

# TRANSATLANTIC RELATIONS: THE CRISIS



**SUMMARY OF A ROUNDTABLE**  
*(Including Policy Recommendations)*

HELD IN  
NEW YORK CITY

**March 20, 2012**

# *Our Mission*

The National Committee on American Foreign Policy (NCAFP) was founded in 1974 by Professor Hans J. Morgenthau and others. It is a nonprofit activist organization dedicated to the resolution of conflicts that threaten U.S. interests. Toward that end, the NCAFP identifies, articulates, and helps advance American foreign policy interests from a nonpartisan perspective within the framework of political realism.

American foreign policy interests include:

- preserving and strengthening national security;
- supporting countries committed to the values and the practice of political, religious, and cultural pluralism;
- improving U.S. relations with the developed and developing worlds;
- advancing human rights;
- encouraging realistic arms control agreements;
- curbing the proliferation of nuclear and other unconventional weapons;
- promoting an open and global economy.

An important part of the activity of the NCAFP is Track I½ and Track II diplomacy. Such closed-door and off-the-record endeavors provide unique opportunities for senior U.S. and foreign officials, think-tank experts, and scholars to engage in discussions designed to defuse conflict, build confidence, and resolve problems.

Believing that an informed public is vital to a democratic society, the National Committee offers educational programs that address security challenges facing the United States and publishes a variety of publications, including its bimonthly journal, *American Foreign Policy Interests*, that present keen analyses of all aspects of American foreign policy.



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## ***Letter From the President***

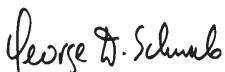
Dear Reader,

On March 20, 2012 the National Committee on American Foreign Policy convened a closed-door and off-the-record roundtable on “Transatlantic Relations: the Crisis.” The conference organizers were: Bernard E. Brown, professor emeritus of political science at the CUNY Graduate School, and director of the Transatlantic Relations Project of the NCAFP; and Ambassador Herman J. Cohen, former Assistant Secretary of State for African Affairs, and a member of the Transatlantic Relations Project of the NCAFP. The morning workshop on “NATO: A New Realism” was moderated by Ambassador Donald Blinken; the afternoon workshop on “Euro Crisis and its Implications for Transatlantic Relations was moderated by Ambassador Herman J. Cohen. Speakers and discussants included two former U.S. ambassadors to NATO, a Danish economist now based at the Peterson Institute for International Economics; and numerous specialists on transatlantic relations and international economics. A list of speakers, discussants, and observers is appended to this report.

In early 2012 the transatlantic relationship was being severely tested by the conflict in Libya and the tribulations of the Euro currency. France and the UK, assumed a leading role in Libya; but the defense structures so laboriously built over two decades by the European Union were totally absent. At the same time the integrity of the common currency in the Eurozone (17 of the 27 members of the EU), and the viability of the European Union itself was threatened by a series of deep financial crises in Portugal, Ireland, Italy, Greece, and Spain. Serious questions were thus raised about the resilience of decision-making processes within the European Union in both security and financial domains. The underlying links between North America and Europe were also at stake.

The frank discussion among practitioners and specialists on both NATO and the Euro crisis are summarized and edited by Professors B.E. Brown (Part I) and Giuseppe Ammendola (Part II) in this (not-for-attribution) report. On behalf of the National Committee on American Foreign Policy I wish to thank a donor, based in a New York financial institution, who wishes to remain anonymous for a generous grant making this conference possible. One of the main speakers in the conference alluded to the vital role played by leading New Yorkers in finance, business, law, and universities in saving the country after World War II. They helped imagine, create, and implement the Marshall Plan. Their contributions, he said, illustrated the importance of collaboration between government and civil society, in symbolic terms between Washington, DC and New York. Perhaps, he suggested, the energy and creativity in this city again can be mobilized to help serve and save the country. I am pleased that our conference ended on this note.

Sincerely,



George D. Schwab

## **Part I**

**O**n March 20, 2012, a conference on “NATO: The New Realism” was convened by the NCAFP. Participants included two former U.S. ambassadors to NATO and more than a dozen academic specialists on NATO and transatlantic relations. Ambassador Donald Blinken moderated the session. In his opening remarks, Ambassador Blinken called attention to the need for a new definition of security and a new relationship between the United States and the European Union.

To help structure the discussion, two NATO experts made a few general comments. The first speaker called attention to the need for a clear concept of who (the United States or Europe) does what in transatlantic relations. He emphasized the importance of bringing the Afghan conflict to an acceptable conclusion and the importance of a shift from a purely military to a comprehensive approach, including the nonmilitary—which must be the future of NATO. More than ever, we must work on closer U.S.–EU relations and for the United States to provide more assertive political leadership within NATO. The second speaker said that NATO has always been in crisis—this time the crisis really is different. Although in a time of austerity budgets must be cut, withdrawing too many U.S. forces from Europe would be a mistake. He called attention to issues confronting the West today that will not be on the agenda at the Chicago summit scheduled for May 2012. These include: Syria, Iran, and the Arab Spring. The overriding issue remains how the United States and Europe together can deal with the world.

In the lively session that followed, a number of major topics were discussed. They are summarized below.

### **How to Increase Support for NATO?**

The discussion opened with a question by a participant. He pointed out that the American public does not appear to have a great interest in NATO. In a poll in the 28 member states, support for NATO was lowest in the United States compared with the other 27 members. How can we make NATO a more prominent issue for discussion, whether inside or outside of the coming presidential campaign? National security issues continue to be debated by editorialists and experts, but are not a subject of concern or do not arouse curiosity at the average American or European dinner table. What should our leadership do to try to show the American public the vital importance of NATO?

One NATO expert replied that what was just said about NATO could be said about any foreign policy issue in the eyes of the American public. Little attention is given to foreign policy. It is hard to think of innovative ways of dealing with the problem and, while a cliché, the problem does appear to start at the top. If our political leaders and candidates talk about what is important in foreign policy, they send a signal. Most people do not know very much; but they are willing to be persuaded by those who are knowledgeable about and committed to advancing U.S. foreign policy. When explaining foreign policy to the public, we should speak in terms of values, strategies, and alliances. Our thinking about foreign policy should start with values, then move on to the need for a strategy to advance those values, and then should introduce or reinforce the idea that U.S. interests are served by working together with allies.

If our leaders link foreign policy to their philosophy, a lot of people would give them running room. In the absence of such leadership, most people do not understand our government's actions and cannot answer foreign policy questions; for example: Why do we spend money on Afghanistan or why do we give foreign aid? Most people in the United States are mainly concerned with domestic problems.

The second NATO expert agreed, adding a few examples to the argument. Hillary Clinton recently talked about a “pivot to Asia.” A pivot needs a base as it swings around; our base is the Europeans. But Secretary Clinton barely mentioned Europe in her speech and made no mention of NATO—as if it did not exist. The military is turning its attention to Asia because that region is now a focus of public interest. One great advantage for the military is that most of the burden of strengthening defense in the Pacific falls to the Navy. There is no need for a massive army in the Pacific, and the American public has no appetite for suffering casualties in another land war. Yes, it starts from the leadership, which now is thinking about domestic politics and the need to slash budgets. We need affirmative leadership and new thinking—perhaps by individuals outside of Washington—in the NGOs, for example.

### **Lessons from Libya**

Another participant referred to comments previously made about the need for a new definition of security and a new relationship between the United States and the European Union. He agreed, especially in the light of the use of force in Libya in 2011. The most important event in the Libyan war was a non-event, he argued, something that did not happen. France and the UK took the lead in that war; the foreign policy and defense structures so laboriously constructed by the European Union were totally absent. Advocates for the creation of an autonomous European power (“puissance”) were shocked and many are now in despair. This is evident in recent commentary by Nicole Gnesotto, former director of the European Union’s think tank on security and foreign policy and poet laureate of l’Europe puissance. There are good reasons why the EU was absent in the Libya operation. First, the UK made clear that it would not participate in this military operation if EU institutions were involved. Those institutions were denounced as “paralytic” and inducive of paralysis. A coherent foreign policy backed by force if necessary cannot be made by 27 states. The UK had already stated this position in announcing the Lancaster House agreement of December 2010, which endorsed a far-reaching coordination of British and French military forces. This bilateral agreement, it declared, was to be implemented totally outside of EU defense structures. Second, Germany was flatly opposed to the Libya intervention, hence the EU could not have participated in any case. The British defense minister, Liam Fox, declared subsequently that pacifist sentiment is pervasive in German political parties and institutions. Accordingly, the UK cannot count on Germany as a reliable partner in military operations. Other nations (notably Italy and even Sweden), as a condition of their participation, insisted that the operation be conducted through NATO, not the EU. What is happening to the European pillar of the Atlantic Alliance, what should be a realistic relationship between NATO and the EU?

Coinciding with the Libyan war, this participant continued, was the crisis within EU institutions in dealing with the tribulations of the euro currency.

Seventeen finance ministers of the euro zone along with finance ministers of the other 10 members of the EU were meeting weekly trying to determine how to fix the common currency. The two crises—Libya and the euro—raise fundamental questions about the viability of decision-making processes in the EU as regards defense and economic governance. The problem in working out a new relationship between the United States and the European Union is that the EU is not a state. To use the term popularized, if not coined by, Jacques Delors, former head of the European Commission, the EU is a “fédération des états-nations”—a federation of nation-states. Federations are often expert at creating a single market; they do less well in creating and managing a common currency; and they do poorly in formulating a common foreign policy and amassing armed forces to back it up. So long as nation-states with diverse interests remain the key players, this participant concluded, how does the United States work with a European Union that is a strong partner in economic matters and a very weak partner (and likely to remain so) in foreign and defense policy?

A NATO expert said that he was not worried about this problem. NATO and the EU have run into the same problem, namely, the European governments are not meeting their responsibilities. The United States has had a hard time persuading the Allies to budget 2 percent of GDP for defense, to get them involved in operations, and to remove caveats from deployed forces. The EU has the same problem trying to do this under the Common Foreign and Security Policy (CFSP). It is not an EU problem; it is a European problem. Defense capabilities are inherently national assets—not EU assets. All this talk about CFSP has not really been about a single European defense capability. Discussion has been about planning staffs, operational headquarters, and civil and military crisis management working groups. Although it is all excuses instead of capabilities, he would not toss it aside as an issue. If the Europeans can produce capabilities, which they are not doing, they can organize them in any way they want. They can do it through the EU and we can work with that, or they can do it through NATO and we can work with that. If they want to organize bilaterally, we can work with that. The real issue is being competent and capable on the defense front—but they do not want to do it or put up the money right now.

Another NATO expert said he might start by saying, so what? When we (in NATO) first started work on building a relationship with the EU, they were two institutions in the same town on different planets. We're beyond that now. At first, NATO policy was highly negative on the EU doing anything significant in military affairs. We had to have central management of the Cold War in dealing with the Soviet Union. We wanted the EU to play an effective military role provided it did what it was told. When the Soviet Union disappeared, so did the need for centralization. The U.S. government took a while to catch up. If Europeans want a “United States of Europe,” the last thing they will get around to is defense (because people can get killed)—the next to last thing is foreign policy. It is a long time off. If they want to spend money on foreign affairs, that is a great thing.

He continued, alliances, including both NATO and the EU, do not have military forces. Countries have military forces. All NATO owns is a bit of real estate, a pipeline, and a few aircraft—the rest belongs to the Allies. When it comes time to do something, NATO sits down and says “Who can give me this, who can give me that?” If anybody decides at some point they want to pull out,

they can pull out. But one of the striking things about NATO is whenever a decision has been made by consensus, nobody has ever gotten off the bus. Ever! No one wants to establish a precedent. This NATO expert is delighted to see that the European Union isn't nudging us the way it used to about whether NATO or the EU has primacy. In part the French finally came to understand that they were not in the game unless they got back into Allied command operations. De Gaulle had withdrawn from Allied command operations to deal with his "German problem." Foreign policy for France was all about Germany then and is still. You talk about the Brits not wanting to deal with Brussels on defense. That's part of the competition between Britain and France and Germany. Right now, it is Britain and France versus Germany on defense. Britain's basic grand strategy is to have a small NATO so it would work and also to stop enlargement in three countries—Hungary, the Czech Republic, and Poland—plus throw in Slovenia for icing on the cake and then stop. Britain wants a large European Union so it won't work. That Britain does not want to work through Brussels is not of great concern, however. But the EU does smaller military operations very well, for example, Bosnia. The EU should be doing even more in North Africa because these are essentially nonmilitary operations. Now, if for reasons of morale, the French want to have something they can run and push on the military side—that's fine! If they assume leadership positions maybe they will contribute more. But where we really need their help is on the nonmilitary side. That is why we need a new Atlantic Charter.

Concerning relations between NATO and the EU, the same NATO expert continued, someone has got to put serious pressure on the Turks. When the president went to Turkey he used his influence with the Turks to get them to accept Anders Rasmussen as NATO Secretary General despite the controversy over the Muslim cartoons. President Obama should have added a demand that they find a way to stop Turkish opposition to collaboration between NATO and the EU as their way of protesting admission of Cyprus to the EU. Another problem involves intelligence: if a member of the NATO forces or organization has a piece of intelligence that he wants to share with his EU counterpart across the hall, communication must go through national capitals. That is ludicrous—lives are lost that way. We have to look at the total situation of the EU. The European Union does very well on finance and trade—here is where we should expand our mutual dealings. When the transatlantic relationship was created after World War II, it was done as much in New York City as in Washington. Bankers, businessmen, and others who understood the importance of finance and the economy in national defense were involved. The Marshall Plan was also about giving the United States access to European markets and trade and establishing a viable Western economy. Only later did it become a tool for dealing with the Russians. NATO was formed more or less for the same reasons that years later Central European countries wanted to join after the collapse of the Soviet Union: to give people a sense of security in the future with U.S. commitment so they can get on with the business of life. That is where we need to be working together to shape the world including, frankly, the defense of our democratic values.

### **NATO, the EU, and Russia**

A participant with a special interest in Eastern Europe brought up the problem of dealing with Russia. In his opinion, we should not be concentrating so much on defending Europe from Russia as the possibility of a Russian army invading

Europe is most remote. Rather, our concern should be to bring Russia closer to Europe—the central desire of progressive Russia. The goal should be to Westernize the country.

A NATO expert agreed completely. Russia is not, in any perceivable time frame, a threat to Europe. We want to see Russia come closer to Europe not just in terms of relationships but also in values, democracy, freedom, human rights, and cooperation on common issues. How to go about it? Focusing primarily on the relationship with the Russian leadership, which is antagonistic to all of these, is a mistake. We should emphasize the direction that Russia needs to go as a society and work with the Russian people. If we miss that opportunity, we end up being seen as on the wrong side in Russia and actually seeming to support the contention of their antagonistic leaders that we are against them.

Another NATO expert added that the time has come to repeal Jackson-Vanik. Twenty years ago, he argued for the instant inclusion of Russia in the World Trade Organization even though it might not have met all the standards. Neither does Georgia and it is a member. This would be a way of integrating Russia and its peoples into the Western world at the human level.

### **Are the U.S. and Europe Pulling Apart?**

A participant pointed to a basic deterioration in the attitude of the American people toward Europe. Euro-centric courses in an American university are not politically correct. No American university gives a course in Western civilization anymore—the teaching has to be on world civilization. Courses on European languages are disappearing. In the wake of 9/11, airport security was increased. To avoid the charge of ethnic profiling, Europeans are given an especially hard time, causing understandable resentment. Universal health care is denounced in the United States as European socialism. The term “European” is constantly used in a negative way. None of this supports a normal relationship between Europeans and Americans.

A NATO expert considered this to be a profound insight into the difficulties we have in relating to Western and other civilizations. He agreed that overly zealous security procedures, especially at airports, are creating widespread resentment among Europeans and other visitors. If you are coming from a Third World country, you may put up with it. If you are a European, you are going to be outraged. We are supposed to be sharing a common civilization, including civil liberties and democratic values. If anything, the Europeans are better at promoting democracy in the world than we are.

### **Global versus Regional Strategy**

A participant with research interests in Africa raised a general question: Should the focus of strategic policy be global or regional? In the Eisenhower administration, experts were asked what Africa was going to be like when all those colonies became independent. The answers were pessimistic, with the experts predicting a great deal of instability. Eisenhower then put in writing a commitment that we will never deploy NATO in Africa. Stability in Africa must be achieved by Africans themselves, with the help of the United Nations. In Africa today, Africans are engaged in stabilization operations under the auspices of the United Nations. Are we not moving now, in the absence of a big strategic threat, to the regionalization of stabilization? Turkey is playing a leadership role

in Syria that is hardly less effective than any policy we might adopt. Negotiations on Middle East issues are taking place in—Doha! In Latin America, Brazilians are currently the leaders. Isn't this the way to go? In the absence of an overriding external strategic threat, why not have each region deal with its own problems? Those who really care about Afghanistan are in Iran, India, Pakistan, and China (which has mining interests in Afghanistan). Why aren't they taking the lead in solving Afghanistan's problems? The bottom line question is: Where is it written that American leadership must be everywhere?

A NATO expert agreed that many problems could and should be handled regionally. Many problems are not about military intervention, but are about economics—much better handled by the private sector and NGOs. He opposed, for example, the creation of AFRICOM (U.S. Africa Command), which was originally run out of Stuttgart because office space was available. Creating AFRICOM gives the impression that the emphasis will be on military solutions. This is a big mistake. But when it comes to actions that nobody else would take in some parts of the world, the United States must take the lead. In Africa, particularly, he is glad to see we are not in the lead. Libya is a question mark. American policy, to sit out most of it, may affect how we will be perceived when other big problems arise closer to Europe. That debate is ongoing.

Another NATO expert said his response to the question about regionalism would be: "Well, how is that working out?" Darfur is not a good example; Rwanda is not a good example; Afghanistan, throughout its history, has not been a good example. He thinks we have to consider: "Can we get a better outcome by being involved?" In Syria, without the United States playing any role, where are we? We have 100 U.S. military advisors in the Eastern Congo trying to go after the Lord's Resistance Army; he and a lot of other people are glad that we do. He thinks a U.S. role in trying to put our hand on the scales to tip them toward an outcome that is going to be better for people and better for our own interests is the right thing to do. This kind of intervention, however, should be separated from NATO's main job. The only thing that NATO has done in Africa is to transport African Union troops to Darfur for a very short period. The Europeans do not want NATO in Africa because they view it as a former colonial domain of some 7 countries of Europe before the union. We lost support for NATO missions abroad because of discontent with our own expeditionary roles. He believes that NATO should focus a little bit more on Article 5 but broaden its vision about the nature of the threats. NATO should, in his opinion, focus on energy independence, cyberspace, and terrorism and rely less on expeditionary missions. We should also recognize that effective coalitions will not necessarily be U.S.–European only. NATO's operation in Libya is an example: 30,000 feet in the air and to protect civilians. The real (ground) operation was undertaken by an effective coalition of the UK, France, the UAE, and Qatar, with Armenians training Libyan rebels. In the future, coalitions that deal with regional crises may involve many different actors, including NATO.

The previous NATO expert added a comment on Libya, observing that the NATO command structure is what enabled the allies to pull together. A European or bilateral command structure would not have been effective; indeed, it did not really exist. The habits of working together over the years and creating interoperability were absolutely critical. Although not wanting to sound like an isolationist, he does think that doing zero-base analysis of U.S.

interests in the world to determine which might be significant enough to use military force to protect would be reasonable. Then, if a compelling argument cannot be found, make non-intervention by armed forces the norm. We now have advisors in every part of the world because for many years the Pentagon had all this money to spend. The one exception this expert would make would be to offer education to and maintain relationships with military officers in those parts of the world that might be important in the future. One reason Egypt came out positive, at least in the beginning, is that the U.S. military had an established relationship with the Egyptian military. One reason Pakistan is going so badly is that Congress has determined that we can have no relationship with the Pakistani military because of Pakistan's nuclear weapon program. In his opinion, the British do a better job. But you've got to pick and choose—and he was against the creation of AFRICOM for that reason: once you create something like that somebody will want to push it.

A participant then asked: Are you saying that the United States is still indispensable for regional stabilization? One NATO expert agreed, saying that we are the big kid on the block; rightly or wrongly, people look to us to lead, to take action. We are the target and aspiration of everybody else's policies.

The other NATO expert said that such indispensability holds true in some places more than others. He also hates the word "stabilization." Instead of asking the Europeans to put 2 percent of GDP into defense, ask them to put X percent into security and define security in the broadest way. He stated that the Europeans did a tremendous job contributing to security in Central Europe, way beyond what we did. The German expenditure in the eastern part of Germany was something like 100 billion marks a year for 10 years. Let them structure their forces to do what is needed where they are involved and we are not. The United Nations has kept us Americans from having to put lives on the line in many different parts of the world. So, a lot of people are contributing to security. If they need some American airplanes to fly from here to there, they can get it. In the Berlin Plus agreement between NATO and the EU, NATO will provide its assets to the EU. What it meant was transport, with U.S. aircraft going to work for the EU. It did not mean some coalition of NATO aircraft (which does not exist).

A participant asked what percentage of the NATO budget is paid by the United States. The answer is about 70 percent. One NATO expert pointed out that the U.S. defense budget is three times that of the other allies put together. The other NATO expert added that is a global U.S. defense budget—it is not just about defending Europe. If you make that adjustment, Europe has about two million men and women on the ground and they spend about one-third as much as we do. That is large contribution but is structured incorrectly. Nevertheless, the matériel and people are there.

#### **Article 5: What Does It Cover?**

A participant related that her students asked a question about Article 5 that she could not answer. When Estonia was subjected to a cyber attack, why did NATO do nothing under Article 5?

A NATO expert explained that Article 5, as written, refers to an attack on the territory of a member state of NATO. Over time, we have broadened its meaning and scope because the nature of threats has changed. The first step was to decide

that NATO could engage in “out-of-area” operations in Bosnia and Kosovo, which were not the territory of any member state. After 9/11, we ended up in Afghanistan, deciding that threats must be dealt with wherever they arise. Then we added successive strategic concepts, points about energy security, cybersecurity, counterterrorism, and missile defense, and other ways in which our societies have to be protected. In reality, we have never really internalized the idea that a cyber attack is like an Article 5 attack. Assigning accountability for a cyber attack is difficult—troops are not crossing a border. Everyone believes that the Kremlin authorized the attack on Estonia, and it was carried out by Russian intelligence or organized crime or both working through relays around the world. If you actually look at the record, most of the attacks against Estonia came from the United States, where servers had been commanded to route communications back to Estonia. The attack was not actually targeting a government entity, rather it was a denial of service attack accomplished by overloading the circuits. What kind of response can be made? Do you launch a military operation because of a cyber attack? Would you attempt a “counter cyber attack” against states when you cannot prove that they are the ones that did it? The whole idea of an offensive cyber capacity makes a lot of allies very uncomfortable. So, it gets into this gray zone as to what you would really do. A clear-cut example of a cyber attack was the Russian military invasion of Georgia, when they also attacked the Georgian government websites. In that case, the electronic world experienced an attack parallel to a ground military attack. But, in the case of Estonia, it is not so clear. To this day, NATO does not really have a policy on cyber attacks. We say we have a policy. It is in the strategic concept. But in reality, we do not.

Another participant said that the National Committee is considering establishing a project on sovereignty in relation to cyber issues. Where are the borders? How should American foreign policy be formulated as a consequence? Is this a legitimate issue for us to get involved in and how should it be done?

A NATO expert replied that this is a really hard question. Cyber attacks occur in different ways—the issue for cyber is that policy must be technology driven.. Service can be denied by overloading a system; attackers can get into our system and steal data or insert malware. Responsibility for putting safeguards in the production and procurement process must be assigned somewhere to prevent all forms of attack. For example, a cyber attack could take down the power grid on the whole East Coast of the United States. The question is why would you build your power grid with that vulnerability? Why not make sure this cannot happen? Standards to reduce vulnerability are vital, thus responsibility (and authority) must be clearly assigned to specific government departments and individuals within those departments.

An international organization for cyber security does exist and it tries to set standards for systems. But China often builds bugs into the equipment that we buy because it is cheaper. On the international level, we should develop best practices and keep exchanging ideas with other countries to come up with better models. We should develop industry standards through an international organization to prevent computer “infections” and then conduct random inspections. We also have to have a response capacity so denial of service (DOS) attacks can be stopped before they get a firm hold on nation’s computer infrastructure. For example, in the case of Estonia, alternative servers could have been labeled “Estonia” so that information could have been routed differently to

get around the relays causing the DOS attack. We can also set up a dead end so that attempts to take over servers are prevented. We should start at home first—which we have not done.

For another NATO expert, the first thing is “Don’t panic!” Second, decentralize by offering more alternatives. Many people are working to prevent any single cyber incident from having crippling effect. In addition, important data should be backed up in remote places.

Another participant raised a larger question about the meaning of Article 5. Suppose, he said, Estonia is attacked by Latvia. Some member states might say yes, we will attack Latvia. The overwhelming majority might say they are not interested. Or, it could also be that nobody is interested. So, what is the validity of Article 5? Is it propaganda or is it more than that, less than that?

A NATO expert replied that Article 5 is a political commitment of American strategic power to Europe and one that establishes that we would not be dragged into any war alone. Article 6 defines where Article 5 applies: territory of the member countries north of the Tropic of Cancer. The United States insisted on this parallel so that we would not get dragged into colonial conflicts. Algeria was originally part of NATO. When it became independent, a codicil had to be added to remove it from NATO because it had been part of metropolitan France. The basic point is that Article 5, which has only been invoked once, has never been violated nor has any country backed away from it. Nonetheless, the NATO expert felt that some controversial situations might justify the use of Article 5, giving as an example the possible membership of Ukraine and Georgia in NATO. Rather than have these two countries prepare membership action plans, those attending the Bucharest summit decided to delay a decision by saying simply that Georgia and Ukraine would both become allies. He protested when that happened, saying “You just committed yourself to their security under Article 5. But you do not mean it.” Two heads of state reacted as he had. Saakashvili of Georgia decided to poke the Russians with the end of a sharp stick, and Putin decided to poke back. When that happened, not a single ally was willing to come to Georgia’s defense. So, when you give that commitment, you had better mean it. Everybody knew when we said we will defend Hungary and, later, Latvia and others, that we meant it. The U.S. Congress held a full debate that made clear that an attack on Hungary would be considered to be an attack on the United States and we would take appropriate action. Nobody has ever tested that commitment. He related a story told by a former chairman of the Joint Chiefs who had a conversation with the last general at the head of Soviet armed forces. The American general asked the Soviet general why they never attacked NATO or any of its member countries. The reply, “Because we knew if we attacked one, we would have to take on all sixteen.” Was the American commitment to defend Hungary and, later the Baltic countries a bluff? asked the NATO expert. He has no idea; but Article 5 worked. That is why you have to be extremely careful about making that commitment. And, that is why he does not like the idea of further NATO enlargement—it has already become quite unmanageable. He continued that some of the countries that might have a problem in the future, none of which do now, are outside our concerns. We went into Bosnia without it being in the Article 6 area and into Kosovo, which was part of a sovereign state. NATO expansion in Central Europe was done in recognition that, for these countries to have confidence that they would no

longer be playthings of a greater power, a strategic commitment was required from the United States and hence of NATO. At the time, we thought these countries needed the Partnership for Peace and the European Union, but not NATO. But then they said, "If you take into account our history, you would want the American strategic guarantee." And we said, "OK! You are right." The question now is: Would you want to enlarge NATO more?

Another NATO expert replied that, yes, he wanted enlargement to continue. First, he clarified a few points. Article 5 is a commitment to consultation, not to action. It is now understood to mean that an attack on one is an attack on all and should be met with a response, but not necessarily a military response. It is made practical by planning what to do to defend NATO territory and for conducting military exercises. Until 1989, the commitment to a massive NATO response to military attack was solid. After 1989, and with the admission of Poland, the Czech Republic, Hungary, and others, we gradually stopped talking about Russia as a threat. Therefore, we did not plan or conduct exercises to defend them. That allowed questions to arise about the current meaning of Article 5. The Baltic states had a great disagreement with other allies because they wanted defense plans to say what we would do if they were attacked. The NATO expert, who was Ambassador to NATO at the time, said, "Absolutely! We ought to have defense plans." That's what NATO is there for, he continued, to do planning. We needed a few more years of pushing the other allies until we finally got it done. Now we have plans to back up what is otherwise just another paper political commitment.

He disagreed with his colleague, the previous speaker concerning the way in which the events of 2008 are read. He was also concerned when it was announced that Georgia and Ukraine will be members but for different reasons. We had always told countries interested in joining NATO that they are great candidates, gave them a list of the reforms you must make, and provided a second list of other requirement to be a member. The invitation to membership came at the very end when they were as ready as they would ever be. We never made a commitment in advance. In Bucharest, this process was upended. For Georgia and Ukraine, we put the cart before the horse. We were unwilling to give them a membership action plan to help them get ready and reform. We said up front, "They will be a member of NATO." How can we commit to them if they have not done everything required? That statement, however, did not mean that either is a member of NATO; in addition, nobody thought a defense commitment had been made to Georgia or Ukraine. He did not believe Saakashvili thought that—many people were on the phone telling him he was on his own and that we are not coming to help him out. This NATO expert is quite confident that Putin did not think NATO had made an Article 5 commitment. Otherwise, he would not have invaded. This NATO expert believes it was a mistake to announce that Georgia and Ukraine would be members, but not for the reasons given by the previous speaker.

As for further enlargement, this NATO expert agreed with his colleague, the previous speaker that a Europe whole and free has been a driving force for good in the development of the Euro-Atlantic area for decades. But we are not done! Numberless citizens of various European countries are not living in free societies, are not living in market economies, and do not have adequate security for their future. They have every much a right to that as the rest of us. We have to keep working at that. Does it mean that you invite Georgia to join

NATO today? No—but it does mean that we must keep the momentum going forward in that direction. The country that is doing the best is Montenegro. Were it a bigger country (Montenegro's population is 600,000), a case could be made for a one-of-a kind enlargement. Montenegro is already in a membership action plan. But if you solve the Macedonian name issue, or if Serbia and Kosovo work out their problems, we are going to see a membership action plan for Bosnia soon. Croatia's impending EU membership has given rise to some political developments in the Balkans. He ended by saying that enlargement cannot be considered to be over because he would not want to consign those in Europe who did not happen to be in Poland or Hungary to a second-class security and political status.

A participant asked, how do you justify saying you want to get closer to Russia when you attack the Russia near-abroad? When you offer Georgia and Ukraine NATO membership, it has to be considered an attack on Russia.

A NATO expert totally disagreed. Georgians and Ukrainians get to make their own decisions. Does Georgia want to be under Russia's thumb forever? Decidedly not. Do the Ukrainians want to be under Russia? Here, the people are divided, with some wanting independence and others feeling that Russian sovereignty might be desirable. The Azerbaijanis certainly do not want to be under Russia.

A participant asked what this has to do with NATO? In response, the NATO expert observed that NATO is a collective defense club—everyone looks out for each other, so everyone knows they never again have to worry about their security. Many of these countries, whether Hungary, Poland or the Baltic states, were Russia's satellites for forty years; they want to maintain and continue their independence, their sovereignty, and their integrity. If you are up against or next door, literally and physically, to a big country like Russia that has invaded and taken over your land before, you want to make sure it cannot happen again.

Another participant said he agreed in principle. But he asked whether that is how the United States sees NATO's function? That is, to defend Georgia and small countries against Russia. It might not be in our national interest. The NATO expert responded that that was why NATO was created, except that the countries involved then happened to be France, Germany, the Netherlands, and the “big country” of Luxembourg.

A participant from Latvia disagreed with assertions at the beginning of the session that a crisis exists in the transatlantic relationship. The crisis is mainly about the euro and finance. The term “crisis” would please our Russian “friends” who want NATO replaced by their proposed new European security architecture; he hopes this will not happen. The challenges to NATO are related to the transformation of the countries already within it and also candidates for membership. For Latvia, NATO has always been the heart of the security issue and is, unquestionably, the major factor in assuring security for the Baltic States. This Latvian participant continued, our internal transformation met the requirements for membership in NATO. These requirements have to be kept in place through the Partnership for Peace and membership action plans. A country transformed mentally and economically can then be a strong and good partner within NATO.

This Latvian participant continued: as for contingency and defense plans, we

pushed our American friends primarily and the British very hard to get them. We knew that within NATO many members were not eager to put anything in writing about defense of the Baltic states. But, even if you say publicly that Russia is no longer a threat, it is still a question. We finally ended up with planning, military exercises and accords on transformation of infrastructure within all three Baltic states. The military exercises should be taking place more often—that gives a push to the country. Awareness of a NATO involvement that shields from direct Russian threats enables our country to develop even in the face of indirect threats like the totally unnecessary violations by the Russians of our airspace. Nobody knows why they are doing this. It is important that NATO maintain air surveillance of the Baltic airspace and also continue to provide economic and financial support for transforming these countries. We have achieved some agreements on funneling supplies to Afghanistan through a northern route involving Russia and Kazakhstan. Possibilities are thus created for increased economic development. As for Georgia and other countries, the possibility of membership is absolutely crucial for their own internal changes to be effected. NATO has a much broader and stronger role to play even today in the Baltic and in engaging Russia. On the basis of our experience, we totally support NATO enlargement when and if candidate countries are ready. We have done our homework and we ask others to do the same.

A NATO expert thanked the Latvian participant for giving his perspective as it helps to throw a number of issues into relief. One reason for the admission of the Baltic states to NATO is an accident of geography. They are contiguous to many areas that are important to a number of allies. Georgia is not so fortunately geographically situated. As we demonstrated regrettably after the pledge made at Bucharest, nobody feels that strongly about Georgia. Yet the Russians paid a high price for what they did in Georgia, losing a lot of trust. Some European countries were stronger supporters of the Baltic states being admitted to NATO than was the United States. At the Madrid summit in 1997, in a small meeting in which the final decisions were made, the Americans opposed any mention of the Baltic states. The Danish foreign minister said “No mention of the Baltic states? No agreement! Failed summit.” The Americans had to back down. The reference was made because a European foreign minister demanded it.

The Baltic countries earned their way in. Georgia really has not. Latvia made a superb presentation of its membership action plan—much better than that of either Estonia or Lithuania. It demonstrated that Latvia was taking the actions required of an ally. Also, the United States never recognized the incorporation of the Baltic states into the Soviet Union following the Molotov-Ribbentrop pact. For geographical and historical reasons, the Baltic states are very different from Georgia.

He continued: some similarity exists here to the Berlin airlift during the blockade. Berlin was absolutely indefensible, but the Soviet Union was led to believe that if they touched Berlin, they touched everything else. We have done a lot to indicate that if you touch Latvia, you are touching a lot of other areas. That is why many countries are keeping airplanes up over Baltic air space continually. The NATO expert then recounted an anecdote to illustrate why there may still be reason for concern. In the early 1990s, he was invited to attend a meeting of the Latvian foreign policy association in Riga. Everybody in the Latvian establishment was there—including the foreign minister. The speaker was a high-level Russian diplomat. At the insistence of the Latvians, the

proceedings were conducted in English—even though everyone in attendance spoke Russian. The Russian diplomat told his audience that the Latvian economy depends absolutely on Russia and not to even think about joining NATO. He reminded them that Russia is a nuclear power and they are nobody. The audience pushed back, and the NATO expert decided to intervene. After greeting the Russian speaker, whom he happened to know personally, he laid out the policy of the United States regarding Latvia. As late as several years after the collapse of the Soviet Union, Russians continued to engage in blackmail and intimidation, considering the Baltic states as part of their near-abroad, their backyard. They did not understand then, but they understand now. They would be smart to follow the lead of the Baltic states in terms of their economy. The areas of the Russian Federation that are closest to the Baltics are doing much better than the rest of the Russian Federation. Estonia, for example is one of the most wired countries in the world. To come back to Georgia, the Article 5 commitment is meaningless until you get a country transformed to a point where the allies are willing to back it up as we now are with the Baltic states.

Another NATO expert protested that this was putting it backwards. Article 5 is meaningless when you do not back it up. You do not give anyone an Article 5 commitment until the allies are willing to back it up. Then you have to make a judgment: Is it something that is reasonable to do or not? Suppose that a candidate country meets NATO requirements, develops its democracy and security, and contributes to a wider community. Is the commitment worth making or not? The only difference described by the previous speaker between Georgia and Latvia is geography and the state of Georgian reforms. His colleague replied that they disagreed on one point: when NATO said that Georgia will become a member of NATO, the allies had to be ready to make a firm Article 5 commitment—they were not ready. Saakashvili tested it and came up short. No, replied his colleague, we did not say they are a member of NATO, we said they will be. But they're not, and if you're not, you're not. The previous speaker countered that we have not said that to any other country.

Another participant related that when the National Committee went on record supporting the enlargement of NATO, including the Baltic states, the honorary chairman at the time was George Kennan, who advised against it. "Why," Kennan asked, "do you want to stick it in their eyes?" We argued that it was in our national security interest, but he was not convinced.

One NATO expert said this is another reason to try to engage the Russians in the outside world far more than we are doing. The basic reason Russia is supporting the northern route into Afghanistan is the drug problem; the two countries that suffer the most are Russia and Iran—far more than anybody else. That is why sticking the Russia in the eye on missile defense is a mistake. We have, as a government, failed to surround missile defense with other things to do with Russia through NATO. We just have not done it.

One participant asked whether NATO expansion has not given Putin the nationalist card to play in internal politics. Or is that not relevant at all?

One NATO expert replied that Putin could play it but he understands that other countries have joined. It is a fait accompli. Many played politics with Yalta and China for years, but they eventually understood that it was too late for that. We should try to parlay the nationalist card into something else—helping Russia to

enter into a positive economic relationship with the outside world that it still desperately needs.

Another NATO expert agreed. Why do we not have more NATO–Russia cooperation? In a word, Russia. NATO has been putting itself out there for years and Russia does not want to engage. Part of the reason is that they want to maintain an enemy image because it serves domestic interests and justifies clamping down on dissent.

A participant asked whether NATO has any common policy about the quasi-states located in Europe or just on the border of Europe, for example, Abkhazia, Nagorno-Karabakh, and North Cyprus. Or is each one being treated separately?

A NATO expert replied that NATO does not comment on these matters because it would not reach agreement and it does not affect the core mission in terms of security. Individual countries work on these issues, but you will not get NATO to talk about it.

A participant asked about the status of Kaliningrad. Is it considered to be a separate country today? Or is it considered to be part of Russia and NATO ignores it?

One NATO expert replied, it is part of Russia, and is so recognized internationally. If he were a Russian, he would try to cut a deal with the EU to turn Kaliningrad into a showcase of what Russia can do. One problem is that such action would be an embarrassment to the rest of Russia. Another NATO expert added that is why they will never do it. One reason you don't hear about Kaliningrad is that it has no population other than Russians anymore. Previously, Kaliningrad had a mix of Poles, Germans, and others. Now, it is principally a Russian military base for the surrounding area. If you're a Lithuanian, added his colleague, with trains and trucks going over your territory, it is a tough problem.

### **Will Turkey Ever Enter the European Union?**

A participant asked whether Turkey would ever enter the European Union. A NATO expert replied that about 15 years ago the EU made a commitment to accept Turkey. Negotiations for membership were opened and went through several rounds. But the political will to follow through in Europe is completely bogged down for many reasons: the migration of workers from new members of the EU in Central Europe to Western Europe; issues arising from immigration from North and sub-Saharan Africa; the Muslim identity of the majority of the population of Turkey; the size of Turkey compared with the size of other countries in the EU; and the disparity in economic development between Turkey and other parts of the EU. Accordingly, most political leaders of the big EU countries have now come out against Turkish EU membership even though they are officially on record as being in favor.

A participant from Denmark opined that there is now a decisive factor that will prevent Turkey from ever becoming a member of the EU. The Lisbon Treaty establishes a dual majority mandate for the EU Council combining GDP weight and population weight. By 2020, the time it would take to go through the admission process, Turkey, were it to be admitted, would be the most powerful country of the EU Council because it would have a larger population than Germany. Neither France nor Germany would accept that. Population

weight is likely to become even more important in achieving greater democratic legitimacy. The chances of full Turkish membership in the EU are thus zero. It will never happen. But, in a way, the process has been the goal. Were it not for the possibility of admission to the EU, the role of the military would not have been reduced in Turkey. That Turkey will not necessarily become a full member of the EU should not cause us to despair. Turkey's admission would make the EU too big, too poor, and, in many ways, too different. The UK is greatly in favor of admitting Turkey because that would sink the EU as an entity. But, looking at it from Turkey's perspective, this process has helped it to modernize and to become more democratic. Turkey has become a sort of model for North Africa. That would not have been possible without this ultimately futile attempt to join the EU.

A NATO expert voiced a note of caution, saying that there is a real danger of showing so much disrespect to Turkey—its culture, civilization, and aspirations—as to end up doing ourselves an injury with this hypocrisy that has gone on for years. There was never any prospect of Turkey joining the European Union. The question now is whether Turkey will turn to the east and away from democratization. Turkey should be shown the respect that its people deserve.

A participant of Turkish origin, recently returned from Turkey, said the country really has no interest in EU membership right now. Although many Turks are appreciative of the membership process that they have gone through, they have no hope that they could ever join the EU because they consider the EU a club. And clubs exclude those who do not fit in. Turkey has a wonderful history and an admirable culture, but it is not the European culture. The speaker believes EU policy on Cyprus is a huge insult. Geographically, it is part of Turkey. In any event, the Turkish economy is growing and wealth is increasing. The Turks, at the moment, are quite happy that they do not have to bail out a lot of the European countries. She added that religion really does play a big role, as does the status of Turks in Germany. We should remember that Turks living and working in Germany were invited; they did not immigrate, she said, of their own volition.

A NATO expert said that Turkey should be a member of the European Defense Agency (EDA), which is involved in what NATO is trying to do. Its membership in the EDA has been blocked, and that is a big mistake.

### **Capacity to Act**

A participant stated that the mandate of the National Committee is to clearly state what we think are American foreign policy and security interests, noting that both presenters had mentioned the importance of having a project and also the capacity to act. As regards the latter, how should we deal with the economy here in the United States?

A NATO expert replied that the entire defense budget could be eliminated and we would still have a deficit this year. The deficit would only be cut by 50 percent. The deficit has to be tackled and defense is not the source of the problem. But we need to do something serious about the deficit in general because the economy and the health of the country depend on it. We cannot justify the size of the defense budget if the country is struggling with a huge deficit. The bipartisan commission that made recommendations last year was on

the right track. We need to devise some combination of raising revenue and cutting expenditures through wholesale reform of the tax code. That is necessary to preserve our ability to keep putting money into defense because it will remain a target for cutting until then.

Another NATO expert pointed out that defense spending in this country is 4.5 percent of GDP. During the Eisenhower and Kennedy administrations, it was 10 percent of GDP. That is a relatively small amount and it is going down; it will drop by at least 1 percent in the next budget. The problem is we are spending on the wrong items and in the wrong areas in terms of American influence in the world. That is why he is so enthusiastic about NGOs, which are out there doing tremendous things on low budgets. The Partnership for Peace within NATO was about sending civilians to Central Europe—not to tell them how to run their militaries, but how to hold a knife and fork and how to talk to enlisted people. It was about demonstrating the meaning of freedom and democracy.

We are presenting it in the wrong way. 17% is spent for the military to 1% for the State Department. That is insane. Constituencies for the State Department do not exist. In the original draft of Eisenhower's speech some fifty years ago, he referred to the "military-industrial-congressional complex." He was talked into deleting "congressional." This NATO expert remembered once that when he was working on the military budget in the Pentagon, some colleagues were complaining that the State Department was not spending enough on some problems. He said "Why don't you buy the State Department out of petty cash?" The situation is ludicrous. The speaker is especially upset because some at the Joint Chiefs of Staff are trying to eliminate the research component of the National Defense University. They think all you need do is train people to pull triggers, even though every four-star knows what we are talking about. The budget cutters do not have a clue; their futures do not depend on getting the answers right. We are doing it to ourselves.

### **Democracy and Legitimacy**

A NATO expert raised an issue that he believes is worth thinking about: What is happening to democracy? In Greece, the EU replaced a government incapable of running itself with a technocratic government. Italy had a government reasonably capable of running itself but not in a very attractive way. Turkey is showing both good and bad trends. In Central Europe, we have seen the rise of movements to the right, for example, in Poland and Slovakia. Many people, especially in Southern Europe, are expressing their anger through protests that may be a danger to democracy. In Greece, demonstrators have attacked the Parliament, the one bastion of elected representatives of the people. The EU itself is not democratically organized. And, why talk only about Europe? Unprecedented gridlock and partisanship exist in the United States. We have to wonder, "How is democracy doing? And how do we make sure democracy does well?"

He went on to raise a second issue: we should think about what we want our State Department and our Foreign Service officers to do. The Foreign Service Act of 1980 largely was a reform of the pre-World War II civil service. It defined many new roles within the structure, including political and economic officers. Now, we are asking our State Department and Foreign Service to engage in actions that are far removed from traditional diplomacy. One

problem is that we no longer have strategists who can think about long-term policy. At the same time, we are asking people to run assistance programs in the field and be advisors in areas where they have no expertise beyond a liberal arts degree. What do we want our foreign policy flagship, the State Department and Foreign Service, to be and to do? We have just been squeezing the system and seeing what comes out.

A participant who is a former diplomat agreed. We have to train people to do these new tasks, but we do not have a budget for this type of training anymore. The military will send people out for one or two years to get a master's degree. We do not do that and thus are thrusting people into jobs for which they have not been trained.

The previous speaker agreed, but said it is not just about training. We have to decide what functions have to be performed and what types of people should be hired to perform those functions. We might better justify allocation of budgetary resources if you structured it that way rather than just taking Foreign Service officers and training them.

Another NATO expert then made a recommendation to the National Committee on American Foreign Policy. New York rescued American foreign policy in the 1940s. Maybe you should do it again. How? Marry the governmental sector (civilian and military) with the private sector and the NGOs—the two great engines of American inspiration around the world. Much good in the world is being done by the private sector and NGOs. They are not being tapped into and they are not getting their due in what we in our funny little town on the Potomac call foreign affairs.

On that positive note, the first part of the conference on NATO and the new realism was ended.



## **Part II**

Ambassador Herman J. Cohen moderated the session on the euro. He stated upfront that the greatest threat to US national security was, in his opinion, Greece and that the economic crisis weighed very heavily on transatlantic relations. The Ambassador noted also that the frequent meetings of finance ministers did not seem to be yielding any results and that the occasional participation by the US Treasury Secretary did not lead him to go much past the “Well they’ve got to do something soon!” type of statement to the press.

After these introductory remarks, the session proceeded with an extended presentation by the main speaker, followed by shorter contributions by three expert discussants.

The main speaker started by stating that in economic terms the transatlantic relationship is the most important international relationship that there is and that, furthermore, it is a vital U.S. interest that Europe sort out its problems. However, he added, the crisis that Europe is still in is actually probably the best thing that has happened to the European Union, and certainly the euro area, for

the past 25 years. This is so because, as Jean Monnet used to say, "Europe was always forged in crisis", and a lot has been accomplished during this crisis. We should not despair, he continued. Not certainly to the degree that you might feel like doing if you read the editorial pages of most of the English-speaking press (e.g. Financial Times, The New York Times), which has profoundly misinterpreted the crisis and the responses to it.

### Several Crises

In reality there has not been just one crisis, the main speaker pointed out. There have in fact been several crises that have taken place at the same time. First, there is a fiscal crisis in several countries, not just in the euro area (think of the US and Japan as well). And, most notably, Greece has experienced the first sovereign debt restructuring in an OECD country in 60 years (the previous one had been West Germany's in 1948). Second, there is a banking crisis going on in the euro area. Ireland, notably, was not running large deficits. It was its having a banking system out of control and its very unwise decision to guarantee it in its entirety that led to its government having to go to the IMF. Further, in Spain too there was a banking crisis, stemming from almost the same kind of issues related to the housing bust that we have in this country. [Prior to 2008, both Ireland and Spain had what appeared to be improving fiscal positions. Ed.] Further still, consider Iceland, added the main speaker. Certainly, not a member of the EU (it could be one relatively soon, incidentally), but the issue was the same: it was the banking system that dragged down the entire economy. Most importantly, he continued, one should not forget that in the Euro area, 80 percent of all credit intermediation goes through the banking system. If any nation in the euro area has a problem in its banking system, therefore, the sovereign government has a problem, even more so than you would have it here in the US [ where the trend toward banking disintermediation has been much more rapid and extensive, Ed. ].

The third crisis in the euro area, continued the main speaker, is a crisis of competitiveness. He noticed how the structural reforms enacted before the crisis by Germany turned out to be to its advantage. But such advantage was dramatically compounded by Germany's use of the euro. Had the country continued to use the Deutschmark, the DM would probably be trading today at parity with the dollar, which clearly would not have been particularly great for an export-oriented economy. In other words, the euro made the German economy more competitive. Conversely, countries like Greece, Portugal, Spain, and Italy have run persistent large current account and trade deficits pretty much since the euro area was established. Thus, while the euro area as a whole has been largely in external balance, the single currency has helped in hiding these very large internal imbalances. For instance, Spain ran a current account deficit of nearly 10 percent of GDP for a number of years. If Spain had its own currency and had to finance that external deficit, i.e. attracting that amount of foreign capital, the speaker added, it just would not have been possible to do so for such an extended period. [The currency would have inevitably had to depreciate, Ed.].

At this point the main speaker reminded everybody how earlier on, in 2009, the Europeans liked to blame the Americans for the financial crisis. [The other experts nodded in agreement, Ed.]. But what the financial crisis actually did was to bring to an end a colossal market failure, the risk pricing of sovereign

debt in the euro area. Greece and all of the peripheral countries in the euro area from the introduction of the euro in the late 1990s up until 2008 had “significantly” negative real interest rates, leading, for instance, to the kind of housing bubbles seen in Spain and Ireland. This essentially revealed that many of the framers of the euro area had failed to anticipate that the markets could be so wrong for so long. The main speaker added: “why could anybody really have lent money to Greece for 20 years in 2008 at German interest rates?” It had been known for a while—he himself had written this in 2003—that Greece has cooked its books to get into the euro zone in the first place. It was well known that that this country was not reliable with respect to its fiscal accounting. Yet, markets were clearly happy to continue to fund them. And fortunately, the speaker argued, the financial crisis has brought this to an end, even though probably the markets overreacted (as it usually happens when they do not pay attention to something for a long time).

The main speaker continued by stressing that actually the deep underlying and fundamental political crisis in the euro is a crisis of design. When there is a financial crisis or even perhaps a sovereign debt crisis, there is always a bailout at one point. If there isn’t a bailout right away, he added, usually the second time around policy makers get to the bailout, as we saw in September 2008. In the United States, there was clearly a collaborative effort between the Central Bank and the fiscal authorities. Initially, of course, the central bank is able to act faster. Thus, it was the Federal Reserve that bailed out AIG. Subsequently, the political system legislated the fiscal resources, as we saw with the TARP; and then, eventually, they will work together, which is what we saw with TALF and with other Treasury and Federal Reserve joint programs here in the United States—in this way, “you will gradually stabilize the situation.” In the euro zone, instead, the main speaker added, there was no Treasury Department, only a Central Bank. And the Central Bank refused to just start writing checks to buy sovereign bonds left and right to stabilize the market: “We are going to wait until you policy makers, European elected leaders get your act together and construct a more viable euro area.” But this is something that takes quite a long time—which is why this is a crisis that has been going on for a long time. And, the speaker continued, with all due respect to the Treasury Secretary, while it is true that the Europeans need to come up with something, he seems to underestimate the political commitment that the Europeans actually need to make to be able to effectively deal with this design issue that they are confronting.

### Some Historical Considerations

We should not forget how we got where we are now, the main speaker went on. The original Maastricht Treaty and the economic and monetary union were essentially a European response to German reunification. [French President] François Mitterrand wanted the Germans to give up the Deutschmark. But he also wanted a fiscal union. He also wanted to pool the debt of these countries [part of the fiscal union]. Now, [German Chancellor] Helmut Kohl said, “That’s fine! Then we also need a political union.” That, of course, was a concept that for a federal country like Germany was easier to deal with than it was for France. Mitterrand could not agree with it because of the Gaullist and French belief in the sovereignty of the nation states within the EU. In the end, the main speaker noted, the solution was the lowest common denominator: economic and monetary union, which was in reality only a monetary union.

In this context, he added, it is important to remember, going back to the 1970s,

the Werner report and, going back to the 1980s, the Delors report. Both documents, with regard to the creation of an economic and monetary union, stressed that you should always have them simultaneously or that you should have the economic integration, the fiscal integration, first and then, eventually, you could get to share your currency. But, the main speaker continued, for political reasons there was a lot of hurriedness, a lot of corners had to be cut, and the end result was a currency union with member states that were far too different to really be able to function smoothly in a currency union. The speaker hastened to point out that he did not believe that a currency union has to be in narrow Mundellian terms an optimal currency area [here the reference is to the work of Nobel prize winning economist Robert Mundell Ed.], but certainly having member states as different as Germany and Greece sharing a currency is not a good idea either.

### **On the U.S. and EU Responses to the Crises**

Basically, the main speaker continued, the crises showed that the EU was a half-built house. All that Hank J. Paulsen and Timothy Geithner had to do was to stabilize the US financial system as well as the US economy within a set institutional framework. On the other hand, the challenge facing [then European Central Bank (ECB) President] Jean-Claude Trichet and the European leaders was that they knew they had to establish institutions which would have been politically impossible to create before the crisis. Such was the case of the European Financial Stability Facility (EFSF). But, the speaker added, matters are not so simple as some of the Wall Street people here in New York seem to believe when they ask questions—referring to the role of the European Central Bank—such as: “Why aren’t they just copying what the Federal Reserve did?; why aren’t they just doing quantitative easing?; why aren’t they using their balance sheet to stabilize the financial markets?” Well, there are several reasons for that. First of all, Europe does not sell Treasury bonds. Then, while it is true that the US Federal Reserve has bought all sorts of securities in their Maiden Lane bailout “...one thing they haven’t bought is state and local government bonds.” [Maiden Lane refers to the three limited liabilities companies created by the New York Fed to assist Bear Stearns (I) and AIG (II and III). Ed.]. This raises the issue of, say, a Federal Reserve purchase of California bonds to bail out the state and the reaction of other states to that. And, the main speaker added, let us not forget the fundamentally different situation in terms of redistributive aspects confronting the ECB when purchasing national bonds. Further, the ECB wanted the European leaders to move ahead first and essentially agree to much more integration in the euro area before it would utilize its balance sheet to calm the markets and thereby reduce the political pressure on European leaders to act. The speaker continued by stressing that, unlike the Federal Reserve’s appropriate focus on stabilizing the economy and restarting growth [also pursuant to its dual mandate Ed.], the European Central Bank was always predominantly focused on avoiding political moral hazard. Namely, it was not going to bail out European leaders before they took the tough political decisions that were necessary to complete the economic and monetary union. And, it is important to understand that the ECB, unlike any other Central Bank (and certainly unlike the Federal Reserve) can make very explicit political demands of elected leaders. The main speaker added: “Why is Silvio Berlusconi not in office anymore? It is because Mario Draghi, when he became the president of the ECB on November 1, 2011, stopped buying Italian government bonds.” This occurred because in August 2011, Draghi and Trichet sent a letter to the then Italian Prime Minister with a list of reforms that he

needed to implement. Reneging on his promise, Berlusconi did nothing and two weeks after Draghi took over in Frankfurt, [with the yields on the Italian government bonds rising rapidly because of the scarce demand for them, Ed.] the Italian Prime Minister was out of office. This is how you do regime change north of the Mediterranean, the main expert quipped.

### **More on the ECB and the Federal Reserve**

Most assuredly, the ECB is the only pan-European institution that has the capacity to act in a crisis; and it is uniquely independent. The Federal Reserve and every other Central Bank in the world is independent typically because of an act of Congress or an act of Parliament, the main speaker reminded the others. It is an independence that can be taken back by elected officials through legislation. The ECB, on the other hand, derives its institutional independence from the EU treaty. No single country can change that. Further, while Ben Bernanke has to go before the Congress and testify couple of times of a year, the ECB is accountable to nobody. And Germany, he added, the most powerful of the 17 countries [members of the Eurosystem, Ed.] does not get involved with the running of the Central Bank at all. Imagine, he continued, if Ben Bernanke and the Federal Reserve Board had sent a letter to the Super Committee in October 2011, saying "Look guys, unless you come to an agreement on the long-term budget outlook for the United States, we are going to sell and liquidate our entire portfolio of Treasuries, we are going to drive the long term interest rates up, the economy is going to tank, and you guys are going to be basically out of the job". How long would it have taken Congress to amend the Federal Reserve Act? Probably about 45 minutes. Well, this is exactly what happened to Silvio Berlusconi.

### **What the ECB Wanted from the Crisis**

The main speaker then asked: Why did the ECB act only in December 2011, carrying out quantitative easing for the banking system in a manner functionally equivalent to what the Federal Reserve did back in September 2008? Why did the ECB wait so long? Well, he continued, because the ECB wanted three outcomes from this crisis and demanded them from the European politicians. The ECB wanted first of all structural reforms in the peripheral countries, which meant that the ECB wanted reform-oriented governments in place. Well that only happened in Italy when Berlusconi was ousted from office. And in Spain in November 2011, when the new government of Mariano Rajoy was elected. The second outcome the ECB wanted from this crisis was a new set of credible fiscal rules. Well, it was only at the EU summit held on December 9, 2011, that the EU leaders finally agreed to come up with a new fiscal compact treaty. And then, finally, the ECB wanted a deeper integration of the euro area, with more decision making powers handed over to Brussels. In point of fact, the main speaker added, the Commission (an EU 27-type of entity) now engages in surveillance much more powerfully [some critics from the periphery countries would say intrusively, Ed.] than before.

So, he continued, essentially the ECB held off until the European politicians began to deliver on its fully political agenda. Of course, there was growing collateral damage because of the ECB's need to maintain the pressure on European policy makers, which is why everybody on Wall Street and everybody else in the financial markets in October and November of last year were despairing. They looked at the amount of rollovers that the European banks had

to do and the amount of sovereign debt that Italy, Spain, and others had to roll over and they felt the ECB would make everything come crashing down, the main speaker added. But, he pointed out, just as we discovered here in the United States when the Federal Reserve decided to pump a trillion or two into the financial system, when the ECB did that (through two three-year liquidity operations in December 2011 and February 2012), quite a lot of stability was (and has been) restored in the European financial system. This has meant that the ECB has now bought a sort of a window of opportunity for European leaders to continue building the European institutions up and also maintaining the process of very significant structural reform in the economies that need it. This has been accomplished through brinkmanship, a political strategy of going up to the edge of an abyss and running the risk of falling over. It is through this kind of risk (akin to that of the game of chicken) that the game among multiple players such as the International Monetary Fund, The European Central Bank, [German Chancellor] Angela Merkel, the Greek government, and the Italian government permits the extraction of concessions from your political opponents, the main speaker added. Notably, if you were asked two years ago “Do you think that a Socialist government in Spain would cut public wages by 10 percent?” you would consider that person crazy. And yet this is what happened. Or, continued the speaker, as we are about to find out soon in Italy, “Do we think that the Article 18 of the main Italian Labor Law, which essentially makes the laying off of workers very difficult, will ever be changed?” Well, for over forty years it did not happen but now it will.

### National Politics and Populism

All this is happening because of the crisis. The crisis in that sense is, in the opinion of the main speaker, a huge opportunity for Europe as it has caused a massive political shift in the peripheral countries. He thus rejected the notion that “the pendulum is going to swing back,” that nothing has changed, and that things are like in many emerging markets where you can have a government that is in favor of reform for, say, a couple of years and then it goes back to the bad old days again. But, the speaker pointed out, the most appropriate analogy to what is happening in Southern Europe—in Greece, Spain and Portugal but also Italy—is with New Labor. Or with the very significant shift to the political center that happened with the Northern European Social Democratic parties in the 80s and early 90s. Thus, whether we are talking about the Swedish Social Democratic Party, the Danish SF, the Finnish SDP, the German SPD, or the New Labour in the UK, these are not axiomatically fiscally irresponsible parties. Nor are these parties that are actually in favor of retirement at 55, and these kinds of things, he added. Therefore, the entire political spectrum of what the welfare state and the social systems in Europe are going to look like has shifted quite dramatically as a result of this crisis. Many would say that if they look at the French presidential elections they would be inclined to say “François Hollande is likely going to win”. Well, he may or he may not. We will have to see but, if you compare the platform that he is running on this time, to the platform that Ségolène Royal ran on in 2007, you see that this is a far more centrist and in many ways economically responsible platform—certainly in fiscal policy terms—and that he has in fact endorsed exactly the same fiscal targets that Nicholas Sarkozy has. So, in that sense, in the opinion of the speaker, it actually does not matter very much who wins the French presidential election. But there can be little doubt that the spectrum of politics has shifted as a result of this crisis in Europe and actually the difference between the center left and the center right on the core issues of economic

policy have actually narrowed quite a lot. There are many more areas of consensus than before.

Interestingly, the main speaker noted, in reading, once again, the New York Times and many other newspapers in the English-speaking world, you always would come across the question: "Well, how about populism in Europe?" Yes, he added, there are lots of populist parties in Europe. True Finns Party, the Freedom Party in the Netherlands, the Front National in France, the Sweden Democrats in Sweden, and you have the Danish People's Party in Denmark. These parties are broadly anti-immigrant, nationalistic, and xenophobic and they clearly have a platform, a right-wing immigration platform. But these are not new parties. For instance, Jean Marie Le Pen [of the Front National, Ed.] ran for president in 1981. Further, one has to understand that these parties, the successful ones of these parties, are not just right-wing populist parties. They are actually also the parties that are now most in favor of traditional welfare state policies. These are the parties that are in favor of low retirement age for blue-collar workers. Thus, they are a mixture of right-wing, anti-immigration rhetoric and left wing welfare policies—which is exactly tailor-made for the low-income blue collar segment of the population. This is a balance that you have got to be a pretty skilled communicator and populist to make work. Clearly, such political platforms have been made easier by the shift of the mainstream center-left parties to the center. These parties essentially abandoned many of their traditional blue collar constituency in a way not very dissimilar from what many thought Bill Clinton did with welfare reform in 1996.

It is important to note however, the main speaker continued, that the platform of these protest parties may lead them to obtain 15 to 20 percent of the vote. But in the European parliamentary system, when the remainder of the political center of the spectrum—center-left, center-right—is pretty much in agreement on where most of Europe and broader politics is going, this does not matter. And, the idea that these parties are very skilled at extracting various political concessions or, worse, the idea that these parties are going to take over are vastly overblown. Greece could be a bit different when it holds elections in April. Most importantly, in the countries of the euro area with rising unemployment rates and attendant economic problems there may have been an ousting of the incumbent government but there was not a massive vote for populist parties. Notably, in Ireland, they could have voted for Sinn Féin; in Spain and Portugal, they could have voted for the far-left Communist Party. Voters did not. In these three countries they essentially elected governments (in the case of Spain with historic majority) which basically said, "Look we are going to implement what the IMF tells us to do." So, the crisis in Europe, the main speaker continued, has absolutely not led to a rising populism where it matters very much. And, he added, this is true in Germany as well. One often hears that Germany is going to wake up one day and say "Oh we want to leave the euro". Well, it is not going to happen. There is a political reason. First of all, the only party that has flirted with a euro-skeptical platform so far is the FDP. Well, it didn't do them very much good at the Berlin state elections where they got 1.8 % of the vote. Economically, it used to be that if Germany were to leave the euro, then the German banking system would collapse because of all their exposures to the peripheral economies. Most notably, the speaker continued, "all the loans of the German private banks to Italy, if they were to be repaid in new Lire... well, they wouldn't be repaid, let's put it that way. So, you know this is easily half a trillion euros, in other words, far beyond any bailout that Germany would ever

be asked to pay for.” Now, however, what has actually happened is that essentially what used to be in Germany the private banking exposure to the periphery has now shifted from the private to the public sector. [ Incidentally, the shifting of risk from the private to the public sector associated to bailouts could in the future arguably be the object of even greater debate on both sides of the Atlantic than what we have seen so far; especially in connection with banking executives’ compensation, too-big-to-fail financial institutions’ trading activities, and, of course, electoral politics. Ed.]

### **Integration Moves Forward**

The main speaker continued by stating that, on the whole, one should not underestimate the forward movement in integration that has taken place because of the crisis. Take for instance the “European semester”[ approved by member states in September 2010 ] — which is the idea that national governments must submit their budget proposals for review with the other EU countries before they go before (and are voted on in) national parliaments. This is basically the functional equivalent of a line-item veto as the Hungarian government is about to find out, even though Hungary is not part of the euro area. Look also at the Euro Plus Pact [agreed upon by the 17 member states of the euro area, with Bulgaria, Denmark, Latvia, Lithuania, Poland, and Romania in the Spring of 2011]. There used to be the Pillars of the European Union, which identified the areas where the European Union had no authority. [The three-pillar structure was introduced in 1993 with the Maastricht Treaty and remained in effect until December 2009, when the Treaty of Lisbon entered into force. The first pillar covered areas such as the internal market and monetary union. The second pillar dealt with common foreign and security policy. The third pillar covered justice and home affairs. In terms of decision-making, the more “federalist” Community procedure was followed for the first pillar, while the more “intergovernmental” procedure was followed for the other two. Ed.] Areas such as healthcare, pensions, labor markets where reform was most needed, were all within the exclusive purview of member states. The main speaker stressed that the Euro Plus Pact is a new entity in which you can debate anything, any policy area [Clearly a major pro-integration, “federalist” development, Ed.]. For instance, you can debate pension reforms in France and this certainly will happen if Hollande comes to power and tries to lower the French retirement age back down to 60.

Another very significant development is the recent Six Pack [entered into force in December 2011; applicable to all 27 member states with some ad-hoc rules for the euro-area member states; comprises both fiscal and macroeconomic surveillance. Ed.] which basically gives the European commission all the powers they wish they had in 1997. Unfortunately, [Hungary’s Prime Minister ] Victor Orban has been, in the main speaker’s opinion, not politically astute enough to realize that he is going to be the sacrificial lamb. “He is going to be ‘pushed’ in just the same way as the Greeks were.” In the end, the speaker continued, the choice will be between caving in to the European Union’s demands on various political issues or default. Orban is not going to get a new IMF program and he is not going to get any euro area funding. The speaker added “he has just lost about half a billion euros in EU funds... and this is something that again was totally impossible under the old regime....So one shouldn’t underestimate the things that have actually been accomplished.” The question then becomes, he added, “what needs to be done

going forward?" since it is obvious that you need to have this process continue and this cannot happen until and unless you have a change in the political process of the EU. In other words, one cannot continue to transfer this amount of de facto sovereignty to what is fundamentally a technocratic institution, whether it is the ECB or the European Commission. This means that you are going to have to reopen the Lisbon Treaty whether you like it or not.

The main speaker continued: "You may have heard this although it has been strangely underreported, but actually today [March 20, 2012] the European foreign ministers are meeting in Berlin at a meeting convened by Westerwelle [ Guido Westerwelle, Germany's foreign minister, Ed.] in which they are explicitly going to be" discussing a reopening of the Lisbon Treaty precisely to ensure that the political legitimacy of the euro area is enhanced. How is this going to be done? Well that is a very open question. Do you have direct elections of the European Commission president? There are many ways in which you can talk about it. But it is something that is happening. And it is going much more rapidly than many people realize, continued the main speaker. Certainly, while there is a need to continue on the road of structural reform in Greece, Spain, Italy, and actually across the entire euro area, one should not forget growth. Not the short-term growth rates most people worry about, those for the next quarter or two, but the potential growth rate of the economy, the average rate of growth that Europe is going to have in the next 10 years. Of course, the main speaker added, this is a structural reform issue and you are not going to deal with it unless you reform pension and labor markets, as well as other regulated areas [ notably, product and especially service markets, I would add, Ed.]. For instance, you're not going to have a stable and ultimately solvent country in Italy in the long run if the labor force participation of Italian women continues to be less than 50 percent.

### **Greece, Portugal, and Ireland**

Considering all that is being done and all that needs to be done, the main speaker continued, the ECB has definitely bought some time. Then, of course, there are the program countries [ typically understood to mean the EU/IMF program countries: Greece, Ireland, and Portugal. Ed. ]. As it has as been noted before, there was the first sovereign default in an OECD country (Greece) in 60 years. Unfortunately that does not mean that Greece is now a sustainable country. The speaker predicted that Greece will have another default at some point in the future. But, he added, it will not have the effects that the previous default had because at this point markets do not care. "It will be essentially between the taxpayers of Greece and the taxpayers of the rest of the euro area because the majority of the debt now is held by the euro area as well as the IMF," with "the IMF being senior to the euro area so, if there are any losses to be distributed, they are incurred by the euro area," the main speaker stated. He added that that he could easily see a scenario where in the next couple of quarters the IMF would say, "Look, you're not in compliance with your program just like you weren't with any of your previous programs. But the difference now is that if we cut you off, there will not be huge contagion to the rest of the euro area. And, therefore, it is politically possible for us to do it." In reality, he went on, if you talk to anybody at the IMF...they want to cut the Greeks off because they're fearful for the institutional integrity of the IMF. And, at that point, this question comes up: What will the euro area do? Does it make up for the funding that the IMF no longer provides? It is probably about 20 billion or so euros. So

that's not a huge amount of money, but it is nonetheless, a significant amount of money. The EU can demand that Lukas Papademos [the "provisional" Greek prime minister at the time of the conference, Ed.] comes back as prime minister or finance minister. This talk about an EU Commissioner for Greece that Jean-Claude Juncker [Luxembourg's Prime Minister, Ed.] proposed....well, there are many ways in which you can do it. But it cannot change the fact that the loss of Greek sovereignty is going to be considerable. Which raises the question: Is that politically feasible in Greece? The speaker said that he thought that the real question is whether or not the Greeks themselves at some point decide to call it quits saying "All right! We've had it. In the name of national sovereignty, we're going to leave." Now that would be an economic disaster. Many say that Greece has to leave the euro in order to ever get any growth. This is insane, according to the main speaker. Greece will suffer a further decline in living standards of easily 30-to-40 percent if they ever quit the euro. Greece is not Argentina for a whole list of reasons which we do not have time to get into.

With regard to Ireland and Portugal, they probably also need to be restructured. But again, by restructuring, the main speaker elaborated, he did not mean that there should be a haircut imposed on private debtors, but rather that more money should come from the euro area. And that is something that, politically, will be much easier than in Greece because both Ireland and Portugal have actually been adhering to their IMF programs. Most importantly, we are never going to get again into the situation where 2 percent of the euro area, which is Greece, essentially threatens to overturn the entire applecart.

### The Transatlantic Relationship

What does this all mean for the transatlantic relationship? the main speaker asked. Well, first of all, this means that the euro area is here to stay and it is actually going to integrate much more quickly than is generally perceived on this side of the Atlantic. Further he added, despite all this talk in terms of security in the Pacific region, the reality is that in economic terms, the policy integration across the Pacific is "a damp squid." You may have heard about the Tran-Pacific Partnership (TPP), he added. Well, the Trans-Pacific Partnership is a fig leaf that covers for the Obama administration's pretense of having a trade policy. It is very likely that you will not find any report showing that TPP will create any jobs in America, and, he added, "we all know what happens to trade initiatives that don't create any jobs in America...Congress is not going to even bother to look at them."

The main speaker expressed his belief that the upcoming G8 meeting could very well see the announcement of a new transatlantic trade initiative. Both Chancellor Merkel and Prime Minister Cameron, and certainly Mario Monti, would be for it. Further, regardless of who is elected president of France, we should probably not take too seriously the talk of protectionism we heard during the election campaign. There is clearly a political window of opportunity here again that will be used and, of course, we will have to see what the Administration does about it. He added that "this is something that can be done in terms of industrial standards and various other types of non-tariff barriers; if that is the case, then you can very easily get to very high numbers in terms of job creation. Because that is real trade creation in a way that whatever is politically feasible across the Pacific is not." The main speaker ended at this point his presentation.

Ambassador Cohen thanked the main speaker for his presentation and invited

the participants to ask questions.

## Two Questions

One of the participants noted that he was glad to see that the political side had turned more positive and asked: what kind of economic stimulation is available? The ECB's is not big enough; even the American spending is not enough to stimulate that many countries at one time. Given the problems mentioned earlier, how do you see these countries achieving adequate growth rates?

The main speaker replied that probably right now, in 2012 as a whole, and probably in the first half of 2013, the euro area is likely to experience a relatively shallow recession; if there is growth it is going to be slow for the next 18 months. Further, he added, the recession in the periphery may reduce, in a sort of perverse way, the current account deficit. But, he continued, the real issue here is not the short-term growth rate: it is instead the potential long term growth rate. And that growth rate is only going to be affected by implementing the kind of structural reforms that were politically impossible until just a few months ago. And, since they do not take effect right away, this is not government stimulus. But it is certainly long-term growth stimulus. Concerns about growth, while understandable, should not be given excessive weight. More important, the speaker pointed out, is to focus on the ECB's liquidity injection and its preventing a major credit crunch, and, therefore, the emergence of a deep recession.

One participant asked the main speaker what he thought about the squabble in the preceding couple of weeks between the Bundesbank and the ECB. After all, isn't the Bundesbank a major shareholder of the ECB? The main speaker answered that it is Germany (and therefore the German government) which owns 27 percent of the ECB, not the Bundesbank. The latter has one member on the ECB governing board. But Jens Weidmann [the Bundesbank's President, Ed.] is only one of 23 voting members. His questioning the long-term liquidity injections and the changes to the ECB collateral policies which were supported by Chancellor Merkel, who typically refuses to comment on the ECB and the Bundesbank, was in the opinion of the main speaker something that made Weidmann's becoming the next ECB President much less likely.

Ambassador Cohen, after a brief break, asked each of the three discussants for their opinions.

## The First Discussant

The first discussant stated upfront that he was, on the whole, in agreement with what he had heard from the main speaker and that he was going to elaborate on a few points. He stressed his concurring with the importance of the distinction drawn between fiscal crisis and banking crisis. He added that the main speaker's characterizing the third crisis of the euro area as one of competitiveness was also adroit. However, he added, it is important to understand that talking about a competitiveness crisis is tantamount to saying that there is essentially a balance of payments crisis. Which is somewhat counterintuitive if one looks at the first ten years of existence of the euro. In the period between 1999 and 2008 the United States had a very significant negative external position as a percentage of GDP (in absolute terms, also), while euro zone area had a small surplus. But, the first discussant noted, within the euro zone it is the external balances

between the various member countries that make the difference. Thus, the first discussant asked “Why do these imbalances exist? Because there are very significant differences in competitiveness.” In other words, the countries on the periphery of the euro zone are less effective at exporting and are significant importers. And, for many years, this has been neglected by the markets. The discussant added that he himself had written in 2008 that the spread between the government bond yields of the euro zone was inexplicably narrow. Notably, the close difference between the yields on German 10-year government bonds and on debt of similar maturity for the countries of the periphery meant that the markets were essentially dismissing any possibility of default of the latter countries and assumed that the thrifty and competitive would bail out the profligate. The very thin margins, the discussant continued, reflected an implicit assumption by the markets that some sort of political union existed already, which we knew and know was not there.

With regard to the question of the relationship between Mitterrand and Kohl, the first discussant noted that it has been the subject of much debate. In addition to what the main speaker said, the discussant added that many people think that, in reality, Mitterrand strong-armed Kohl into accepting the European monetary union by threatening continued and forceful opposition to German reunification by his government, the British, and the Soviet Union. However, the discussant added, the French came to accept that to gain German acquiescence in the years ahead, much would have to be done. The establishment of the headquarters of the Central Bank in Frankfurt certainly responded to this logic. The Stability Pact also did, while its being renamed Stability and Growth Pact was clearly meant to satisfy the French. For him, this is clearly a point of particular relevance to the looming stability versus growth debate.

Another point the first discussant raised was that the ECB’s intervention in the financial markets was only in the secondary markets since the Maastricht Treaty prevents it from buying bonds directly from governments. Similar limitations are faced by other central banks such as the US Federal Reserve and the Bank of Japan, all deriving from the desire to prevent a central bank from acting as a lender of last resort.

With regard to the socialist parties in the periphery countries shifting toward the center of the political spectrum (as pointed out by the main speaker), the first discussant made reference to his personal experience in watching the television news programs coming from Italy, Spain, Portugal, and France. Across time, the first discussant stated, he noticed an evolution in how not just the politicians but also the labor leaders talked. Their tone has changed, he argued, and they acknowledge (however obliquely) the need to reform the most stringent aspects of their labor laws. This was unthinkable years ago. Most notably, the famous article 18 of the Statuto dei Lavoratori, which he studied as a very young man, has been on the books for decades. Regardless of how it will be modified, you hear Italian labor leaders talk in an entirely different way. This evolution can be readily connected to the main speaker’s clever references to the concept of “brinkmanship”. It is the brinkmanship game that has helped the new leaders in Europe to force their electorate, to force their taxpayers, into accepting change. The language currently employed by socialist parties and unions in the countries mentioned before, the first discussant added, would have been completely unacceptable before the crisis, not to mention years ago. It would have been labeled “kowtowing before Big Capital, pandering to the

interests of big business, multinational corporations ..." That kind of language has largely abated. There is just an acceptance (however reluctant) among socialist parties that certain things have to change because of new realities stemming not just from the process of European integration but also from globalization in general.

Another, related, cluster of ideas the discussant wanted to briefly talk about was the major shift that everybody in the previous six or seven months had noticed from great pessimism over the future of Europe and the euro zone to significant optimism. He was in agreement with the main speaker's view that a lot of it had to do with the more "marginal" role that Greece played. In other words, no longer was a Greek default seen as a major tragedy for the European integration process. But, the first discussant added, there had been on the part of those who were pessimistic months before a significant ignoring of some lessons of history. "You do not build European integration for well over fifty years, you do not create a huge EU bureaucracy and, more importantly still an incredible body of laws for decades without also investing the politicians who want to dismantle this with a tremendous responsibility." So, he continued, "I think the brinkmanship game could have been probably anticipated." The difficulty from a political and psychological point of view of throwing out of the window fifty years of European integration weighed very heavily on the shoulders of all major players in the euro crisis. Further, the first discussant added, nobody should have shunted aside the technical nightmare of re-denominating everything from euros to drachmas, all currency in circulation, commercial contracts, bank accounts, bonds, etc. Not to mention having the process unfold for larger countries such as Spain (and most improbably for Italy or even—more unthinkably—France). At this point two participants made very brief comments stating their agreement that this would be a disaster. The first discussant added to their characterization and labeled it a cauchemar [nightmare, Ed.] as he recalled having characterized this scenario on French TV a few months earlier. He concluded by stating his strong belief that, throughout the crisis, considerations of a historical nature had been significantly neglected or dismissed too easily.

### The Second Discussant

The second discussant noted upfront that it seemed to her that most of the people in the room were "on the same page", although she believed that "we are a very small minority." It was interesting in following the crisis as a professor, lecturer, and commentator, to hear so many in the media state that according to all economic rationale Greece should default and that the euro zone made no sense and "let's just get over the whole thing." The reality was of course entirely different, she added.

Her contribution today, she explained, would be to pick up on some of the valid points heard earlier. First, one has to note that this crisis has been very interconnected with the U.S. crisis in the sense that we morphed from a financial crisis in 2008. Since "European banks were doing very well," we did not actually assume Europe would become a major problem and thought that it was responding to what had occurred in the U.S. and moving forward. Second, between 2008 and 2010 neither the markets nor, certainly, the public at large had any idea how high European banks' exposure level to peripheral countries' sovereign debt was. This was simply not available as public information and ended up spooking the markets more and more as information would trickle

out. Another point she raised was that in 2008 European governments, including the UK, stepped in with a truly massive partial or full nationalization or re-nationalization of banks (Incidentally, the UK government owns 83 percent of Royal Bank of Scotland, a bank accused of granting huge bonuses to top management). How this was done showed the “very different approaches to the concept of nationalization of the financial sector between the US and the EU.” Further, the second discussant continued, both the IMF and the ECB had in a sense to totally redefine their scope, redefine their fundamental functions and also, in a sense, redefine the perception the public at large held of them. Until this crisis happened, “for forty years the IMF dealt with transitional developing countries. We did not think of the IMF coming into Europe. In 2008, they had to come into Iceland, they had to come into Latvia, they had to come into Hungary, and all of the sudden they’re brought in as a partner with Greece.” From her own experience as a guest on Bloomberg, she added, hearing “why doesn’t the IMF just do x? Why doesn’t the ECB just do x?” begs the answer: because it is not in their mandate. Thus, the European Central Bank had to step in to recapitalize the EU capital banking sector but it had to do it within the scope of its mandate. And this was in a way the genius of Draghi. Likewise, the IMF could not step into sovereign country banking sectors. But it could step in “as a stopgap for sovereign countries according to its mandate.” We were in a very unique situation where you had to redefine the multilaterals and you had to redefine the scope of central bank activities during the unfolding of the crisis, she pointed out.

The second discussant went on to note that in 1998 in Kohl’s opinion Greece (which would enter the Euro zone later in 2001 as opposed to 1999) was not the problem for Germany. Italy was, and “Chancellor Kohl and Germany certainly did not want to even accept the concept that the deutsche mark would be equivalent to the lira.” Another point to ponder, she added, was that in 2004 when Europe went through the huge expansion bringing in the CE [central European] and FSU [former Soviet Union] countries, “a lot of the lessons should have been made clear to Greece, Portugal, Spain, even to Italy [on account of its less economically developed South, Ed.], about what was going to be their future role in the expanded European Union.” And this was not done. Thus, we were suddenly looking at absorbing basically 10 new countries: an increase, using the figures at the time, of 20 percent in population and 5 percent in terms of GDP. In other words, the so called poorer countries were suddenly not going to be so poor any more [in relative terms, that is, Ed.] and now they were going to have to get their act together and no longer depend on subsidies coming from the EU. These lessons were barely mentioned because, she continued, “we were in extraordinary boom” times “and we simply in a lot of ways could get away with it.”

The second discussant also declared herself rather skeptical about the effectiveness of outside monitors in Greece and their ability to impose discipline. She also noted the shift in terms of placing blame from Brussels to Berlin, unfortunately bringing out “the ghosts of history”. More broadly, there is a set of cultural and in many ways psychohistorical elements whose importance on economic realities are often totally misunderstood in the United States. For instance, she expressed her disagreement with those who think that the election of Hollande or Sarkozy does not make any difference. Given that right now Europe needs stability (as the decision to replace Strauss-

Kahn with Christine Lagarde attests), Hollande concerned her because she saw him as “out of the mainstream” and likely to “spook the markets.”

For the second discussant there are three categories of interpreters of the crisis. The first is that of “euroskeptics”. When she was in the Clinton Administration in the 1990s as a senior adviser in finance policy in the Department of Commerce, the second discussant continued, she noted that only Larry Summers stood in marked contrast with the deep tradition of skepticism toward the euro that pervaded Washington. And incidentally, she added, this group’s relevance can be seen now by the fact that “the U.S. market suddenly began to ignore the crisis in Greece … because major U.S. banks, equity firms, hedge funds are no longer largely invested into Greek debt.”

The second group is that of the “euro-hawks.” In this regard, she stated that she found very interesting some of the main speaker’s comments about the European Central Bank and the fact that he “thought that whatever remarks that Widemann made were not that important.” And, she admitted, indeed in the long term they may not have any impact. But, she added, Jürgen Stark [German, former ECB Executive Board member, Ed.] has made remarks along the same lines and [likewise] Alex Weber [German, former President of the Bundesbank and member of the ECB Governing Council, Ed.] who, if he had not expressed his opinions so clearly, could probably have become head of the European Central Bank. Thus, we are talking of a very hard line German Bundesbank monetary policy, carrying with it “all of the history of the hyperinflation trauma, the history of the anti-inflation policy which is embedded in the European Central Bank in what we can call its prime directive—which is price stability. Again, history does play out.”

The third group is that of the “europragmatists” . Among them “we have economists like Mundell, Summers, …we have Lagarde, Draghi, Merkel, and, in many respects, Bernanke,” the second discussant stated. What is most striking is that despite the White House being largely detached from Europe and detached from the issue “at the level of the Federal Reserve, at the level of Treasury… there has been a great deal of cooperation” albeit in not too visible ways. And this, she added, has moved issues forward. In fact, she totally agreed that “we are moving clearly into a period past the worst of it” even though with the looming Greek and French elections and the ongoing situation in Italy where, uniquely in a major EU country, we do not have a legitimately elected leader, politics shows all its fragility. On the whole, however, the second discussant summed up, political and historical realities have been far more of a propeller and far more of a major determinant in many ways than economic rationale. Last, she noted her agreement with the previous two speakers that going back to the drachma would be a disaster and concluded by reminding the participants of that wonderful song by the Eagles, “Hotel California.” “You can check out any time, but you can never leave.” The lack of an exit clause in the Maastricht Treaty is at the heart of some the structural reforms that will have to take place.

### **The Third Discussant**

The third discussant began by stating that he was Swiss and not German, explaining that in so doing he wanted to silence any remark of the type “Oh well of course he is German! Therefore he is that way.” He praised the main speaker for his very interesting presentation. He then proceeded to note how,

at the very beginning of the EMU, it had been emphasized that one was talking about “monetary union” not “economic and monetary union.” Now, he said, the distinction had fallen by the wayside, but if the German Stability Pact had been enacted, if that had been possible, “then the whole thing might not have happened”. The third discussant then noted that “historically speaking, when the whole thing evolved, we talked about the possibility of a Europe à la carte, we talked about a two-speed Europe, we talked about all kinds of possibilities because we said Europe is really economically not ready to be forced and one size does not fit all.” “The Irish had extreme growth rate and inflation” and Germany had stopped being the locomotive of the European Union—incidentally, he said that he would prefer to call it the European Community, but he acknowledged the difficulties of fighting history and a “nomenclature” that is years ahead. With regard to Greece, the key question is “where is Greece going to develop?...A large part of the Greek economy is not in private hands... It could export perhaps more shipping or more olives but there is...well, tourism of course. But”...all in all, Greece’s possibilities in terms of expansion are very limited. The third speaker’s skepticism extended to Basel I, II, III etc. and he offered a real world anecdote. One time he was having a conversation with an EU commissioner and told him: “Look, you have three pillars, three arms, with the stability and cooperation. You have preventive, corrective, and punitive measures. What are you doing? Why isn’t it working?” The commissioner answered “Well, professor, you have to understand....We are friends!” And, the third speaker added, this is part of the reason why he was skeptical about “that whole supervisory thing”. He continued by describing to the participants a comparison suggested by the German economist [Wilhelm] Röpke who decades ago compared the two systems of fixed and flexible exchange rates to what happens when the clown in the circus has to play on the 11 foot grand piano and he has to play sitting down. The problem is that the grand piano and the chair are not close and his arms are not long enough to reach the keyboard. Now he has two possibilities. He either moves the chair to the piano—that is what you do through flexible exchange rates. Or he tries to move the grand piano to the chair—adjusting the whole economy to fit what would be the right exchange rate. Of course, the clown that he was, you know which way he tried to do it, the third discussant continued. He also mentioned the importance of the *acquis communautaire* and asked whether it was wise to insist that new members join the monetary union before they are ready.

The third discussant, making a reference to the first discussant’s observations on interest rates, recalled that there was a very interesting signal in the 1990s as we were moving closer to the monetary union and Italy had to devalue. Now, he continued, when you devalue your currency you have three possibilities: you devalue to make up for the inflation differentials; you devalue by less than the inflation differential; or you devalue by more than the inflation differential. Experience has it that countries were advised to devalue by more than the inflation rate so that they did not have to devalue every few years. What Italy did was to send out a signal that it was very serious about getting the inflation rate down; it devalued by less than the inflation differential in order also to benefit from lower import prices than those it would experience with a larger devaluation. And, he added, the world took Italy “at its word”, and accepted that Italy was serious about meeting the convergence criteria. The third discussant then concluded by observing how in a paper he wrote years before, he offered all

the arguments that the European monetary and economic union was premature. In presenting it at a conference in honor of Theo Weigel [Minister of Finance in the Cabinet of Helmut Kohl, Ed.], the third discussant continued, he extemporaneously stated that politicians could not care less what economic analysis says. "If they want to do something, they are going ahead" so that they can say: "It is to my credit that this was created."

### The Main Speaker's Response to the Comments

At this point, at the urging of Ambassador Cohen, the main speaker responded to some of the comments. He began by addressing the issue that the third discussant had raised, namely, that of "why should we believe that the stability and growth pact, fiscal surveillance, and peer pressure are going to work? They clearly failed" in the period preceding the crisis. But, the main speaker continued, there is quite a lot of ground for optimism that they will work a lot better going forward. Because of this crisis, there is now a permanent mechanism, whether one calls it the EFSF or the EFSM, which is an expression of fiscal solidarity. So, in other words, right now, there are 500 billion euros that will be used if another situation like that in Greece emerges at some point in the future. This means that the Eurogroup knows that if they let one of their peers drive themselves into the ditch, (consider, incidentally, the way Greece was totally ignored in the ten years leading up to the crisis), then they will all share the bill. So, from now on, the peer reviews will be a lot more thorough. Further, he added that only Poland and most likely Latvia should join the euro area, even though he thought that this was not necessarily a good idea. What is instead rather prudent is to wait until a country is ready, since Greece and others have taught us that you should not certainly rush into joining until you have an economy that is fundamentally ready for it.

The main speaker, along the lines of the comments of the first discussant, reminded the participants that the situation with some countries running large external surpluses and others running large external deficits was not viewed by many as a great problem for the euro area. He added: "...you could find quite a lot of literature from the European Commission and the ECB as late as 2007 arguing that it didn't really matter that Spain and others were running 10 percent of GDP current account deficits." Now, he continued, we know better but "how do you remedy that, how do you especially remedy that, if the obvious way to do it is to go back and reintroduce your national currency? Well that's a cure that's gonna kill the patient every time." Incidentally, he went on, "I find it outrageous that we have a large number of generally respected American economists such as Martin Feldstein and others, who come out and say 'They should just take a couple of years out of the euro and reestablish' " [their original currency]. The main speaker was unequivocal: "A euro vacation is breathtakingly irresponsible." And "what do you do with these imbalances when you cannot quit? It is a Hotel California as was mentioned." Further, referring to the piano example introduced by the third discussant, the main speaker equated moving the piano, or even changing it, to the structural reforms that are all the harder to undertake if you cannot use the exchange rates to regain competitiveness. Of course, here in the United States, one uses fiscal transfers. The main speaker continued: "The problem, of course, is that in the euro area it may be difficult to move the piano, but moving to fiscal transfers is even harder as it requires a kind of legitimacy, a common political union for that to happen. That, in my opinion, in the euro area is decades away from." Thus, for the clown or clowns there is no choice. They will have to move the piano [that is, structural reforms have to be enacted, Ed.] or they will fall off the stage, the main speaker concluded.

## On Legitimacy

At this point one participant stated that, as a mere geo-politician who knows less about economic systems than Henry Kissinger, he learned a long time ago that you never vote, never bet against the long-term success of the European Economic Community, the European Communities, the European Community, or the European Union. You will lose your money. It is a political venture and it will be made to succeed.

Professor Bernard E. Brown, one of two organizers of the conference, noted that that was the point and issue which had been raised by the second discussant and that the main speaker had sort of glossed over it by saying that the worse it gets, the better off we are. If the operation is a success, who cares what happens to the patient? Well the patient may die. The organizer continued by saying that the problem with this argument is that you are looking at this as a political scientist, not as an economist. We tried to create a world currency, a reserve currency, a major currency without creating a state. It is the first time that a non-state entity issued such a currency. This is an immense problem because many of us would say "well, okay then, go ahead and there is a state." We don't want to just create a state, we want to create a democratic state. And in order to have a democratic state which is legitimate, which permits the expression of political dissent, constructive criticism, friction, political process, and conflicting interests, and at the same time generates some large consensus, you have to have a country. He added that maybe the basic question is whether Europe is sufficiently a country in view of all its historic rivalries and differences in culture. As the main speaker said, "it is no longer Brussels, it is Berlin." Well, that has all kinds of connotations, the organizer continued. There are still different cultures with different ways of perceiving national interests and the interests in particular of neighboring states and so on. One is tackling the immense problem of creating a legitimate state which is democratic and which has a sufficient consensus to support this kind of political mechanism, a political system. One does not do it with just a wave of some magic wand. It requires perhaps more. "The question is...you don't just add to the power of the parliament because you can have an elected parliament and so on". Parliaments do not govern. The real issue is creating a single executive and are you capable of creating a single political executive in a system as varied as the European political system with 28 different interests and so on? He asked.

The organizer continued by making reference to a speech given in Toulon in December by Sarkozy which he felt was very relevant to these issues of legitimacy and political mechanisms. The French president basically said: "Look, the European Union in itself has no legitimacy, the Commission has no legitimacy, it has no democratic legitimacy, it is not elected by anybody, the Commission is not accountable to anybody. The only people who are accountable are the elected leaders of democratic countries in the major countries and it is up to us (in particular the major countries) to get together to make a proposal, to persuade countries to join in and to support it." Something like this is happening in NATO as well as in the European defense community. It is about bilateral agreements which other countries may join in, and there are similarities between defense and economic trends, the organizer added. He concluded, addressing the main speaker: "My basic criticism," is that "you are glossing over a huge political problem which involves the deeper questions of legitimacy, democratic legitimacy, and ultimately, consensus ...sufficiently vibrant and strong to support this immensely weighty political mechanism."

The main speaker answered with: “Quick, no!” And added that “the issue is basic, because the problem of course is that Europeans do not feel (at least when they live in Europe) as European, they feel Dutch, English, German, whatever. That is their primary self-identity, the level at which they are willing to be taxed.” Which means, he continued, that the EU would not be able for the next many decades to tax directly from Brussels. Because people would not be accepting to be taxed by a sort of political entity of which they do not feel a part of. The main speaker noted how he liked to point out with a smile that everybody says that Europeans are much more willing to pay taxes than Americans. Well, that is true at the nation-state level but that is not true at the continental level. “So, in that sense you [the previous speaker, Ed.] are right, and the question then becomes how will you then overcome this issue? The interesting thing is that in one respect, the euro area is moving to adopt what America has had for a long time,” the main speaker continued. Namely, the EU will have balanced budget amendments at the member state level. But, at least again for the foreseeable future, it will not be like in the United States where the majority of the taxing power lies in Washington and Congress distributes revenues as it sees fit. In the EU, the vast majority of money will be raised and spent at the nation-state level, he continued, so the issue is that “you have to have coordinative rules in place that guide that spending. And those rules are now being decided, as I think I tried to capture in my speech, at the euro-area level, at pretty unprecedented rates.” Whether that “is that legitimate or not, well that remains to be seen in the long run. I predict that they will be because it will be democratically elected governments that agree to these rules and what this crisis has shown is that if you do not adhere to these rules when you are in the euro, something really, really bad can happen to you.” The main speaker concluded by thanking the previous speaker for having raised the issue.

## Conclusion

In his final remarks, the President of the NCAFP thanked all participants and acknowledged how instructive this session had been for someone like him, who is steeped more in political theory and political philosophy than in economics. He expressed his hope that this new project would be expanded, also in the context of an even wider exploration of the connections between politics and economics.



# POLICY RECOMMENDATIONS

In light of the discussions in our workshops on NATO and the crisis of the euro currency, the National Committee on American Foreign Policy makes the following recommendations:

**Partnership.** In the Libyan conflict only 8 members of NATO (out of 28) were engaged in the fighting. The most powerful NATO member in Europe, Germany, was flatly opposed and sent no forces at all. Some non-NATO members (notably Saudi-Arabia, Jordan, and Qatar) sent military forces and others offered precious support, contributing more to the joint effort than most of the full members who participated. We strongly recommend that consultations between NATO and states eager to cooperate be further extended. The emphasis should be on making possible interoperability between NATO and other forces. Some provision should be made for strategic discussion of common interests (including counter-terrorism and energy policy). Partnership arrangements between NATO and four non-European democratic nations (Australia, New Zealand, Japan and South Korea) are already established and should be formalized. Other partnership discussion could be extensions of existing dialogue in NATO's own Partnership for Peace and Mediterranean Dialogue. NATO is evolving as the most important institution in the world capable of engaging in military action in response to requests by the international community.

**Flexibility.** The Libyan conflict also underlines the importance of flexibility in decision-making. Two European nations (France and the UK) took the lead in launching the military intervention with approval of the UN Security Council. They had the support of the United States, which provided indispensable firepower and logistical aid. For the first time ever a major NATO military operation was taken with European nations in the forefront. However, the European defense institutions in Brussels, so laboriously constructed over the past two decades, were totally absent.

Command structures within NATO are constantly being renegotiated and rearranged. President François Hollande seems intent on reversing all of his predecessor's policies, and has appointed a study group to make recommendations concerning possible "Europeanization" or reform of NATO. We urge that several principles be kept in mind. Distribution of commands should reflect the relative contributions of individual nations. Insofar as the European Union is able to create a coherent, unified military force the Americans should welcome its efforts to conduct operations independently of NATO. We cannot imagine any such effort that would not also be in the interests of the United States. Until now the EU has been able to mount some two dozen operations abroad, primarily in the Balkans and Africa, under European command. These interventions were relatively minor and in some cases little more than police actions. For any major effort, as has been shown in the Libyan conflict and the crisis of the euro currency, the key roles have been played by nation-states. NATO cannot be held hostage to the cumbersome decision-making process in the EU, which requires long negotiations among 27 foreign affairs and defense ministers. The great strength of the EU is its achievement of a regulated free trade zone. It is best able to coordinate with NATO in providing civilian, economic and humanitarian assistance in preventing, or following conflict. The credibility of NATO requires flexibility in decision-making, not paralysis.



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*continued on next page*

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