US Multinationals' Shifting Strategy: De-Emphasizing Western Europe

Sentiment toward the euro appears as negative as it has been since the joint intervention a little more than eleven years ago, even if the exchange rate is considerably higher. The net speculative position at the IMM is record short the euro.

US money markets have dramatically cut their exposure to European bank paper. This has been widely reported and has intensified the dollar funding needs of some European, especially French and Italian banks.

When we talk about European banks needing to secure dollar funding, where are they getting those dollars? The recent flow of funds data shows US entities have increased their euro exposure. This does not contradict the bearish stance as US banks were paid handsomely to take on euro risk.

Yes some demand is being met recently through official channels. The Federal Reserve was persuaded to lower the price at which it makes dollar available to a number of central banks, including of course the ECB.

European banks also secured dollar funding by swapping euros for dollars. US banks appeared to have been on the opposite side of this trade. At its extreme, the cross currency swap was 160 bp below 3-month Euribor.

In recent weeks, since the Fed made dollar funding cheaper to access and the ECB pumped in hundreds of billions of euros of liquidity the cost of swapping the euros for dollars has been cut in half. The next flow of funds report may shower slower euro accumulation by US banks.

There is another segment of American investors that have strategically reduced their European exposure and in a way that few have recognized or appreciated: US multinational companies. Over the past decade the value added that US companies create in Western Europe has fallen and in some countries, considerably.

Table 1 Value Added by affiliates of US multinational companies
(Billions of dollars, chain-weighted 2005)

	1999	2009
Austria	2.3	2.2
France	27.2	21.3
Germany	56.8	41.5
Italy	24.3	13.4
Ireland	14.8	20.7
Netherlands	15.9	13.9
Spain	10.8	7.7
UK	58.2	38.0

(Source BEA Nov 2011)

Ireland is the notable exception to the clear pattern. Affiliates of US multinationals, dominated by pharmaceutical and technology companies account almost one fifth of Ireland's GDP. Ireland also has among the lowest corporate tax schedules in Europe, though as we have noted previously, the effective tax rate in Ireland is lower than in France.

Also note that although structural reforms in Germany and its ability to limit increases in unit labor costs makes the country what some observers have called hyper-competitive, the withdrawal of value-added activity in western Europe by US multinationals applies to Germany as well.

This shift from Western Europe appears to be part of a larger strategic move toward eastern and central Europe on one hand and Asia on the other.

Table 2: Value Added by affiliates of US multinational companies (Billions of dollars, chain-weighted 2005)

	1999	2009
Czech Republic	2.5	4.1
Hungary	2.1	4.1
Poland	2.4	5.3
Slovakia	0.3	0.9
China	8.1	40.8
Japan	10.1	15.4
S.Korea	2.4	7.4

(Source BEA Nov 2011)

There are numerous considerations behind foreign direct investment strategies. While taxes are among the most recognized factors, host country/region growth prospects are important as well. Even prior to the crisis, Europe typically grew slowly and the demographic considerations are working against it.

The euro zone is also continues to move toward a financial transaction tax. Given that the US and UK, most notably, but others as well, will not adopt such a tax, the clear risk is tax is passed, more financial services activity will leave the euro area.

The austerity regime being adopted in Europe, partly by command (e.g., technocrat governments in Italy and Greece) and partly as a result of the electoral process (notably in the UK and Spain), looks likely to condemn Europe to a protracted period of slow growth. The population is aging and in some parts, soon to be shrinking.

For more than two decades now more goods have crossed the Pacific than the Atlantic, for the first time in history. Short-term and long-term trends threaten to increasingly marginalize the Western Europe.

When observers talk about the hardships that the euro has forced countries to endure, they may not be fully taking into account some of these trends. A break up of the euro zone into a patch work of different countries, currencies and regulatory regimes would hasten many of these trends toward the marginalization of Europe.

We have consistently argued that the way out of the European crisis will be more integration rather than less. European officials need to reaffirm their commitment to the project. Thomas Schelling, the Nobel-prize winning economist, argued that one way to demonstrate one's commitment to a particular path is to deny oneself an alternative. He cited the example of two people playing chicken (driving car at each other and the first one to turn "loses").

Schelling argued that to demonstrate one's resolve not to turn first, one driver could unroll their window and throw out their steering wheel. In so doing, they are committed to not turning.

This logic though runs contrary to an op-ed piece in the Financial Times recently that advocated that euro zone officials provide a plan for the orderly dissolution of the monetary union. Under the rubric of game theory (a la Schelling) this would send a signal of weakening resolve by European officials. That is among the last things Europe needs.

As Benjamin Franklin told the thirteen colonies on the eastern seaboard of North America is so applicable to Europe today: Hang together or hang separately.

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