offers substantial prospects for market expansion for U.S. firms, even if European markets remain relatively stagnant -- which they probably will not.
Take two examples. First, the EU telecommunications equipment market is currently around $18 billion annually.\textsuperscript{12} U.S. exports supply around 12 percent of that market ($2.25 billion),\textsuperscript{13} with further sales coming from U.S. operations in Europe and elsewhere.

If new technologies and planned deregulation expand the equipment market by only 7.5 percent annually -- a conservative estimate -- and if the share open to U.S. firms expands by only 7.5 percent annually over the next five years -- also a conservative estimate -- U.S. exports could quite easily double by 1999, in real terms, to more than $4.5 billion. That growth would alone be more than the total expected U.S. telecommunications equipment market in China, currently the "market opportunity of the decade."

Second, deregulation and privatization are coming to European aerospace markets just as inexorably as they are coming to telecommunications. Once again, this will sharply increase demand for aircraft, even as ticket prices fall. Perhaps more important, deregulation also implies the erosion and eventual destruction of tied links between the Airbus consortium and the various national airlines. Freed of government pressure to buy Airbus, some companies are likely to choose U.S. competitors, as British Airways does already. Hence there is every likelihood that the demand for U.S. aircraft and parts will increase substantially over the next ten years, especially if air traffic expands after deregulation as fast in Europe in the 1990s as it did in the United States in the 1980s.

In short, even though many U.S. industries are already exporting rigorously to Europe, the removal of rigidities and market failures that have in the past reduced European growth and closed out U.S. firms may now offer significant new opportunities. And because Europe controls a substantial part of the world's capital stock, this demand can materialize quite rapidly. In addition, Europe has its own emerging hinterland: Eastern Europe and the

\textsuperscript{12}Eurobit Information Technology Observatory, 1993, p. 24.

\textsuperscript{13}Definitions of "telecommunications equipment" are highly elastic, and it is likely that the European definition is quite different from the Commerce Department’s. The data above use European definitions.
former Soviet Union. These markets are not likely to provide any substantial additional demand for U.S. products over the next few years, but may become more attractive in the medium term.

Finally, of course, Europe has been suffering from the worst sustained recession since World War II. The slump, however, was precipitated largely by the specific problems created by Germany’s desire to achieve rapid economic integration with the former East Germany. When European growth resumes, as it seems likely to by the end of 1994 or early 1995, U.S. views on the relative significance of European markets could again become much more positive.

Conclusions: The real story of regional trade patterns

The data presented in this section suggest that the views often headlined in the media are mistaken. It is obvious that Asia is a large and important market for U.S. exports. Yet it is also true that:

- European markets in many key manufacturing sectors are larger; in the industries where conflicts have been most visible between the United States and Europe, U.S. exports have been extremely strong;

- U.S. trade balances with Europe in these sectors are consistently positive; U.S. trade balances with Asia in these core sectors are not only highly negative, they are not improving;

- There is no sign that any of these realities or trends might be substantially reversed in the near future;

- Trade with Europe is susceptible to management through macroeconomic levers, such as exchange rates; trade with Asia is much less so;
• America's trade with Europe in both primary and manufactured goods is balanced; American trade with Asia shows small surpluses in the first and big deficits in the second, a fact with profound implications for the future development of the U.S. economy;

• Current perceptions of growth patterns almost certainly exaggerate the long-term rate of growth in Asia (however impressive it will surely be), and probably understate growth rates in Europe.

These conclusions should not come as a surprise. U.S. industry has complained for years about access to Asian markets. If conflicts have erupted more visibly with Europe, perhaps it is because the European Commission has been more open to meaningful negotiation and to implementing reforms. Each of the major issues with Europe in the three sectors discussed has in the end generated an acceptable negotiated settlement. As both sides are fond of noting, more than 95 percent of U.S.-EU trade is trouble-free.
II. FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

The massive trade deficits of the last decade required a corresponding influx of foreign investment into the United States at the same time that U.S. firms have continued to invest abroad. As a result, inward foreign investment in America has been growing at unprecedented rates, to unprecedented levels, and at rates much faster than trade. At the same time, U.S. firms have of course also continued to invest abroad.

Much of the inflow has taken the form of portfolio investment (investment in securities, cash deposits, and other relatively liquid assets). There are arguments that this inflow has helped to avert liquidity crunches, although there are also darker claims that it makes the U.S. financial system vulnerable to the actions of foreign creditors.

Still, the most visible component of investment into the United States has been foreign direct investment (FDI). Massive inflows from Japan, in particular during the 1980s, moved that country into second place in total direct investment (called "position") by 1992, behind only Great Britain, which after all had a three-century start.

Foreign direct investment now plays a large and growing role in the U.S. economy, now totaling about $420 billion, or 7 percent of GNP (the stock of U.S. investment abroad is now some $485 billion). It has, by and large, had a positive impact on the U.S. economy. Studies from the Institute of

\[14\] FDI is defined by the Department of Commerce as the ownership of 10 percent of or more of a U.S. corporation. In fact, most investors own much more than that, but 10 percent provides a standard and recognized line of demarcation that reflects influence if not necessarily control.

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International Economics\textsuperscript{15} and the Office of Technology Assessment\textsuperscript{16} indicate that foreign companies bring with them jobs, taxes, and sometimes technology when they set up shop in the United States. Whether they bring as much to the table as similar U.S.-owned corporations is a matter of dispute, but the fact that jobs and wealth are created in the United States cannot be disputed.

Figure 15. Foreign Direct Investment in the U.S.

\begin{figure}
\centering
\includegraphics[width=0.8\textwidth]{figure15.png}
\caption{Position by Region, 1992\newline Total: $420 billion}
\end{figure}

\begin{tabular}{l|c|c|c|c|c}
Region & Canada & Latin America & Japan & Other Asia & Other \\
$\text{bil.}$ & 39 & 248.5 & 96.7 & 11 & 6 \\
\end{tabular}


In recent years, Japanese FDI into the United States has been very high profile.\textsuperscript{17} Big money went into existing manufacturing operations, especially for small high tech companies; an array of big greenfield (newly constructed) plants, especially for auto production; big bets on established media giants (e.g., Sony with Columbia and Matsushita with MCA); and massive amounts of prime real estate (e.g. Rockefeller Center in Manhattan and the Pebble


\textsuperscript{17}Japan is used as the reference point instead of Asia for most of this section partly because Japan accounts for more than 90 percent of Asian investment in the United States, and partly because data on Japanese operations here are much more plentiful than is information on Asian operations in general.
Beach golf course in California). Collectively, these investments constitute perhaps the biggest and most visible international buying spree in history.

Yet even after the investment binge ended in 1991, Asian investment was still dwarfed by the massive position built up by European investors over the years. As Figure 15 shows, Europe still accounts for almost 60 percent of all foreign direct investment in the United States, while Asian investors account for just slightly more than a quarter.\(^\text{18}\)

The same story applies to FDI in manufacturing, despite those well-publicized Japanese investments. European affiliates account for 71 percent of total FDI in the manufacturing sector, while Asian firms account for just 14 percent (see Figure 16).

\(^{18}\)In fact, data from the U.S. Commerce Department's Bureau of Economic Analysis, on which all FDI analysis rests, significantly understates European investment relative to Asian investment because BEA data is calculated on an historical cost basis. This approach systematically undervalues older investments relative to newer ones. One recent survey of 3,700 majority-owned foreign investors by KPMG Peat Marwick found that 62 percent of European investment dated back at least to 1985 (and much of it no doubt to much earlier periods), while that was true for only 46 percent of Japanese firms surveyed. (KPMG, European Investment in the United States, vol. 1. study prepared for the Commission of the European Communities, March, 1993).
The link between current account surpluses and direct investment in the United States now appears to be weakening, particularly for firms from Asian countries. Continuing massive U.S. deficits with Asia are not being reflected in continuing inflows of direct investment from the region.Apparently, the scars from financial hits taken by earlier Asian investors continue to take their toll (Japanese investors in particular lost heavily with the fall in the yen value of the dollar and the weakness of many of the investments -- especially, but by no means exclusively, in real estate). As a result, the massive expansion of Asian FDI in the United States seems unlikely to be replicated in the coming decade.

**Contributions to the U.S. economy: jobs, trade, and taxes**

Foreign investors bring a lot more than just money to the United States. They are a source of jobs in the economy; a focus for trade, both imports and exports; and payers of U.S. taxes. In addition, they mediate technology transfers, an issue discussed in Section IV of this paper.
**Jobs**

In 1990, European-owned firms employed 2.9 million American workers. This total represented

- 62 percent of all U.S. jobs at foreign-owned companies -- a figure slightly higher than Europe's share of FDI;
- 3 percent of total U.S. employment; and
- Job growth at a rate more than twice the rate of job growth in the U.S. economy as a whole, in both 1989 and 1990.\(^1\)

Surprisingly, even after a decade of strong Asian investment, the impact of Asian investment on jobs continues to be relatively small, especially compared to that flowing from European FDI. The distribution of jobs from FDI by region does not seem to have changed very much during the 1980s, as Europe continues to dominate, as shown in Figure 17:

---

\(^{1}\)Jobs and Investments of European Firms Operating in the United States (Washington, D.C.: European American Chamber of Commerce), 1993.
European firms account for 62 percent of jobs produced by foreign affiliates, right in line with their overall share of jobs produced by FDI.

**Good Jobs?**

Jobs with European-owned firms tend to be good jobs. Exactly half are in manufacturing, compared with less than 20 percent for all jobs in the U.S. economy. They also pay well. On average, European firms’ employees made $2,477 monthly in 1990, or 18.8 percent more than the U.S. average of $2,085.\(^{20}\) Even within manufacturing, European firms are slightly better-paying than average.\(^{21}\)

Because so much European FDI is concentrated in manufacturing, the direct jobs it creates are accompanied by a much greater number of indirect jobs. In fact, according to the job multipliers calculated by the Economic Policy Institute, every single U.S. manufacturing job creates more than four indirect jobs. For retail trade and personal and business services, the multipliers are lower -- about 0.94 and 1.47, respectively.\(^{22}\)

It is also worth pointing out that some European firms are strong supporters of worker training. Anecdotal evidence suggests that some at least have brought European levels of support for worker training to their U.S. operations. Siemens, for example, started European-style apprenticeship

\(^{20}\)Ibid., p.13

\(^{21}\)In fact, European-owned firms alone accounted in 1990 for more than 7 percent of U.S. employment in manufacturing, and for more than 10 percent of manufacturing employment in four states: New Jersey, West Virginia, South Carolina, and Maryland. Source: Ibid. p.23

programs in North Carolina, Florida, and Kentucky in 1993. Similar initiatives are being developed nationwide.\textsuperscript{23}

\textbf{Trade}

Foreign affiliates operating in the United States account for a substantial part of overall U.S. trade. In 1991, European and Japanese firms each shipped about $41 billion in exports (together amounting to about 18 percent of total U.S. exports) but Japanese firms imported far more than their European counterparts.\textsuperscript{24} As Figure 18 shows, European imports were about $60 billion, while those of Japanese firms were around $90 billion. Together, these imports account for just under 30 percent of total U.S. imports.

Collectively, foreign affiliates generated a net merchandise trade deficit of $81 billion -- slightly less than the total U.S. trade deficit. Of this total, $48.5 billion (60 percent) came from the activities of Japanese firms. European firms collectively accounted for $12.1 billion, or 15 percent.\textsuperscript{25} Figure 19 shows imports, exports, and balances by region.

\textsuperscript{23}Siemens, \textit{Siemens '94: A Review of Siemens Businesses in the U.S.A.}, p.3


\textsuperscript{25}Europe defined as the UK, France, Germany, the Netherlands, and Switzerland.
The patterns in manufacturing (Fig. 19) are quite similar, although Europe accounts for a larger share of both imports and exports. Japanese-owned firms account for 64 percent of the total trade deficit stemming from foreign investment in the manufacturing sector.²⁶

²⁶This picture is somewhat misleading, as many imports -- especially from Japan -- are channeled through wholesalers who count as direct investment in the United States, but who really do little more than trans-ship finished imports.
Looking only at the export side, European investment in manufacturing accounts for 70 percent of the total, or 46 percent of U.S. exports associated with FDI; Japanese firms account for only 12 percent of total FDI in manufacturing, but 28 percent of the related exports. Explanations for these differences are not immediately apparent, but they do suggest that Japanese investments are not, as myth might have it, weak sources of U.S. exports, at least in manufacturing.

**Taxes**

All multinational corporations -- U.S.- and foreign-owned -- have the opportunity to reduce their taxes either through paper transactions or by managing the physical flow of production. As a result, multinationals as a whole tend to pay less taxes than large firms without substantial foreign operations. In the case of European-owned firms, though, the impact is surprisingly small. All U.S.-owned firms paid an effective corporate income tax rate of 1.1 percent on their revenues in 1990. European-owned firms paid 1.0 percent, while Asian firms paid less than a tenth of that -- just under 0.1
percent (firms from America’s partners in the North American Free Trade Agreement, Canada and Mexico, paid 0.4 percent).\textsuperscript{27}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Figure20.png}
\caption{U.S. Taxes Paid by Foreign Affiliates 1990}
\end{figure}

Different tax rates lead to major differences in payments. The $7 billion paid by European-owned firms for corporate income taxes in 1990 was more than 70 times the amount paid by Asian firms, on revenues that were less than 6 times larger. Indirect taxes tell a rather less extreme story, as they are much harder to evade or avoid legally. In 1993, European firms paid $13 billion in indirect taxes, more than half of all indirect taxes paid by foreign-owned firms, and roughly in line with the European share of overall FDI into the United States.

**Trends in foreign direct investment**

With FDI, as with trade, straight-line extrapolation does not always lead to a plausible future. The most important recent development -- the massive

\textsuperscript{27}Jobs and Investments of European Firms Operating in the United States, \textit{op.cit} p.46

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increase in Japan's U.S. FDI position during the 1980s -- was fueled by a number of factors, several of which may not be repeated. These include:

- **Heavy overextension of the financial sector in Japan** (the "bubble economy"), which provided massive liquidity to underpin foreign investment. The bubble economy has now burst;

- **The relatively closed nature of other Asian markets**, which diverted Japanese direct investment toward Europe and the United States. China and other Asian markets are now opening to Japanese firms;

- **Industry-specific needs**, as in the auto industry (a big source of Japanese FDI), where protectionist measures to support U.S.-based auto manufacturing encouraged much FDI, but where Japanese firms have now completed their major plant expansions in the United States and are in some cases retrenching;

- **A belief that the United States would remain the economic center** of the industrialized world, and a fear that the United States might turn protectionist under a Democratic administration. Neither are such powerful beliefs any longer; and

- **A belief that investment in the United States would provide insurance against regional market downturns and a good rate of return.** In the event, the latter at least has proved to be a disastrous assumption, especially with the steady decline in the yen value of the dollar.

In the near future, moreover continuing international pressure on Japan may force their trade surpluses to decrease. This development would directly reduce the pressure to invest abroad, directly or indirectly. Other Asian countries are unlikely to step into the gap, especially while Asian markets are booming, although there may be a substantial inflow from Hong Kong as the 1997 transition to Chinese rule draws closer.
In addition, some of the highest profile Asian investors are now having second thoughts about America: Japanese firms are trying very hard to clean up their balance sheets in U.S. real estate, even if this means taking huge losses, while Sony is apparently seeking ways to reduce its holdings in Columbia pictures.

For Europe, circumstances are again rather different:

- *European manufacturers, especially from Germany, have come to see the United States as a low-cost, high quality, production base.* The recent decisions by BMW and Mercedes-Benz to move production outside Germany for the first time and into the United States underline the weight of this new trend;

- *European capital flows are internationalizing* under the liberalizing effect of the Single Market program, and these flows are increasingly seeking off-shore harbors; and

- *Asian markets are not seen in Europe as stable or easily penetrated,* while the United States remains highly attractive.

Straight-line extrapolations would suggest that Japanese FDI in the United States will continue to expand fast. A more plausible scenario, however, is that the Japanese share of U.S. FDI has already topped out, and may even start to decline given greater opportunities closer to home. And although non-Japanese investment from Asia is likely to expand as other countries in the region become richer, that expansion will come from a very small base (around $2 billion in 1991). It will probably not reach anything like the level attained by Japanese FDI in the late 1980s, at least for the foreseeable future.

**Conclusions**
Despite the highly publicized inflow of Japanese FDI into the United States in the second half of the 1980s, European FDI still dominates both overall and particularly in manufacturing. European firms retain a dominant share of the assets, sales, jobs, taxes, and research and development -- as Section IV will show -- related to FDI in the United States.

This balance is not likely to change in the near future. In fact, inflows from Japan are already declining sharply, and it seems most likely that the golden age of Japanese FDI in the United States is already over.

In the medium term, Europe will remain the most important source of foreign investment in the U.S. economy. This, in turn, means that European firms investing in the United States will continue to act as a substantial source of jobs, taxes, and other benefits.
III. U.S. INVESTMENT ABROAD

U.S. investment abroad is a crucial element in the U.S. economy for three main reasons.

- **The direct flow of profits and revenues is substantial.** Both have in the past moved countercyclically with the U.S. economy, flowing in at times when U.S. profits were weak. Certain firms -- notably Ford and General Motors -- have been rescued by inflows from Europe when North American markets were unprofitable and liquidity pressures were severe. In all, U.S. overseas investment currently generates more than $1.2 trillion in sales revenue annually -- with $734 billion of that coming from Europe.

- **Trade does follow the corporate flag,** and a strong U.S. presence on the ground is a crucial contribution to U.S. exports. Two-thirds of the flow of goods across the Atlantic is accounted for by trade between multinational corporations; one-third of all transatlantic trade is trade within the same company. By contrast, limited presence on the ground in certain countries, notably Japan, has been closely linked to relatively low levels of U.S. exports.

- **Access to foreign technologies and suppliers** has become extremely important for U.S. companies, as competing foreign firms have caught and sometimes passed the United States in a range of technologies. A direct presence is often necessary both to identify the sources of new technologies (often small and domestically oriented firms) and to build the relationships necessary to access those technologies. Conversely, the absence of a strong presence on the ground has made the acquisition of such technologies and suppliers more difficult.

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For all of these reasons, it is strategically important for U.S. firms to invest globally, especially in high tech sectors. But different governments treat foreign firms quite differently.

In Europe, U.S. investors face a considerable range of treatment. Officially, the European Union has placed language in its treaties that guarantees the right of establishment, and the equal rights of all companies registered within the physical boundaries of the Union -- language which covers U.S. investors. The rights are backed by legal recourse, although legal proceedings are at least as slow and cumbersome in Europe as they are in the United States.

In addition, a number of European countries are moving toward a model of corporate financing and government that more closely approximates the market-driven, shareholder based model prevalent in the United States and United Kingdom. Privatization in particular is now sweeping through almost all European countries. Opportunities to buy into local firms are therefore on the rise, although it will be years or even decades before complex cross-share holding and bank-holding arrangements, such as those common in Germany, unwind.28

In practice, foreign-owned firms clearly face a range of national policies in Europe. Britain in the main does not distinguish between foreign and domestic firms; France, on the other hand, has traditionally been highly suspicious of U.S. capital (indeed of foreign capital generally), and has only recently become somewhat more hospitable to foreign investment. Germany remains officially open but at the same time a difficult market because of traditional share holding patterns. Other European countries fall somewhere between the British and German cases. Overall, though, U.S. firms have found it possible to invest substantially in Europe, accumulating a stock of investment amounting to nearly $240 billion.

28And there are of course many who would argue that the German model should be imitated in the United States, rather than dismantled. See Michael Porter, Capital Choices (Washington, D.C.: Council on Competitiveness), 1992.
The story in Asia is quite different. U.S. firms have found it much harder to invest in Japan, and also -- to varying degrees -- in other countries in the region. According to the Organization for Economic Cooperation and Development (OECD), official barriers to inward FDI in the region are substantial. Yet even these official barriers are less important than the unofficial barriers posed by the structure of financial and industrial holdings.

These factors are reflected in the distribution of U.S. direct investment abroad. Europe’s $240 billion represents 49.2 percent of the total, while Asia, including Japan, accounts for much less -- $78 billion, or 16.3 percent, as shown in Figure 21:

![Figure 21. U.S. Direct Investment Abroad, 1992](image)

These patterns are also reflected in the data for U.S. investment in manufacturing operations abroad, depicted in Figure 22:

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Given the crucial importance of Japan in manufacturing industries, especially in sectors where access to leading-edge components heavily influences downstream competitiveness, this investment short-fall presents a major potential problem for U.S. firms and U.S. policy.\(^3^0\) That problem is reflected most clearly in the ratio of inward to outward investment, where Japan is once again an extreme outlier, as Figure 23 shows:

These patterns are reflected in the data for net income from U.S. subsidiaries abroad. In 1990, European affiliates produced net income of $49 billion, while those in Asia produced $14.7 billion. On a dollar investment basis, European operations produced $0.22 per $1 of investment; Asia produced $0.19. Thus European operations are on this basis about 16 percent more productive.\(^\text{31}\)

**Trade**

U.S. affiliates operating in Europe generated more than $32 billion in U.S. exports in 1990, while at the same time maintaining a significant trade surplus of around $16 billion.\(^\text{32}\) In 1991, this figure rose to $20 billion. Rather surprisingly, although trade does normally follow the corporate flag, U.S. affiliates operating in both Japan and Asia as a whole generated a U.S. trade deficit ($7.5 billion in 1990, and $6 billion in 1991 -- see Figure 24).


\(^{32}\)Ibid., Table II E. 7
The main point here, once again, is not the balance in Asia, but the extremely positive relationship with Europe. Even for those concerned that U.S. investment abroad reflects a drain on U.S. capital, investments in Europe clearly produce a substantial direct return in the form of U.S. jobs.

**Majority-owned U.S. affiliates abroad (MOFAs)**

All the FDI data presented so far for outward U.S. investment cover affiliates in which U.S. firms have a stake of at least 10 percent -- the standard statistical benchmark for FDI. ³³

Yet, the Bureau of Economic Analysis also maintains a database of U.S. affiliates abroad where U.S. interests are at least 50 percent (known as majority-owned foreign affiliates, or MOFAs). The assets of MOFAs are shown in Figure 25.

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³³This is also the benchmark used by the Organization for Economic Cooperation and Development (OECD).
These data suggest that as U.S. firms venture abroad, they tend to take a majority stake much more often in Europe than in the rest of the world. The following table shows this to be the case. The data for Asia -- and for Japan in particular -- support the argument that the structure of Japanese capital does not encourage such an approach.

### Table 1. Majority Ownership and U.S. Investment Abroad

<table>
<thead>
<tr>
<th></th>
<th>Europe</th>
<th>Asia (except Australia)</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total U.S. Assets</strong></td>
<td>$839 bn</td>
<td>$239.5 bn</td>
<td>$155.0 bn</td>
</tr>
<tr>
<td><strong>U.S. MOFA Assets</strong></td>
<td>$740 bn</td>
<td>$143.5 percent</td>
<td>$61.4 bn</td>
</tr>
<tr>
<td><strong>MOFA Assets as percent of Total Assets</strong></td>
<td>88%</td>
<td>59.9%</td>
<td>39.6%</td>
</tr>
</tbody>
</table>


Do these difference matter? It is certainly plausible to argue that the European case approximates the "neutral" case and reflects the real desires of U.S. corporations for a majority or minority presence. There is certainly
plenty of anecdotal evidence that U.S. firms investing abroad may be pressured to set up joint ventures, as they are in some parts of Asia today and have been in many parts of Europe in the past. These arrangements can have significant effects on the transfer of technology over the long run, and on both the opportunities open to U.S. corporations, as well as the profits they might reap from their activities abroad.

MOFA assets are generally very productive. In 1991, they accounted for substantial amounts of net income for U.S. parents, and European MOFAs accounted for almost $40 billion in net income, as Figure 26 shows:

![Figure 26. U.S. Majority-Owned Affiliates](image)

MOFAs also have a substantial impact on U.S. trade flows. In Europe, MOFAs have generated hefty U.S. trade surpluses -- $20 billion, on the basis of $35 billion in MOFA exports in 1991 (see Figure 27). These MOFA exports to Europe account for around 8 percent of U.S. global exports.
Trends in U.S. direct investment abroad

With Europe still in recession and the late 1980s period of “Euro-phia” clearly over, flows of U.S. direct investment into Europe have slowed somewhat. Partly compensating for this trend has been the continuing reinvestment of European earnings in European operations by U.S. corporations. Yet the apparent attractiveness of Europe has nonetheless declined, at least in the short term.

At the same time, some have argued that Japan is changing, and that Japanese barriers to foreign investment are declining. Moreover, as the Asian boom continues, the region’s attractiveness for U.S. corporations is likely to increase — again, at least in the short run. With major corporations like General Electric claiming to expect a rapidly growing share of their revenues to come from Asia, the tone in the business community is strongly oriented toward more Asian investments.34

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Yet the apparent strength of these arguments does not hold up under scrutiny even for the present and recent past, let alone the future. Between 1989 and 1992, U.S. direct investment increased by around 30 percent for Europe, and 50 percent for Asia. Because the baselines for the two regions are so different, however, the additional investment in Europe over the period was almost equal to almost the total accumulated stock of U.S. direct investment in Asia at the beginning of the period, and total additional investments were approximately $50 billion for Europe and $20 billion for Asia (see Fig. 28).

![Fig. 28. U.S. Direct Investment in Europe & Asia Position, 1989-92](source: U.S. Department of Commerce, Survey of Current Business, July, 1993, p.91)

In fact, on an annual basis, the flow of U.S. investment into Europe is still more than twice the flow of U.S. investment into all of Asia combined, including Japan ($12.5 billion vs. $5 billion). These are very substantial differences.
Conclusions: U.S. direct investment abroad

The United States has been investing in Europe for decades. Henry Ford set up a manufacturing plant in England before World War II, and other big U.S. names (e.g., General Motors, IBM, Woolworth's) have been operating in Europe for many decades.

This history is reflected in the powerful stream of revenues that U.S. corporations still derive from Europe. Table 2 shows European revenues as a percentage of worldwide revenues for the 16 biggest U.S. corporations which break down their revenues geographically. Of the 16 companies, 6 had 30 percent or more of revenues coming from Europe. The average was 27.5 percent:

Table 2. European Revenues as a Percentage of Worldwide Revenues, Selected Major Corporations, 1992

<table>
<thead>
<tr>
<th>Company</th>
<th>%</th>
<th>Company</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coca-Cola</td>
<td>30.5</td>
<td>Pepsico</td>
<td>6.1</td>
</tr>
<tr>
<td>Philip Morris</td>
<td>29.4</td>
<td>Chevron</td>
<td>28.9</td>
</tr>
<tr>
<td>Merck</td>
<td>44.1</td>
<td>GM</td>
<td>21.8</td>
</tr>
<tr>
<td>Du Pont</td>
<td>36.7</td>
<td>Mobil</td>
<td>34.6</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>28.5</td>
<td>Amoco</td>
<td>4.2</td>
</tr>
<tr>
<td>Bristol-Myers</td>
<td>28.4</td>
<td>Microsoft</td>
<td>25.7</td>
</tr>
<tr>
<td>IBM</td>
<td>40.5</td>
<td>Ford</td>
<td>24.8</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>30.9</td>
<td>Intel</td>
<td>25.4</td>
</tr>
</tbody>
</table>

Source: Annual Reports

Naturally, as Asia industrializes, U.S. investment will tend to shift in that direction. Over a long period of time, it is possible, though not perhaps likely, that U.S. investments in Asia will develop the same significance and character that they currently have in Europe. For the time being, however, there are real and important differences between the two regions for U.S. investors. Among the most important conclusions to be drawn from this section are:
• **U.S. investment in Europe dwarfs U.S. investment in Asia,** and will continue to do so for many years to come;

• **U.S. investment flows into Europe are still more than twice those into Asia;**

• **U.S. affiliates in Europe have revenues of more than $800 billion annually,** equal to 13 percent of U.S. GDP. A selection of Fortune 50 firms revealed that on average they received 27.5 percent of their worldwide revenues from Europe in the 1989-92.

• **Profit flows from Europe are higher than they are from Asia,** even per invested dollar; and

• **U.S. investment in Europe has more favorable implications for U.S. trade than similar investments in Asia.**

In short, despite all the excitement about the potential of U.S. investment in Asia, and the likely increase of U.S. investment flows into the region, the United States has a huge existing investment in Europe, and Asian figures will not match these totals in either quantity or quality for a very long time.
IV. TECHNOLOGY

Technology now plays a powerful role in international competitiveness, especially in the industrialized world. The comfort and wealth of our children will be largely determined by how the United States plays the technology game today.

There are no conclusive comprehensive indicators of international technology flows. Collectively, however, the available data most likely capture something of the real state of play. Aside from international technology agreements and trade patterns, there are four main areas worth analyzing:

- **The level of research and development expenditures by foreign firms in the United States.** This can be taken to indicate an expansion of U.S.-based technology capabilities;

- **Royalties and licensing payments from affiliates to foreign parents,** which indicate technology acquisition and inward technology transfer;

- **Technology and national security,** and the targeted acquisition of high tech firms and workers in the United States;

- **Strategic alliances,** which are clearly becoming a key element in the strategies of high tech firms.

**R&D expenditures**

Foreign investors in the U.S. economy already play a significant role in developing the U.S. technology base. And their expenditures also reflect the
extent to which foreign firms are fully integrating themselves into the U.S. economy, as R&D is usually one of the last functions to be transferred from the home country.

In 1991, European firms spent $7.7 billion on R&D in the United States, accounting for 65 percent of total R&D by foreign-owned firms. Asian firms, by contrast, spent just $1.5 billion (see Fig. 29).\textsuperscript{35} Spending by European-owned firms amounts to about 5 percent of total U.S. R&D spending, and about 10 percent of R&D spending in the civilian sector.

On a dollar-invested basis, European firms spent 3.1 cents per dollar on R&D in the United States; Asian firms spent less than half that much -- 1.4 cents.

**Royalties**

Royalties are an indirect measure of technology transfer. With the growth of foreign investment in the United States, royalty payments and net receipts

\textsuperscript{35}Jobs and Investments of European Firms Operating in the United States, op.cit p.57

North Atlantic Research, Inc.  Economic Strategy Institute
with their parent companies offer an important window into the related transfer of technology into the United States.

For both Europe and Japan, there is a big imbalance in favor of payments made by U.S.-based subsidiaries to foreign parent companies, which indicates the net provision of technology to the United States. European firms paid more than $1.7 billion in 1991 and $2.1 billion in 1992 to acquire technology from their parents.

Once again, on a dollar invested basis, European affiliates had net inward technology transfers equivalent in 1991 to 0.6 cents per dollar; Japanese firms had less than 0.4 cents.

**Technology and security**

Congress has recently become concerned about foreign firms using the relative openness of the U.S. economy in ways that are not reciprocated. This issue has also been raised by a number of provocative books, notably works
by Susan and Martin Tolchin, and may be especially important in relation to high technology companies, some of which play an important role in U.S. national security.  

The view of the military -- and now the view of the Clinton administration -- is that maintaining completely reliable sources of supply for crucial military inputs is a central goal of national security. These views underpin the new stress on support for dual-use technologies. The administration also recognizes that in many areas civilian technology now leads military technology; hence the health of the civilian technology base has direct security implications.

These views raise some important questions about the broad pattern of technology acquisition by Japanese companies. Quite naturally, and entirely legitimately, Japanese firms have focused on the small, highly innovative firms that the U.S. financial system often denies sufficient working capital -- particularly the mezzanine financing needed to move from development into full-scale production. Large Japanese firms with deep pockets and long time horizons are particularly well placed to work with such firms, taking a large financial stake in exchange for technology access. The situation is summarized in Table 3, drawn from a database maintained at the Economic Strategy Institute:

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37 Technology for America’s Economic Growth, a New Direction to Build Economic Strength, President William J. Clinton and Vice President Albert Gore Jr., February 1993

North Atlantic Research, Inc. Economic Strategy Institute
Table 3. Foreign Acquisitions of U.S. High Technology Companies

<table>
<thead>
<tr>
<th></th>
<th>Materials</th>
<th>Chemicals</th>
<th>Electronics</th>
<th>Semicond.</th>
<th>Biotech</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Aerosp.</td>
<td>Computers</td>
<td>Semi.Equip</td>
<td>Telecoms</td>
<td>Other</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>42</td>
<td>18</td>
<td>25</td>
<td>108</td>
<td>36</td>
<td>34</td>
</tr>
<tr>
<td>UK</td>
<td>12</td>
<td>6</td>
<td>7</td>
<td>14</td>
<td>14</td>
<td>1</td>
</tr>
<tr>
<td>France</td>
<td>3</td>
<td>5</td>
<td>11</td>
<td>10</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Germany</td>
<td>0</td>
<td>1</td>
<td>6</td>
<td>10</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Canada</td>
<td>1</td>
<td>3</td>
<td>7</td>
<td>2</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taiwan</td>
<td>1</td>
<td>0</td>
<td>8</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Australia</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>S.Korea</td>
<td>0</td>
<td>0</td>
<td>4</td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Totals</td>
<td>70</td>
<td>34</td>
<td>61</td>
<td>171</td>
<td>71</td>
<td>43</td>
</tr>
</tbody>
</table>

The data indicate that Japanese firms accounted for more than 60 percent of all high tech acquisitions in the United States during this period, and Asian firms for more than 63 percent. This is more than four times the Asian share of FDI in manufacturing (14 percent).

Clearly, the acquisition of small high tech firms has become a specialty of Japanese firms. The question is whether these activities enhance or erode U.S. economic strength and U.S. security, given that U.S. firms cannot operate in a similar way in Japan. That question remains open.

It is critical to note, however, that the activities of European governments and firms are not of particular concern in this area. The five most active European countries have accounted for only 171 acquisitions during the period surveyed. That is 24 percent of the total, or just over one-third of the level of European investment in U.S. manufacturing (70 percent). And as we have already seen, European countries are also much more open to U.S. direct investment abroad, including the purchase of their own domestic high tech firms by U.S. corporations.
Technology and U.S. firms abroad: strategic alliances

The past 20 years have been marked by a rapid increase in the number of international corporate strategic alliances. Here, as elsewhere, the newspaper headlines would suggest that U.S. firms have been overwhelmingly interested in forming alliances with Japanese firms. Yet the following charts show the data for a range of industries, between 1980 and 1984 and 1985 and 1989:

Figure 31: International Corporate Strategic Alliances in Selected Sectors, 1980-84 and 1985-89

Biotechnology

New Materials

Chemicals

Aviation/Military
Two trends are apparent from the data. First, in most industries, most U.S. alliances have historically been with European firms, not Asian ones. Second, although this pattern is starting to change, it is changing surprisingly slowly. The most recent data still show a U.S. tilt toward European alliances. Overall, U.S.-EU alliances have fallen only slightly as a share of total international corporate strategic alliances. They still account for 61 percent of the total, as opposed to 32 percent for U.S.-Japan, and 14 percent for EU-Japan. Of course, the MERIT database is not completely current; nor does it include the obviously growing number of U.S. alliances with non-Japanese firms in Asia.

38The MERIT database, maintained by the Dutch national university system, is the best of its kind in the world. Yet, it does not track alliances by size or value; it relies (naturally) on published reports; and it may have a Eurocentric bias, although it is designed to avoid that problem. In short, it is the best available source of quantitative data, but may be missing a considerable amount of information.
Conclusions

Alliances are also made for many reasons, not least to secure help in cracking foreign markets. They may therefore indicate the existence of negative factors in an economic relationship as well as positive ones.

Still, in technology, as elsewhere, the ties between the United States and Europe are much stronger than they appear. They can crudely be captured in the following table, which illustrates U.S. technology links with Europe and Asia in several dimensions:

Table 4. Indicators for International Technology Flows

<table>
<thead>
<tr>
<th></th>
<th>Europe</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual R&amp;D expenditures in U.S. - percentage of total investment</td>
<td>3.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Net royalties - percentage of total investment</td>
<td>0.6</td>
<td>0.4**</td>
</tr>
<tr>
<td>Percent share of high tech acquisitions in the U.S. by all foreign investors 1988-93</td>
<td>24</td>
<td>63</td>
</tr>
<tr>
<td>Percent share of international strategic alliances with U.S. partners, 1985-89</td>
<td>54</td>
<td>32</td>
</tr>
</tbody>
</table>

** Japan only
V. CONCLUSIONS

In each of the four dimensions, the link between Europe and the United States is central to U.S. economic relationships. In most areas, relations with Europe are much more important quantitatively than are similar U.S. relations with Asia. The evidence strongly suggests that this will remain true well into the next century.

Moreover, it is the Europeans who share most strongly U.S. views about the future of the world economic order. Although there are clear differences between American capitalism and European capitalism, they are dwarfed in comparison with the gulf existing across the Pacific. On a number of economic issues central to the next decade and the next century -- trade law, competition policy, labor law -- U.S. interests and those of the Europeans are tightly aligned.

From this analysis flow some important policy prescriptions. First, it is crucial not to mistake policy differences for conflicts over principle. The United States fundamentally agrees with the Europeans on most major issues concerning the organization of the international economic order.

Second, if the United States is to influence significantly the rapidly emerging new global economy, it will need allies. Many of these allies are to be found within Europe.

Third, the Europeans take U.S. works and U.S. actions seriously. Words said at conferences in Seattle and Seoul are read carefully in Bonn and Barcelona. It is unwise to push Europe into considering a future without close links to the U.S. In particular, the notion of the United States playing an Asian card against Europe should be buried.
Finally, both Europe and the United States need to consider new ways to support and manage joint interests. Currently, there are serious policy dislocations across the Atlantic and insufficient mechanisms for integrating the needs of the public and private sectors. New channels of communication inside and especially outside government are clearly needed.

Two specific sets of steps should be taken.

First, North America and Europe should open exploratory discussions aimed at broadening and deepening economic relations among those countries fully committed to market-based economic systems. Although talks would begin around a North American-European core (possibly building on current, low-level U.S.-European Union discussions of regulatory harmonization) their scope would not be limited by geography. Non-Atlantic countries that would be excellent early candidates for inclusion would be Chile and Singapore. Moreover, participation -- and the benefits of freer trade, investment, and technology flows -- would be open to countries willing to conform with the group's core principles and practices.

These discussions would encourage the world's most market-oriented countries to resolve their remaining differences not only on international economic policy but on those domestic issues that bear heavily on international commerce, such as labor policy, competition policy, and environmental and other forms of non-economic regulation. It would also offer an opportunity to develop more strategic and longer-term views of the world economy, while allowing these countries to work more closely together to address the many difficult domestic problems that have emerged in a world of rapidly accelerating economic, technological, and social change.

Such discussions should not be seen as a challenge or threat either to the new World Trade Organization or to any less market-oriented economy. The former should simply be seen as a platform from which like-minded countries can go further in integrating their economies on terms that they find mutually acceptable; the latter would simply find further encouragement to move in directions that both the United States and European Union would applaud.
These discussions would, in short, start the United States and Europe down the path toward an economic parallel to NATO. The latter has provided a forum for the development of joint policies with specific aims and objectives. As US and European concerns shift from military security to economic security, it is equally important to develop a similar forum for economic issues, both international and domestic. It is the continuing absence of such a forum which has placed the spotlight squarely on US-EU quarrels in recent years, rather than on shared practices and mutual interests and objectives.

Second, as this effort proceeds, business leaders on both sides of the Atlantic should set up a forum through which they can communicate their views to their governments. Businesses around the Pacific Basin have benefited from the creation of the Pacific Basin Economic Council, which serves as a private-sector voice and promotes business interests and expanded trade and commerce among North America, Pacific Latin America, East and Southeast Asia, and Australasia. Businesses in North America and Europe could secure the same benefits by creating an Atlantic Basin Economic Council.