EUROPEAN COMMUNITY - UNITED STATES RELATIONS:
A CURRENT ASSESSMENT

Speech Given

by

Roland de Kergorlay
Head of the Delegation of the Commission of the European Community

July 12th, 1982

before the

National Foreign Trade Council

Washington, D.C.

I. INTRODUCTION

Four months ago, I spoke before a distinguished group of American economists (National Economists Club, March 16, 1982) on a subject similar to the one I have been asked to speak on today. Assessing the prospects for transatlantic trade relations, I predicted that things would get worse before they got better.

Unfortunately, I seem to have been vindicated.

The optimism which preceded the Versailles Summit has been overshadowed by the continuation of trade-restrictive actions on the part of the European Community's (E.C.) leading trade partner, the United States.

As the world economic recession persists, we are witnessing the growing inability of governments to resist protectionist pressures from domestic interest groups in both the industrial and agricultural sectors. Furthermore, there is emerging on the European side of the Atlantic a perception that the United States is insensitive to the economic plight of Western Europe. Countervailing duties on steel exports, limitations on East-West trade, and persistent high interest rates are only some of the U.S. actions which are troubling Western Europe.

Moreover, the fact that the world economy will recover only modestly, if at all, over the next half-year or year - combined with two consecutive years of virtually no growth - is accentuating the level of frustration and pessimism among peoples and governments on both sides of the Atlantic.

Before I outline some of the major issues in U.S.-Western European economic relations, I would like to take a few moments to describe the European Community's role and objectives in the trade area. Only in this way, I think, can the E.C.'s views on international economic policy be fully understood.

II. THE EUROPEAN COMMUNITY AND TRADE

The consolidation of ten national economies, a process that began some 25 years ago, has created the world's largest trading entity. The E.C., excluding internal trade, accounts for 22% of all world trade. The United States' share is 15%; Japan's 9% (1980).

Commitment to free trade was a key element in the creation and development of the Community and remains an essential element of Europe's economic survival. The E.C.'s high trade dependency is evidenced by a trade deficit with the world which totalled some $58 billion in 1981 (1982 Economic Report of the President. U.S. deficit in 1981 was $31.4 billion).

By assuming the trade policy responsibilities of ten member states, the E.C. has been able to moderate the protectionist pressures exercised within the member states, all of which are subject to similar pressures domestically that the U.S. government is. The challenge of the European institutions, and one which has met with relative success, is continually to balance inevitable protectionist pressures against free-market forces.

The United States has greatly benefited from Europe's growth. The E.C. is the United States' largest single export market. In 1981, the United States enjoyed a $10.7 billion trade surplus with the European Community.

Western Europe today, like the United States, is in the midst of a severe economic crisis. The E.C., with its 270 million people (U.S. has 230 million) and a GDP which, like that of the U.S., is close to $3 trillion, is facing continued, if somewhat abated, inflation (over 12% on average in the E.C.) and growing unemployment [11 million or over 9.3%. (1981 OECD figures].

The Community's GDP declined by 0.7% in 1981 from 1980 (OECD figures) and, unless the United States experiences substantial recovery in the second half of 1982, it will grow by no more than 1.5% in 1982.

This economic situation in the Community and the equally worrisome economic situation in the United States exacerbate the economic tensions across the Atlantic. The convergence of disagreements on a number of economic issues has created perhaps a severe transatlantic crisis.

III. STEEL SECTOR

The issue of steel exports from the European Community to the United States is the most recent manifestation of the transatlantic trade tensions that have characterized our relations for close to a generation.

The decision last month by the Department of Commerce to impose countervailing duties on European Community steel imports is a matter of grave concern to us. The result of this decision is that steel exports of a substantial value from certain E.C. member states will be virtually eliminated from the U.S. market.

This decision is all the more unfortunate because over the last ten years the Community has adopted a series of difficult, painful and far-reaching measures to restructure its steel industry. Production capacity has already been drastically reduced and is continuing to decline. Official assistance to the industry has been subjected to very stringent criteria and a gradual phase-out which will be completed by the end of 1985.

The irony of this step to impose duties at this time is that it will undermine the Community's efforts at restructuring its steel industry, a goal shared by the United States, whose steel industry is suffering from similar structural problems.

It is interesting to note that E.C. steel exports to the U.S. constitute a mere 5% of the American market. The problems of the U.S. steel industry, in our view, can be ascribed to the U.S. recession, high U.S. interest rates, which discourage investment for plant modernization, and an overvalued dollar, which favours imports. As the New York Times said less than a month ago (editorial on June 18, 1982):

> "No legal or diplomatic maneuvering can solve the industry's fundemantal problems: excess capacity and low productivity."

The impact of this recent decision on steel imports will be the increased cost of steel products to the U.S. consumer and continued deterioration of the U.S. steel industry, which is thus further protected from the need to adjust to world competitiveness.

Many have claimed that this action by the United States could be the first shot in a major trade war among the world's industrialized nations. It is true that no country previously has tried to countervail against the industrialized policies of its leading partners on so massive a scale.

However, while the reaction in Europe has been strong, we will attempt to refrain from actions that would escalate the dispute.

IV. AGRICULTURE

The situation in the field of agriculture is no better. There has been a noticeable heightening of the criticism of the E.C.'s agricultural trade policies over the past year.

The E.C. remains the world's largest importer of agricultural goods, and the U.S. benefits from a $7 billion agricultural trade surplus with the E.C. The E.C. imports from the U.S. such key agricultural commodities as corn, soy beans, and other animal feedstuffs.

Nevertheless, consumed by a seemingly great desire to provide the U.S. farmers with higher prices and larger export markets, some U.S. government officials have 'escalated' agricultural disputes and raised the level of rhetoric, by openly challenging the arrangements of the Common Agricultural Policy. This has been done in disregard of agreements reached in the Tokyo and earlier 'rounds' of trade negotiations.

The E.C. has been attacked for being responsible for the growing difficulties - particularly in export markets - being experienced by the American farmer. It is absolutely absurd to ascribe this blame to the Common Agricultural Policy at a time of world record crops and low world prices for many agricultural commodities and of a spectacularly high value of the dollar and high interest rates internally.

The E.C. in particular stands accused of subsidizing its exports of agricultural commodities, which allegedly reduces the potential access of U.S. products in third markets. The use of agricultural subsidies is permitted by a 'code' negotiated and agreed to in the Tokyo Round of trade negotiations, as long as these subsidies do not entail the acquisition of more than an equitable share of world trade. We have abided by this code.

The United States, by filing an unparalleled number of cases against the E.C. for adjudication to the GATT - for wheat flour, sugar, poultry, pasta, canned fruit, raisins and citrus - risks straining the dispute settlement process.

In addition, perhaps more dangerous than these rhetorical and legal challenges to European policies is what is perceived to be an American preoccupation for altering the arrangements for regulating trade policy.

As the U.S. uses the GATT instruments to seek adjudication of a series of disputes on both industrial and agricultural goods, we find it even more difficult to understand declarations according to which the U.S. would press for a revision of GATT rules, should the cases not go its way. This would set a dangerous precedent for other countries, that in turn could themselves seek renegotiation of GATT rules if future cases went against them. Such renegotiations are particularly dangerous for the preservation of free trade in times of low growth and high unemployment.

At a time when world demand in agricultural products is increasing, how can we tell our farmers that they cannot participate in world trade expansion? This being said, overall E.C. agricultural exports, as a percentage of world agricultrual exports, have risen from 10 to 11% between 1971 and 1980, while the U.S. share went from 14% to 17% in the same period.

V. EAST-WEST ECONOMIC RELATIONS

Another continuing problem in the United States-E.C. relationship is the differing approaches each of us takes vis-a-vis economic relations with the Eastern bloc, particularly the Soviet Union.

The recent decision by the American Administration to place restrictions on the sale of European pipeline-related equipment which contains components manufactured under U.S. license or is produced by U.S. subsidiaries, illustrates the differing perceptions between Western Europe and the United States on how to conduct East-West economic relations.

In the E.C.'s view, this action - taken without consultation with the Community - involves an extra-territorial extension of U.S. jurisdiction which, in the circumstances, is contrary to the principles of international law, unacceptable to the Community and unlikely to be recognized in E.C. courts.

On a more general level, the pipeline 'case' reflects differing approaches of how to deal with the Soviet Union and its East European allies. These approaches differ because the <u>nature</u> of the European relationship with the Soviet Union cannot be the same as that of the United States.

- Western Europe shares the same continent with the Soviet Union and the Eastern European nations;
- While our political ideologies and economic systems differ, we have historical, social and in some cases personal associations with the East which cannot be ignored;
- Finally, our economic interrelationship is more intricate and involves both a wider spectrum and a greater volume of products.

The European view on East-West trade is that severe limitations on trade are counter-productive, economically and politically, and will be hurting those who are imposing them more than those against whom they are imposed.

True, prudence should be exercised when granting export credits and transferring technology to the Eastern bloc countries.

We have agreed with the United States that East-West trade should be of equal benefit to both sides and not result in the transfer of militarily-relevant high technology. Within the COCOM, the Western European allies have demonstrated their willingness to adopt a more restrictive policy vis-a-vis high technology exports to the countries of Eastern Europe.

However, only by maintaining a respectable level of trade with the Eastern bloc can we hope to stabilize East-West political relations and encourage some process of change in Eastern Europe.

VI. EXPORT CREDITS

The issue of export credits at lower-than-market rates has been preoccupying U.S. and E.C. policy makers for many months now. The United States has been pressing for rates that would be close to or equal to market rates.

As you know, the E.C. has recently approved a proposal for a new export credit 'consensus' within the OECD framework that raises interest rates and re-classifies certain countries, including the Soviet Union, in a higher category, putting it in the same category as other industrialized countries.

Let there be no misunderstanding about the reasons for the delays on reaching agreement. The E.C. has not disagreed that present rates should be raised and that there should be a reclassification of certain nations. Our disagreement has rested on the degree of credit-rate increases, the reclassification of some E.C. countries and the need for a transitional adjustment period for some Third World nations.

VII. INTEREST RATES AND EXCHANGE-RATE POLICY

Continuous high and volatile U.S. interest and exchange rates exacerbate many of the trade-related problems confronting the American as well as European governments.

Given the increasing interdependence of Western economies and the still-dominant role of the dollar in international transactions, the fiscal and monetary policies of the United States unquestionably have a direct impact on European economies. European countries have been, and are still today, *de facto* prisoners of U.S. monetary and credit policies. Since 1979, excessively high *real* interest rates in the U.S. have provoked a renewed flow of funds into the dollar. Record-high real U.S. interest rates and the related appreciation of the dollar, while benefiting European exports over time, have depressed capital investment in Europe, and made the restructuring process more difficult.

Of course, the effects on Europe of American interest rate developments and budgetary policy are also a reflection of the weakeness of the European economies themselves. However, the role of the state in Western Europe has always been much greater than in the United States. Budgets have historically represented a larger percentage of GNP; and budget deficits have been considerably larger as well; but their financing created few problems, due primarily to the traditionally high European propensity to save. Because of the tremendous openness of European capital markets, the high U.S. interest rates have created problems with regard to major capital outflows, exchange rate instabilities and balance of payments. As European governments have been obliged to adapt their monetary policies to those of the United States, their scope of action has consequently been significantly limited in trying to start economic recovery and fight unemployment. In addition, as a direct consequence of the U.S. monetary policy, Europe now has, for the first time, difficulty in meeting its financing requirements.

Apart from concern about the high level of U.S. interest rates, there is also widespread concern in Europe regarding the volatility of U.S. interest rates and the effect that it has had in raising exchange-rate volatility. The exchange-rate volatility that we have recently witnessed tends to discourage investment, impede growth, and represents a substantial barrier to international trade. Decisions not to intervene in the financial markets have accentuated this volatility. There have been recent signals, however, that greater U.S. cooperation on exchange intervention is possible, as evidenced by the U.S. intervention last month when the French franc was devalued and the Deutschmark revalued. Exchange-rate stability is an important element of economic recovery for Western Europe and must be achieved.

VIII. UNITARY TAXATION

Another long-standing source of friction in U.S.-E.C. relations is that of unitary taxation. On several occasions over the past few years, E.C. members presented official demarches to the U.S. government expressing their dissatisfaction with the application by certain American states (California in particular) of the world-wide combined reporting method on subsidiaries of European-based corporations. This system of taxation, based on a formula which includes worldwide income rather than income generated within a state, contravenes understandings agreed to by all OECD states (including the United States); is contrary to accepted and honored international understandings that a nation may not tax a foreign company on its worldwide income, but only on income generated within the taxing nation; violates international tax treaties; and is an inevitable source of double taxation problems.

In our view, only the separate accounting, or 'arm's length,' system is fair and reasonable in taxing international business. In addition to demarches earlier this year, the E.C. has urged the administration to support the desire by the U.S. Solicitor General's office to file an _amicus curiae_ brief in the U.S. Supreme Court arguing that worldwide combined reporting is unconstitutional. (We are satisfied with the brief that was actually filed, and we hope that the U.S. Administration will continue to push in that direction.)

The persistence of this taxation system would, in the short-term, have a negative influence on potential European investment in those states that continue to embrace the principle of unitary taxation, and, in the long-term, could not but reduce general levels of investment. Furthermore, outside the United States, possible 'retaliatory' measures by foreign countries or their own political subdivisions cannot be ruled out.

While we understand the motivations on the part of individual states in imposing such a system, it must be realized that Western European governments face the same severe economic constraints on available financial resources. The unilateral application of the worldwide combined reporting system unnecessarily further damages already greatly strained economic relations.

IX. CONCLUSIONS

After having outlined the major problems, it is only fair that I attempt to suggest some solutions.

First, it is important to adopt a pragmatic approach and non-confrontational tone in our relations. This is difficult to do when economic interests are at stake. Yet, I would submit that, thus far, we have prevented the eruption of conflicts in the trade area and the the export credit area. Through the mechanisms of the GATT and of the OECD, we have succeeded in "managing" numerous problems. Granted, the process is currently being severely strained and numerous questions are being raised about the need to alter these mechanisms. What is critical, however, is the need to play by and stick to rules that have been set forth. Otherwise, the potential for chaos is high.

Second, we must address the problems one-by-one, by focusing on the ones which can affect our economic relations most egregiously and which have the best chance of being resolved. Trying to solve all the problems all at once becomes an impossible task and only leads to frustration and failure.

In my view, the steel issue is the one to which the first priority must be given, because the longer a resolution of this problem is not found, the greater are the risks of counter-measures. Our disagreement on the steel trade issue - I am convinced - can be worked out. The E.C. has declared its intention not to retaliate at this stage because of our confidence in being able to work out our differences through mutually acceptable arrangements regarding the amount and nature of steel exports to the United States. Such an attitude is the necessary prerequisite for the avoidance of a trade war between Europe and America.

Third, we must - on both sides of the Atlantic - commit ourselves to broadening and intensifying the process of consultation and dialogue at all levels - including the highest - of government. Over the past few months, high-level officials in the E.C. and the United States have sought to institutionalize the process of discussion and consultation by regularizing meetings among officials. Only through intensified bilateral contacts can current conflicts be resolved satisfactorily.

Fourth, there needs to be a greater sensitivity towards one another's political and economic circumstances in the formulation and implementation of policies, and a greater confidence in one another. This is essential if we wish to have an effective strategy towards the Soviet Union and the Eastern bloc. Our objectives vis-a-vis the Soviet Union are similar. The means to accomplish these objectives seem, more often than not, to be different. Wrong perceptions about each other's motivations create an atmosphere of suspicion and irritation that is detrimental to the transatlantic relationship. Correcting perceptions seems like an impossible task; but it is one that must be done. It is a difficult and often frustrating task and one that will probably take many years to bear fruit; but we must carry on with it today, tomorrow and on every conceivable occasion.

The U.S.-E.C. relationship has been fraught with crises and conflicts among its participants from the time of its inception more than a generation ago. Most of these crises and conflicts have been, if not surmounted, at least handled in such a way as to ensure the continuation of a relationship that has provided a peace and prosperity unparalleled in modern history.

The current continuing economic recession has exacerbated tensions to an unusual degree and has heightened the concern about the long-term health of the relationship.

Yet, while the convergence of so many challenges at the same time may cause us to despair about our ability to reconcile our differences, I am convinced that enough good faith and good men remain on both sides of the Atlantic to refurbish the relationship and ultimately to strengthen it further.